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Module 1 - The role and importance of financial reporting

Purpose of financial reporting

What is the purpose of financial reporting? [p17]

- Provide useful financial information for various users to support their decision-making needs.
- Provides a stewardship or accountability role by requiring managers to give an account of how they have used (efficiently and effectively manage) the resources with which they have been provided.

What is the difference between special purpose financial statements and general purpose financial reporting? [p18]

- Special purpose financial statements are more tailored financial statements for specific needs or providing useful information. Eg bank extending credit.
- General purpose financial reporting has a much broader focus catering for users who do not have the authority to demand special reports: "Financial statements that are intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs."

How does IASB resolve the conflict that a range of users require different information and have different information needs? [p18]

- To provide information that will meet the needs of the maximum number of primary users. The criterion in judging whether information should be included or required in financial statements is to see whether it is useful for a wide range of users.

Limitations of decision-usefulness objective for wide range of users [p19]

- Lack of familiarity with new types of information making it difficult to assess its usefulness.
- Decision-usefulness may vary among users.
- Capable of multiple interpretations.

What does the Conceptual Framework and IFRS provide? [p20]

- A coherent set of objectives, assumptions, principles and concepts within which judgements are to be made.
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Who should prepare GPFS? [p21]

- This is left to governments and regulatory agencies to decide and no stipulated in the Conceptual Framework.
- In Australia, reporting obligations are found in the Corporations Act 2001 (Cwlth): which sais financial reports must comply with accounting standards and be prepared by all disclosing entities, public companies, large proprietary companies and registered schemes.
- In Australia, AASB adopts IFRS for 'reporting entities' which need to prepare GPFR [p21]: reporting entities are entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on GPFR for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.
- Not all entities are required to prepare financial reports in accordance with IFRSs [p22]

What comprises of the IFRS accounting standards? [p21]

- International financial Reporting Standards (IFRS), issued by IASB
- International Accounting Standards (IAS), issued by predecessors of IASB
- IFRIC Interpretations, authoritative guidance provided by IFRS Interpretations Committee and approved by IASB
- SIC Interpretations, official interpretations of IASBs and issued by a predecessor committee and approved by IASB. Interpretations have the same authority as IFRSs.

What does not comprise of the IFRS accounting standards? [p21]

- IFRS Interpretations Committee Agenda Decisions: When the IFRS Interpretations Committee decides that an issue does not require further consideration it publishes that on the Agenda including the issue and a detailed explanation of why further action is not required. These do not have the authority of IFRSs but may be used as guidance for understanding issues.

What are the international initiatives to decrease complexity of financial reporting? [p22]

1. reducing differences in reporting standards between countries [p23]
   - Over 100 jurisdictions worldwide require the use of IFRSs for their publicly listed companies.
2. reducing reporting requirements of specific organisations [p23]
   - IASB introduced IFRS for SMES which are less complex than full IFRS [p23]
   - AASB introduced differential reporting framework with reduced disclosure requirements (RDR) where organisation meet the category of Tier 2. [p23]
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- XRB introduced multi-tiered Accounting Standards Framework where the level of disclosure and compliance requirement depends on the nature of organisations. [p24]

3. catering to information needs of multiple stakeholders, how to measure 'performance' from multiple perspectives that cannot be met simply by the reporting of financial statements (eg. strategy and plan) [p24]
  - Implemented projects: IAS 7 statement of cash flow and IAS 8 accounting policies and estimates [p24-25]
  - Research projects: Materiality, principles of disclosure (develop a disclosure standard that binds together financial statements and their contents), standards level review of disclosure (improve disclosure in respective standards) [p25]
  - Completed projects: Amendments to IAS1 [p25]
  - FRC UK, introduced Financial Reporting Lab as a forum for companies and investors to solve contemporary reporting needs. [p26]

What are the interaction between financial reporting and the regulatory environment? [p26]
- The financial reporting depends on the type of organisation and the jurisdiction in which it operates
- Financial reporting has economic consequences and this creates incentives for different groups to influence financial reporting and the standard-setting process.
- Regulatory capture is when regulated parties (prepares of financial reports) are able to exert influence on the standard-setting body
- Private interest theory is the capacity of various private interests to exert influence on standard setters

What is the role of accounting standards? [p44]
- Provide a practical mechanism for achieving the overall objective of financial reporting and outlining how best to achieve as many qualitative characteristics as possible (eg, more consistency and understandability)
- Limits the scope for abuse and misreporting that may arise when the economic self-interest of organisations or their managers interferes with objective reporting.

How does the AASB differ from IFRS? [p45]
- IFRS is designed for profit-seeking enterprises but AASB is sector-neutral
- IFRS forms the foundation for AASB but AASB adds new paragraphs (prefix Aus) relevant to Australia such as to not-for-profit and public sectors (eg in impairment of assets)
The Conceptual Framework for Financial Reporting

What is the purpose and application of the Conceptual Framework? [27]

- As accounting standards do not cover all areas of transactions of business entities, when they do not provide guidance, or where their guidance is not sufficiently specific, it is the role of the Framework to provide guidance to facilitate consistency in the reporting of transactions and events.
- It is a practical tool that assists the IASB when developing and revising IFRSs.
- It provides a formal frame of reference for the types of transactions and events that should be accounted for, when they should be recognised, how they should be measured, and how transactions should be summarised and presented in financial statements.
- Auditors may use the framework to help them when forming an opinion on compliance with IFRS.
- Those who use financial statements may also use the Framework in order to better understand and interpret the financial reports they are reviewing.

