UPDATE ON THE CONCEPTUAL FRAMEWORK

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Introduction

This supplement examines the effect of the adoption of international accounting standards in Australia from 1 January 2005 on the current and proposed conceptual framework.[i] It covers the following matters:

1) Background to the development of conceptual framework projects in Australia, at the IASB and in the United States of America (US);
2) Changes to the Australian conceptual framework as a result of adoption of international accounting standards; and
3) The future of the conceptual framework in Australia and internationally.

Key Points

1) The AASB had produced four statements in the conceptual framework (SAC 1, 2, 3 and 4) prior to the Financial Reporting Council's (FRC) decision in 2002 to adopt IASB standards. The IASB issued in 1989 a conceptual framework which covered similar issues to SAC 3 and 4.
2) Since accounting standards and the framework on which they are based should be consistent, the adoption of AASB equivalents to IFRS required the AASB to review the Australian conceptual framework.
3) From 1 January 2005, SAC 1 and 2 will be retained and SAC 3 and 4 superseded by the AASB's *Framework for the Preparation of Financial Statements* based on the IASB Framework.
4) The Framework is influential in the development of accounting standards as the definition and recognition criteria contained the Framework are adopted into standards.
5) Future work on the conceptual framework by the AASB will be dependent on international developments such as the IASB/FASB review of their frameworks and international projects such as that on measurement.
6) A conceptual framework has a key role in the development of high quality international standards. However, given international differences among national accounting systems on topics such as measurement, the process of developing and applying a robust international conceptual framework will be a challenging one.

Background

The Australian conceptual framework was developed by the Australian Accounting Standards Board (AASB) and Australia Accounting Research Foundation (AARF) over the period 1985-1995 (p. 452).[ii] The *Statements of Accounting Concepts* (SAC) that had been released prior to 2002 (when the FRC decided that Australia would adopt international accounting standards) were SAC 1, 2, 3 and 4. The aim of the conceptual framework is to provide a set of interrelated concepts that will define the nature, subject, purpose and broad content of financial reporting and to provide and "explicit rendition" of the thinking that governs standard setting (ED 42, quoted on p. 452). Other proposed benefits, listed on p. 454, include promoting more consistent and logical reporting requirements because they stem from an orderly set of concepts, and making Boards that establish accounting standards more accountable and the thinking behind specific requirements more specific.[iii]

The aim and proposed benefits of the conceptual framework assume that the conceptual framework in use in a particular country underpins that country's accounting standards. Therefore the adoption of IASB standards in Australia necessitated a review of the Australian conceptual framework to determine whether the framework could fulfil its function when the AASB issued standards based on IFRS, or whether the framework had to be altered to meet the changed circumstances in Australian standard setting.

The IASB Framework

The *Framework for the Preparation and Presentation of Financial Statements* was issued by the IASC in 1989 and subsequently adopted by the IASB in 2001.[iv] The Framework describes the basic concepts by which financial statements are prepared. It serves as a guide to the Board in developing accounting standards and as a guide to resolving accounting issues that are not addressed directly in an International Accounting Standard or International Financial Reporting Standard or Interpretation (IASPLUS, 2004).

The Framework:

(a) defines the objectives of financial statements;

(b) identifies qualitative characteristics that make information in financial statements useful; and

(c) defines the basic elements of financial statements and the concepts for recognising and measuring them in financial statements. The framework acknowledges that a variety of measurement bases are used in financial reports (for example, historical cost, current cost, net realisable value and present value) but it does not include principles for selecting measurement bases (IASB Framework, paragraphs 1, 100, 101).

IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting policies, changes in accounting estimates and errors* deal with the presentation of financial statements and make reference to the Framework.[v] IAS 8 paragraph 10 requires that in the absence of an IASB Standard or Interpretation that specifically applies to a transaction, other event or condition, management must use its judgement in developing and applying an accounting policy that results in information that is:

(a) relevant to the economic decision making needs of users; and
(b) reliable, in that the financial statements:
  (i) represent faithfully the financial position, financial performance and cash flows of the entity;
  (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
  (iii) are neutral, i.e. free from bias;
  (iv) are prudent; and
  (v) are complete in all material respects.

IAS 8 paragraph 11 provides a 'hierarchy' of accounting pronouncements. It requires that in making the judgement required in paragraph 10, management shall refer to, and consider the applicability of, the following sources, in descending order:

(a) the requirements and guidance in Standards and Interpretations dealing with similar and related issues; and
(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.

