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CHAPTER 1

Accounting regulation and the conceptual framework

CHAPTER AIM

This chapter introduces the regulatory framework that governs financial reporting in Australia, including the conceptual framework and accounting standards issued by the Australian Accounting Standards Board (AASB) and the International Accounting Standards Board (IASB), the *Corporations Act 2001* and the Australian Securities Exchange Listing Rules.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1.1 assess whether an entity is a reporting entity in the context of the regulation of financial reporting
1.2 identify the roles of the key bodies involved in accounting regulation in Australia
1.3 explain the structure, role and processes of the International Accounting Standards Board (IASB) and the IFRS Interpretations Committee (IFRIC)
1.4 explain the key components of the conceptual framework
1.5 explain the qualitative characteristics that make information in financial statements useful
1.6 discuss the going concern assumption underlying the preparation of financial statements
1.7 define the basic elements in financial statements — assets, liabilities, equity, income and expenses
1.8 explain the principles for recognising the elements of financial statements
1.9 distinguish between alternative bases for measuring the elements of financial statements
1.10 outline concepts of capital maintenance.

CONCEPTS FOR REVIEW

Before studying this chapter, you should understand and, if necessary, revise:

- the basic accounting system used to record and classify transactions
- the rules of double-entry accounting and how to apply these rules in analysing transactions
- the purpose and basic format of accounting journals, ledger accounts and financial statements.

1.1 Key sources of regulation of financial reporting in Australia

LEARNING OBJECTIVE 1.1 Assess whether an entity is a reporting entity in the context of the regulation of financial reporting.

The major sources of regulation of financial reporting in Australia are:

- the *Corporations Act 2001*
- Australian accounting standards
- the *Framework for the Preparation and Presentation of Financial Statements*
- the Australian Securities Exchange Listing Rules.

1.1.1 The Corporations Act

Australian companies must comply with the requirements of the *Corporations Act 2001* (the **Corporations Act**). The Corporations Act covers many aspects of the management of companies and the relationships between the company — as a legal person — and directors, shareholders and others. Our discussion of the Corporations Act will focus on its implications for the preparation of financial statements, which are contained in Part 2M.3 of Chapter 2M of the Act.

The Corporations Act requires certain types of entities to prepare financial reports. The categories described in the Corporations Act are as follows.

- *Disclosing entity.* With few exceptions, entities whose securities are listed on a securities exchange are disclosing entities (Corporations Act s. 111AC).
- *Proprietary company.* To qualify for registration as a proprietary company under s. 45A of the Corporations Act a company must:
    - be limited by shares or be an unlimited company with a share capital
    - have no more than 50 non-employee shareholders
    - not do anything that would require disclosure to investors under Chapter 6D (except in limited circumstances).

  Section 45A of the Act further classifies proprietary companies as small or large, as follows.
  - *Small proprietary company.* A small proprietary company is a proprietary company that satisfies at least two of the following criteria, specified in s. 45A(2).
    (a) The consolidated revenue for the financial year of the company and the entities it controls is less than $25 million.
    (b) The value of the consolidated gross assets at the end of the financial year of the company and the entities it controls is less than $12.5 million.
    (c) The company and the entities it controls have fewer than 50 employees at the end of the financial year.
  - *Large proprietary company.* A proprietary company is a large proprietary company if it does not satisfy the definition of a small proprietary company.
- *Public company*. A public company means any company other than a proprietary company.
- *Registered scheme*. A registered scheme refers to a managed investment scheme that is registered under s. 601EB of the Corporations Act.

  Accountants face two related questions.
- *Is the entity required to prepare a financial report?*
- *If so, does the report need to comply with Australian accounting standards?*

The answers to these questions are found in the Corporations Act. In relation to the second question, we will also need to refer to the AASB conceptual framework (particularly Statement of Accounting Concepts *SAC 1: Definition of the Reporting Entity*) and AASB 1053 *Application of Tiers of Australian Accounting Standards* for further information about the extent of the application of accounting standards.

Section 292 of the Corporations Act requires the preparation of a financial report and directors' report each financial year. This requirement applies to:

(a) all disclosing entities; and
(b) all public companies; and
(c) all large proprietary companies; and
(d) all registered schemes.

For example, Commonwealth Bank of Australia (CBA) is a public company registered in Australia. It is also a disclosing entity because its shares are listed on the Australian Securities Exchange (ASX). In accordance with s. 292 of the Corporations Act, CBA prepares an annual financial report and a directors' report. The directors' report of CBA includes information about the directors of the company, the company's principal activities, company operations, dividends and compliance with environmental regulations, as well as a remuneration report.

Note that small proprietary companies are not required to prepare a financial report or a directors' report under s. 292 of the Corporations Act. Does this mean shareholders of small proprietary companies cannot obtain financial reports on the financial position and performance of the company in which they have invested? No — shareholders holding at least 5% of the voting power may give the company a direction to prepare a financial report and directors' report under s. 293 or, in the case of a small proprietary company limited by guarantee, a members' direction in accordance with s. 294A. When shareholders and members make directions for the preparation of financial reports they may specify that the report does not have to comply with accounting standards or that some part of the report does not have to be prepared. They may also specify whether the financial report needs to be audited. In addition, the Australian Securities and Investments Commission (ASIC) may make a direction for a small proprietary company to prepare a financial report and a directors' report under s. 294 or s. 294B. Section 292(2)(b) requires foreign-controlled small proprietary companies to prepare a financial report if the parent did not lodge consolidated financial reports for that year with ASIC.

ILLUSTRATIVE EXAMPLE 1.1

Preparation of a financial report according to the Corporations Act

Nature Walk Resort Pty Ltd is a proprietary company that operates a resort in the Australian outback. It has 10 shareholders and 28 employees. According to internal accounting records, Nature Walk Resort Pty Ltd has total assets of $14 million and total liabilities of $5 million. Its revenue for the current year was $27 million. Neither ASIC nor shareholders have made a direction for the preparation of a financial report.

Required

Is Nature Walk Resort Pty Ltd required to prepare a financial report?

Solution

Nature Walk Resort Pty Ltd is required to prepare a financial report in accordance with s. 292 of the Corporations Act because it is a *large proprietary company*. Nature Walk Resort Pty Ltd fails to satisfy the definition of a small proprietary company because it does not meet the minimum of two of the three criteria specified in s. 45A(2) of the Corporations Act. The company has less than 50 employees, but its total revenue is more than $25 million and total assets are more than $12.5 million.

Table 1.1 details the reporting requirements for various types of entities under the Corporations Act.

TABLE 1.1 Reporting requirements for various types of entities under the Corporations Act

Type of entity	Reporting requirements
Disclosing entity	Disclosing entities must: • comply with continuous disclosure requirements • prepare annual and half-year reports that include a directors' report and directors' declaration • prepare financial statements as required by the Australian accounting standards • prepare notes to the financial statements • have the financial report audited in accordance with Division 3 of Part 2M.3 of the Corporations Act • lodge the financial report, directors' report and auditor's report with ASIC within 3 months of the end of the financial year • report to members within 4 months of the end of the financial year or 21 days before the next annual general meeting, whichever is the earlier.
Small proprietary company	Small proprietary companies are not required to prepare annual financial reports in accordance with Chapter 2M of the Corporations Act unless controlled by foreign companies or directed by ASIC or shareholders with at least 5% of the voting rights. Shareholders may request, under s. 293, that the company prepare the financial reports in compliance with accounting standards and have the reports audited. The financial report must be sent to members within 4 months of the financial year-end or 2 months after the request, whichever is the later.
Large proprietary company	Large proprietary companies are required to: • prepare annual financial reports in accordance with Chapter 2M of the Corporations Act • have the financial reports audited • send the annual report to members within 4 months of the end of the financial year.
Public company	Public companies (other than wholly owned entities that meet certain criteria) are required to: • prepare annual financial reports in accordance with Chapter 2M of the Corporations Act • have the financial reports audited • lodge the reports with ASIC within 4 months of the end of the financial year • send the reports to members within 4 months of the financial year-end or 21 days before the next annual general meeting, whichever is the earlier.
Registered scheme	Responsible entities of the registered scheme must: • prepare financial reports, a directors' report and an auditor's report each financial year • lodge the reports with ASIC • send the reports to members within 3 months of the end of the financial year.

The financial statements, including the notes, for a financial year must provide a true and fair view of the financial position and performance of the entity (Corporations Act s. 297). This section does not affect the obligation under s. 296 to comply with accounting standards. In other words, companies cannot rely on presenting a true and fair view as an excuse for non-compliance with accounting standards. So what should the directors of a company do if they believe that compliance with accounting standards would not produce a true and fair view? In these circumstances the Corporations Act requires compliance with accounting standards and the inclusion of additional information in the notes to the financial statements so as to give a true and fair view.

The expression 'true and fair' is not defined in the Corporations Act. However, auditing standard ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance*

with Australian Auditing Standards indicates that 'gives a true and fair view' and 'presents fairly' are equivalent in all material respects. According to paragraph 15 of AASB 101 *Presentation of Financial Statements*, fair presentation requires the:

> faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Framework*.

The requirements for additional disclosure in the notes when necessary to present a true and fair view are considered further in chapter 16.

1.1.2 Australian accounting standards

Section 296 of the Corporations Act requires compliance with accounting standards issued by the AASB. Under the direction of the Financial Reporting Council (FRC), the AASB adopted **International Financial Reporting Standards (IFRSs)**, effective for reporting periods commencing on or after 1 January 2005. To achieve this, the AASB issues Australian accounting standards with requirements that are the same as those of IFRSs for application by for-profit entities.

The requirements of IFRSs have a significant impact on financial reporting in Australia because the standards issued by the AASB are Australian equivalents of IFRSs. So what are IFRSs? International Financial Reporting Standards comprise the authoritative pronouncements issued by the International Accounting Standards Board (IASB). They include two series of accounting standards and two series of interpretations:

- standards that are labelled IFRS (e.g. IFRS 8 *Operating Segments*)
- standards that originated as part of the older series of International Accounting Standards, originally issued by the International Accounting Standards Committee and reissued or revised and reissued by the IASB (e.g. IAS 16 *Property, Plant and Equipment*)
- interpretations that are issued by the IFRS Interpretations Committee (e.g. IFRIC 10 *Interim Financial Reporting and Impairment*)
- interpretations that were issued by the former Standing Interpretations Committee (e.g. SIC 32 *Intangible Assets — Website Costs*).

The Australian equivalents of the IASB's 'IFRS' series are numbered from AASB 1. For example, the Australian equivalent of IFRS 8 *Operating Segments* is AASB 8 *Operating Segments*. The Australian equivalents of the IASB's 'IAS' series are numbered from AASB 101. For example, the Australian equivalent of IAS 16 *Property, Plant and Equipment* is AASB 116 *Property, Plant and Equipment*.

The AASB also issues Australian accounting standards that are not an equivalent of a corresponding standard issued by the IASB. These standards typically cover specific local requirements, such as additional disclosure requirements, and requirements for not-for-profit and public sector entities; for example, AASB 1051 *Land Under Roads,* which applies to the financial statements of various public sector entities.

The Corporations Act requires compliance with Australian accounting standards, which, in turn, are consistent with IFRSs. IFRSs include both standards and interpretations issued by the IASB. Interpretations do not have the same status as accounting standards under the Corporations Act. The AASB has addressed this problem by bringing the content of interpretations into the ambit of accounting standards. This is achieved through AASB 1048 *Interpretation of Standards*.

As noted above, accounting standards issued by the AASB have legislative backing under s. 334 of the Corporations Act. An exception is provided for small proprietary companies that prepare financial reports under the direction of shareholders or members where the direction specifies that the report does not have to comply with accounting standards.

The inclusion of the **reporting entity** concept in most Australian accounting standards establishes a form of **differential reporting** whereby certain entities are allowed to adopt substantially reduced

disclosures while complying with the recognition, measurement and presentation requirements of accounting standards. Most Australian accounting standards apply only to:

- each entity that is required to prepare financial statements in accordance with Part 2M.3 of the Corporations Act *and that is a reporting entity*
- general purpose financial statements of each *reporting entity*
- financial statements that are, or are held out to be, general purpose financial statements (essentially capturing those entities that opt for the preparation of general purpose financial statements).

The reporting entity concept is used to determine whether entities are required to prepare general purpose financial statements. Paragraph 40 of SAC 1 *Definition of the Reporting Entity*, which forms part of the Australian conceptual framework, states:

> Reporting entities are all entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.

Deciding whether an entity is a reporting entity requires professional judgement. The critical factor in identifying an entity as a reporting entity is the existence of users who depend on general purpose financial statements produced by that entity for resource allocation decisions. Where dependence is not readily apparent, SAC 1 suggests some factors that might indicate the existence of user dependence:

> 20 The greater the spread of ownership/membership and the greater the extent of the separation between management and owners/members or others with an economic interest in the entity, the more likely it is that there will exist users dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions.
>
> 21 Economic or political importance/influence refers to the ability of an entity to make a significant impact on the welfare of external parties. The greater the economic or political importance of an entity, the more likely it is that there will exist users dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions. Reporting entities identified on the basis of this factor are likely to include organisations which enjoy dominant positions in markets and those which are concerned with balancing the interests of significant groups, for example, employer/employee associations and public sector entities which have regulatory powers.
>
> 22 Financial characteristics that should be considered include the size (for example, value of sales or assets, or number of employees or customers) or indebtedness of an entity. In the case of non-business entities in particular, the amount of resources provided or allocated by governments or other parties to the activities conducted by the entities should be considered. The larger the size or the greater the indebtedness or resources allocated, the more likely it is that there will exist users dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions.

Note that the definition of reporting entity requires only that there be a reasonable expectation that users exist. Thus, an entity cannot claim to be a non-reporting entity merely because it is not aware of the identity of particular users.

Users who are able to demand financial statements to meet their specific needs would not be considered dependent users. The specific needs of such users can be satisfied through the preparation of special purpose financial statements. For example, the information needs of taxation authorities can often be satisfied by the preparation of financial statements tailored to meet their specific needs.

Does this mean that a non-reporting entity that is required to prepare a financial report in accordance with Chapter 2M of the Corporations Act need not be concerned with Australian accounting standards (other than AASB 101, AASB 107, AASB 108 and AASB 1048)? Not exactly. The guidance issued by ASIC on the application of the reporting entity concept in 'Regulatory Guide 85: Reporting requirements for non-reporting entities' specifies that the definition and measurement requirements of other Australian accounting standards should also be applied by non-reporting entities. Figure 1.1 provides extracts from Regulatory Guide 85 that explain why non-reporting entities should apply the recognition and measurement requirements of Australian accounting standards when preparing financial reports in accordance with the Corporations Act.

FIGURE 1.1 Application of recognition and measurement requirements to non-reporting entities

Section 2: Accounting provisions applicable to non-reporting entities

2.1 The accounting standards provide a framework for determining a consistent meaning of 'financial position' and 'profit or loss' in financial reporting across entities.

2.2 In the absence of any such framework, the figures disclosed in financial statements would lose their meaning and could be determined completely at the whim of the directors of individual entities. The profit or loss reported by an individual entity would vary greatly depending upon which individuals were responsible for the preparation of its financial statements.

2.4 The following requirements of accounting standards that apply to all entities reporting under Chapter 2M are also relevant:

(a) Paragraph 13 of accounting standard AASB 101 *Presentation of Financial Statements* requires the financial report to present fairly the financial position, financial performance and cash flows. Fair presentation requires 'the faithful representation of the effects of transactions, other events and conditions' in accordance with the definitions and recognition criteria for 'assets', 'liabilities', 'income' and 'expenses' set out in the *Framework for the Preparation and Presentation of Financial Statements (Framework)*.

(b) Paragraph 25 of AASB 101 requires all entities reporting under Chapter 2M to apply the accrual basis of accounting.

(c) Paragraphs 10 and 11 of AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* provides that, in the absence of an Australian Accounting Standard that specifically applies to a transaction, other event or condition, management should refer to, and consider the applicability of, the following sources in descending order:

(i) the requirements and guidance in Australian Accounting Standards dealing with similar and related issues; and

(ii) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Framework*.

2.5 Hence, the recognition and measurement requirements of accounting standards must also be applied in order to determine the financial position and profit or loss of any entity preparing financial reports in accordance with the Act.

2.6 As noted earlier, the recognition and measurement requirements of the accounting standards include requirements relating to depreciation of non-current assets, tax effect accounting, lease accounting, measurement of inventories, and recognition and measurement of liabilities for employee entitlements.

2.7 The provisions of accounting standards dealing with the classification of items as assets, liabilities, equity, income and expenses also apply. This would include the provisions of AASB 132 *Financial Instruments: Disclosure and Presentation* concerning the classification of financial instruments issued as debt or equity.

Source: ASIC (2005, pp. 5–6).

In 2010, the AASB provided further guidance on differential reporting by issuing an accounting standard AASB 1053 *Application of Tiers of Australian Accounting Standards* which introduces a two-tier reporting system for companies producing general purpose financial statements. Companies complying with Tier 1 requirements will comply with all relevant accounting standards, whereas Tier 2 comprises the recognition, measurement and presentation requirements of Tier 1 but has substantially reduced disclosure requirements in comparison with Tier 1. Each Australian accounting standard sets out the disclosure requirements from which Tier 2 entities are exempted. This differential reporting requirement applies to annual reporting periods beginning on or after 1 July 2013. In relation to which companies shall comply with Tier 1 reporting requirements, paragraph 11 of AASB 1053 states:

> Tier 1 reporting requirements shall apply to the general purpose financial statements of the following types of entities:
> (a) for-profit private sector entities that have *public accountability*; and
> (b) the Australian Government and State, Territory and Local Governments.

Given that public accountability is central to the requirement, Appendix A of AASB 1053 provides the definition as follows.

> *Public accountability* means accountability to those existing and potential resource providers and others external to the entity who make economic decisions but are not in a position to demand reports tailored to meet their particular information needs.
> A for-profit private sector entity has public accountability if:
> (a) its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or
> (b) it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.

Paragraph B2 of Appendix B of AASB 1053 further states:

> The following for-profit entities are deemed to have public accountability:
> (a) disclosing entities, even if their debt or equity instruments are not traded in a public market or are not in the process of being issued for trading in a public market;
> (b) co-operatives that issue debentures;
> (c) registered managed investment schemes;
> (d) superannuation plans regulated by the Australian Prudential Regulation Authority (APRA) other than Small APRA Funds as defined by APRA Superannuation Circular No. III.E.1 *Regulation of Small APRA Funds*, December 2000; and
> (e) authorised deposit-taking institutions.

In regards to the types of companies that shall at least apply Tier 2 reporting requirements in preparing general purpose financial statements, paragraph 13 of AASB 1053 lists:

> (a) for-profit private sector entities that do not have public accountability;
> (b) not-for-profit private sector entities; and
> (c) public sector entities, whether for-profit or not-for-profit, other than the Australian Government and State, Territory and Local Governments.

In sum, for example, a large proprietary company must at least prepare Tier 2 financial statements. Companies applying Tier 2 reporting requirements would not be able to state compliance with IFRSs unless they elect to also apply Tier 1 reporting requirements.

Paragraph BC6 of AASB 1053 states that all companies including those eligible for the Tier 2 reduced reporting burden must apply in full the following Australian accounting standards:

- AASB 101 *Presentation of Financial Statements* (refer to chapter 16)
- AASB 107 *Statement of Cash Flows* (refer to chapter 17)
- AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* (refer to chapter 18)
- AASB 1048 *Interpretation of Standards*.

ILLUSTRATIVE EXAMPLE 1.2

Application of Australian accounting standards

Seaside Resorts Pty Ltd is a proprietary company that operates a holiday resort in the Whitsundays. It has 10 shareholders, all of whom are involved in the management of the company. Seaside Resorts Pty Ltd has 33 employees. According to internal accounting records, Seaside Resorts Pty Ltd has total assets of $28 million and total liabilities of $10 million, most of which represents a secured bank loan. Seaside Resorts Pty Ltd must provide the bank with financial information each year as specified in the loan agreement. Seaside Resorts Pty Ltd's revenue for the current year was $24 million. Neither ASIC nor shareholders have made a direction for the preparation of a financial report.

Required

Does Seaside Resorts Pty Ltd need to prepare a financial report and apply Australian accounting standards?

Solution

To address this question, it is necessary to first consider whether the Corporations Act requires Seaside Resorts Pty Ltd to prepare a financial report. If so, then we must consider whether Seaside Resorts Pty Ltd is a reporting entity and the implications of being either a reporting entity or a non-reporting entity.

Seaside Resorts Pty Ltd is not required to prepare a financial report in accordance with s. 292 of the Corporations Act because it is a small proprietary company. Seaside Resorts Pty Ltd satisfies the definition of a small proprietary company because it meets two of the three criteria specified in s. 45A(2) of the Corporations Act, by having fewer than 50 employees and revenue less than $25 million even though the company's total assets exceed $12.5 million.

Seaside Resorts Pty Ltd is unlikely to be considered a reporting entity. The shareholders are unlikely to be dependent upon general purpose financial statements for their information needs because they are able to access internal financial information through their involvement in management. The major creditor is a bank that is able to demand special purpose financial statements under the terms of the loan. While it could be argued that employees are potential users of general purpose financial statements, Seaside Resorts Pty Ltd does not have many employees. Thus, it is not reasonable to expect the existence of users dependent upon general purpose financial statements.

However, if Seaside Resorts Pty Ltd is directed by the shareholders with at least 5% voting power to prepare a financial report under s. 293 of the Corporations Act, the financial report must comply with AASB 101, AASB 107, AASB 108 and AASB 1048 in full and apply the recognition and measurement requirements of accounting standards. Given that the company does not have public accountability, it is allowed to provide reduced disclosure through a regime of partial or full exemptions from the relevant accounting standards.

1.1.3 A conceptual framework

The purpose of a conceptual framework is to provide a coherent set of principles:

- to assist standard setters to develop a consistent set of accounting standards for the preparation of financial statements
- to assist preparers of financial statements in the application of accounting standards and in dealing with topics that are not the subject of an existing applicable accounting standard
- to assist auditors in forming an opinion about compliance with accounting standards
- to assist users in the interpretation of information in financial statements.

