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The Critical Role of the Reporting Entity Concept in Australian Financial Reporting

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The Critical Role of the Reporting Entity Concept in Australian Financial Reporting

1. Introduction

- 1.1 The reporting entity concept was introduced in Australia through publication of Statement of Accounting Concept (SAC) 1 *Definition of the Reporting Entity* (August 1990). Under SAC 1 a reporting entity is an entity (including an economic entity)¹ in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which would be useful to them in making and evaluating decisions about the allocation of scarce resources. SAC 1 remains part of the AASB Conceptual Framework and the reporting entity concept continues to be used in Australian Accounting Standards.²
- 1.2 The notion of a general purpose financial report was introduced into the Australian accounting conceptual framework through publication of SAC 2 *Objective of General Purpose Financial Reporting*. SAC 2 has now been replaced by Chapter 1 of the revised AASB *Framework for the Preparation and Presentation of Financial Statements* and, with the adoption of IFRS in Australia, the term ‘financial statements’ is used in place of ‘financial report’. However, the notion remains and general purpose financial statements (GPFs) are defined in AASB 1053 *Application of Tiers of Australian Accounting Standards* as financial statements 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. (If users have the ability to command the information they need, they could ask for financial statements that contain information satisfying their specific needs. Such financial statements are referred to as special purpose financial statements (SPFSs).)
- 1.3 SAC 1 links the need to prepare GPFs to the existence of users dependent on those financial statements for purposes of making and evaluating resource allocation decisions. Thus, under SAC 1, the reporting entity concept is concerned with both determining the boundaries of the entity and whether the entity should prepare GPFs. SAC 1 provides guidance for identifying the likely existence of dependent users by identifying the primary characteristics of entities that should prepare GPFs, namely:
- (a) separation of management from economic interest;
 - (b) economic or political importance or influence; and
 - (c) financial characteristics, such as the amount of resources controlled to provide goods and services and the amount of indebtedness.
- 1.4 The reporting entity concept enunciated in SAC 1 embodies a notion of differential reporting, in that certain entities would not be identified as reporting entities and thus,

1 Reporting entities to which Australian Accounting Standards apply may be individual entities or groups.

2 See for example AASB 101 *Presentation of Financial Statements* or AASB 1053 *Application of Tiers of Australian Accounting Standards* for the current definition of ‘reporting entity’, which is not substantively different from the SAC 1 definition.



in the context of SAC 1, would not be obliged to prepare GPFs. This notion of differential reporting has been incorporated in Australian Accounting Standards since the early 1990s. A look at the application paragraphs of Australian Accounting Standards reveals that they generally apply to reporting entities, with a few (including AASB 101 *Presentation of Financial Statements*, AASB 107 *Statement of Cash Flows*, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, and AASB 1054 *Australian Additional Disclosures*) also applying to non-reporting entities preparing financial statements in accordance with Part 2M.3 of the *Corporations Act 2001*.³ In other words, under Australian Accounting Standards, reporting entities and corporate non-reporting entities are subject to different reporting requirements. The differentiator is the reporting entity concept.

2. Concerns about the application of the reporting entity concept

- 2.1 To determine whether an entity is a reporting entity, regard is had to the definition of reporting entity and the guidance in SAC 1 on the primary characteristics of entities that should prepare GPFs. If it is reasonable to expect the existence of users dependent on the entity's financial statements for economic decision making and who cannot command preparation of SPFSs to satisfy their information needs, then the entity is a reporting entity.
- 2.2 Over the years, the AASB has received feedback indicating that the degree of subjectivity involved in applying the reporting entity concept has resulted in it being applied in a way that results in some entities that should prepare GPFs being treated as non-reporting entities and preparing only SPFSs. Concerns have been raised that, in such cases, user needs are not being satisfied.
- 2.3 The AASB also received feedback from constituents indicating that the costs of preparing GPFs in accordance with Australian Accounting Standards (now Tier 1) for some entities were greater than the benefits for the users of those GPFs.
- 2.4 The AASB issued a number of consultative documents containing its proposals for addressing the above concerns. The first of these documents was Invitation to Comment ITC 12 *Request for Comment on a Proposed Revised Differential Reporting Regime for Australia and IASB Exposure Draft of A Proposed IFRS for Small and Medium-sized Entities* issued in May 2007. In light of the comments received, the AASB developed revised proposals published in a Consultation Paper *Differential Financial Reporting – Reducing Disclosure Requirements (A Proposed Reduced Disclosure Regime for Non-publicly Accountable For-profit Private Sector Entities and Certain Entities in the Not-for-profit Private Sector and Public Sector)* and accompanying Exposure Draft ED 192 *Revised Differential Reporting Framework* in February 2010.