FASB's conceptual framework

The AASB's concept statements and the IASB's Framework were developed following the lead of the US standard setter, FASB.[vi] In the period 1987-2000 FASB issued seven concept statements covering the following topics:

- Objectives of financial reporting by business enterprises and non-profit organisations;
- Qualitative characteristics of useful accounting information;
- Elements of financial statements;
- Criteria for recognising and measuring the elements; and

- Use of cash flow and present value information in accounting measurements.

The US framework has been subject to extensive criticism. There has been little work on the US framework since the 1980s. A possible explanation for the lack of activity was suggested by Dean and Clarke (2003). They argued that the search for the 'principles' that underpin conventional accounting practice diminished as the threat of intervention in business activities receded.

AASB review of the conceptual framework

As part of the process of issuing AASB equivalents to IFRS, the AASB reviewed the Australian concept statements (SAC 1-4) for consistency with the international framework. The AASB decided to retain SAC 1 and 2 to ensure clear interpretations of the application paragraphs of AASB equivalents to IASB standards. The IASB has no equivalent to SAC 1 *Definition of the reporting entity* yet this concept is embedded in Australian GAAP. SAC 2 *Objective of general purpose financial reporting* is also essential to the application of AASB standards. Retaining these statements does not compromise compliance with IASB standards (AASB 2004b).

SAC 3 and 4 are superseded by the AASB equivalent to the IASB Framework which will be applicable from 1 January 2005. SAC 3 and 4 were withdrawn because of the overlap between the material in them with that in the IASB's Framework. Consistency between the AASB and IASB frameworks was necessary because Australian standards refer to the Framework (as in AASB 108 discussed below). In addition, the Framework is considered when the AASB evaluates proposed standards for application in Australia (AASB Framework, p. 5). The AASB Framework is equivalent to the IASB Framework and it has additional paragraphs inserted to explain its application in Australia (AASB Framework, p. 9).

The aims of framework are unchanged. They encompass:

- Assisting the AASB in the development of future accounting standards;
- Promoting harmonised regulations and reducing the number of alternative treatments;
- Assisting preparers, auditors and users of financial reports; and
- Showing the AASB's approach to formulating accounting standards (AASB Framework, para. 1).

The IASB Framework covers similar topics to SAC 3 and 4, namely objectives of financial reports, qualitative characteristics that determine the usefulness of information in financial reports, the definition, recognition and measurement of the elements from which financial statements are constructed and the concepts of capital and capital maintenance (AASB Framework, p. 37).

The AASB has stated that the Framework is relatively brief in comparison to SAC 3 and SAC 4. Two key differences are that the Framework includes prudence as a qualitative characteristic and identifies two components to both income and expenses. The Framework (pp. 37-38) explains the implications of the differences in this way:

(a) The framework includes prudence as a qualitative characteristic while SAC 3 places more emphasis on neutrality. Under the Framework it is more likely that assets or income are understated and liabilities or expenses are overstated.

(b) SAC 4 defines revenue as 'inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in assets or reduction in liabilities of the entity'. In the Framework, income is defined as both revenue and gains. Thus, under SAC 4 inflows are shown on a gross basis, while under the Framework some inflows are shown on a gross basis and others on a net basis.

(c) SAC 4 defines expenses as "consumptions or losses of future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners, that results in a decrease in equity during the reporting period". Under the Framework, expenses include losses that are determined on a net basis and may or many not arise in the course of ordinary activity of an entity. Thus under SAC 4 outflows are shown on a gross basis while under the Framework some outflows are shown on a gross basis while others are shown on a net basis.

Reference to the Framework in accounting standards

The AASB issued AASB 108 *Accounting policies, changes in accounting estimates and errors* (equivalent to IAS 8) a part of the adoption of IASB standards. AASB 108 established a hierarchy of requirements and guidance that entities will need to apply under AASB equivalents to IASB standards. Consistent with IAS 8 paragraph 10 (quoted above), AASB 108 paragraph 7 means that where an Australian accounting standard specifically applies to a transaction, event or condition, the accounting policy to be applied will be determined by applying that standard and any relevant implementation guidance issued by the AASB. In the absence of an applicable Australian accounting standard, management shall use its judgement in determining the accounting policy so that information is relevant and reliable (paragraph 10), as defined in the Framework. Paragraph 11 requires that in making this judgement management should consider, in this order, (a) requirements and guidance in Australian accounting standards dealing with similar and related issues; and (b) the definitions, recognition criteria and measurement concepts in the Framework. The effect of AASB 108 it to ensure that the hierarchy of relevant sources in Australia in consistent with the hierarchy established by the IASB in IAS 8 (shown above).[vii]