In Australia, the conceptual framework includes the AASB's *Framework for the Preparation and Presentation of Financial Statements* (which incorporates the IASB's *Conceptual Framework for Financial Reporting*) and Statement of Accounting Concepts SAC 1 *Definition of the Reporting Entity*. The AASB intends to incorporate the IASB's forthcoming chapter on the reporting entity into the Australian conceptual framework, which will potentially see the withdrawal of SAC 1. The conceptual framework is considered in more detail in sections 1.4 to 1.10.

AASB 108/IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires preparers to consider the definitions, recognition criteria and measurement concepts in the conceptual framework when developing accounting policies for transactions, events or conditions in the absence of an Australian accounting standard that specifically applies or that applies to similar circumstances. AASB 108 is considered in more detail in chapter 18.

1.1.4 Australian Securities Exchange Listing Rules

The **Australian Securities Exchange** Group **(ASX)** requires companies that list on the stock exchange to comply with the **ASX Listing Rules**, which deal with listing and quotation, market information,

trading and settlement, and general supervisory matters. The principles underlying the Listing Rules embrace the interests of listed entities and investors and seek to maintain the reputation of the market. Figure 1.2 shows some of the principles that underpin the ASX Listing Rules, selected on the basis of their relevance to financial reporting.

FIGURE 1.2 Selected principles that underpin the ASX Listing Rules

- An entity should satisfy appropriate minimum standards of quality, size and operations and disclose sufficient information about itself before it is admitted to the official list.
- Timely disclosure should be made of information which may have a material effect on the price or value of an entity's securities.
- Information should be produced to high standards and, where appropriate, enable ready comparison with similar information.
- Information should be disclosed to enable investors to assess an entity's corporate governance practices.

Source: ASX, www.asx.com.au.

The Listing Rules include requirements for continuous disclosure and periodic reporting. In accordance with ASX General Rule 3.1, if an entity 'is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information'. Listing Rule 3.1A provides for exceptions to General Rule 3.1 where all of the following conditions are satisfied.

- A reasonable person would not expect the information to be disclosed.
- The information is confidential and ASX has not formed the view that the information ceased to be confidential and at least one of the following applies.
  - It would be a breach of a law to disclose the information.
  - The information concerns an incomplete proposal of negotiation.
  - The information comprises matters of supposition or is insufficiently definite to warrant disclosure.
  - The information is generated for the internal management purposes of the entity.
  - The information is a trade secret.

The Listing Rules are primarily concerned with disclosure rather than with the accounting policies applied in determining classifications and amounts reported in financial statements.

LEARNING CHECK

- ☐ The *Corporations Act 2001* (the Corporations Act) specifies reporting requirements for various reporting entities. It stipulates the types of entities that are required to prepare financial statements and a directors' report each financial year.
- ☐ Under the Corporations Act, entities required to issue financial statements must comply with the Australian accounting standards, issued by the Australian Accounting Standards Board (AASB).
- ☐ SAC 1 provides the definition of the reporting entity.
- ☐ AASB 1053 specifies two-tier disclosure requirements for general purpose financial statements. It stipulates the extent of the compliance required under the differential reporting requirements.
- ☐ The AASB, following a directive from the FRC, has adopted accounting standards issued by the IASB for use in Australia, and is responsible for development of accounting standards in the public and not-for-profit sectors in Australia.
- ☐ The AASB has taken on the task of adopting the interpretations issued by the IFRS Interpretations Committee for use in the Australian context.

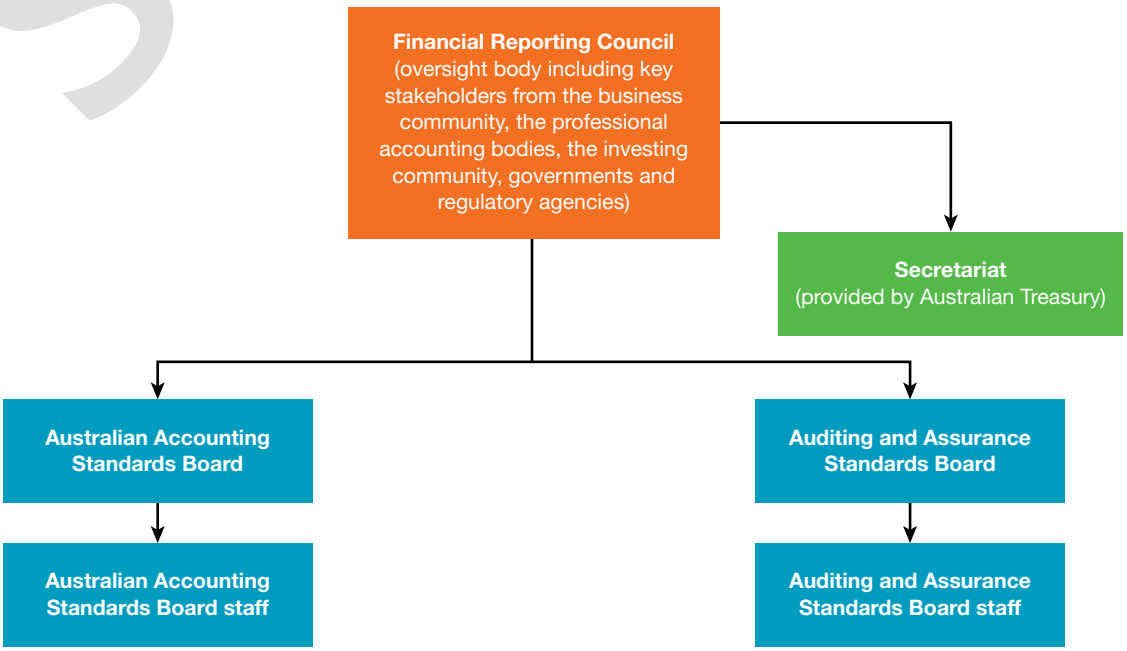
- A conceptual framework is a set of principles to assist: standard setters to develop a consistent set of accounting standards; preparers of financial statements in the application of accounting standards; auditors in forming an opinion in relation to compliance with accounting standards; and users in the interpretation of information in financial statements.
- The Australian conceptual framework consists of the *Framework for the Preparation and Presentation of Financial Statements* (incorporating the IASB's *Conceptual Framework for Financial Reporting*) and SAC 1 *Definition of the Reporting Entity*.
- A company listing on the ASX must comply with the ASX Listing Rules, which generally require additional enhanced disclosure.

1.2 The role of key players in financial reporting regulation

LEARNING OBJECTIVE 1.2 Identify the roles of the key bodies involved in accounting regulation in Australia.

The key players in standard setting in Australia are the Financial Reporting Council (FRC) and the AASB. A diagrammatic representation of the Australian accounting standard-setting institutional arrangements is shown in figure 1.3.

FIGURE 1.3 Australian accounting standard-setting institutional arrangements



Source: FRC (2008).

Other key players in financial reporting regulation include the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA) and the Australian Securities Exchange Group (ASX). The role of each body is discussed, in turn, below.

Professional accounting bodies, such as CPA Australia, Chartered Accountants Australia and New Zealand (created by the combination of the former Institute of Chartered Accountants Australia

and the New Zealand Institute of Chartered Accountants) and the Institute of Public Accountants, also play a part in accounting regulation. They contribute to the standard-setting process by responding to exposure drafts and other invitations to comment, as well as communicating information to their members about developments in accounting standards and other accounting regulations, and providing professional development resources. Another important role of the professional bodies is in the regulation of accountants through professional codes of conduct. The focus of this chapter is on the regulation of financial reporting, rather than the regulation of accountants. As such, we do not elaborate on the role of the professional bodies. More information about the professional accounting bodies can be obtained from their websites:

- CPA Australia: www.cpaaustralia.com.au
- Chartered Accountants Australia and New Zealand: www.charteredaccountantsanz.com
- the Institute of Public Accountants: www.publicaccountants.org.au.

1.2.1 Financial Reporting Council (FRC)

The **Financial Reporting Council (FRC)** is a statutory body under the *Australian Securities and Investments Commission Act 2001* (the ASIC Act 2001), as amended by the *Corporate Law Economic Reform Program* (*Audit Reform and Corporate Disclosure*) *Act 2004*. The FRC has responsibility for the broad oversight of the processes for setting accounting standards. The general functions of the FRC established by s. 225(1) of the ASIC Act 2001 are:

> (a) to provide broad oversight of the processes for setting accounting standards in Australia; and
> (b) to provide broad oversight of the processes for setting auditing standards in Australia; and
> (d) to give the Minister reports and advice about the matters referred to in paragraphs (a) and (b); and
> (e) the functions specified in subsections (2) (specific accounting standards functions), (2A) (specific auditing standards functions) and (2B) (specific auditor independence functions); and
> (f) to establish appropriate consultative mechanisms; and
> (g) to advance and promote the main objects of this Part; and
> (h) any other functions that the Minister confers on the FRC by written notice to the FRC Chair.

Section 225(2) also details the specific accounting standards functions of the FRC, these being:

> (a) appointing the members of the AASB (other than the Chair); and
> (b) giving the AASB advice or feedback on the AASB's:
> (i) priorities; and
> (ii) business plans; and
> (iii) procedures; and
> (ba) giving the Office of the AASB advice or feedback on the Office's:
> (i) budgets; and
> (ii) staffing arrangements (including level, structure and composition of staffing); and
> (c) determining the AASB's broad strategic direction; and
> (e) monitoring the development of international accounting standards and the accounting standards that apply in major international financial centres; and
> (f) furthering the development of a single set of accounting standards for world-wide use with appropriate regard to international developments; and
> (g) promoting the continued adoption of international best practice accounting standards in the Australian accounting standard setting processes if doing so would be in the best interests of both the private and public sectors in the Australian economy; and
> (h) monitoring:
> (i) the operation of accounting standards to assess their continued relevance and their effectiveness in achieving their objectives in respect of both the private and public sectors of the Australian economy; and
> (ii) the effectiveness of the consultative arrangements used by the AASB.

In 2002, the FRC exercised its power to determine the AASB's broad strategic direction with a directive to adopt IFRSs. As a result, Australia adopted IFRSs effective for reporting periods

commencing on or after 1 January 2005. Notwithstanding this strategic direction, the key determinant in selecting Australian accounting standards is that they be in the best interests of both the private and public sectors in the Australian economy. Sections 225(5) and 225(6) impose explicit limits on the power of the FRC:

(5) The FRC does not have power to direct the AASB in relation to the development, or making, of a particular standard.
(6) The FRC does not have power to veto a standard made, formulated or recommended by the AASB.

Although the FRC may provide strategic direction to the AASB, it cannot direct the board to make a specific standard or to provide specific solutions to accounting issues. Details about the rules of operation of the FRC, including meeting procedures, charter of functions and framework for appointment of members, are available on the FRC website, www.frc.gov.au.

1.2.2 Australian Accounting Standards Board (AASB)

The AASB is an Australian government agency under the ASIC Act 2001. The FRC appoints the members of the AASB, except the chair, who is appointed by the treasurer of the Australian government. The AASB has the authority delegated by the Federal Parliament to issue Australian accounting standards. The functions of the AASB are specified in s. 227(1) of the ASIC Act 2001 as follows:

(a) to develop a conceptual framework, not having the force of an accounting standard, for the purpose of evaluating proposed accounting standards and international standards; and
(b) to make accounting standards under section 334 of the Corporations Act for the purposes of the corporations legislation (other than the excluded provisions); and
(c) to formulate accounting standards for other purposes; and
(d) to participate in and contribute to the development of a single set of accounting standards for world-wide use; and
(e) to advance and promote the main objects of this Part [of the ASIC Act 2001].

The AASB must have regard to the interests of Australian corporations that raise or propose to raise capital in major international financial centres. This requirement can be a source of tension because Australian accounting standards must also be applied by many entities that do not raise finance in international capital markets. Providing certain disclosures has expected benefits in terms of lower cost of capital. Such benefits are more likely to be realised by entities that compete for funds in global capital markets.

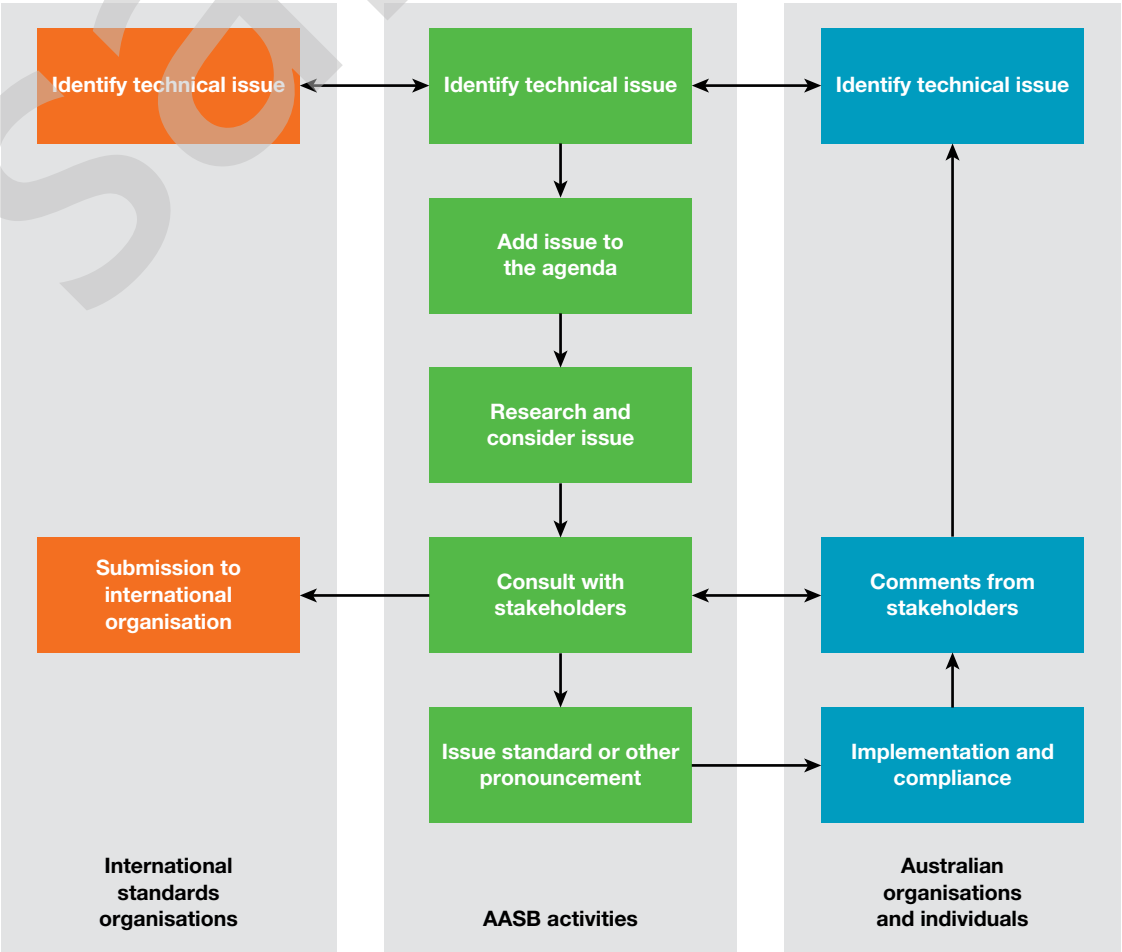
The AASB may formulate an accounting standard by issuing the text of an international accounting standard (s. 227(4) of the ASIC Act 2001). The text of the international accounting standard may be 'modified to the extent necessary to take account of the Australian legal or institutional environment and, in particular, to ensure that any disclosure and transparency provisions in the standard are appropriate to the Australian legal or institutional environment'. While the ASIC Act limits the modifications that the AASB may make to international accounting standards, it does not limit the capacity of the AASB to formulate new accounting standards that are not equivalent to, or are modifications of, an international standard. For example, AASB 1054 *Australian Additional Disclosures*, which was issued by the AASB, is not based on a standard issued by the International Accounting Standards Board. The Australian Federal Parliament has a power to disallow standards issued by the AASB.

The AASB has power under s. 227(3) of the ASIC Act 2001 to establish committees, advisory panels and consultative groups. At the time of writing, the AASB has two focus groups: the User Focus Group, which comprises representatives of financial statement users such as investors and investment professionals, equity and credit analysts, credit grantors and rating agencies; and the Not-for-Profit (Private Sector) Focus Group, which comprises representatives of financial statement preparers, donors, credit grantors and community agencies in that sector. Project advisory panels comprise a group of people appointed for their expertise on a particular topic. The AASB may appoint an interpretation advisory panel, constituted as a committee of the AASB, on a topic-by-topic basis. The interpretation advisory

panels may prepare alternative views on an issue and make recommendations for consideration by the AASB.

Figure 1.4 outlines the process for setting Australian accounting standards. Technical issues may be identified by international standards organisations, such as the IASB or the Financial Accounting Standards Board (FASB) in the United States. They may alternatively be identified by sources within Australia, such as members or staff of the AASB or other stakeholders. Once an item has been added to the board's agenda and it has researched and considered an issue, consultation with stakeholders may proceed with the issue of exposure drafts, invitations to comment, draft interpretations and discussion papers. Exposure drafts issued by the AASB often incorporate exposure drafts issued by the IASB, along with Australian-specific matters for comment as applicable. Exposure drafts can be accessed on the AASB's website. The consultation process may involve roundtable discussions with stakeholders and consultation with focus groups, project advisory panels and interpretation advisory panels, as well as the receipt of submissions in response to exposure drafts and other documentation on which the AASB publicly invites comment.

FIGURE 1.4 AASB standard-setting process



Source: AASB (2016).

More information about the AASB can be found on its website, www.aasb.gov.au.

1.2.3 Australian Securities and Investments Commission (ASIC)

The **Australian Securities and Investments Commission (ASIC)** is Australia's corporate, markets and financial services regulator. It administers the Corporations Act. Figure 1.5 outlines the functions of ASIC under the ASIC Act 2001.

FIGURE 1.5 Functions of ASIC

The *Australian Securities and Investments Commission Act 2001* requires ASIC to:
- maintain, facilitate and improve the performance of the financial system and entities in it
- promote confident and informed participation by investors and consumers in the financial system
- administer the law effectively and with minimal procedural requirements
- enforce and give effect to the law
- receive, process and store, efficiently and quickly, information that [it receives]
- make information about companies and other bodies available to the public as soon as practicable.

Source: ASIC, www.asic.gov.au.

ASIC undertakes financial reporting surveillance with the purpose of improving the quality of financial reporting. Entities' financial statements are selected for review. The selection is based on several criteria including the current issues, or 'hot topics', in financial reporting and public complaints. The financial statements are reviewed for compliance with the Corporations Act and Australian accounting standards. ASIC informs the entity if it has any concerns about its financial statements and invites the issuer to explain the accounting treatment used. ASIC publishes the findings of its surveillance program on its website, www.asic.gov.au. Figure 1.6 provides an overview of the accounting issues examined by ASIC in its reviews of 30 June 2015 financial reports.

FIGURE 1.6 Issues examined in ASIC's review of 30 June 2015 financial reports

1. Overstatement of assets
2. Recognition of revenue on construction contracts
3. Accounting for income tax
4. Classification of expenditure as an asset or expense
5. Classification of liabilities as current or non-current
6. Disclosure of estimates and judgements in applying accounting policy

Source: ASIC (2015).

1.2.4 Australian Prudential Regulation Authority (APRA)

The **Australian Prudential Regulation Authority (APRA)** is the prudential regulator of the Australian financial services industry. It oversees:
- banks
- credit unions
- building societies
- general insurance and reinsurance companies
- life insurance
- friendly societies
- most members of the superannuation industry.

APRA identifies the key risks taken by an entity, ensures the risks are adequately measured, managed and monitored, and assesses the adequacy of the entity's financial resources to accommodate potential losses. The aim of APRA's supervision is to promote financial stability by requiring these institutions to manage risk prudently so as to minimise the likelihood of financial losses to depositors, policy holders and superannuation fund members.

Regulated entities provide financial and other information to APRA. Summary statistics, such as monthly banking statistics, are reported by APRA. More information about the activities of APRA and its publications are provided on its website, www.apra.gov.au.

1.2.5 Australian Securities Exchange Group (ASX)

The Australian Stock Exchange Ltd was formed in 1987 through the amalgamation of six independent stock exchanges that formerly operated in Australia. In 2006, the Australian Stock Exchange merged with the Sydney Futures Exchange and operated under the name 'Australian Securities Exchange'. Following a restructure, the name Australian Securities Exchange Group (ASX) was adopted from 1 August 2010.

The ASX operates the largest securities market in Australia. Several of its functions have implications for financial reporting practice. As discussed in section 1.1.4, the ASX establishes Listing Rules for entities that offer securities on its exchange. The ASX oversees compliance with its operating rules, promotes standards of corporate governance among Australia's listed companies and helps to educate retail investors. The ASX relies on a range of subsidiary brands to monitor and enforce compliance with its operating rules. These subsidiaries are as follows.

- Australian Securities Exchange — which handles ASX's primary, secondary and derivative market services. It encompasses ASX (formerly Australian Stock Exchange) and ASX 24 (formerly Sydney Futures Exchange).
- ASX Clearing Corporation — the brand under which ASX's clearing services are promoted. It encompasses ASX Clear (formerly the Australian Clearing House) and ASX Clear (Futures) (formerly SFE Clearing Corporation).
- ASX Settlement Corporation — the brand under which ASX Group's settlement services are promoted. It encompasses ASX Settlement (formerly ASX Settlement and Transfer Corporation) and Austraclear.
- ASX Compliance — the brand under which services are provided to the ASX Group for the ongoing monitoring and enforcement of compliance with the ASX operating rules. This entity replaces ASX Markets Supervision.

More information about the ASX can be obtained from its website, www.asx.com.au.