What is the structure of the Conceptual Framework? [p27]

- Introduction: provides a detailed description of the purpose, status and scope of the Conceptual Framework
- Chapter 1: Objectives of general purpose financial reporting. The paragraphs are identified by the OB included before its paragraph numbers.
- Chapter 2: Addressing the reporting entity (part of Conceptual framework project)
- Chapter 3: Guidance on the qualitative characteristics of useful financial information. The paragraphs are identified by the QC included before paragraph numbers.
- Chapter 4: Rest of the framework such as going concern assumption as well as the definitions of the elements of financial statement and recognition criteria

What is the authority of the Conceptual Framework? [p28]

- The Framework is not an Accounting Standard or Interpretation.
- Where conflict with IFRS occurs, IFRS overrides the Framework.
- However IAS 8 requires the Conceptual Framework to be considered when there is an absence of a specific accounting standard or interpretation.

What are some constraints on the framework? [p43]

- Business and legal environment in which entities operate. External regulators may impose their own desires on how reporting is performed.
- The social and political environment within which standard setting takes place.
The Conceptual Framework for Financial Reporting

- The inconsistencies between the Framework and accounting standards may arise as a result of economic constraints (e.g., GFC and impact on financial instruments).
- The human resources and cost: considerable amount of time and cost required to create and apply the framework.
The objective of general purpose financial reporting

What are the primary users of GPFR and why are they regarded as the primary user? [p78, Question 1.3]

- Primary users are existing and potential investors, lenders and other creditors who do not have the ability to require a reporting entity to provide this information.
- They rely on GPFR as they do not have the ability to require a reporting entity to provide this information.

What are the limitations of general purpose financial reporting? [p28]

- There are limitations to the extent that GPFR can provide useful information to all users so it recommends supplement it with other sources to help gain a clearer understanding.
- It acknowledges the reports are 'not designed to show the value' of the organisation but to help decision-makers make their own estimates as to its value.

How does GPFR help users? [p28]

- GPFS provide information about an entity's financial position and the effects of transactions and other events that give rise to changes in financial position.
- The presentation of financial reports help with comparability with previous year financial statements and the statements of other entities.

What are the two important assumptions that form the foundation of GPFR? [p29]

- Accrual basis: transactions are recognised when they occur (which may not correspond to the time that cash is exchanged in response to a transaction) and reports them in the financial statements in the periods to which they relate. Expenses are 'incurred' and revenue are 'earned'. Accrual is used on the assumption that it provides a better basis for assessing the entity's past performance and predicting future performance (as it compares revenue with expenses incurred in the same period) than relying only on financial statements prepared on a cash basis.
- Going concern: financial statements are prepared with the assumption the entity will continue to operate for the foreseeable future. The carrying amounts of assets and liabilities are based on going concern. Where going concern is not appropriate, financial statement should be prepared on some other basis which the Conceptual Framework does not specify. Eg. assets at net realisable value and liabilities at immediate settlement.
Module 1 - The role and importance of financial reporting

Qualitative characteristics of useful financial information

For financial statements to be useful, it must possess two qualitative characteristics [p30]

- Relevant: information is relevant when it is capable of influencing the decisions which could occur through the predictive value or the confirmatory value of information.
  - Relevance encompasses materiality: information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. Materiality could be impacted by the nature or size of the item of information; quantitative thresholds are not used as it is entity-specific.
- Faithful representation: financial statements faithfully represent the transactions and events that they purport to represent. This means that information is complete in all material respects, neutral, prudent, reflect the economic substance of events and transaction and not merely the legal form, and free from error.
- Trade off may occur in the application of these qualitative characteristics so professional judgement is required [p31]

The usefulness of financial information is enhanced by enhancing qualitative characteristics [p30]

- Comparable [p32]: comparing between different entities and the same entity for another reporting period. This is helped with consistent methods, disclosure of accounting policies adopted and changes and their effects. Note that comparability is not satisfied by merely uniformity of accounting policies and methods as it may fail to reflect dissimilarities.
- Verifiable [p33]: knowledgeable and independent observers can reach a consensus that the information is faithfully represented.
- Timely [p33]: Undue delays may reduce the relevance of information to users so it may be better using estimates rather than waiting until more directly observable information is available.
- Understandable [p33]: information in financial statements must be clearly and concisely classified, characterised and presented. Information is not excluded because it is hard to understand. Users are presumed to have reasonable knowledge of business and economic activities and understand the measurement attribute adopted for a particular financial statement item.
- Enhancing characteristics improve the relevance or faithful representation of information, they do not make irrelevant or unfaithfully represented information useful.

What is the cost constraint associated with financial statements? [p34]

- There is a trade off between the cost of providing information versus the benefits derived from their preparation and presentation.
Examples

- Costs incurred on items such as internally generated brands, publishing titles, customer lists and magazine mastheads must be accounted for as expenses and not assets as these items cannot be distinguished from the cost of developing the business as a whole. (faithful representation) [p35] It is hard to measure the costs or value reliably.
- Changing accounting policies may forego comparability at the expense of relevant and faithfully represented. [p34]
- Asset's carrying amount may be stated above disposal value as the entity expects to obtain greater economic benefits through he continued use of the asset (going concern) [p29]
- In some cases, expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised. In the case of the supply of goods, the entity recognises such expenditure as an expense when it has a right to access those goods. (IAS 38) Eg. start up cost, training activities, advertising, relocating entity.