Although the Framework does not have the same status as accounting standards, the recognition and measurement concepts included in the Framework are included in accounting standards. Thus, the changes to the Australian framework will flow through to accounting standards. Three examples are AASB 118 *Revenue,* AASB 1004 *Contributions and* AASB 1031 *Materiality.*

AASB 118, based on IAS 18, has replaced the existing AASB 1004 and uses recognition and measurement concepts consistent with the new Framework. Consequently, AASB 118 contains a narrower definition of revenue than AASB 1004. Revenue is defined as "the gross inflow of economic benefits from ordinary activities". AASB 1004 had considered revenue to be all inflows, regardless of whether or not they were attributable to ordinary activities. Therefore, companies will report a narrower range of items in revenue (ICAA, 2004). This change reflects the impact of IFRS adoption on accounting requirements. The AASB may have preferred the definition of revenue contained in SAC 4, but harmonisation with IASB standards means that a new definition, based on the IASB Framework, has been adopted.

AASB 1004 has been issued to ensure that existing Australian requirements relating to the recognition of contributions received by not-for-profit entities continue to operate after 1 January 2005. The AASB has made AASB 120 *Accounting for government grants and disclosure of government assistance* applicable only to for-profit entities because it is based on dated IASB requirements that are currently under review. In AASB 1004, income is to be measured at fair value at the point at which control over the income is obtained, consistent with the previous Australian requirements in AASB 1004 and AAS 15 (ICAA, 2004). Adoption of IASB standards means that the AASB was obliged to adopt IAS 120. Because of the AASB's reservations about the quality of the standard, the Board has restricted its application to for-profit entities and required not-for-profit entities, whose quality of reporting may been adversely affected by the change in standards, to comply with Australian requirements existing before the adoption of AASB equivalents to IFRS.

AASB 1031 relates to materiality and is consistent with the IASB Framework (paragraphs 29 and 30). However, the Australian standard is more comprehensive. Therefore the AASB has retained AASB 1031 and broadened its requirements to cover entities previously covered by AAS 5 to ensure that the meaning of materiality remains clear (AASB, 2004b). In this case, the AASB has ensured that adoption of IASB standards does not reduce the quality of requirements applying to Australian reporting entities.

These examples show that the composition of the Framework is important. While the Framework provides guidance and does not have the same status as accounting standards, elements of the framework become part of law when they are included in standards, as shown above. This is consistent with the way the AASB used the conceptual framework in the past. For example, SAC 4 definitions and recognition criteria were not mandatory, but were used in standards and in this way became part of legally binding requirements.

The future of the conceptual framework

National conceptual frameworks, such as those developed in US and Australia, have played a key role in guiding standard setting initiatives. For example, FASB stated that the framework provides both a foundation for setting standards and concepts to use as tools for resolving accounting and reporting questions (FASB, 2001). Although existing concept statements have not been recently issued (the FASB's most recent statement was SFAC No. 7 in 2000), convergence of accounting standards has highlighted the importance of the conceptual statements that underpin the development of accounting standards and the quality of financial reporting. A study by the SEC (required by the *Sarbanes-Oxley Act*) has recommended that US accounting standards should be developed using a principles-based approach and that standards should be based on an improved and consistently applied conceptual framework (SEC, 2003a). FASB has adopted an objectives-oriented approach to standards setting which includes:

- Addressing deficiencies and inconsistencies in the conceptual framework;
- Ensuring that new standards are aligned with an improved conceptual framework (SEC, 2003b).

Thus events in the US following the collapse of Enron, WorldCom and Arthur Andersen, together with international activity to converge accounting standards, have revived interest in conceptual framework projects at the FASB and IASB. The SEC's study recommends that as FASB adopts a more objectives-oriented approach to setting standards it should improve its conceptual framework in the following ways:

1) More clearly articulate how the trade-offs among relevance, reliability and comparability should be made;

2) Eliminate the inconsistencies between the discussion of the earnings process (found in SFAC No. 5) and the definitions of the elements of financial statements (found in SFAC No. 6); and
3) Establish a paradigm for selecting from among possible measurement attributes (FASB, 2004).