LEARNING CHECK

- ☐ The key players in standard setting in Australia are the Financial Reporting Council (FRC) and the AASB. Other key players in financial reporting regulation include the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA) and the Australian Securities Exchange Group (ASX).
- ☐ The FRC provides broad oversight of the accounting standard-setting process in Australia.
- ☐ The AASB formulates and issues accounting standards in Australia.
- ☐ ASIC is the regulator of corporations, markets and financial services.
- ☐ APRA regulates the financial services industry, overseeing banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies and most members of the superannuation industry.
- ☐ The ASX operates the largest securities market in Australia and maintains a set of rules for entities that list on its exchange.

1.3 The International Accounting Standards Board (IASB)

LEARNING OBJECTIVE 1.3 Explain the structure, role and processes of the International Accounting Standards Board (IASB) and the IFRS Interpretations Committee (IFRIC).

Following the direction of the FRC, Australia adopted accounting standards issued by the **International Accounting Standards Board (IASB)** commencing on or after 1 January 2005. The IASB is an independent standard-setting board that develops and approves International Financial Reporting Standards (IFRSs). The IFRS Interpretations Committee (formerly known as International Financial Reporting Interpretations Committee) issues interpretations (IFRICs) and guidance for accounting standards and for specific transactions or events. Compliance with IFRSs includes compliance with IFRICs. The IASB and IFRS Interpretations Committee are appointed and overseen by a geographically and professionally diverse group of trustees (IFRS Foundation Trustees) who are publicly accountable to a monitoring board comprising public capital market authorities. The IFRS Foundation Trustees appoint an IFRS Advisory Council, which provides strategic advice to the IASB and informs the IFRS Foundation Trustees. The Trustees are accountable to the Monitoring Board, which comprises public authorities including the International Organization of Securities Commissions.

Further information about the IASB and international standard-setting arrangements is available on the IASB website, www.ifrs.org, including a document titled *Who we are and what we do* that provides an overview of the IFRS Foundation and the IASB.

LEARNING CHECK

- ☐ The IASB is responsible for the development and publication of IFRSs, which are adopted in Australia as AASBs.

1.4 The components of the conceptual framework

LEARNING OBJECTIVE 1.4 Explain the key components of the conceptual framework.

The role of a conceptual framework of accounting is to provide guidance to standard setters in developing accounting standards and to guide preparers on accounting issues that are not addressed by accounting standards. In 1989, the International Accounting Standards Committee (IASC), the predecessor to the IASB, adopted the *Framework for the Preparation and Presentation of Financial Statements*. This document was superseded by the *Conceptual Framework for Financial Reporting* in 2010. The IASB's conceptual framework comprises four chapters:

- Chapter 1: the objective of general purpose financial reporting
- Chapter 2: the reporting entity (to be added by the IASB)
- Chapter 3: the qualitative characteristics of useful financial reporting
- Chapter 4: the *Framework* (1989): the remaining text (comprising underlying assumption, definition and recognition of elements of financial statements, measurement and concepts of capital and capital maintenance).

In 2015, the IASB published an exposure draft proposing a revised *Conceptual Framework for Financial Reporting*. The revisions are intended to improve financial reporting. They improve the coverage of measurement, financial performance, presentation and disclosure, derecognition, and the reporting entity, as well as clarifying and updating other aspects of the existing conceptual framework.

At the time of writing, the AASB has retained its existing *Framework for the Preparation and Presentation of Financial Statements* in anticipation of further revisions to the IASB's conceptual framework. It issued *Amendments to the Australian Conceptual Framework* in December 2013 to incorporate

the IASB's Chapters 1 and 3 as an Appendix to the *Framework for the Preparation and Presentation of Financial Statements*. Thus, at the time of writing, the Australian conceptual framework comprises:

- the *Framework for the Preparation and Presentation of Financial Statements*
- SAC 1 *Definition of the Reporting Entity,* issued in August 1990. This document contained a number of key concepts. In particular, it raised the classification of financial statements into general purpose financial statements and special purpose financial statements. For a financial statement to be classed as general purpose, it had to be prepared in accordance with Statements of Accounting Concepts and accounting standards. The other key contribution of SAC 1 was the definition of a 'reporting entity' as an entity 'in respect of which it is reasonable to expect the existence of users dependent on general purpose financial statements for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources'. This definition was to be crucial in determining which entities in Australia should be required to prepare general purpose financial statements.

Even though the title of the Australian conceptual framework is different from the IASB's, the contents are compatible. They will be discussed in following sections.

1.4.1 The objective of financial reporting

The conceptual framework deals only with the objective of general purpose financial statements; that is, financial statements intended to meet the information needs common to a range of users who are unable to command the preparation of reports tailored to satisfy their own particular needs.

Paragraph OB2 of the conceptual framework states:

> The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential equity investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

This objective reflects several value judgements made by the IASB and the FASB about the role of financial statements, which are described in the *Basis for Conclusions on Chapter 1: The objective of general purpose financial reporting*. The Basis for Conclusions includes the following arguments.

- Financial statements should reflect the perspective of the entity rather than the perspective of the entity's equity investors. The focus is then on the entity's resources and the changes in them rather than on the shareholders as owners of the entity. Shareholders are providers of resources as are those who provide credit resources to the entity. Under the entity perspective, the reporting entity is deemed to have substance of its own, separate from that of its owners (paragraph BC1.8).
- The key users of financial statements are capital providers — existing and potential investors, lenders and other creditors. An entity obtains economic resources from capital providers in exchange for claims on those resources. Because of these claims, capital providers have the most critical and immediate need for economic information about the entity. These parties also have common information needs. The focus on these users of information, as opposed to other potential users such as government, regulatory bodies, employees and customers is a narrowing of the user groups in comparison to the groups considered in the former version of the IASB conceptual framework (paragraphs BC1.9–1.12).

Before the objective of general purpose financial reporting can be implemented in practice, the basic qualitative characteristics of financial reporting information need to be specified. Further, it is necessary to define the basic elements — assets, liabilities, equity, income and expenses — used in financial statements.

1.4.2 The reporting entity

Chapter 2 of the conceptual framework is reserved for the reporting entity. On 28 May 2015, the IASB released an exposure draft proposing a revised *Conceptual Framework for Financial Reporting*, which sought to, amongst other things, improve coverage of the reporting entity. At the time of writing, the IASB expected to complete the revisions to the Conceptual Framework in 2017. The AASB's SAC 1

Definition of the Reporting Entity remains applicable (see section 1.1.2) until Chapter 2 of the conceptual framework is adopted. Further information about the developments on the conceptual framework project can be found at www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Pages/Conceptual-Framework-Summary.aspx.

LEARNING CHECK

- ☐ The conceptual framework applicable in Australia includes *The Framework for the Preparation and Presentation of Financial Statements*, which incorporates the IASB's *Conceptual Framework for Financial Reporting*, and SAC 1 *Definition of the Reporting Entity*.

1.5 Qualitative characteristics of useful information

LEARNING OBJECTIVE 1.5 Explain the qualitative characteristics that make information in financial statements useful.

What characteristics should financial information have in order to be included in general purpose external financial statements? The following discusses both the qualitative characteristics of useful information and the constraint on providing useful information. The qualitative characteristics are divided into fundamental qualitative characteristics and enhancing qualitative characteristics.

1.5.1 Fundamental qualitative characteristics

For financial information to be decision useful, it must possess two fundamental qualitative characteristics:
- relevance
- faithful representation.

Relevance

Paragraphs QC6 to QC11 of the conceptual framework elaborate on the qualitative characteristic of **relevance**. Information is relevant if:
- it is capable of making a difference in the decisions made by the capital providers as users of financial information
- it has predictive value, confirmatory value or both. Predictive value occurs where the information is useful as an input into the users' decision models and affects their expectations about the future. Confirmatory value arises where the information provides feedback that confirms or changes past or present expectations based on previous evaluations.
- it is capable of making a difference, whether the users use it or not. It is not necessary that the information has actually made a difference in the past or will make a difference in the future.

Information about the financial position and past performance is often used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as future dividends and wage payments, future share prices, and the ability of the reporting entity to pay its debts when they fall due. The predictive ability of information may be improved if unusual or infrequent transactions and events are reported separately in the statement of comprehensive income.

Materiality is an entity-specific aspect of the relevance of information. Information is **material** if its omission or misstatement could influence the decisions that users make about a specific reporting entity (paragraph QC11).

Small expenditures for non-current assets (e.g. tools) are often expensed immediately rather than depreciated over their useful lives to save the clerical costs of recording depreciation, and because the effects on performance and financial position measures over their useful lives are not large enough to affect decisions. Another example of the application of materiality is the common practice by large companies of rounding amounts to the nearest thousand dollars in their financial statements.

Materiality is a relative matter — what is material for one entity may be immaterial for another. A $10 000 error may not be important in the financial statements of a multimillion-dollar company, but it may be critical to a small business. The materiality of an item may depend not only on its relative size but also on its nature. For example, the discovery of a $10 000 bribe is a material event even for a large company. Judgements as to the materiality of an item or event are often difficult. Accountants make judgements based on their knowledge of the company and on past experience, and users of financial statements must generally rely on the accountants' judgements.

Faithful representation

Paragraphs QC12 to QC16 of the conceptual framework elaborate on the concept of faithful representation. **Faithful representation** is attained when the economic phenomenon is depicted completely, neutrally and free from material error. This results in the depiction of the economic substance of the underlying transaction. Note the following in relation to these characteristics.

- A depiction is *complete* if it includes all information necessary for faithful representation.
- *Neutrality* is the absence of bias intended to attain a predetermined result. Providers of information should not influence the making of a decision or judgement to achieve a predetermined result.
- As information is provided under conditions of uncertainty and judgements must be made, there is not necessarily certainty about the information provided. It may be necessary to disclose information about the degree of uncertainty in the information in order that the disclosure attains faithful representation.

As explained in paragraph BC3.23 of the *Basis for Conclusions on Chapter 3: Qualitative Characteristics of Useful Financial Information*, the boards noted that there are a variety of notions as to what is meant by reliability. The boards believe that the term faithful representation provides a better understanding of the quality of information required (paragraph BC3.24).

The two fundamental qualitative characteristics of financial information may give rise to conflicting guidance on how to account for phenomena. For example, the measurement base that provides the most relevant information about an asset will not always provide the most faithful representation. The conceptual framework (paragraphs QC17–QC18) explains how to apply the fundamental qualitative characteristics. Once the criterion of relevance is applied to information to determine which economic information should be contained in the financial statements, the criterion of faithful representation is applied to determine how to depict those phenomena in the financial statements. The two characteristics work together. Either irrelevance (the economic phenomenon is not connected to the decision to be made) or unfaithful representation (the depiction is not decision useful) results in information that is not decision useful.

1.5.2 Enhancing qualitative characteristics

The conceptual framework (paragraph QC19) identifies four enhancing qualitative characteristics:

- comparability
- verifiability
- timeliness
- understandability.

These characteristics are *complementary* to the fundamental characteristics. The enhancing characteristics distinguish *more useful* information from *less useful* information. In relation to these enhancing qualities, note the following.

- **Comparability** is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. Making decisions about one entity may be enhanced if comparable information is available about similar entities; for example, profit for the period per share.
- **Verifiability** is a quality of information that helps assure users that information faithfully represents the economic phenomena that it purports to represent. Verifiability is achieved if different independent

observers could reach the same general conclusions that the information represents the economic phenomena or that a particular recognition or measurement model has been appropriately applied.

- **Timeliness** means having information available to decision makers before it loses its capacity to influence decisions. If such capacity is lost, then the information loses its relevance. Information may continue to be timely after it has been initially provided, for example, in trend analysis.
- **Understandability** is the quality of information that enables users to comprehend its meaning. Information may be more understandable if it is classified, characterised and presented clearly and concisely. Users of financial statements are assumed to have a reasonable knowledge of business and economic activities and to be able to read a financial report.

Alternative accounting policies exist in the treatment of many items, such as inventories and cost of sales, non-current assets and depreciation, intangible assets (e.g. patents, copyrights and goodwill), and leasing transactions. The standard setters have expressed their position regarding the consistency of accounting methods in accounting standard AASB 108/IAS 8, which states that an entity must select and apply its accounting policies in a consistent manner from one period to another. Consistency of practices between entities is also desired. Any change made in an accounting policy by an entity must be disclosed by stating the nature of the change, the reasons the change provides reliable and more relevant information, and the effect of the change in monetary terms on each financial statement item affected. For example, a change in policies may be disclosed in a note such as this:

> During the year, the company changed from the first-in first-out to the weighted average cost method of accounting for inventory because the weighted average cost method provides a more relevant measure of the entity's financial performance. The effect of this change was to increase cost of sales by $460 000 for the current financial year.

Note that the need for consistency does not require a given accounting method to be applied throughout the entity. An entity may very well use different methods for different types of inventories and different depreciation methods for different kinds of non-current assets. (Different inventories costing and depreciation methods are discussed in chapters 4 and 5.) Furthermore, the need for consistency should not be allowed to hinder the introduction of better accounting methods. Consistency from year to year or entity to entity is not an end in itself, but a means for achieving greater comparability in the presentation of information in general purpose financial statements. The need for comparability should not be confused with mere uniformity or consistency. It is not appropriate for an entity to continue to apply an accounting policy if the policy is not in keeping with the qualitative characteristics of relevance and faithful representation.

1.5.3 Cost constraint on useful financial reporting

Paragraphs QC35 to QC37 of the conceptual framework note that cost is the constraint that limits the information provided by financial reporting. The provision of information incurs costs. The benefits of supplying information should always be greater than the costs. Costs include costs of collecting and processing information, costs of verifying information and costs of disseminating information. The non-provision of information also imposes costs on the users of financial information as they seek alternative sources of information.

LEARNING CHECK

- ☐ To be useful for decision making, financial information must be relevant and faithfully represent the economic phenomena.
- ☐ Accounting information is more useful when it possesses comparability, verifiability, timeliness and understandability.
- ☐ The provision of accounting information is constrained by the cost of providing that information.

1.6 Going concern assumption

LEARNING OBJECTIVE 1.6 Discuss the going concern assumption underlying the preparation of financial statements.

Paragraph 23 of the conceptual framework states that financial statements are prepared under the assumption that the entity will continue to operate for the foreseeable future. This assumption is called the **going concern assumption** or sometimes the *continuity assumption*. Past experience indicates that the continuation of operations in the future is highly probable for most entities. Thus, it is assumed that an entity will continue to operate at least long enough to carry out its existing commitments.

Adoption of the going concern assumption has important implications in accounting. For example, it is an assumption used by some to justify the use of historical costs in accounting for non-current assets and for the systematic allocation of their costs to depreciation expense over their useful lives. Because it is assumed that the assets will not be sold in the near future but will continue to be used in operating activities, current market values of the assets are sometimes assumed to be of little importance. If the entity continues to use the assets, fluctuations in their market values cause no gain or loss, nor do they increase or decrease the usefulness of the assets. The going concern assumption also supports the inclusion of some assets, such as prepaid expenses and acquired goodwill, in the statement of financial position even though they may have little, if any, sales value.

If management intends to liquidate the entity's operations, the going concern assumption is set aside and financial statements are prepared on the basis of expected liquidation (forced sale) values. Thus, assets are reported at their expected sales values and liabilities at the amount needed to settle them immediately. Paragraph 25 of AASB 101/IAS 1 *Presentation of Financial Statements* details disclosures required when an entity does not prepare financial statements on a going concern basis (see chapter 16).

LEARNING CHECK

- ☐ Financial statements are prepared under the going concern assumption; that is, the assumption that an entity will continue to operate for the foreseeable future.

1.7 Definition of the elements of financial statements

LEARNING OBJECTIVE 1.7 Define the basic elements in financial statements — assets, liabilities, equity, income and expenses.

The conceptual framework identifies and defines the elements of financial statements: assets, liabilities, equity, income and expenses.

1.7.1 Assets

An **asset** is defined in paragraph 49(a) of the conceptual framework as:

> a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

This definition identifies three essential characteristics of an asset, as follows.

1. The resource must contain *future economic benefits*; that is, it must have the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. An asset can cause future economic benefits to flow to the entity in a number of ways.
   - It can be exchanged for another asset.
   - It can be used to settle a liability.
   - It can be used singly or in combination with other assets to produce goods or services to be sold by the entity.

2. The entity must have *control* over the future economic benefits in such a way that the entity has the capacity to benefit from the asset in the pursuit of the entity's objectives, and can deny or regulate the access of others to those benefits.
3. There must have been a *past event*; that is, an event or events giving rise to the entity's control over the future economic benefits must have occurred.

An asset may have other characteristics, but the conceptual framework does not consider them essential for an asset to exist. For instance, assets are normally acquired at a cost incurred by the entity, but it is not essential that a cost is incurred in order to determine the existence of an asset. Similarly, it is not essential that an asset is tangible; that is, has a physical form (see paragraph 56 of the conceptual framework). Assets such as brands, copyrights and patents represent future economic benefits without the existence of any physical substance. Such assets may be classified as intangible assets. Furthermore, assets can be exchanged normally for other assets, but this does not make exchangeability an essential characteristic of an asset. Finally, it is not essential that an asset is legally owned by the reporting entity. Control by the entity often results from legal ownership, but the absence of legal rights or ownership does not preclude the existence of control; for example, a lease (see paragraph 57 of the conceptual framework).

1.7.2 Liabilities

A **liability** is defined in paragraph 49(b) of the conceptual framework as:

> a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

There are a number of important aspects concerning this definition, as follows.

- A legal debt constitutes a liability, but a liability is not restricted to being a legal debt. Its essential characteristic is the existence of a *present obligation,* being a duty or responsibility of the entity to act or perform in a certain way. A present obligation may arise as an obligation imposed by notions of equity or fairness (referred to as an 'equitable' obligation), and by custom or normal business practices (referred to as a 'constructive' obligation), as well as those resulting from legally enforceable contracts. For example, an entity may decide as a matter of policy to rectify faults in its products even after the warranty period has expired. Hence, the amounts that are expected to be spent in respect of goods already sold are liabilities. It is not sufficient for an entity merely to have an intention to sacrifice economic benefits in the future.

  A present obligation needs to be distinguished from a future commitment. A decision by management to buy an asset in the future does not give rise to a present obligation. An obligation normally arises when the asset is delivered, or the entity has entered into an irrevocable agreement to buy the asset, with a substantial penalty if the agreement is revoked.
- A liability must be expected to be settled, thus resulting in the *giving up of resources* embodying economic benefits. The entity must have little, if any, discretion in avoiding this sacrifice. This settlement in the future may be required on demand, at a specified date, or when a specified event occurs. Thus, a guarantee under a loan agreement is regarded as giving rise to a liability in that a sacrifice is required when a specified event occurs, for example, default under the loan.

  Settlement of a present obligation may occur in a number of ways:
  - by paying cash
  - by transferring other assets
  - by providing services
  - by replacing that obligation with another obligation
  - by converting that obligation to equity
  - by a creditor waiving or forfeiting their rights.
- A final characteristic of a liability is that it must have resulted from a *past transaction* or event. For example, the acquisition of goods and the work done by staff give rise to accounts payable and wages payable respectively. Wages to be paid to staff for work they will do in the future is not a liability as there is no past transaction or event and no present obligation.

1.7.3 Equity

Paragraph 49(c) of the conceptual framework defines **equity** as:

> the residual interest in the assets of the entity after deducting all its liabilities.

Defining equity in this manner shows clearly that it cannot be defined independently of the other elements in the statement of financial position. The characteristics of equity are as follows.

- Equity is a residual; that is, something left over. In other words:

$$\text{Equity} = \text{Assets} - \text{Liabilities}$$

- Equity increases as a result of profitable operations (i.e. the excesses of income over expenses) and by contributions by owners. Similarly, equity is diminished by unprofitable operations and by distributions to owners (drawings and dividends).
- Equity is influenced by the measurement system adopted for assets and liabilities and by the concepts of capital and capital maintenance adopted in the preparation of general purpose external financial statements. (These aspects are discussed later in the chapter.)
- Equity may be subclassified in the statement of financial position; for example, into contributed funds from owners, retained earnings, other reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments.

1.7.4 Income

The conceptual framework defines **income** in paragraph 70(a) as:

> increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Note that this definition of income is linked to the definitions of assets and liabilities. The definition of income is wide in its scope, in that income in the form of inflows or enhancements of assets can arise from providing goods or services, investing in or lending to another entity, holding and disposing of assets, and receiving contributions such as grants and donations. To qualify as income, the inflows or enhancements of assets must have the effect of increasing equity, excluding capital contributions by owners. Also excluded are certain increases in equity under various inflation accounting models that require the recognition of capital maintenance adjustments.

Another important aspect of the definition is that, if income arises as a result of an increase in economic benefits, it is necessary for the entity to *control* that increase in economic benefits. If control does not exist, then no asset exists. Income arises once control over the increase in economic benefits has been achieved and an asset exists, provided there is no equivalent increase in liabilities. For example, in the case of magazine subscriptions received in advance, no income exists on receipt of the cash because an equivalent obligation also has arisen for services to be performed through supply of magazines to clients in the future.

Income can also exist through a reduction in liabilities that increase the entity's equity. An example of a liability reduction is if a liability of the entity is 'forgiven'. Income arises as a result of that forgiveness, unless the forgiveness of the debt constitutes a contribution by owners.

Under the conceptual framework, income encompasses both revenue and gains. A definition of **revenue** is contained in Appendix A of AASB 15/IFRS 15 *Revenue from Contracts with Customers*:

> Income arising in the course of an entity's ordinary activities.

Thus, revenue represents income which has arisen from the ordinary activities of an entity. On the other hand, *gains* represent income that does not necessarily arise from the ordinary activities of the entity; for example, gains on the disposal of non-current assets or on the revaluation of marketable securities. Gains are usually disclosed in the statement of profit or loss and other comprehensive income net of any related

expenses, whereas revenues are reported at a gross amount. As revenues and gains are both income, there is no need to regard them as separate elements under the conceptual framework.

1.7.5 Expenses

Paragraph 70(b) of the conceptual framework contains the following definition of **expenses**.

> Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

To qualify as an expense, a reduction in an asset or an increase in a liability must have the effect of decreasing the entity's equity. The purchase of an asset does not decrease equity and therefore does not create an expense. An expense arises whenever the economic benefits in the asset are consumed, expire or are lost. Like income, the definition of expenses is expressed in terms of changes in assets, liabilities and equity. This concept of expense is broad enough to encompass items that have typically been reported in financial statements as 'losses'; for example, losses on foreign currency transactions, losses from fire or flood, or losses on the abandonment of a research project. Losses are expenses that may not arise in the ordinary course of the entity's activities.

LEARNING CHECK

- ☐ The conceptual framework identifies and defines the elements of financial statements: assets, liabilities, equity, income and expenses.
- ☐ An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- ☐ A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- ☐ Equity is the residual interest in the assets of the entity after deducting all its liabilities.
- ☐ Income is defined as increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
- ☐ Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

1.8 Recognition of the elements of financial statements

LEARNING OBJECTIVE 1.8 Explain the principles for recognising the elements of financial statements.

There are recognition criteria to be followed in the preparation and presentation of financial statements in practice. These criteria have been set down as part of the conceptual framework. **Recognition** means the process of incorporating into the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element. In other words, it involves the inclusion of dollar amounts in the entity's accounting system. Note that an item must satisfy the definition of an element and the recognition criteria before it is 'recognised'.

1.8.1 Asset recognition

The conceptual framework states in paragraph 89 that an asset should be recognised in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or other value that can be measured reliably. Here, emphasis is placed on criteria

for determining *when to record* an asset in the entity's accounting records. An asset is to be recognised only when both the probability and the reliable measurement criteria are satisfied. The term 'probability' refers to the degree of certainty that the future economic benefits will flow to the entity. The benefits should be more likely rather than less likely. For example, some development costs are not recognised as an asset because it is not 'probable' that future economic benefits will eventuate.

Even if such probability of future benefits is high, recognition of an asset cannot occur unless some cost or other value is capable of reliable measurement. In practice, reliable measurement of internally generated goodwill has been difficult, and therefore such goodwill has not been recognised as an asset. Similarly, reliable measurement of an entity's mineral reserves is difficult. It is argued in the conceptual framework that assets that cannot be measured reliably may nevertheless be disclosed in notes to the financial statements, particularly if knowledge of the item is considered relevant to evaluating the entity's financial position, performance and cash flows.

1.8.2 Liability recognition

Paragraph 91 of the conceptual framework establishes criteria for the recognition of a liability in an entity's accounting records. A liability is recognised in the statement of financial position when it is probable that an outflow of resources embodying economic benefits will result from settling the present obligation and the amount at which the settlement will take place can be measured reliably.

As with the recognition of assets, the concept of probability is concerned with the level of uncertainty that the outflow of economic benefits will be required to settle the obligation. The additional need for reliable measurement is an attempt to measure, in monetary terms, the amount of economic benefits that will be sacrificed to satisfy the obligation. Any liabilities that are not recognised in the accounting records because they do not satisfy the recognition criteria may be disclosed in notes to the financial statements, if considered relevant. Further discussion of the recognition of liabilities is provided in chapter 8.

1.8.3 Income recognition

In accordance with paragraphs 92 and 93 of the conceptual framework, income is recognised in the statement of profit or loss and other comprehensive income when an increase in future economic benefits relating to an increase in an asset or a decrease in a liability can be measured reliably. As with the recognition criteria for assets and liabilities, probability of occurrence and reliability of measurement are presented as the two criteria for income recognition. For many entities, the majority of income in the form of revenues results from the provision of goods and services during the reporting period. There is little uncertainty that the income has been earned since the entity has received cash or has an explicit claim against an external party as a result of a past transaction. However, the absence of an exchange transaction often raises doubts as to whether the income has achieved the required degree of certainty. In situations of uncertainty, the conceptual framework requires the income to be recognised as long as it is 'probable' that it has occurred and the amount can be measured reliably.

As stated previously, income includes both revenues and gains. The standard setters have provided further requirements for the recognition of revenues in accounting standard AASB 15/IFRS 15 *Revenue from Contracts with Customers*, which deals with the recognition of revenue that can arise in an entity from transactions with customers. The standard requires all revenue recognised in the entity's financial statements to be measured at the fair value of the consideration received or receivable. See chapter 15 for a detailed discussion of revenue recognition.

1.8.4 Expenses recognition

Just as the income recognition criteria have been developed in the conceptual framework as a guide to the timing of income recognition, the expense recognition criteria have been developed to guide the timing of expense recognition. The formulators of the conceptual framework view expenses in terms of decreases in future economic benefits in the form of reductions in assets or increases in liabilities of the

entity (see the definition of expenses in section 1.7.5). In addition to the probability criteria for expense recognition, the conceptual framework states that expenses are recognised in the statement of profit or loss and other comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase in a liability can be measured reliably (paragraph 94). This means that an expense is recognised simultaneously with a decrease in an asset or an increase in a liability. An expense is also recognised in the statement of profit or loss and other comprehensive income when the entity incurs a liability without the recognition of any asset, for example, wages payable.

In years past, the process of recognising expenses was referred to as a 'matching process', whereby an attempt was made to associate each cost with the income recognised in the current period. Costs that were 'associated' with the revenue were then said to be 'matched' and written off to expenses. This idea of matching expenses with income has been dropped in the conceptual framework in favour of assessing the probability of a decrease in economic benefits that can be measured reliably. Matching is no longer the expense recognition criterion under the conceptual framework.

ILLUSTRATIVE EXAMPLE 1.3

Asset recognition

Richie Ltd produces snowboards and ski gear in Victoria. It invested $15 million in researching new technology to enhance the stability of its snowboards. It also invested $10 million for a patent to develop the production of ski poles with new technologies purchased.

Required

Should Richie Ltd recognise the research and development costs as assets?

Solution

To address this question, it is necessary to first consider whether the research and development costs meets the definition of an asset. If so, we must consider whether the recognition criteria are met.

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. In relation to the research cost, there is an uncertainty in future economic benefits to be generated for Richie Ltd. Hence, it does not fulfil the definition of an asset and cannot be recognised as an asset of the company.

The development cost of ski poles will probably generate future economic benefits to the entity through increased future sales. The purchased of the registered patent on the new technologies (past event) gives the entity control over the future economic benefits. Hence, it fulfils the definition of an asset. Given that it is probable that future economic benefits will flow to the entity and the costs can be determined reliably, it meets the recognition criteria. Therefore, the development cost can be recognised as an asset of the company.

LEARNING CHECK

- ☐ An item or transaction must meet the definition of an element of financial statements and the recognition criteria stipulated in the conceptual framework to be included in financial statements.
- ☐ An asset should be recognised in the statement of financial position when it is probable that future economic benefits will flow to the entity and the asset has a cost or other value that can be measured reliably.
- ☐ A liability is recognised in the statement of financial position when it is probable that an outflow of resources embodying economic benefits will result from settling the present obligation and the amount at which the settlement will take place can be measured reliably.
- ☐ Income is recognised in the statement of profit or loss and other comprehensive income when it is probable that there is an increase in future economic benefits relating to an increase in an asset or a decrease in a liability and the amount can be measured reliably.
- ☐ Expenses are recognised in the statement of profit or loss and other comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase in a liability can be measured reliably.

1.9 Measurement of the elements of financial statements

LEARNING OBJECTIVE 1.9 Distinguish between alternative bases for measuring the elements of financial statements.

Paragraph 99 of the conceptual framework describes the process of **measurement**:

> Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet [statement of financial position] and income statement [statement of profit or loss and other comprehensive income].

Because the concepts of equity, income and expenses are highly dependent on the concepts of assets and liabilities, measurement of the former depends on measurement of the latter. In other words, emphasis is placed on measuring assets and liabilities; the measurement of equity, income and expenses then follows. Measurement is very important in accounting in that it is the process by which valuations are placed on all elements reported in financial statements. Measurements thus have an important effect on the economic decisions made by users of those financial statements. The conceptual framework (paragraph 100) points out that a number of different measurement bases may be used for assets, liabilities, income and expenses in varying degrees and in varying combinations in financial statements. They include the following, the most common of which, in practice, is the historical cost basis.

- *Historical cost*. Under the *historical cost* measurement basis, an asset is recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire it at its acquisition date. Liabilities are recorded at the amount of the proceeds received in exchange for an obligation, or at the amount of cash to be paid out in order to satisfy the liability in the normal course of business.
- *Current cost.* For an asset, *current cost* represents the amount of cash or cash equivalents that would be paid if the same or equivalent asset was acquired currently. A liability is recorded at the amount of cash or cash equivalents needed to settle the obligation currently.
- *Realisable or settlement value*. For an asset, the *realisable value* is the amount of cash or cash equivalents that could be obtained currently by selling the asset in an orderly disposal, or in the normal course of business. A liability is measured as the amount of cash or cash equivalents expected to be paid to satisfy the obligation in the normal course of business.
- *Present value*. The present value of an asset means the discounted future net cash inflows or net cash savings that are expected to arise in the normal course of business. The *present value* of a liability is the discounted future net cash outflows that are expected to settle the obligation in the normal course of business.

In relation to measurement principles, the conceptual framework merely describes practice rather than establishing any principles that should be applied in the measurement of elements of financial statements. The measurement basis most commonly adopted by entities is the historical cost basis, although there is a trend towards greater use of fair values. For example, in order to comply with AASB 102/IAS 2 *Inventories,* inventories are to be measured at the lower of cost and net realisable value. The list is somewhat dated. There is little use of current cost (replacement cost) in financial statements. The omission of fair value reflects the need to revise and update this chapter of the conceptual framework. The use of *fair value*, which is defined as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' (AASB 13/IFRS 13 *Fair Value Measurement* paragraph 9) is also referred to in many accounting standards.

LEARNING CHECK

- ☐ Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the financial statements.
- ☐ Various measurement bases may be used for assets, liabilities, income and expenses: historical cost, current cost, realisable or settlement value, present value and fair value.

1.10 Concepts of capital

LEARNING OBJECTIVE 1.10 Outline concepts of capital maintenance.

Scant attention has been given to the concept of capital in accounting in the last 30 years, but it was a topic that received considerable focus during the current value debates of the 1960s to the early 1980s. It was argued then, and now, that before an entity can determine its income for any period, it must adopt not only a measurement basis for assets and liabilities but also a concept of capital. Two main concepts of capital are discussed in the conceptual framework, namely financial capital and physical capital.

Under the *financial capital* concept, capital is synonymous with the net assets or equity of the entity. It can be measured in two ways. It can be measured either in nominal monetary units by subtracting the total of liabilities from assets, or in terms of the purchasing power of the dollar amount recorded as equity. Profit exists only after the entity has maintained its capital, measured as either the dollar value of equity at the beginning of the period or the purchasing power of those dollars in the equity at the beginning of the period.

Under the *physical capital* concept, capital is seen not so much as the equity recorded by the entity but as the operating capability of the entity's assets. Profit exists only after the entity has set aside enough capital to maintain the operating capability of its assets. A number of different measurement systems have been devised in the past to provide alternatives to the conventional historical cost system, which is the system predominantly used in practice.

These alternatives, which represent different combinations of the measurement of assets and liabilities and the concept of capital maintenance, include:

- the *general price level accounting system*, which had its origins in Germany after World War I when inflation reached excessive levels — this system modifies the conventional historical cost system for the effects of inflation and therefore follows a financial capital concept
- *current value systems,* which attempt to measure the changes in the current values of assets and liabilities — these systems include measures of the current buying or input prices of net assets, and/or measures of the current selling or realisable values of net assets. Capital may be measured as either financial or physical.

LEARNING CHECK

- ☐ Two main concepts of capital are discussed in the conceptual framework: financial capital and physical capital.
- ☐ Under the financial capital concept, capital is synonymous with the net assets or equity of the entity. It can be measured either in terms of the actual number of calculated dollars by subtracting the total of liabilities from assets, or in terms of the purchasing power of the dollar amount recorded as equity.
- ☐ Under the physical capital concept, capital is seen as the operating capability of the entity's assets. Profit exists only after the entity has set aside enough capital to maintain the operating capability of its assets.

SUMMARY

This chapter has provided an overview of key sources of regulation of financial reporting. While the Corporations Act is an overriding authority, Australian accounting standards are a very important source of regulation of financial reporting. The requirements of specific Australian accounting standards are covered throughout this text. The adoption of IFRSs has increased the importance of developments in international standards setting for financial reporting in Australia.

The conceptual framework describes the basic concepts that underlie financial statements prepared in conformity with accounting standards. It serves as a guide to the standard setters in developing accounting standards and in resolving accounting issues that are not addressed directly in an accounting standard. The conceptual framework identifies the principal classes of users of an entity's general purpose financial statements and states that the objective of financial statements is to provide information — about the financial position, performance and changes in financial position of an entity — that is useful to existing and potential investors, lenders and other creditors, in making decisions about providing resources to the entity. It specifies the fundamental qualities that make financial information useful, namely relevance and faithful representation. The usefulness of financial information is enhanced by comparability, verifiability, timeliness and understandability, and constrained by cost.

The conceptual framework also defines the basic elements in financial statements (assets, liabilities, equity, income and expenses) and discusses the criteria for recognising them. The conceptual framework identifies alternative measurement bases used in practice and describes alternative concepts of capital maintenance.

KEY TERMS

asset A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

ASX Listing Rules The set of rules that the Australian Securities Exchange Group imposes on companies that list on the ASX.

Australian Prudential Regulation Authority (APRA) The Australian financial services industry regulator.

Australian Securities and Investments Commission (ASIC) The Australian corporate, markets and financial services regulator, responsible for administering the Corporations Act.

Australian Securities Exchange (ASX) Australia's principal securities exchange (and the company that operates it).

comparability The quality of information that enables users to identify similarities in and differences between two sets of economic phenomena.

Corporations Act The *Corporations Act 2001* is Australian Commonwealth legislation that covers many aspects of the operations of Australian companies, including requiring certain types of entities to prepare financial statements.

differential reporting The provision made in the Australian accounting standards for certain entities to adopt substantially reduced disclosures.

equity The residual interest in the assets of the entity after deducting all its liabilities.

expenses Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

faithful representation When an economic phenomenon is depicted completely, neutrally and free from material error.

Financial Reporting Council (FRC) The statutory body that oversees the accounting standard-setting process in Australia.

going concern assumption The assumption that the entity will continue to operate for the foreseeable future.

income Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

International Accounting Standards Board (IASB) An independent international body that sets International Financial Reporting Standards (IFRSs).

International Financial Reporting Standards (IFRSs) Accounting standards issued by the International Accounting Standards Board (IASB).

liability A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

material The quality of information that exists when the omission or misstatement of the information could influence the decision that users make.

measurement The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of profit or loss and other comprehensive income.

recognition The process of incorporating into the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element.

relevance The quality of information that exists when the information influences economic decisions made by users.

reporting entity All entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.

revenue Income arising in the course of an entity's ordinary activities.

timeliness The quality of information that exists when the information is presented before it loses its ability to influence decisions.

understandability The quality of information that exists when users are able to comprehend its meaning.

verifiability The quality of information that exists when different independent observers could reach the same general conclusions that the information represents the economic phenomena or that a particular recognition or measurement model has been appropriately applied.

COMPREHENSION QUESTIONS

1. What are the key sources of regulation in Australia for a listed company?
2. Describe the standard-setting process of the AASB.
3. Distinguish between the roles of the FRC and the AASB.
4. How does the IASB influence financial reporting in Australia?
5. Explain the potential benefits and problems that can result from the adoption of IFRSs in Australia.
6. What is the difference between Australian accounting standards and IFRSs?
7. Specify the objectives of general purpose financial reporting, the nature of users and the information to be provided to users to achieve the objectives as provided in the conceptual framework.
8. One of the functions of the FRC is to ensure that the Australian accounting standards are 'in the best interests of both the private and public sectors in the Australian economy'. How might the FRC assess this?
9. Outline the fundamental qualitative characteristics of financial reporting information to be included in general purpose financial statements.
10. Discuss the importance of the going concern assumptions to the practice of accounting.
11. Discuss the essential characteristics of an asset as described in the conceptual framework.
12. Discuss the essential characteristics of a liability as described in the conceptual framework.
13. A government gives a parcel of land to a company at no charge. The company builds a factory on the land and employs people at the factory to produce jam that is sold in local and interstate markets. Considering the definition of income in the conceptual framework, do you think the receipt of the land is income to the company? Would your answer depend on how the land is measured?

14 Discuss the difference, if any, between income, revenue and gains.

15 Describe the qualitative characteristics of financial information according to the conceptual framework, distinguishing between fundamental and enhancing characteristics.

16 Define 'equity'. Explain why the conceptual framework does not prescribe any recognition criteria for equity.

17 In relation to the following multiple choice questions, discuss your choice of correct answer.

(a) Which of the following statements about the conceptual framework is incorrect?
- (i) The conceptual framework considers timeliness and materiality to be constraints on relevant and reliable information.
- (ii) The conceptual framework states that the elements directly related to the measurement of financial position are assets, liabilities and equity.
- (iii) The conceptual framework applies to the financial statements of all commercial, industrial and business reporting entities.
- (iv) In accordance with the conceptual framework, income is recognised when an increase in future economic benefits related to an increase in an asset or a decrease in a liability has arisen that can be measured reliably.

(b) The conceptual framework's enhancing qualitative characteristics include:
- (i) understandability, timeliness, verifiability and comparability
- (ii) faithful representation, relevance, understandability and verifiability
- (iii) comparability and reliability
- (iv) substance over form and relevance.

(c) Which of the following statements about the conceptual framework's definition of expenses is correct?
- (i) Expenses include distributions to owners.
- (ii) Expenses are always in the form of outflows or depletions of assets.
- (iii) Expenses exclude losses.
- (iv) Expenses are always decreases in economic benefits.

(d) In accordance with the conceptual framework, a lender should recognise the forgiveness of its $20 000 interest-free loan as:
- (i) an increase in income and a decrease in a liability
- (ii) an increase in an expense and a decrease in an asset
- (iii) an increase in an asset and an increase in income
- (iv) an increase in an expense and a decrease in a liability.

CASE STUDY 1.1

THE AASB

Visit the AASB website (www.aasb.gov.au) and answer the following.

1. Who is the Chair of the AASB?
2. Who are the members, and which organisations do they represent?
3. Which accounting standards have been issued in the past year?
4. Why are there differences in the numbering systems for current accounting standards (e.g. AASB x, AASB xxx and AASB xxxx)?
5. What current projects (if any) is the AASB working on in cooperation with the IASB?

CASE STUDY 1.2

THE IASB AND CONVERGENCE

Visit the website of the International Accounting Standards Board (www.ifrs.org). Report on:

1. the most recent stage of the conceptual framework revision project
2. the accounting standards being changed as a result of moves towards international convergence

3. the membership of the IASB and which countries the members come from
4. the goals of the IASB.

CASE STUDY 1.3

ASIC

Visit the website of the Australian Securities and Investments Commission (www.asic.gov.au). Report on:
1. what ASIC is and its role
2. the tips given to prospective shareholders regarding the reading of a company's prospectus
3. the policy statements and practice notes issued by ASIC.

CASE STUDY 1.4

THE FRC

Visit the website of the Financial Reporting Council (www.frc.gov.au). Locate its strategic plan and report on:
1. the key purpose of the strategic plan 2013–16
2 the four sources of complexity in financial reporting that the Managing Complexity in Financial Reporting Task Force outlined in its report to the FRC in May 2012.

APPLICATION AND ANALYSIS EXERCISES

★ BASIC ★★ MODERATE ★★★ DIFFICULT

1.1 Relevant information ★ **LO5, 8**

A year ago you bought shares in an investment company. The investment company in turn buys, holds and sells shares of business enterprises. You want to use the financial statements of the investment company to assess its performance over the past year.

Required

1. What financial information about the investment company's holdings would be most relevant to you?
2. The investment company earns profits from appreciation of its investment securities and from dividends received. How would the concepts of recognition in the conceptual framework apply here?

1.2 Measuring inventories ★ **LO8**

AASB 102/IAS 2 *Inventories* allows producers of gold and silver to measure inventories of these commodities at selling price even before they have sold them, which means income is recognised at production. In nearly all other industries, however, income is recognised only when the inventories are sold to outside customers. What concepts in the conceptual framework might the standard setters have considered with regard to accounting for gold and silver production?

1.3 Recognising a loss ★ **LO8**

The law in your community requires store owners to shovel snow and ice from the footpath in front of their shops. You failed to do that and a pedestrian slipped and fell, resulting in serious and costly injury. The pedestrian has sued you. Your lawyers say that while they will vigorously defend you in the lawsuit, you should expect to lose $25 000 to cover the injured party's costs. A court decision, however, is not expected for at least a year. What aspects of the conceptual framework might help you in deciding the appropriate accounting for this situation?

1.4 Financial statements ★ **LO5, 9**

An entity purchases a rental property for $10 000 000 as an investment. The building is fully rented and is in a good area. At the end of the current year, the entity hires an appraiser who reports that the fair value of the building is $15 000 000 plus or minus 10%. Depreciating the building over 50 years would reduce the carrying amount to $9 800 000.

Required

1. What are the relevance and faithful representation accounting considerations in deciding how to measure the building in the entity's financial statements?
2. Does the conceptual framework lead to measuring the building at $15 000 000? Or at $9 800 000? Or at some other amount?

1.5 The conceptual framework versus interpretations ★ **LO4, 8, 9**

Applying the conceptual framework is subjective and requires judgement. Would the IASB be better off to abandon the conceptual framework entirely and instead rely on a very active interpretations committee that develops detailed guidance in response to requests from constituents?

1.6 Meaning of 'decision useful' ★ **LO5**

What is meant by saying that accounting information should be 'decision useful'? Provide examples.

1.7 Performance of a business entity ★ **LO5**

A financial analyst said:

> I advise my clients to invest for the long term. Buy good shares and hang onto them. Therefore, I am interested in a company's long-term earning power. Accounting standards that result in earnings volatility obscure long-term earning power. Accounting should report earning power by deferring and amortising costs and revenues.