FASB is addressing changes to its concepts statements in three current agenda projects. The Revenue Recognition project is addressing inconsistencies between earning process and elements definitions. The Liabilities and Equity project is reconsidering distinction between liabilities and equity and aspects of the liabilities definition. In the Fair Value project, FASB will consider how the qualitative characteristics of relevance and reliability should be applied in selecting an appropriate measurement attribute (FASB, 2004). These projects address the first two recommendations above. The third recommendation will be addressed following the work of the Canadian Accounting Standards Board (AcSB) on measurement.[viii] The work by the AcSB, the IASB and FASB on the measurement project illustrates the collaborative nature of standard setting in the current environment. This initiative aims to produce global rather than national pronouncements in relation to measurement concepts.

In April 2004, FASB and the IASB agreed to undertake a joint project to develop a single, complete and internally consistent conceptual framework that would be used by both boards (FASB, 2004). FASB has advised that in this project it will complete and refine its existing framework rather than comprehensively reconsidering all the components of that framework. The Boards plan to focus initially on troublesome unresolved issues that appear in several projects, such as the term probable, the liabilities definition, accounting for contractual rights and obligations, and the unit of account (FASB, 2004, p. 9).

Revisiting the conceptual framework at the IASB is timely. The original Framework was issued in 1989 and has not been substantially revised in the meantime. However, since 1989 many new standards have been issued, including standards that conflict with the Framework. For example, Bradbury (2003) outlined many inconsistencies between IAS 139 *Financial Instruments* and the Framework. They arose because of the demand for a standard (to be part of the set of standards presented to IOSCO in 2000),[ix] the complexity of accounting for financial instruments, the incompleteness of the Framework, and the lack of acceptance a Framework based solution by preparers. Areas where the Framework provided inadequate guidance included accounting for derecognition of financial assets and hybrid financial instruments. Further, Bradbury (2003) suggested that the Framework ignores risk, one of the main attributes of financial instruments. If the conceptual framework is to fulfil its intended role, it must be reviewed to ensure that it is relevant to current standard setting issues.

An area not covered in the IASB or Australian Frameworks is measurement concepts. This issue will be addressed in due course as a result of the AcSB project undertaken on behalf of the IASB. The purpose of the project is to identify, consider and make recommendations with respect to issues related to the selection of an appropriate measurement objective or set of objectives.[x] The project is intended to provide the IASB and its national standard setting partners[xi] with a basis for initiating active projects to revise and expand their conceptual frameworks and improve their financial reporting standards by basing them on a coherent conceptual basis (IASPLUS, 2004).

Other IASB projects could also lead to changes in the IASB and Australian Frameworks. For example, the Concept of Revenue, Liabilities and Equity project is considering general principles for the recognition of revenue and related liabilities.[xii] Since the Framework considers definition and recognition of the elements of financial statements including revenue and liabilities, the outcome of this project may provide an extension to the IASB's framework.

However, international differences between countries in their current approaches to accounting may hamper future developments of the IASB Framework. Conceptual frameworks deal with issues that are challenging to existing accounting practice, with the topic of measurement being a case in point. Gaining consensus on these issues at a national level has proved problematic, as illustrated by SAC 4 in Australia and SFAC No. 7 in the USA. Gaining consensus at an international level will be even more difficult and limit the extent to which a robust conceptual framework can be developed.

Dean and Clarke (2003) described many issues that are relevant to understanding why the development of conceptual frameworks at a national level has been problematic. The authors argue that development of conceptual frameworks have been more a search for a rationale for current practice than a re-affirmation of the legal, social and economic framework within which accounting is to function. They suggested that current conceptual framework projects have sought to develop a constitution based framework for accounting, instead of focusing on concepts underpinning ordinary, everyday commerce. This analysis is highly relevant to international standard setting. It will be difficult to obtain support for a Framework that departs from existing practice, and difficult to determine a framework to represent practice where this differs between countries.

International convergence of accounting standards, and adoption of IASB standards in Australia, the European Union and many other countries, has increased the importance of the IASB. Ironically, it has also made standard setting more difficult for the IASB as many parties are now actively concerned about the content of accounting standards. In this environment, the conceptual framework that underpins the accounting standards becomes more important. Jones and Wolnizer (2003) suggest that the conceptual framework has a crucial role in stating the agreed scope, objectives, qualitative and measurement characteristics of accounting which influence standard setting. Such a framework would assist the IASB to withstand the political pressures in the standard setting process. However, given the controversial nature of measurement issues, further development of the framework will be a demanding task. Whether the IASB is able to refine and extend the Framework to allow it to fulfil its ideal role is a matter to be observed with interest in future years.