Is this analyst's view consistent with the fundamental characteristics of financial information established in the conceptual framework?

1.8 Going concern ★ **LO6, 9**

What measurement principles might be most appropriate for a company that has ceased to be a going concern (e.g. creditors have appointed a receiver who is seeking buyers for the company's assets)?

1.9 Assessing probabilities in accounting recognition ★ **LO7, 8**

The conceptual framework defines an asset as a resource from which future economic benefits are expected to flow. 'Expected' means it is not certain, and involves some degree of probability. At the same time the conceptual framework establishes, as a criterion for recognising an asset, that 'it is probable that any future economic benefit associated with the item will flow to or from the entity.' Again, an assessment of probability is required. Is there a redundancy, or possibly some type of inconsistency, in including the notion of probability in both the asset definition and recognition criteria?

1.10 Purchase orders ★ **LO8**

An airline places a non-cancellable order for a new aeroplane with one of the major commercial aircraft manufacturers at a fixed price, with delivery in 30 months and payment in full to be made on delivery.

Required

1. Under the conceptual framework, do you think the airline should recognise any asset or liability at the time it places the order?
2. One year later, the price of this aeroplane model has risen by 5%, but the airline had locked in a fixed, lower price. Under the conceptual framework, do you think the airline should recognise any asset (and gain) at the time when the price of the aeroplane rises? If the price fell by 5% instead of rising, do you think the airline should recognise any liability (and loss) under the conceptual framework?

1.11 Definitions of elements ★ **LO7, 8**

Explain how Q Ltd should account for the following items/situations, justifying your answers by reference to the conceptual framework's definitions and recognition criteria.

Required

1. Receipt of artwork of sentimental value only.
2. Q Ltd is the guarantor for an employee's bank loan:
   (a) You have no reason to believe the employee will default on the loan.
   (b) As the employee is in serious financial difficulties, you think it likely that he will default on the loan.

3. Q Ltd receives 1000 shares in X Ltd, trading at $4 each, as a gift from a grateful client.
4. The panoramic view of the coast from Q Ltd's café windows, which you are convinced attracts customers to the café.
5. The court has ordered Q Ltd to repair the environmental damage it caused to the local river system. You have no idea how much this repair work will cost.

1.12 Definitions and recognition criteria ★ **LO7, 8**

Explain how T Ltd should account for the following items, justifying your answers by reference to the definitions and recognition criteria in the conceptual framework. Also state, where appropriate, which ledger accounts should be debited and credited.

Required

1. Photographs of the company's founders, which are of great sentimental and historical value.
2. (a) T Ltd has been sued for negligence — likely it will lose the case.
   (b) T Ltd has been sued for negligence — likely it will win the case.
3. Obsolete plant now retired from use.
4. T Ltd receives a donation of $10 000.

1.13 Definitions and recognition criteria ★ **LO7, 8**

Glenelg Accounting Services has just invoiced one of its clients $3600 for accounting services provided to the client. Explain how Glenelg Accounting Services should recognise this event, justifying your answer by reference to relevant conceptual framework definitions and recognition criteria. Would your answer be different if the services had not yet been provided; that is, the payment is in advance?

1.14 Assets ★ **LO7, 8**

Glam Cosmetics has spent $220 000 this year on a project to develop a new range of chemical-free cosmetics. As yet, it is too early for Glam Cosmetics' management to be able to predict whether this project will prove to be commercially successful. Explain whether Glam Cosmetics should recognise this expenditure as an asset, justifying your answer by reference to the conceptual framework asset definition and recognition criteria.

1.15 Asset definition and recognition ★ **LO7, 8**

Recently, $20 000 cash was stolen from Fremantle Ltd's night safe. Explain how Fremantle should account for this event, justifying your answer by reference to relevant conceptual framework definitions and recognition criteria.

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CHAPTER 2

Application of accounting theory

CHAPTER AIM

This chapter examines the notion of an accounting policy, including its four components: definition, recognition, measurement and disclosure. Then it considers the meaning of accounting theory, different types of theories and their role in professional judgement in accounting.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

2.1 describe the role of professional judgement in the preparation of financial reports
2.2 identify the major decision areas in considering policies to account for transactions and other events
2.3 explain how normative and positive theories are used in accounting
2.4 explain the implications of positive accounting theory for accounting policy choice
2.5 compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting.

CONCEPTS FOR REVIEW

Before studying this chapter, you should understand and, if necessary, revise:

- the conceptual framework, particularly the definition of elements of financial statements
- the statement of financial position.

2.1 Professional judgement in accounting

LEARNING OBJECTIVE 2.1 Describe the role of professional judgement in the preparation of financial reports.

Accounting is not merely following a set of accounting rules or procedures — accountants are often called upon to exercise **professional judgement**. While there are various decision contexts in which accountants might exercise professional judgement, we will focus on judgements about accounting policies made in the preparation of financial statements. For example, the accountant may need to exercise professional judgement in deciding how to account for a transaction that is not covered by a specific accounting standard.

Accounting standards do not remove the need for accountants to exercise professional judgement. Even when a particular transaction or event is covered by a specific accounting standard, accountants often still need to exercise professional judgement in applying the standard. Accountants may need to exercise professional judgement in deciding how to measure an asset or a liability where the relevant accounting standard permits choice, or in the estimation of expected inflows or outflows used in the measurement of assets and liabilities. For example, in measuring a provision for warranty, the accountant must estimate the cost of settling the obligation at the end of the reporting period.

The accounting standards issued by the International Accounting Standards Board (IASB) and the Australian Accounting Standards Board (AASB) are considered to be predominantly principles-based, rather than rules-based.

A rules-based standard attempts to prescribe the accounting treatment for every possibility, leaving little room for judgement or discretion in its application. Rules-based accounting standards use objective criteria in determining which accounting treatment should be applied to a transaction, such as whether an item of expenditure should be accounted for as an asset or an expense. For example, a rules-based standard might state that all expenditure on advertising, internally generated brand names and internally generated mastheads must be accounted for as an expense. This leaves little scope for the exercise of professional judgement. If the entity spends money on an advertising campaign, in applying the standard the accountant must classify the expenditure as an expense because it was for advertising. The accountant would not need to consider whether the entity controlled the advertising campaign or whether future economic benefits were expected to flow to the entity as a result of the advertising campaign.

In contrast, a principles-based standard prescribes principles that can be applied to a range of different situations. The application of the standard involves subjective assessment in applying the principles to various circumstances. For example, let us assume that a principles-based standard specifies that a purchased intangible asset should be recognised if it meets all of the following conditions:

- the entity has control over the intangible asset as a result of a past transaction or event
- the intangible asset is expected to generate future economic benefits for the entity
- it is probable that the future economic benefits will flow to the entity
- the intangible asset has a cost that can be measured reliably.

In applying this principles-based standard to the acquisition of a patent, the accountant would need to exercise judgement, particularly in assessing the probability that the patent will generate future economic benefits.

Theories can help us to predict accounting policy choice and to understand the implications of alternative accounting policies, as well as providing a source of guidance for our accounting policy decisions.

LEARNING CHECK

- ☐ The application of accounting standards to the preparation of financial statements requires accountants to exercise professional judgement.
- ☐ Professional judgement may involve making estimates in the measurement process, the assessment of probability, the choice of an accounting policy from alternatives permitted by accounting standards, and in making decisions about how to account for transactions and events that are not specifically addressed by accounting standards.

2.2 What is an accounting policy?

LEARNING OBJECTIVE 2.2 Identify the major decision areas in considering policies to account for transactions and other events.

Accounting for routine transactions is typically straightforward. For example, you are probably quite familiar with accounting for cash sales by recording an increase in cash and an increase in income. Entities develop policies for transactions that are routine for their operations. For example, the entity may adopt a policy of recognising property, plant and equipment as an asset when acquired and measuring it at cost, with subsequent depreciation on a straight-line basis over the remaining useful life of the item. Accounting policy decisions may also need to be made for one-off transactions or events, such as accounting for major renovations to the entity's head office building.

Whether we are accounting for a one-off transaction or developing a policy for routine transactions, the **accounting policy** decision involves four components, as follows.

- *Definition*. Did a past event give rise to an item that meets the definition of a financial statement element?
- *Recognition*. When does the item satisfy the recognition criteria?
- *Measurement*. How should it be measured initially and, in the case of an asset or a liability, how should it be measured subsequent to initial measurement?
- *Disclosure*. How should the information be presented and disclosed?

ILLUSTRATIVE EXAMPLE 2.1

Definition of an asset

Sun Power Ltd spent $30 000 installing solar panels on the roof of its office building.

Required

What must Sun Power Ltd's accountant consider in deciding how to account for the expenditure?

Solution

Sun Power Ltd's accountant must consider the definition, recognition, measurement and disclosure components of the accounting policy.

First the accountant must consider whether the modifications to the roof meet the definition of an asset. Recall from chapter 1 that an asset is defined in the conceptual framework as:

> a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

The accountant needs to make a judgement about whether the solar panels are controlled by Sun Power Ltd and whether future economic benefits, either in the form of cash inflows or a reduction in cash outflows, are expected to flow to Sun Power Ltd.

Does Sun Power Ltd control the solar panels? Perhaps Sun Power Ltd owns the building on which they have been installed. Alternatively, Sun Power Ltd might have control over the building, and therefore the solar panels, under a long-term lease. The relevant past events here would be the acquisition or lease of the building and the installation of the solar panels on the roof of the building.

In forming a judgement about whether the solar panels are an asset, it is also necessary to consider whether future economic benefits are expected to flow to Sun Power Ltd. In this case, it seems reasonable to expect that the solar panels will provide benefits in future in the form of reduced electricity costs.

If the solar panels meet the definition of an asset, the accountant will need to form a judgement about whether they satisfy the recognition criteria of an asset. According to the conceptual framework, an item that meets the definition of an element should be recognised if:

> it is probable that any future economic benefit associated with the item will flow to or from the entity; and the item has a cost or value that can be measured with reliability.

The probability of future economic benefits flowing to the entity, in the form of cost savings for electricity, may depend on whether the solar power can be harnessed for Sun Power Ltd's own use or whether the electricity provider or energy authority will continue to allow credit for power that is fed back into the grid from solar panels. The other consideration is whether the solar panels have a cost or value that can be measured reliably. The cost of $30 000 is known and thus the reliability of measurement is not at issue in this case.

If the accountant decides that the solar panels should be recognised as an asset, it will be necessary to consider how to measure them. Initial recognition is usually at cost. A related measurement consideration is how the asset would be measured subsequent to initial recognition. This may involve a choice of depreciation method and the estimation of useful life. Subsequent measurement of property, plant and equipment also involves a choice between the cost model and revaluation based on **fair value**, which is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants.

Lastly, there is the disclosure component of accounting for the acquisition of solar panels. The accountant must consider how the information should be presented in the financial statements and what disclosures should be made. For example, Sun Power Ltd might disclose in the notes to the financial statements the depreciation method used for the solar panels and other items of property, plant and equipment.

LEARNING CHECK

- ☐ In developing or selecting accounting policies, decisions must be made about the definition, recognition, measurement and disclosure of items.
- ☐ Decisions about accounting policies require the exercise of professional judgement, particularly in the context of principles-based accounting standards.

2.3 What is accounting theory?

LEARNING OBJECTIVE 2.3 Explain how normative and positive theories are used in accounting.

Theories are constantly used in the world around us. Builders, engineers and architects rely on structural engineering and mathematical theories in building design and development. Structural theories are based on physical laws and research that explain the structural performance of materials. Governments use economic theories to formulate policies and strategies, such as whether to increase or decrease taxes, or whether to introduce a new tax. These theories relate to the effect of expenditure or taxes on inflation and the national debt, as well as social justice considerations, such as unemployment.

You may have come across various theories in finance, economics or other discipline areas that you have studied, but what do we mean by *theory*? Hendriksen (1970, p. 1) defines **theory** as the 'coherent set of hypothetical, conceptual and pragmatic principles forming a general framework of reference for a field of inquiry'. This is a broadly applicable definition that applies to different types of theories, which are discussed in section 2.3.1.

Despite popular opinion, accounting involves much more than recording financial transactions according to a set of rules or standards. Accountants need to make decisions about what information to provide, how accounting methods are to be applied and the extent of information to disclose to users.

Accounting is a human activity, and while we can never fully know what motivates people to make the decisions they do, theories can be useful in helping us to understand and to explain what might have influenced the decision-making process. Theories in accounting can help us to understand decisions of financial information preparers, as well as those of users of the output of the accounting system, including investors, lenders and other creditors.

Theories that examine the operation of capital markets explain how share prices change when accounting information is provided to the market. Other theories explain and predict managerial choice of accounting methods and how they relate to remuneration contracts and lending agreements.

Rather than explaining actions, some accounting theories can assist in determining what methods should be used, or how accounting information should be measured and reported. Such theories are designed to provide solutions or improvements.

2.3.1 Types of theories

There are two main types of theories used in accounting:

- normative theories
- positive theories.

Normative theories

A **normative theory** provides recommendations about what *should* happen. It *prescribes* what ought to be the case based on a specific goal or objective. The outcome of a normative theory is derived from logical development based upon a stated objective. The conceptual framework is one example of a normative theory. Based upon the objective of financial reporting stated in the conceptual framework, a range of principles are established about who should report; what qualities financial information should have; how elements, such as assets and liabilities, should be defined; how the recognition of items in the financial statements should be determined, and how information should be presented to be meaningful. Normative theories are also referred to as prescriptive theories.

A normative theory is not necessarily based upon what is happening in the world, but on what *should* be done given the objective upon which the theory is based. That does not mean that the development of normative theories is completely divorced from reality. Often normative theories evolve from observations and research into practice, undertaken using positive theories. For example, research might provide evidence of the relevance or understandability of various types of financial information.

Positive theories

The purpose of a **positive theory** is to describe, explain or predict activities or outcomes. For example, a positive theory might be *descriptive* of accounting practice. Another theory might *explain* why managers choose particular accounting methods in situations where accounting standards allow such choice, and could be used to *predict* what other entities might do when faced with similar circumstances. Positive theories can help us to understand what is happening in the world, and why entities act the way they do. As such they rely on real-world observations. Positive theories can assist us to understand the decisions that users make with regards to accounting information, which can facilitate more informed decisions about how to present information.

2.3.2 Development of theories

Theories may be derived from inductive reasoning or from deductive reasoning. Both the inductive and deductive approaches to the development of theory share common basic elements of objectives, assumptions, principles and definitions or actions. However, the logic linking the elements flows in opposite directions for inductive and deductive reasoning.

Inductive reasoning

The process of **inductive reasoning** is illustrated in figure 2.1.

FIGURE 2.1 Inductive approach to theory development

A person developing a theory using inductive reasoning would begin by observing definable activities and actions. Based on the definable activities and actions, the theorist would then infer the principles that conform to the observations. Having inferred certain principles on the basis of detailed observations, the theorist would then attempt to infer higher level assumptions and objectives. Illustrative example 2.2 illustrates the inductive approach to developing a theory.

ILLUSTRATIVE EXAMPLE 2.2

Inductive approach to theory development

Theo intends to develop a theory to explain why some gains and losses are recognised in profit or loss, while others are recognised in other comprehensive income. Gains and losses that are recognised in other comprehensive income are reported below profit in the statement of profit or loss and other comprehensive income. (Chapter 16 considers the statement of profit or loss and other comprehensive income in detail.) Theo intends to develop a theory that goes beyond a simple explanation of compliance with accounting standards. He will attempt to infer the underlying principles and objectives reflected in the accounting treatment prescribed or permitted by accounting standards, and identify assumptions that have been made.

Required

Describe an inductive approach to the development of Theo's theory.

Solution

Actions

Theo begins with observations of gains/losses that are recognised in profit and gains/losses that are recognised in other comprehensive income (OCI). For simplicity, we will just consider a few observations of accounting treatment (actions).

Gains/losses recognised in profit	Gains/losses recognised in OCI
Downward revaluation of property, plant and equipment (AASB 116/IAS 16 *Property, Plant and Equipment*)	Upward revaluation of property, plant and equipment (AASB 116/IAS 16 *Property, Plant and Equipment*)
Change in fair value of animals classified as biological assets and used in agricultural activity (AASB 141/IAS 41 *Agriculture*)	

Principles

Theo's next step is to identify principles that are consistent with the observed actions. For example, a principle that gains should be recognised in OCI while losses should be recognised in profit or loss is not consistent with all of the observations. It holds for property, plant and equipment, but is inconsistent for biological assets under AASB 141/IAS 41 where all changes in fair value are recognised in profit or loss.

Theo infers the following principles from the observations.

1. Fair value adjustments should be recognised in profit if they capture biological transformations that reflect the performance of the entity during the period.
2. Where the fair value is not easily determined, use of fair value should be discouraged by requiring downward revaluations to be charged against profit while not allowing upward revaluations to be included in profit. (Please note, these principles are merely made up for the purpose of illustrating inductive reasoning, and are not intended to suggest that these were the basis for conclusions of the standard setters.)

Assumptions
Next, Theo would identify assumptions that have been made in identifying the principles, such as assumptions about performance measurement, what is meant by profit and the rationale for the observed actions. For example, the first principle assumes that changes in the fair value of biological assets result from biological transformation that reflects the performance of the entity. (In fact, changes in the fair value may also result from changes in market conditions.) The second principle assumes that the measurement of the fair value of property, plant and equipment is not easily determined. (This may be a valid assumption for some items, such as plant and equipment, but is unlikely to hold for most real estate assets.)

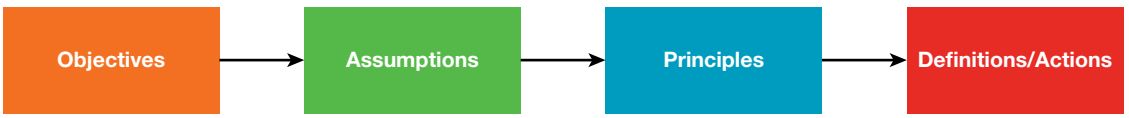
Objectives
Lastly, Theo makes broad generalisations from the principles and assumptions reached. For example, Theo might make a broad generalisation about the objectives for the reporting of profit and comprehensive income. This would provide general rules that could then be applied to new observations or emerging issues, such as how to account for changes in the fair value of assets arising under emissions trading schemes.

Inductive reasoning is useful for developing a positive theory. A limitation of the inductive approach is that it tends to maintain *the status quo*. It does not attempt to improve on how things are done. The inductive approach does not question the appropriateness of the observed actions. Under the inductive approach, observations of practice lead the development of principles. Accordingly, if we used only an inductive approach to develop accounting theories, undesirable accounting practices may emerge. However, if accounting principles had already been developed, the undesirable accounting practices might have been avoided.

Deductive reasoning

The process of **deductive reasoning** is illustrated in figure 2.2.

FIGURE 2.2 Deductive approach to theory development



A person developing a theory using deductive reasoning would begin by setting objectives. The theorist uses his or her own normative values to set the objectives. Having set the objectives, the theorist would then identify the assumptions that underlie those objectives and how they can be achieved. Then, the theorist derives the principles that flow logically from both the objectives and the assumptions. The principles, in turn, enable the theorist to derive the definitions and observable actions that should result.

Deductive logic can be used to develop a prescriptive (or normative) theory, which sets out the way things should be done. The conceptual framework is an example of a normative theory that has been developed through a deductive approach. The conceptual framework commences with the objective of financial statements, to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors for making decisions about providing resources to the entity. The conceptual framework then presents assumptions about the information needs of the target users. For example, the conceptual framework assumes that users of financial statements need information to assess the prospects for future cash flows. Based on these assumptions, the developers of the conceptual framework established principles that serve the objective of providing information that is useful for decision making. For example, one of the principles established in the conceptual framework is that information provided in financial statements should be relevant and should represent faithfully that which it purports to represent. Lastly, definitions and actions, such as the definition and recognition criteria for assets and liabilities, are derived from the principles.

We will now examine a few theories commonly used in accounting and disclosure research. While most of these theories are positive theories, some also have normative underpinnings.

LEARNING CHECK

- ☐ An accounting theory is a coherent set of principles that provides a framework for understanding, predicting and guiding the process, preparation and use of accounting information.
- ☐ A normative accounting theory prescribes how accounting information should be prepared, based on a specified objective.
- ☐ A positive accounting theory describes or explains observed behaviour or predicts actions pertaining to the preparation or use of accounting information.

2.4 Positive accounting theory

LEARNING OBJECTIVE 2.4 Explain the implications of positive accounting theory for accounting policy choice.

As the name suggests, positive accounting theory is a *positive* theory used to explain and predict accounting practice. It is 'designed to explain and predict which firms will and which firms will not use a particular method' (Watts & Zimmerman, 1986, p. 7). The term, positive accounting theory, can be a source of confusion because it is used in two different ways. *Positive accounting theory* can be used to refer to a type of theory, one which is positive rather than normative. *Positive accounting theory* is also used more narrowly to refer to a specific theory about accounting policy choice. In this section positive accounting theory is used in this narrower sense.

Positive accounting theory attempts to explain accounting policy decisions by examining a range of relationships, or contracts, between the entity and suppliers of equity capital (owners), managerial labour (management) and debt capital (lenders or debtholders). It is based on the 'rational economic person' assumption that all individuals act in their own self-interest and are rational wealth maximisers. Positive accounting theory is underpinned by the nexus of contracts view of the firm and agency theory. We will consider each of these in turn.

2.4.1 Nexus of contracts

The organisation is characterised as a 'nexus of contracts' or as the centre of contractual relationships, with the contracting parties having rights and responsibilities under the contracts (Smith & Watts, 1982). It is argued that an organisation is an efficient way of organising economic activity (Coase, 1937). The contracting parties include shareholders, lenders, managers, employees, suppliers and customers (Smith & Watts, 1982). While an entity can facilitate a wide array of contracts, positive accounting theory focuses on three relationships: managerial contracts and debt contracts, both of which are agency contracts used to manage relationships where there is a separation between management and capital providers; and political 'contracts', which refer to relationships between the entity and other parties such as governments, trade unions and community groups.

2.4.2 Agency theory

Agency theory is used to understand relationships whereby a person, or group of persons (the principal), employs the services of another (the agent) to perform some activity on their behalf. In doing so the principal delegates the decision-making authority to the agent. An *agency relationship* exists where one party (the principal) employs another (the agent) to perform some activity on their behalf. For example, the shareholders of a company (the principal) may employ a manager (the agent) to conduct the business of the company, including the negotiation of contracts with other parties.

While the agent has a legal and fiduciary duty to act in the best interests of the principal, the assumption that both parties are utility maximisers means that the agent will not always act in the interests of the principal (Jensen & Meckling, 1976). Jensen and Meckling identify three types of **agency costs**:

- monitoring costs
- bonding costs
- residual loss.

Monitoring costs

Monitoring costs are costs incurred by the principal to observe, evaluate and control the agent's behaviour. Monitoring activities include having the financial statements audited, corporate governance arrangements, other operating policies and procedures, and implementing a management remuneration plan (also referred to as a management compensation plan). Monitoring costs are initially incurred by the principal who will pass them on to the agent. For example, owners, as principals, will incur costs to monitor management and pass the costs on to the manager through reduced remuneration. In the case of debt contracts, lenders are concerned about the financial performance of entities they lend to, and how this might affect the risk involved in lending. Lenders, as principals, will monitor managers (who act as agents for both lenders and shareholders). For example, lenders might obtain valuations on properties used as collateral for loans. Lenders are likely to increase interest rates charged on loans, or lend for a shorter period, if they are required to undertake more monitoring of the entity.

Bonding costs

Bonding costs are costs incurred by the agent when implementing mechanisms to provide assurance that they are acting in the principal's best interests. Agents have an incentive to do this because, as explained above, the agents will actually bear the costs of monitoring through lower remuneration or higher interest rates. Because of this, managers (the agents in both of the managerial and debt contracts) are likely to provide some assurance that they are making decisions in the best interests of the principals. One example might be incurring the time and effort involved in producing and providing quarterly accounting reports to lenders; or by agreeing to link part of their remuneration payment to entity performance. Linking remuneration to entity performance gives management an incentive to enhance entity performance, which is also in the interests of owners.

Residual loss

Monitoring and bonding activities can never completely remove all situations where the agent does not act in the best interests of the principal, as it is too costly to do so. For instance, it might be too costly to monitor the use of a manager's travel expenses to ensure they are only for business purposes, or to monitor his or her use of business stationery for personal use. Residual loss is the amount by which the net value of the agent's output is less than it would be if the agent always acted in the principal's best interest. In other words, it is the loss in value of the entity that results from the separation of ownership of control, when the marginal cost exceeds the expected benefit of additional monitoring and bonding. The majority of monitoring and bonding costs are going to be borne by agents through reduced remuneration (in a managerial contract) or higher interest rates (in a debt contract). Accordingly, managers have incentives to minimise these costs. However, principals are never going to estimate perfectly the full impact of the agent's behaviour. Agents know this and perceive that they will not be fully penalised for all behaviour that is not in the interests of principals. Consequently, residual loss is borne by both the principal and the agent.

Accounting plays a large role in monitoring and bonding mechanisms. Accounting information is used to design the contracts to bond agents' behaviour, as well as to monitor performance against those contracts. As such, agency theory relies heavily on the accounting function. We will now discuss how accounting plays a role in owner–manager relationships and manager–lender relationships, as well as in managing political costs.

2.4.3 Owner–manager agency relationships

As previously mentioned, the separation of ownership and control means that managers, as agents, are likely to act in their own interests, and these actions might not necessarily align with those of the principal, or owners. The theory suggests that when there is separation of ownership and control, managers will act in their own interests through excessive consumption of perquisites and avoidance of effort. Perquisites are non-cash benefits of the job. An extreme example is a manager using entity resources, including internet access, office facilities and time during business hours to operate their own business 'on the side'.

Although the theory is often applied to explain accounting and management practice in large modern corporations with many shareholders, illustrative example 2.3 uses a simple, small-entity setting to illustrate the principles and concepts underlying the theory.

ILLUSTRATIVE EXAMPLE 2.3

Agency relationships

For the purpose of this simplified example, we will ignore the effects of taxation. Mary is both the owner and manager of Poppins Ltd. There is no separation of ownership and control because she is the owner of the business and has control over its operations. Mary has an incentive to work hard in the business because she will reap the rewards of any effort that she exerts in the business. Mary has no incentive to overspend on perquisites because any extra expenditure incurred by the business reduces profit, and thus reduces the benefits she receives as the only shareholder of Poppins Ltd. If Mary spends $4000 of Poppins Ltd's money on unnecessary travel, profit will be reduced by $4000. Mary's share of profit is 100%. Therefore, her share of profit will be reduced by $4000 if she spends an extra $4000 on unnecessary travel. Thus, there is no benefit to Mary, the manager, of overspending on perquisites when she is the only shareholder.

Now assume that Mary decides to raise additional capital for Poppins Ltd and issues more shares to new shareholders. Mary is still the manager but she now owns only 75% of the shares and the new external shareholders own the remaining 25% of the shares. The new shareholders are not managers and they do not have the opportunity, nor would it be efficient for them, to observe Mary's efforts in managing Poppins Ltd.

Required

Explain why Mary now has less incentive to work hard and more incentive to overspend on perquisites.

Solution

Mary has less incentive to work hard because the rewards of her extra effort must be shared with the other shareholders.

Mary has an incentive to overspend on perquisites because the cost of the perquisites will be shared with the external shareholders. For example, if Mary spends $4000 of Poppins Ltd's money on unnecessary travel, profit will be reduced by $4000. Mary's share of profit is 75% because she owns 75% of the shares. Therefore, her share of profit will be reduced by $3000 if she spends an extra $4000 on unnecessary travel. However, she will obtain all of the benefit of the additional expenditure on travel, resulting in a net benefit of $1000, being the benefit of $4000 less Mary's $3000 share of reduced profit. Thus Mary, as manager, has an incentive to overspend on perquisites when she does not own all of the shares.

Smith and Watts (1982) identify three major problems that can arise in owner–manager agency relationships:

- the horizon problem
- risk aversion
- dividend retention.

Horizon problem

The horizon problem stems from the differing time horizons that are important to shareholders and managers. Many shareholders have an interest in the long-term growth and value of the entity, as the current market value of the entity's shares reflects the market's estimates of the present value of the expected future cash flows over the long term. Even shareholders who do not intend to hold their shares in the long term are interested in long-term growth to the extent that it is reflected in the price of their shares when they choose to sell them. Consequently, management's decisions that affect the long-term future cash flows of the entity are important to shareholders. However, management's interest in the cash flow potential may be limited to the period over which they expect to be employed by the entity. This problem is potentially greater when managers are approaching retirement. Managers who are seeking to move to another entity within the short term are more likely to wish to demonstrate the short-term profitability of the entity as evidence of effective management. Doing so is likely to enhance their capacity to find alternative employment as well as the remuneration they can command in the new position.

Managers can demonstrate short-term profitability in a number of ways. For example, they could delay undertaking maintenance or reduce research and development expenditure. While increasing short-term profitability, these activities can have adverse long-term consequences for the future productivity of the entity. For example, if an airline reduced maintenance expenditure, it would have lower maintenance expense, and thus higher reported profit. However, if aircraft are not adequately maintained, the airline may be grounded by aviation authorities, resulting in a loss of income and reputation.

The horizon problem can be reduced by linking management rewards to the entity's performance over a longer period. This occurs through the managerial remuneration contract. Management interests can be aligned, to some extent, with the long-term interests of shareholders through share-based remuneration, such as shares or executive share options. Paying a portion of managerial remuneration as shares or share options encourages managers to focus on long-term performance because it is likely to affect their own wealth. Linking a greater proportion of managerial pay to share price movements as the manager approaches retirement is also likely to encourage managers to maximise long-term performance.

Risk aversion

The problem of risk aversion is that managers generally prefer less risk than do shareholders. Shareholders are not likely to hold all their resources as shares in only one entity. They are able to diversify their risk through investing across multiple entities or other forms of investment, such as real estate. Shareholders may also receive regular income from other sources, such as a personal salary. In addition, shareholders' liability is limited to the amount they are required to pay for their shares. Managers, on the other hand, have more capital invested in the entity than shareholders through their 'human capital' or managerial expertise. It is likely that their remuneration is their primary source of income. As such, losing their job or being paid less can have a substantial impact on their personal wealth.

Economic theory proposes that higher risk potentially leads to higher returns. Shareholders, therefore, prefer that managers invest in more risky projects, which are likely to increase the value of the entity. Managers meanwhile wish to take less risk when deciding on projects for the entity because they have more to lose.

Managerial remuneration contracts can include incentives to encourage managers to invest in more risky projects. For instance, linking a bonus to profits can encourage managers to consider more risky projects that have the potential to increase profits. Share-based remuneration such as executive shares and share option schemes can be less effective in encouraging managers to invest in more risky projects because the cost to the manager of diversifying risk increases with managerial share ownership. For example, the manager of XYZ Ltd may hold other shares in order to diversify the risk associated with the holding of XYZ executive shares. If the number of executive shares increased, the manager may need to purchase more shares in other entities to maintain a balanced portfolio.

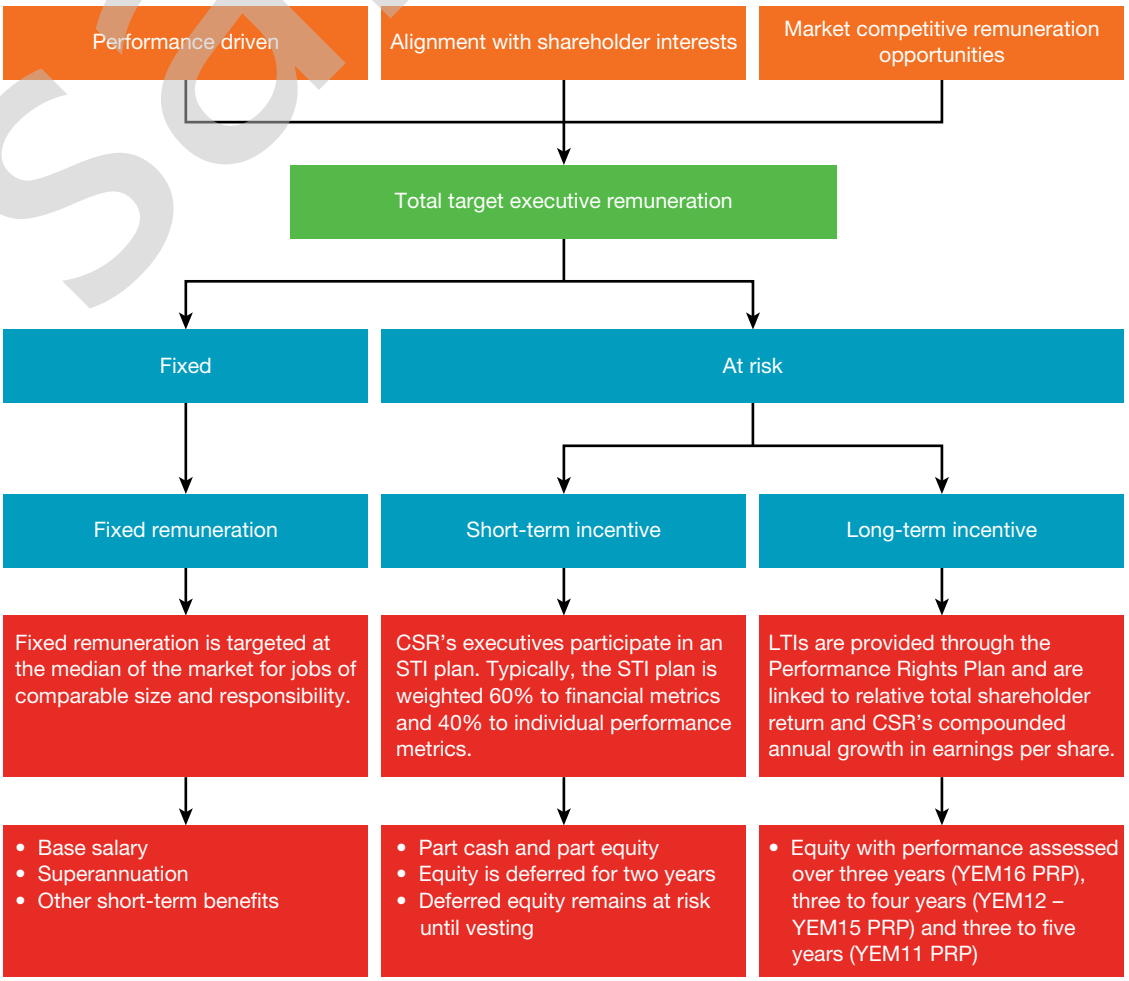
Dividend retention

The dividend retention problem refers to managers' preference to maintain a greater level of funds within the entity, and to distribute less of the entity's earnings to shareholders as dividends. Managers wish to retain money within the business to expand the size of the business they control (empire building) and to pay their own salaries and benefits. Shareholders, on the other hand, may have a preference for increased dividends.

Paying a bonus that is linked to a dividend payout ratio may encourage managers to maintain high dividend payouts to shareholders. Similarly, linking a bonus to profits will also encourage managers to seek additional profit which, in turn, increases funds available for dividends.

Many entities use executive remuneration schemes that reward management with combinations of salaries, bonuses, shares and stock options. The performance criteria used in executive contracts use a range of accounting measures. Figure 2.3 illustrates how CSR Limited uses its remuneration scheme to help align the interests of key management personnel (KMP) with those of shareholders through performance-based short-term incentive (STI) and long-term incentive (LTI) plans.

FIGURE 2.3 Remuneration strategy, CSR



Source: CSR Limited (2016, p. 28).

Note: CSR Limited's financial year ends on 31 March. YEM = year ended March.

2.4.4 Manager–lender agency relationships

Agency theory has also been used to understand the relationship between lenders and management. The lender is the principal, and the manager is the agent, with a duty to comply with the debt contract, but the manager also acts on behalf of shareholders when entering into contracts with lenders.

When a lender agrees to provide funds to an entity, there is the risk that the borrower may not honour its obligation to repay all of the borrowed funds with interest. This is referred to as credit risk. Lenders, such as banks and other financial institutions, seek to be compensated for credit risk through the returns earned in the form of interest. Accordingly, if the lender assesses the loan to be of higher risk, a higher rate of interest is charged. This is referred to as price protection. Conversely, if the loan is assessed to be of low risk, a lower interest rate will be charged.

Debt contracts can contain restrictions, known as debt covenants, which are designed to protect the interest of lenders. According to agency theory, managers will agree to debt covenants in the debt contract that restrict them from acting in a way that is detrimental to lenders because it will reduce the risk to the lender, resulting in lower interest costs being imposed on the borrower. For example, a debt covenant may restrict leverage to 60% of total assets. As a result of agreeing to debt covenants, managers are able to borrow funds at lower rates of interest, borrow larger amounts, or borrow for longer periods. Accounting numbers such as total liabilities and total tangible assets are used in debt covenants. Financial statements are then used to monitor compliance with debt covenants.

Smith and Warner (1979) identify four major problems that can increase the lender's risk:

- excessive dividend payments to owners
- asset substitution
- claim dilution
- underinvestment.

Excessive dividend payments

Management may make excessive dividend payments to shareholders. When lending funds, lenders price the debt to take into account an assumed level of dividend payout. If managers pay more dividends, the entity may have insufficient funds to service the debt. To reduce this problem managers and lenders agree to covenants that restrain dividend policy and restrict dividend payouts as a function of profits. A requirement to maintain a minimum working capital ratio can also discourage payment of excessive cash dividends that reduce working capital.

Asset substitution

The agency problem of asset substitution refers to management investing in riskier assets after the loan has been arranged. For example, the entity may borrow money to expand mining production facilities but then spend the money on mining exploration which carries the risk of non-discovery. Because managers are working on behalf of owners and are often also owners themselves, they have incentives to use the debt finance to invest in alternative, higher risk assets in the expectation that it will lead to higher returns to shareholders. Lenders bear the risk of this strategy as they are subject to the 'downside' risk, but do not share in any 'upside' effects of the investment decision. If the project fails, the entity may be unable to pay all of the interest and principal of the loan. However, no matter how successful the project becomes, the lender will not earn any more than the agreed interest.

Lenders are aware of the agency problem that management might use borrowed funds for more risky assets or projects than those to which they have agreed, and accordingly, factor this risk into determining the interest rate and terms of the loan. Therefore, managers are willing to agree to debt covenants that restrict their actions in order to reduce creditors' risk, and thus reduce the cost of borrowing.

To limit the agency problem of asset substitution, debt contracts will often impose restrictions on investment opportunities of the entity, including mergers and takeovers. The lender might also secure the debt against specific assets. Establishing a minimum ratio of debt to tangible assets can also mitigate asset substitution by restricting investment in intangible assets.

Claim dilution

Claim dilution arises when entities take on debt of an equal or higher priority. For example, after obtaining an unsecured loan, management might offer a secured charge over the entity's real estate assets to obtain additional funding from another lender. This reduces the assets available to the original, unsecured creditor in the event of default. The most common method of avoiding claim dilution is to restrict the borrowing of higher priority debt, or debt with an earlier maturity date.

Underinvestment

The remaining agency problem of debt, underinvestment, can arise when the entity faces financial difficulty. If the entity is struggling to repay the principal and interest components of debt, the extra cash flows that might be generated by additional projects would go to repaying the debt rather than increasing shareholder wealth. Creditors rank above owners in order of payments in the event that an entity is liquidated; thus any funds from these projects would go towards debt rather than equity if the entity were liquidated. Managers, acting on behalf of owners, may have little or no incentive to undertake positive net present value (NPV) projects if the projects would only lead to increased funds being available to lenders.

2.4.5 Political relationships

From an economic perspective, political processes can be viewed as a competition for wealth transfers. Based on an assumption of self-interest, individuals face incentives to join forces to compete for wealth transfers. For example, workers may join forces, such as a union, to seek wealth transfers from other providers of factors of production, such as shareholders.

Political costs refer to wealth transfers imposed on an entity. For example, the government might impose a new tax, which would be a political cost to firms operating in industries that are subject to the tax. Economic sanctions are another example of political costs. A retailer obtaining inventory from suppliers that use child labour may attract political costs from powerful non-governmental organisations, such as a campaign to discourage consumers from purchasing goods from that retailer.

Figure 2.4 provides an example of political processes in response to a decision by Adelaide Zoo to discontinue purchases of ice-cream from a local supplier.

FIGURE 2.4 Political processes at Adelaide Zoo

Pressure on Adelaide Zoo over Golden North ice-cream

Adelaide Zoo actively promoted a campaign against the commercial production of palm oil because the associated unsustainable clearing of tropical forests threatens the natural habitat of endangered species. In conjunction with that campaign, Golden North, a local supplier of ice-cream to Adelaide Zoo, undertook substantial modifications to its production processes to eliminate palm oil from its product. However, in mid 2014, Adelaide Zoo terminated its contract with Golden North in favour of Unilever, a large multinational corporation, whose products contained the contentious palm oil.

There was mounting public outcry in response to the zoo's decision. Senator Nick Xenophon protested outside the zoo by distributing non-palm oil ice-cream and collecting signatures from Zoos SA members on a petition for a special meeting of the Royal Zoological Society. He aimed to place pressure on the zoo's management and board to reverse their decision, explaining, 'What they've done by dumping Golden North actually goes against their aims of conservation'. Some commentators raised concerns about the impact the negative publicity could have on the capacity of the zoo to attract sponsorship and other forms of financial support.

In response to an enormous amount of pressure, particularly through social media, the zoo partly backed down on its previous position. The zoo announced that it would continue to sell Golden North's non-palm oil ice-cream, albeit alongside Unilever products. Unilever aims to source all of its palm oil from certified sustainable sources by 2020.

Sources: ABC News (2014) and News.com.au (2014).

Lobbying and other forms of political action are costly to those who conduct them. One of the costs of political action is obtaining information about the entity, the effects of its operations and its capacity to change operations or redistribute wealth.

Due to the costs of political action and limited resources, lobby groups are more likely to take action against larger, more profitable entities, which control more resources and have power to affect more people. For example, if an environmental interest group intends to lobby against the use of plastic drinking cups, the effect of those actions may be greater if targeted against a large chain of restaurants that uses tens of thousands of cups daily, than against a small retailer that uses less than 100 cups each week. Accordingly, politicians, organisations and other groups within society may draw on financial statement information to identify larger and more profitable firms in deciding how to employ scarce resources in political processes.

2.4.6 Role of accounting information in reducing agency problems

As we saw previously, accounting information forms one of the major components of both manager remuneration and lending contracts. Terms are written into managerial remuneration contracts to link managers' performance to shareholder interests. Bonuses can be tied to accounting measures of entity financial performance, such as earnings per share, or market-based measures, such as growth in share price.

Accounting information plays several related roles in the contracting process. First, it is used in writing terms of the remuneration contract, including the specification of performance hurdles and targets, as well as formulas for determining the amount of remuneration. For example, a CEO's remuneration contract might specify that she will receive a cash bonus of 0.5% of profit before tax, subject to meeting a performance hurdle of a return on equity of 10%. Second, accounting information presented in financial statements is used to measure performance against the terms of the contracts to determine whether the manager is eligible for a bonus. Finally, the accounting information may be used to determine the amount of bonus and other components of remuneration that managers will receive.

Debt contracts may include covenants that reflect different measures of entity performance, such as leverage, dividend payout or interest coverage ratios. For example, a debt contract might include a covenant that the ratio of total liabilities to total assets does not exceed 60%. The interest cover restriction might be in the form of an ongoing requirement, such as maintaining a minimum *times interest earned* (profit before interest and taxes/interest) of 3.0. Alternatively, some lenders require minimum average *times interest earned* to have been maintained over several years for a potential borrower to be eligible for a loan. Lenders rely on audited financial statements to determine whether entities are maintaining accounting-based debt covenants.