Jones and Wolnizer (2003) argued that convergence to the IASB Framework will mean that initiative and innovation in development of conceptual frameworks will decline. The AASB's work on the conceptual framework will be tied to the work of the IASB. Following the FRC's decision that Australia would adopt IASB standards, the AASB aligns its agenda with that of the IASB. Future development of the conceptual framework will proceed in line with initiatives of the IASB.

The IASB measurement project is likely to amend and expand the discussion of measurement in the Framework. Thus it will continue in some form the AASB's previous work on measurement. The AASB's project on SAC 5 failed to reach the stage of issuing a statement for several reasons. It was a controversial topic on which to issue a concept statement and there was a lack of international consensus on preferred measurement concepts. For example, the AASB had made greater use of current value measurements in accounting standards, while the IASB had been more committed to an historical cost model (Jones and Wolnizer, 2003). In addition, in the period after the issue of SAC 4 in 1995 the Board's attention was increasingly taken up with the harmonisation of Australian and international accounting standards. The AASB has been a leader in the development of a conceptual framework, but convergence with the IASB will mean that ground-breaking work in this area is unlikely to continue.

Conclusion

The AASB issued SAC 1, 2, 3 and 4 in the Australia conceptual framework over the period 1985-1995. The Statements provided significant guidance to standard setters and financial report preparers in Australia. They represented innovative work in the area of the reporting entity concept and illustrated how one framework could apply for the private, public and not-for profit-sectors.

Following the decision to adopt IFRS in Australia from 1 January 2005, the AASB has reviewed the Statements. It has retained SAC 1 and 2 and withdrawn SAC 3 and 4, replacing them with the IASB's Framework. Future work on the conceptual framework in Australia is likely to be led by the IASB's agenda. Convergence of accounting standards means that the AASB will not proceed with work on the framework independently of the IASB. The IASB has several project that may influence its Framework and thereby affect Australian financial reporting, including the measurement project and the concepts of revenue, liabilities and equity project.

While the Framework has an important role to play in future standard setting, the ability of the IASB to develop and apply a robust conceptual framework is uncertain. The decision in the US to refine and develop a conceptual framework as a joint project with the IASB is timely. It will assist the IASB in developing its framework because the joint project provides both resources and legitimacy. A joint project between FASB and the IASB combines the resources of the two most powerful standard setting bodies in the world. It provides a unified approach, which increases the chances that the resulting frameworks will be accepted. However, the extent to which the IASB Framework is accepted and used in standards will be the real test of its success. The development of national conceptual frameworks has been controversial. The example of IAS 39 suggests that gaining international agreement on measurement concepts that depart from historical cost will be difficult. The political processes that surround standard setting may hamper the development and use of a sound framework in future years. This could mean that the objectives of the Framework are not fully met, to the detriment of the standard setting process and goal of high quality financial reporting.

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NOTES

[i] See Godfrey et al. (2003) Chapter 12 and the January 2005 Supplement to Chapter 12.

[ii] One of the functions of the AASB is to develop a Conceptual Framework, not having the force of an accounting standard, for the purpose of evaluating proposed accounting standards as per the ASIC Act, 1989, section 227(1)(a) (AASB, 2004a).

[iii] Loftus (2003) notes numerous inconsistencies between Australian accounting standards and the conceptual framework (SAC 1-4) suggesting that the first benefit has not been fully realised.
[iv] The International Accounting Standards Committee (IASC) was the predecessor organisation to the International Accounting Standards Board (IASB, 2004).
[v] For further discussion, see Alfredson et al. (2005) Chapter 13.
[vi] Financial Accounting Standards Board.
[vii] To ensure that the Australian hierarchy was equivalent to the IASB hierarchy, the AASB issued AASB 1048. This standard clarifies the status of UIG interpretations means that Australian equivalents to IASB standards also include UIG interpretations that correspond to IASB interpretations.
[viii] See January 2005 Supplement to Chapter 15 *Measurement of assets and liabilities*.
[ix] In 2000 the International Organization of Securities Commissions (IOSCO) endorsed a set of IASC core standards for use by member exchanges for cross-border stock exchange listings (IOSCO, 2000).
[x] See January 2005 Supplement to Chapter 15.
[xi] The US, Canada, UK, France, Germany, Japan, Australia and New Zealand. See January 2005 Supplement to Chapter 12.
[xii] For further discussion of this project, see January 2005 Supplement to Chapter 17 *Revenue and recognition.*