Accounting is a source of information about the entity in political processes. For example, lobby groups may use an entity's financial statements to assess its capacity to meet their demands. However, various parties with an interest in the entity may differ in terms of their demands and information needs and it is often not cost effective for individuals, or smaller interest groups, to incur costs to analyse financial information. Thus, the extent to which information is generated for political purposes depends on factors including the effects of government policy and the costs and effectiveness of lobbying by interest groups.

As explained above, accounting numbers may be used in management remuneration contracts, debt contracts and political processes. Financial statements are also used to monitor performance against the terms or expectations specified in the contract. The use of accounting information to monitor performance can give rise to incentives for accounting policy choice in the preparation of financial statements.

2.4.7 Implications of agency theory for accounting policy choice

The choice of one accounting policy over another can have economic consequences for contracting parties. Agency theory is used to derive hypotheses about accounting policy choice. These hypotheses are described in general terms below.

- *Bonus plan/management compensation hypothesis: managers of entities with bonus plans prefer accounting policies that increase profit.* Management compensation contracts do not usually specify which accounting policies should be used in the preparation of financial statements. First, it would be very costly, if not impossible, because it would require prediction and specification of all the different types of transactions that might arise and accounting judgements that might be made. Second, it may be in the interests of shareholders to allow managers some discretion so they can strategically select accounting policies that yield more favourable outcomes for shareholders in terms of the entity's contracts with other parties, such as debtholders and governments.

  Managers, acting in their own interest, prefer more remuneration. If their remuneration is based on a bonus, managers may be able to increase their bonus by choosing accounting policies that increase profit. This may involve accounting policies that accelerate the recognition of income or defer the recognition of expenses. For example, management may prefer straight-line depreciation over the diminishing balance method because the straight-line method recognises lower depreciation expenses in the first few years of the useful life of the asset. The amount of profit recognised in the long term will be the same because the total depreciation expense over the useful life of the asset is the same, irrespective of which depreciation method is used. Managers are expected to prefer to report more profit sooner so that they will receive their bonus sooner rather than later. This preference reflects both the time value of the money and the shorter horizon of the manager.

  Some more complicated variations of the general management compensation hypothesis allow for minimum profit hurdles that must be met. The manager is expected to prefer accounting policies that reduce profit in periods when the profit hurdle cannot be achieved. The rationale is that if the entity's profit is so low that the manager will not be eligible for a bonus in the current period, the manager would prefer to recognise more expenses in the current period, so as to increase the prospects of exceeding the profit hurdle and getting a bonus in the next period.
- *Debt hypothesis: managers of entities with high leverage prefer accounting policies that increase profit and equity.* Entities with high leverage are more likely to be close to leverage constraints in debt contracts. Managers are expected to act in the interests of shareholders in the entity's relationships with providers of debt finance because management's interests are more aligned with those of shareholders than with those of debtholders. Debt contracts usually allow for some discretion in accounting policy choice because it would be too costly, if not impossible, to specify in advance how to account for every transaction that might arise.

  Agency theory implies that, when faced with restrictive debt covenants, managers will prefer accounting policies that increase profit and equity so as to reduce the risk of breaching a debt contract and to lower the cost of raising further finance. For example, managers may prefer to capitalise expenditure (i.e. recognise expenditure as an asset) rather than recognising it as an expense. Capitalising expenditure would result in more reported assets and equity than would occur if the expenditure were recognised as an expense. The higher reported assets and equity reduce the proximity to restrictive debt covenants that are expressed in terms of the ratio of debt to total assets.
- *Political cost (size) hypothesis: managers of larger entities are more likely to prefer accounting policies that reduce profit.* Managers of firms that are more politically visible are expected to prefer lower reported profit so as to reduce political visibility, thus reducing potential political costs. Large entities are assumed to be more politically visible. Accordingly, managers of large entities are expected to prefer accounting policies that reduce profit to deflect political costs.

For example, management of a large financial institution may prefer to recognise more bad and doubtful debts expense, so as to reduce pressure from governments and society to pass on interest rate cuts to borrowers.

While agency theory suggests some factors that may influence accounting policy choice, other factors may also be relevant. For example, some accounting policies may be common within certain industries. In some jurisdictions and for some accounting issues, entities need to select the same accounting policy for financial reporting purposes that they intend to use for purposes of determining income tax obligations.

LEARNING CHECK

- ☐ Positive accounting theory is based on the view of the firm as a nexus of contracts and on the assumption that individuals are rational wealth maximisers.
- ☐ Positive accounting theory attempts to explain accounting policy decisions by examining agency relationships between managers and both shareholders and debtholders, as well as political processes.
- ☐ Accounting numbers are used in management remuneration contracts to establish performance targets and to specify how the amount of remuneration will be determined.
- ☐ Debt contracts use accounting numbers in setting restrictions such as a maximum leverage ratio.
- ☐ Accounting numbers reported in financial statements are used to monitor compliance with the terms of debt contracts.
- ☐ Accounting numbers reported in financial statements are used to measure performance against the terms of management remuneration contracts to determine the eligibility for, and amount of, rewards, such as the amount of a manager's bonus.
- ☐ While contracts serve to align the interests of agents with those of the principals, they also provide incentives for managers to choose particular accounting policies. Agency theory and economic theory about political processes are used to derive hypotheses about accounting policy choice.

2.5 The role of accounting in capital markets

LEARNING OBJECTIVE 2.5 Compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting.

Investors and potential investors are considered to be important groups of users of general purpose financial statements. In this section we will consider two competing theories about the role of accounting information in capital markets: the mechanistic hypothesis and the efficient market hypothesis. Both of these hypotheses are based on theories about how the market and, therefore, share prices respond to information.

2.5.1 The mechanistic hypothesis

The **mechanistic hypothesis** predicts that the market reacts mechanistically to changes in accounting numbers. This means that investors are assumed to ignore differences in accounting policies when analysing financial statements. The mechanistic hypothesis suggests that investors respond to an increase in profit in the same way, regardless of whether it has cash flow implications, such as an increase in profit that results from additional sales revenue, or whether it has no cash flow implications, such as an increase in profit resulting from a change of depreciation method. This hypothesis is based on the assumption that investors are functionally fixated on reported numbers.

An implication of the mechanistic hypothesis is that investors could be easily fooled by cosmetic changes in accounting policies, that is, changes that have no cash flow implications. For example, if management changes the straight-line depreciation rate from 20% to 10%, the depreciation expense will decrease and

reported profit will be higher than under the former depreciation rate. Of course, this does not mean the entity is generating more cash flows. It simply means that depreciation is being spread over a longer estimated useful life. According to the mechanistic hypothesis, share prices would be overstated because investors would be tricked into believing the shares are worth more because profit is increased. The mechanistic hypothesis implies that accounting standard setters and regulators should be concerned about accounting policy choice because the use of different accounting methods can be used to mislead investors.

2.5.2 The efficient market hypothesis

The **efficient market hypothesis** is a proposition that markets are efficient. A market is efficient if security prices in that market rapidly adjust to new information so that prices fully reflect the available information (Fama, 1970). If good news about an entity's future prospects were released, investors would interpret this as indicating that the entity's shares were more valuable and the increased demand for the shares would rapidly drive up the share price. An implication of market efficiency is that, on average, it is not possible to earn economic profits by trading on information. That is, investors are unable to earn returns beyond those commensurate with the level of risk, by using information in an efficient market because the share price reflects the information available about the shares.

Fama (1970) identifies the following three forms of market efficiency which differ in terms of the information set reflected in share prices.

- The *weak form of market efficiency* implies that a security's price at a particular time fully reflects the information contained in its sequence of past prices. If the market is efficient in the weak form, investors would not be able to earn abnormal returns from trading strategies that are based on charting and analysing past prices to identify cycles or patterns.
- The *semi-strong form of market efficiency* implies a security's price at a particular time fully reflects all publicly available information, including the information contained in past prices. If the market is efficient in the semi-strong form, investors would not be able to earn abnormal returns from trading strategies that involve analysing publicly available economic, legal, political or financial information, such as financial statements.
- The *strong form of market efficiency* implies a security's price at a particular time fully reflects all information, including information that is not publicly available. If the market is efficient in the strong form, investors would not be able to earn abnormal returns by trading on private information, which is referred to as 'insider trading'. Insider trading is prohibited by securities regulations and laws because capital markets are not considered to be efficient in the strong form.

Figure 2.5 presents a diagram of the three forms of market efficiency. Each circle depicts an information set. The inner circle is the weak form, in which the market is efficient with respect to information in past security prices only. The next circle reflects the semi-strong form in which the information set to which the market is efficient includes all publicly available information. The information set of the weak form of market efficiency is entirely within the information set of the semi-strong form of market efficiency because past share prices are a component of all publicly available information. Lastly, the outer circle reflects the strong form of market efficiency in which the market is efficient with respect to all public and private information.

The semi-strong form of market efficiency is of greatest relevance to financial reporting because general purpose financial statements form part of the publicly available set of information about entities. Much of the empirical research undertaken on the effects of accounting policy choice and disclosures on share prices assumes the semi-strong form of capital market efficiency. This is a reasonable assumption although the market is unlikely to be fully efficient in the semi-strong form because market efficiency assumes (Fama, 1970):

- there are no transaction costs in trading securities
- all information is available free of cost to all market participants
- market participants agree on the implications of current information for the current price and distribution of future prices of each security.

Clearly these assumptions are not met in modern capital markets. The presence of transaction costs, such as stamp duty and brokerage fees, limit the efficiency of capital markets. While information may be available at low cost, many investors incur information costs to obtain sophisticated analyses and interpretation of financial information. Lastly, there are often differences in the assessment of the implications of new information for the valuation of shares, even among sophisticated analysts.

FIGURE 2.5 Weak, semi-strong and strong forms of market efficiency

If the capital market is efficient, the share price will rapidly respond to the release of information, irrespective of whether an item is recognised in the financial statements, or merely disclosed in the notes to the financial statements. For example, according to the efficient market hypothesis, the share price would react to information about an obligation to make future cash payments, regardless of whether it is reported as a liability in the statement of financial position or disclosed as a commitment in the notes to the financial statements.

The semi-strong form of market efficiency implies that what is disclosed is more important than how the information is presented. It does not matter where the information is reported because the share price incorporates all publicly available information. Disclosure is important because if the market is efficient in the semi-strong form, but not in the strong form, information must be made publicly available to be incorporated in share prices.

2.5.3 What does accounting theory tell us about accounting policies?

The capital markets theories considered in sections 2.5.1 and 2.5.2 attempt to explain the effects of accounting policy choice on share prices. The mechanistic hypothesis predicts that investors ignore differences in accounting policy choice and fixate on reported numbers. In contrast, the efficient market hypothesis predicts that in a market that is characterised by the semi-strong form of efficiency, the share price will rapidly incorporate all publicly available information. This implies that the share price would reflect the information about the effect of the choice of accounting policy on profit.

Let us consider an example in which management changes the depreciation policy from the diminishing balance method to the straight-line method, resulting in an increase in reported profit. Information about the change of accounting policy is disclosed in the notes to the financial statements. We will also assume that the change of accounting policy does not affect the entity's tax obligations. The mechanistic hypothesis predicts that the share price will respond to the increase in profit, ignoring that it is the result of a cosmetic change of accounting policy. The efficient market hypothesis predicts that if the increase in profit results from a change of accounting policy that has no cash flow effects, the share price would not be affected. If the share price actually increased in response to this cosmetic accounting policy change, how would we interpret this in light of the competing theories about the behaviour of share prices? One interpretation is that if the share price responds to a cosmetic accounting policy change, it is evidence in support of the mechanistic hypothesis. That is, investors respond to the increase in profit and ignore the additional information in the notes to the financial statements that the increased profit is merely the result of a change of accounting policy. An alternative interpretation is that the change of accounting policy has implications for the entity's contracts with other parties. For example, the increase in profit resulting from the change of depreciation policy may increase the entity's interest coverage and reduce the risk of a breach of its debt contract. The increase in the share price would be consistent with the efficient market hypothesis if it reflects a more sophisticated response that incorporates the economic consequences of the change of accounting policy in terms of the entity's contracts with other parties.

LEARNING CHECK

- ☐ The mechanistic hypothesis assumes that investors ignore differences in accounting policy choice when analysing financial statements.
- ☐ The semi-strong form of market efficiency implies a market in which the share price rapidly adjusts to reflect all publicly available information, including disclosures about accounting policies.

SUMMARY

At the beginning of this chapter we considered the need for professional judgement in deciding on a policy to account for transactions and other events in the context of applying accounting standards. The major decision areas include:

- determining whether the transaction or event results in an item that meets the definition of an element of financial statements
- whether the item should be recognised (i.e. have the recognition criteria been satisfied)
- how the item will be measured both initially and, with respect to assets and liabilities, subsequent to initial recognition
- the nature and scope of detail that is disclosed about a transaction, event or item reported in financial statements.

Accounting theory refers to a set of hypothetical, conceptual and pragmatic principles that form a general framework of accounting. Accounting theory can provide guidance, explanations and predictions about accounting policies that are, or could be, used in practice. Normative accounting theories, such as the conceptual framework, prescribe how we should account for transactions and events. In contrast, positive accounting theories seek to explain or predict phenomena pertaining to accounting practice. Some positive theories try to explain differences in accounting policies between entities, while other theories are more concerned with the effects of different accounting policies or disclosures on users' decisions.

We considered selected positive accounting theories, including agency theory which is used to explain and predict accounting policy choice. Separation of ownership and control gives rise to incentives to overspend on perquisites and can provide disincentives for managerial effort. Specific major agency problems in the owner–manager relationship include the horizon problem, risk aversion and dividend retention. The agency problems relating to the contractual relationship between lenders and managers are:

- excessive dividend payments, which could lead to insufficient funds available to service the debt
- asset substitution — the risk to lenders of managers using the debt finance to invest in riskier assets
- claim dilution, when management takes on debt of an equal or higher priority than that on issue
- underinvestment, which arises when managers have incentives not to undertake positive NPV projects that would lead to increased funds being available to lenders.

Contracts are designed to reduce monitoring and bonding costs and the resulting residual loss in the relationship between agents and principals. Accounting information is used to specify performance targets and covenants in contracts. It is also used to monitor actual performance against the contractual terms and determine the amount of rewards.

Accounting policies, such as whether an item is accounted for as an asset or as an expense, or whether a financial instrument is classified as a liability or equity, also have significant effects on the financial statements. The timing and amount of recognition of items can have significant effects on financial statements which are used to monitor performance in relation to contracts and to determine outcomes, such as the amount of a manager's bonus. Thus, accounting policy choice can have economic consequences for the entity and other parties with which it enters into contracts.

Agency theory posits that managers who are remunerated with bonuses linked to the entity's profit prefer accounting policies that increase reported profit. Similarly, if the entity has a lending agreement with a leverage covenant, management will prefer accounting policies that increase reported assets and equity.

Lastly, we considered selected theories that try to explain the effect of accounting policies and disclosures on share prices. The mechanistic hypothesis assumes investors fixate on accounting numbers, without regard to differences in accounting policies, and thus respond mechanistically to changes in reported profit. In contrast, the efficient market hypothesis predicts that the share price responds rapidly to new information. The semi-strong form of market efficiency implies that the share price rapidly incorporates all publicly available information. Thus, if the market is efficient in the semi-strong form, the share price would also reflect the information about the accounting policy applied in the preparation of financial statements.

KEY TERMS

accounting policy The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

agency costs The monitoring and bonding costs borne by the principal and agent, respectively, and residual loss in value of the firm, arising from the agency relationships.

agency theory The theory that deals with problems caused by separating ownership from control in the modern corporation.

deductive reasoning An approach to theory development that begins with a description of desired outcomes and leads to principles and, in turn, specific actions that should result in those desired outcomes.

efficient market hypothesis The proposition that a market is 'efficient' if security prices fully reflect the available information about the securities.

fair value The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

inductive reasoning An approach to theory development that begins with observations of practice and leads to inferences about principles, assumptions and objectives.

mechanistic hypothesis The hypothesis that share prices respond mechanistically to changes in accounting numbers, ignoring the effects of accounting policies.

normative theory A theory that prescribes what should be done based on a specific goal or objective.

political costs Wealth transfers imposed on the entity, resulting from political processes.

positive theory A theory that describes, explains or predicts activities or outcomes.

professional judgement The use of professional knowledge and skills to make decisions and solve problems.

theory A coherent set of hypothetical, conceptual and pragmatic principles forming a general framework of reference for a field of inquiry.

COMPREHENSION QUESTIONS

1. Describe the four components of an accounting policy. Illustrate your answer with examples.
2. Differentiate normative accounting theory from positive accounting theory. Provide an example of each.
3. What is the difference between the deductive and inductive processes of developing a theory?
4. What is an agency relationship? Explain how monitoring costs, bonding costs and residual loss arise in agency relationships.
5. Why would managers' interests differ from those of shareholders?
6. Explain the following agency problems that can arise in the relationship between owners and managers:
   (a) the horizon problem
   (b) risk aversion
   (c) dividend retention.
7. Outline the four agency problems that can arise in the relationship between lenders and managers.
8. What is a debt covenant and why is it used in a lending agreement?
9. Why would managers agree to enter into lending agreements that incorporate covenants?
10. How does accounting information reduce agency problems in relationships between management and shareholders?
11. How does accounting information reduce agency problems in relationships between management and debtholders?
12. What are the factors a manager might consider in making various expensing–capitalising choices?
13. Linking managerial remuneration to entity performance motivates managers to act in the interests of shareholders. However, it also burdens managers with greater risks than they may like. How do entities balance these two considerations in management remuneration plans?

14 Bonus plans are used to reduce agency problems between managers and shareholders. Discuss two of these problems specific to the relationship between shareholders and managers and identify how bonus plans can be used to reduce the agency problems you have identified. In your answer you should provide examples of specific components that may be included in a bonus plan to address the issues identified.

15 What are political costs? How might political visibility influence accounting policy choice?

16 Distinguish between the three forms of market efficiency. Which form is more relevant for financial reporting? Justify your answer.

CASE STUDY 2.1

ACCOUNTING POLICY DECISION

Penny Ltd made the following disclosure in the notes to its financial statements about how it accounts for insurance premiums.

> **Other current assets**
>
> Insurance premiums are paid in advance and recognised as 'Prepaid insurance' asset at the time of settlement. 'Other current assets' includes an amount of $10 000, which represents the unexpired portion of the insurance contract. The expired portion of the insurance contract is recognised as an expense.

Required

1. List the four components of an accounting policy decision.
2. Analyse Penny Ltd's policy for accounting for the insurance premium in terms of each component.

CASE STUDY 2.2

AGENCY THEORY

At the beginning of the current reporting period City Retail Ltd launched a new logo and spent $1 000 000 on new signage for all its premises. The expenditure on signage was originally accounted for as part of property, plant and equipment. It was recognised as a depreciable asset with a useful life of 10 years.

Tony has been engaged as the new accountant for City Retail Ltd. Tony believes that the expenditure for signage should be recognised as an expense because it is in the nature of advertising and the signage has no resale value. Eager to impress the senior managers, Tony gave a presentation on how he would 'improve' the forthcoming annual financial statements, by expensing signage costs. An extract from his presentation is provided below.

	Before change $'000	% of total assets
Total assets (includes signage with carrying amount of $900 000)	8 400	100
Total liabilities (including a long term debt agreement)	5 000	60
Shareholders' equity	3 400	40
Profit (includes depreciation expense of $100 000)	1 200	14

Tony was puzzled by the senior managers' response: 'You don't understand our business. What might look like an improvement for your financial statements, looks like devastating economic consequences for us.'

Additional information

- Managers receive a bonus, subject to profit exceeding 10% of total assets.
- The long-term debt agreement restricts borrowing to a maximum of 65% of total assets.

Required

For simplicity, assume that the change in accounting treatment has no implications on tax or tax expense.

1. Describe and quantify the effects of recognising the signage costs as an expense in City Retail Ltd's financial statement for the year ended 30 June.
2. How would agency theory explain why the managers of City Retail Ltd did not welcome Tony's accounting treatment for the expenditure on signage?

CASE STUDY 2.3

ACCOUNTING THEORIES

Rocky Retail Ltd had experienced a difficult year with declining sales as a result of increased competition from online retailers. The accountant for Rocky Retail Ltd presented a set of draft financial statements to management to review before the final set of financial statements were published. Management was very worried because the draft financial statements showed a profit of only $230 000 for 2019, compared with $300 000 in 2018. They were concerned that a reduction in profit would result in a fall in the company's share price.

The statement of profit or loss and other comprehensive income included an expense of $80 000 for stamp duty on long-term rental properties. One of the managers announced a 'clever plan' to increase profit, suggesting the company 'classify the stamp duty as an asset and expense it over the term of the lease'.

The accountant did some calculations and advised that if Rocky Retail Ltd accounted for the stamp duty costs of $80 000 as 'Prepayments', and then progressively allocated it to expenses over the term of each lease, only $5000 would be recognised as an expense in 2019. Everyone seemed happy with that plan and the accountant got to work writing the note disclosure about the accounting policy. She explained, 'We must disclose this to comply with accounting standards, but don't worry . . . I think the shareholders and investors will be too busy looking at the profit to read what is says in the notes'.

Required

1. Ignoring taxes, calculate Rocky Retail Ltd's profit for 2019 after the decision to account for stamp duty as an asset.
2. Explain which of the theories discussed in this chapter best describes the managers' expectations about how shareholders and investors will react to the reported profit for 2019.
3. Define the semi-strong form of market efficiency and discuss its implications for how the investors and, therefore, the share price might respond to the release of the financial statements. Assume that the market is efficient in the semi-strong form.

APPLICATION AND ANALYSIS EXERCISES

★ BASIC | ★★ MODERATE | ★★★ DIFFICULT

2.1 Debt covenants and accounting information ★ **LO4**

You have recently been appointed as a lending officer in the commercial division of a major bank. The bank is concerned about lending in the current economic environment, where there has been an economic downturn.

Required

Prepare a report outlining what agency problems the bank should be concerned with, how covenants in debt agreements can be used to reduce those problems, and how accounting information can be used to assist in this process.

2.2 Mechanistic hypothesis and efficient market hypothesis ★★ **LO5**

Douglas Ltd had always classified interest paid as an operating cash flow. In 2019 Douglas Ltd changed its accounting policy and classified interest paid of $100 000 as a financing cash flow in its statement of cash flows. The reported amounts are summarised below.

	2018 $'000	2019 $'000
Net cash inflows from operating activities	800	900
Net cash outflows for investing activities	(600)	(600)
Net cash outflows from financing activities	(100)	(200)
Net movement in cash	100	100

Required

1. Describe the mechanistic hypothesis. What does the mechanistic hypothesis predict about how investors and, therefore, share prices will respond to the increase in operating cash flows reported in Douglas Ltd's 2019 financial statements?
2. Describe the semi-strong form of market efficiency. What does the efficient market hypothesis predict about how investors and, therefore, share prices will respond to the increase in operating cash flows reported in Douglas Ltd's 2019 financial statements?

2.3 Mechanistic hypothesis and efficient market hypothesis ★★ **LO5**

Due to a change of accounting standards Adele Ltd reclassified some of its financial instruments in preparing its financial statements for the year ended 30 June 2019. The fair value of the financial instruments actually declined by $1 000 000. The effect of the reclassification was that changes in the fair value of the financial instruments were no longer recognised in the financial statements and this enabled Adele Ltd to report a profit of $3 000 000, which was an increase of 5% over the previous year's profit. The amount of the decline in the fair value of the financial instruments was disclosed in the notes to the financial statements.

Required

1. What does the mechanistic hypothesis predict about how investors and, therefore, share prices will respond to information about the profit reported in Adele Ltd's 2019 financial statements?
2. Distinguish between the mechanistic hypothesis and the semi-strong form of market efficiency. What does the efficient market hypothesis predict about how investors and, therefore, share prices will respond to information about the profit reported in Adele Ltd's 2019 financial statements?

2.4 Management remuneration plans and performance ★★ **LO4**

UBS is a global financial institution with an executive remuneration scheme that includes both cash-based and share-based remuneration and a mix of shorter term and longer term awards. At least 80% of the performance-based award is deferred. At least 50% of the total performance award (or bonus) is awarded through a share ownership plan, in which the executive receives UBS shares that vest in three instalments over 3 to 5 years. The senior executives do not become legally entitled to the shares until they vest. In addition, 30% of the total performance award is awarded under a deferred contingent capital plan. This award does not vest for 5 years and is conditional upon further performance targets being satisfied. The award is reduced if UBS makes a loss during the 5 years until it vests.

Required

1. Explain how the use of a bonus plan linked to performance and the deferral of part of the bonus can reduce the agency problems of the owner–manager relationship.
2. How does the senior executive equity ownership plan reduce agency problems beyond that which is achieved by the bonus plan?

2.5 Agency theory and management remuneration ★★ **LO4**

Publicly listed companies provide a remuneration report as a component of the annual report, which is often available on the company's website.

Required

Obtain the remuneration report for a publicly listed company. Examine the remuneration arrangement for the chief executive officer (CEO). Prepare a report which summarises your findings for each of the following.

1. What amount of the CEO's remuneration is in the nature of salary and cash bonus for the current year, and for the previous year?
2. What forms of remuneration other than salaries and cash bonuses does the CEO receive?
3. What proportion of the CEO's pay for the current reporting period is fixed and what proportion is performance based?
4. What measures of accounting performance, if any, are used to determine the CEO's bonus?
5. Explain the incentives for accounting policy choice that arise from the CEO's remuneration contract according to agency theory. Use specific accounting policies to illustrate your answer.
6. Can agency theory provide an explanation for the various remuneration components? Justify your answer.

2.6 Debt covenants and agency relationships ★★ **LO4**

On 1 July 2016, Medical Supplies Ltd borrowed $30 million to finance an investment in a laboratory for developing and testing surgical supplies. The loan is due 30 June 2026. The lender insisted on a debt covenant in the loan agreement, specifying that the ratio of total liabilities to total tangible assets not exceed 65%. Medical Supplies Ltd complied with the requirement in 2017 when the ratio of total liabilities to total tangible assets was 64%.

Medical Supplies Ltd also invested in plant and equipment used exclusively to manufacture latex gloves. However, due to a decline in demand for latex gloves, analysts are predicting that the company may need to write down some of its plant and equipment.

Required

1. Debt covenants or restrictions are commonly used in Australian lending agreements. Discuss how they are used to reduce agency problems that exist in the relationship between management and lenders.
2. Why would management choose to enter into a lending agreement that contains a covenant that restricts the company's leverage?
3. How might a write-down of plant and equipment increase the risk of breaching debt contracts?
4. If a company is close to breaching its leverage covenant what actions might it take?

2.7 Accounting policies ★★★ **LO1, 2, 3, 4**

In small teams, obtain the financial statements of three publicly listed companies. Refer to the notes to the financial statements pertaining to accounting policies and the note pertaining to property, plant and equipment reported in the statement of financial position.

Required

1. Describe the measurement and disclosure components of each company's policy for accounting for each class of property, plant and equipment.
2. Prepare a report on the comparability of the accounting policies used by the three companies. Drawing on theories explored in this chapter, do you think all companies should be required to use identical accounting policies?

2.8 Leases and efficient market hypothesis ★★★ **LO5**

Accounting standard setters have introduced changes to the current requirements for accounting for leases, effective 1 January 2019. Currently, if a lease is classified as a finance lease, the leased asset and a corresponding lease liability are recognised in the statement of financial position of the lessee. However, if a lease is classified as an operating lease, a lease asset and a lease liability are

not recognised by the lessee. Instead, lease payments are recognised as expenses as incurred and lease commitments are disclosed in the notes to the financial statements. The following statement has been made in relation to the forthcoming changes to accounting for leases.

> If the efficient market hypothesis is correct, management would be indifferent between classifying the lease as a finance lease or as an operating lease.

Required

Critically evaluate this statement.

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Figure 2.3: © CSR Limited 'CSR's remuneration strategy'. Figure 2 from p. 28 of *CSR Limited 2016 annual report* (copy of report supplied, and downloadable from: http://www.csr.com.au/investor-relations-and-news/annual-meetings-and-reports).

CHAPTER 3

Fair value measurement

CHAPTER AIM

This chapter discusses the application of AASB 13/IFRS 13 *Fair Value Measurement*. The objectives of this standard are: to define fair value, set out a framework for measuring fair value, and establish disclosures about fair value measurement.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

3.1 identify the reasons for needing an accounting standard on fair value measurement
3.2 explain the definition of fair value
3.3 measure the fair value of non-financial assets
3.4 apply the fair value measurement principles to liabilities
3.5 discuss the measurement of the fair values of an entity's own equity instruments
3.6 explain some of the issues relating to financial instruments
3.7 appreciate the disclosures required where assets, liabilities or equity is measured at fair value.

CONCEPTS FOR REVIEW

Before studying this chapter, you should understand and, if necessary, revise:

- the nature of a liability under the conceptual framework
- the nature of an asset under the conceptual framework.

3.1 Introduction and scope

LEARNING OBJECTIVE 3.1 Identify the reasons for needing an accounting standard on fair value measurement.

This chapter explains the meaning and measurement of fair value as set out in AASB 13/IFRS 13 *Fair Value Measurement*. Fair value is used extensively in Australian accounting standards as a measurement basis for assets, liabilities, equity instruments, revenues and expenses. The following topics require an understanding of fair value:

- applying the revaluation method to property, plant and equipment under AASB 116/IAS 16 *Property, Plant and Equipment* (see chapter 5)
- applying the revaluation method to intangibles under AASB 138/IAS 38 *Intangible Assets* (see chapter 6)
- measuring recoverable amounts when applying impairment tests under AASB 136/IAS 36 *Impairment of Assets* (see chapter 7)
- measuring defined benefit plan assets under AASB 119/IAS 19 *Employee Benefits* (see chapter 9)
- classification of leases by the lessor under AASB 16/IFRS 16 *Leases* (see chapter 10)
- applying the revaluation model to exploration and evaluation assets under AASB 6/IFRS 6 *Exploration for and Evaluation of Mineral Resources* (see chapter 34)
- measuring investment property using the fair value model under AASB 140/IAS 40 *Investment Property*
- measuring biological assets and agricultural assets under AASB 141/IAS 41 *Agriculture* (see chapter 35)
- measuring fair values of financial instruments under AASB 9/IFRS 9 *Financial Instruments* (see chapter 11)
- measuring equity-settled share-based payment transactions under AASB 2/IFRS 2 *Share-based Payment* (see chapter 14)
- measuring non-cash consideration under AASB 15/ IFRS 15 *Revenue from Contracts with Customers* (see chapter 15)
- measuring non-current assets or disposal groups classified as held for sale under AASB 5/IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (see chapter 16)
- measuring fair values in accounting for foreign currency transactions and hedges under AASB 9/ IFRS 9 *Financial Instruments* (see chapter 23)
- measuring the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values in a business combination under AASB 3/IFRS 3 *Business Combinations* (see chapter 25)
- measuring the non-controlling interest using the full goodwill method under AASB 3/IFRS 3 *Business Combinations* (see chapter 29)
- measuring the consideration received and any investment retained in the subsidiary at fair value under AASB 127/IAS 27 *Consolidated and Separate Financial Statements* (see chapter 30)
- measuring non-monetary government grants under AASB 120/IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*
- measuring contributions (e.g. the donations) of not-for-profit entities under AASB 1004 *Contributions*
- measuring the assets and liabilities of superannuation entities under AASB 1056 *Superannuation Entities.*

In Australia, companies have been allowed to use fair values for measurement of certain non-current assets for many years. This has not been the case in the United States. As far back as the 1940s, the Securities and Exchange Commission (SEC) in the United States had effectively removed the option of upward revaluation of property, plant and equipment for financial statements filed with SEC registration documents. However, fair values were still applied in relation to acquisitions and contracts entered into by companies. Following various accounting scandals and corporate collapses, some involving irregularities in fair value numbers, the accounting standard-setters moved to issue an accounting standard

on the measurement of fair value. In May 2011, the International Accounting Standards Board (IASB) issued IFRS 13 *Fair Value Measurement*. The Australian Accounting Standards Board (AASB) issued the equivalent standard AASB 13 in September of the same year. According to paragraph 1 of AASB 13/IFRS 13, the standard has three objectives:

1. to define fair value
2. to set out a framework for measuring fair value in a single standard
3. to require disclosures about fair value measurements.

The standard does not introduce new requirements for the use of fair value as a required measurement method or eliminate current practicability exceptions to the measurement of fair value, such as in accounting for agriculture (see chapter 35). Furthermore, the requirements of the standard do not extend to the use of fair values in share-based payment transactions within the scope of AASB 2/IFRS 2 *Share-based Payment* (see chapter 14) and accounting for leases by lessors within the scope of AASB 16/IFRS 16 Leases (see chapter 10). In some accounting standards, terms other than fair value are used, including net realisable value (used in AASB 102/IAS 2 *Inventories* — see chapter 4) or value in use (used in AASB 136/IAS 36 *Impairment of Assets* — see chapter 7). It is important in applying AASBs/IFRSs and interpreting financial information to also understand the meaning of these terms and how they differ from fair value.

LEARNING CHECK

- ☐ In 2011, the AASB/IASB issued AASB 13/IFRS 13 *Fair Value Measurement*.
- ☐ AASB 13/IFRS 13 has three main objectives:
  - to define fair value
  - to establish a framework for measuring fair value
  - to require disclosures about fair value measurements.
- ☐ Measurement at fair value based on AASB 13/IFRS 13 is permitted or required in a number of current accounting standards.

3.2 The definition of fair value

LEARNING OBJECTIVE 3.2 Explain the definition of fair value.

Appendix A of AASB 13/IFRS 13 defines **fair value** as follows.

> The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The measurement of fair value is based on a *hypothetical* transaction. The three key elements of fair value are as follows.

1. It is a current exit price.
2. The asset is sold or the liability is transferred in an orderly transaction.
3. The transaction is between market participants.

3.2.1 Current exit price

Appendix A of AASB 13/IFRS 13 defines **exit price** as follows.

> The price that would be received to sell an asset or paid to transfer a liability.

An important feature of the definition of fair value is that it is an exit price based on the perspective of the entity that holds the asset or owes the liability. The exit price is based on expectations about the future cash flows that would be generated by the asset subsequent to its sale or that would be needed to

transfer a liability to an acquiring entity. These cash flows may be generated from the use of the asset or from the sale of the asset by the acquiring entity. Even where the entity holding the asset intends to use it rather than sell it, the fair value is measured as an exit price by reference to the sale of the asset to a market participant who will use the asset or sell it. Similarly, with a liability, an entity may continue to hold a liability until settlement, or transfer the liability to another entity. The fair value in both cases is based on the price to transfer the liability to a market participant, which can be determined by reference to the expected cash outflows for the settlement of the liability.

In contrast to an exit price, an entry price is one that would be paid to buy an asset or received to incur a liability. According to paragraph BC44 of the Basis for Conclusions on AASB 13/IFRS 13, the IASB concluded that a current entry price and a current exit price will be equal when they relate to the same asset or liability on the same date in the same form in the same market. When an entity acquires an asset or assumes a liability in an exchange transaction, the transaction price is the amount paid by the entity — this is an *entry* price. In contrast, the fair value of the acquired asset or assumed liability is the price that would be received by the entity when it sold the asset or paid to transfer the liability to another entity — this is an *exit* price.

3.2.2 Orderly transactions

Appendix A of AASB 13/IFRS 13 defines an **orderly transaction** as follows.

> A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (e.g. a forced liquidation or distress sale).

Fair value is determined by considering a hypothetical transaction in a market. To measure that fair value, the entity will make observations in current markets. The markets to be observed must be those containing orderly transactions. It is not appropriate to base fair value measurements on prices of goods sold at 'sale price' or in a liquidation or fire sale or in a transaction in which the entities are not at arm's length. Factors that would indicate a transaction is not orderly include the following.

- The seller is in or near bankruptcy.
- The seller was forced to sell to meet regulatory or legal requirements.

Hence, if an entity acquired an asset as a result of a transaction that was not orderly, the amount paid — the actual price (an entry price) — is not necessarily equal to the fair value of the asset.

3.2.3 Market participants

Appendix A of AASB 13/IFRS 13 defines **market participants** as follows.

> Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:
> (a) They are independent of each other, i.e. they are not related parties as defined in AASB 124 [*Related Party Disclosures*], although the price in a related party transaction may be used as an input to a fair value measurement if the entity has evidence that the transaction was entered into at market terms.
> (b) They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.
> (c) They are able to enter into a transaction for the asset or liability.
> (d) They are willing to enter into a transaction for the asset or liability, i.e. they are motivated but not forced or otherwise compelled to do so.

This is the same in concept as 'knowledgeable, willing parties in an arm's length transaction', a phrase that was used to describe fair value before the issue of AASB 13/IFRS 13.

As the fair value is determined by reference to a hypothetical transaction, an entity must measure fair value using the assumptions that relevant market participants would use when pricing the asset or liability. The assumptions are those of the market participants, *not* those of the entity using the valuation. It is presumed that market participants act in their economic best interest. Neither party to an exchange transaction is perfectly informed, but it is assumed that both will undertake sufficient efforts to obtain the relevant information about an asset or a liability prior to committing to the transaction.

An entity does not have to identify specific market participants; rather the entity has to identify characteristics that distinguish market participants generally. For example, the entity does not need to identify, say, BHP Billiton Ltd as a potential market participant, but rather the characteristics of an entity that is a large manufacturer of iron and steel and uses certain assets in that process.

According to paragraph 23 of AASB 13/IFRS 13, the entity needs to consider factors specific to the transaction such as:

- the actual asset or liability being measured
- the principal (or most advantageous) market for the asset or liability
- the market participants with whom the entity would enter into a transaction in that market.

3.2.4 Transaction and transport costs

Two types of costs need to be considered when measuring fair value: transaction costs and transport costs.

Transaction costs are defined in Appendix A of AASB 13/IFRS 13 as follows.

> The costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria:
> (a) They result directly from and are essential to that transaction.
> (b) They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made (similar to costs to sell, as defined in AASB 5 [IFRS 5]).

Transaction costs include selling costs and handling costs because these are incremental and directly attributable to a transaction. The level of transaction costs affects the determination of the principal (or most advantageous) market in which an asset may be sold, and hence the market in which the fair value is measured. However, the price used to measure the fair value of an asset or liability is *not* adjusted for transaction costs. The reason for this is that these costs are specific to a transaction with a particular entity and would change from transaction to transaction. They are not considered to be a characteristic of the asset or liability itself. For example, the registration costs of a bus are not included in the fair value measurement of the bus.

Transport costs are defined in Appendix A of AASB 13/IFRS 13 as follows.

> The costs that would be incurred to transport an asset from its current location to its principal (or most advantageous) market.

An asset may have to be transported from its present location to the market in which it is to be sold. As the location of an asset or a liability is a characteristic of the asset or liability, associated transport costs *do* affect the fair value. The measurement of the fair value of an asset is therefore net of any transport costs.

For example, the fair value of a bus in an isolated country town is lower than the fair value of one located in the city because of the transport costs associated with getting the bus to the market.

Illustrative example 3.1 shows how transport costs and transaction costs affect the measurement of fair value.

ILLUSTRATIVE EXAMPLE 3.1

Transaction costs and transport costs

Pilbara Ltd, a mining company in Western Australia, owns a number of heavy duty machines used in the extraction of ore. A downturn in demand from Chinese companies has prompted Pilbara Ltd to consider selling one of its machines. Pilbara Ltd therefore wishes to determine the fair value of a heavy duty machine. Similar machines are sold in the market for $100 000. In order to sell the machine, Pilbara Ltd would need to incur advertising costs of $250, legal costs of $300 and possibly informational costs (to investigate the market for these machines) of $120. The cost of transporting the machine from the mine site to the nearest town with railway and shipping facilities is $300.

Required

Determine the transaction costs, transport costs and fair value of the heavy duty machine.

Solution

Transaction costs = $250 + $300 + $120
= $670

Transport costs = $300

In calculating the fair value of the machine, only transport costs are taken into account.

Fair value = $100 000 − $300
= $99 700

LEARNING CHECK

- ☐ AASB 13/IFRS 13 introduces a new definition of fair value, which is different from that used previously in accounting standards.
- ☐ Fair value is defined as an exit price rather than an entry price.
- ☐ The transaction used to measure fair value is that between market participants, and fair value is not an entity-specific price.
- ☐ Fair value is measured net of transport costs but not net of transaction costs.

3.3 Application to non-financial assets

LEARNING OBJECTIVE 3.3 Measure the fair value of non-financial assets.

In this chapter, the measurement of fair value is considered in relation to non-financial assets and liabilities, and equity. This section considers non-financial assets. Sections 3.4 and 3.5 consider liabilities and equity instruments, respectively. Whereas financial assets include cash, shares in other entities and rights to receive cash from other entities, non-financial assets include property, plant and equipment, and intangibles.

According to paragraph B2 of Appendix B *Application guidance* of AASB 13/IFRS 13, an entity needs to undertake the following four steps to make a fair value measurement for a non-financial asset.

Step 1: Determine the particular asset that is the subject of the measurement (consistent with its unit of account).

Step 2: For a non-financial asset, determine the valuation premise that is appropriate for the measurement (consistent with its highest and best use).

Step 3: Determine the principal (or most advantageous) market for the asset.

Step 4: Determine the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset and the level of the fair value hierarchy within which the inputs are categorised.

These four steps are now discussed in more detail.

3.3.1 Step 1: what is the particular asset being measured?

According to paragraph 11 of AASB 13/IFRS 13, a fair value measurement is for a particular asset. When measuring the fair value of an asset, it is necessary to consider the particular characteristics of the asset that market participants would take into account when pricing the asset.

Some of the key questions that need to be asked when considering the characteristics of the asset to be measured are as follows.

- *What is the location of the asset?* If the asset is located away from the market, it will need to be transported to the market and transport costs will be incurred. Time constraints or difficulties in transporting the asset may affect its fair value.
- *What is the condition of the asset?* Many of the factors that are considered in depreciating an asset are relevant to assessing the condition of an asset, such as remaining useful life, physical condition, expected usage, and technical or commercial obsolescence. Assets may be new or second-hand, and may be well or poorly maintained.
- *Are there any restrictions on sale or use of the asset?* There may be legal limits on the use of the asset; for example, patents, licences or expiry dates of related lease contracts. It may be illegal to sell certain assets in some countries.
- *Is the asset a stand-alone asset or is it a group of assets?* Where a fair value is being calculated for impairment purposes, the assets being valued may be a cash generating unit as defined in AASB 136/IAS 36 *Impairment of Assets* (see chapter 7). Similarly, if the fair value relates to a business, the definition of a business in AASB 3/IFRS 3 *Business Combinations* would need to be considered (see chapter 25).

In considering these factors, the premise is that the market participants will be taking these factors into consideration when determining how they would price the asset or liability.

According to paragraph 69 of AASB 13/IFRS 13, blockage factors should *not* be considered when measuring fair value. Blockage factors relate to the volume of assets being sold. In general, price per unit can be expected to fall if a large volume of units is sold as a package; for example, the price per vehicle in the sale of a fleet of vehicles would be less than the price in the sale of a single vehicle. Blockage is hence an entity-specific factor. According to paragraph BC42 of the Basis for Conclusions on AASB 13/IFRS 13, the transaction being considered between the market participants is a hypothetical transaction, and as such, the determination of fair value does not consider any entity-specific factors that might influence the transaction. Hence, assets should be measured on a per unit basis.

3.3.2 Step 2: what is the appropriate measurement valuation premise?

The fair value of an asset is determined by considering the price a market participant would pay to buy the asset from a seller. The market participant would determine this price by considering the potential cash flows from the asset, whether from its sale or use. The market participant may have a number of alternative ways in which it can sell or use the asset. Fair value is measured by considering the highest