3 Paragraph 2 of the 'What this guide is about' section of Australian Securities and Investments Commission (ASIC) Regulatory Guide 85 *Reporting requirements for non-reporting entities* states "... ASIC believes that non-reporting entities, which are required to prepare financial reports in accordance with Chapter 2M of the *Corporations Act 2001* (Act), should comply with the recognition and measurement requirements of accounting standards".



- 2.5 ED 192 included proposals for a second tier of financial reporting requirements for preparing GPFs. It also included proposals to withdraw the use of the reporting entity concept for differential reporting purposes by changing the focus of application of Australian Accounting Standards to GPFs and clarifying the meaning of GPFs in an Australian context. After considering constituent comments on the Consultation Paper and ED 192, the AASB decided to proceed with introducing the Tier 2 of GPFs by issuing AASB 1053, but deferred a decision on whether to withdraw the use of the reporting entity concept for differential reporting purposes.
- 2.6 AASB 1053 added another dimension to differential reporting by distinguishing between Tier 1 and Tier 2 entities within the reporting entity category. Based on criteria stipulated in AASB 1053, some reporting entities need to apply all the requirements of Australian Accounting Standards (Tier 1) while other reporting entities must apply all the recognition and measurement requirements of Australian Accounting Standards, but significantly reduced disclosure requirements (Tier 2).
- 2.7 The AASB's deferral of a decision on withdrawing the use of the reporting entity concept for differential reporting purposes in accounting standards was the result of there being strongly opposing views among commentators. Many respondents to the ED 192 proposals agreed that the application of the reporting entity concept involves a high degree of subjectivity and that the term is open to differing interpretations and its use may not be universally understood. The view was expressed that the use of the reporting entity concept does not provide the intended outcomes, and the uncertainty surrounding its application reduces its usefulness as a robust criterion for differential reporting purposes.
- 2.8 In contrast, some respondents to the ED 192 proposals commented that they have not seen evidence of major problems with the application of the reporting entity concept and expressed the view that it works well for differential reporting purposes. Some argued that entities claiming to be non-reporting entities and preparing SPFs do not have dependent users and there is no evidence of a systemic problem of reporting entities claiming a non-reporting entity status to avoid their reporting responsibilities under Australian Accounting Standards.
- 2.9 The AASB concluded, in the light of these contrasting views, that further research should be carried out into the consistency with which the reporting entity concept is applied and the nature and quality of reporting undertaken by entities lodging financial statements with the Australian Securities and Investments Commission (ASIC) and state-based regulators.

Analysing the issue

- 2.10 ED 192 proposed clarifying the meaning of GPFs in an Australian context to ensure that a more objective assessment is made when determining whether an entity is subject to accounting standards. In summary, it was proposed that financial statements satisfying the following two conditions would be GPFs:
- (a) they are publicly available, whether under a legal mandate or voluntarily; and
 - (b) they are either:



- (i) prepared in accordance with all applicable Australian Accounting Standards [Tier 1 or Tier 2]⁴ under a legal mandate or held out to be so prepared; or
 - (ii) required to be GPFs under a legal mandate or held out to be GPFs.
- 2.11 ED 192 also proposed that financial statements held out as having been prepared in accordance with Australian Accounting Standards or held out as being GPFs to any party would be GPFs. This is because there is an expectation that financial statements held out as GPFs would be relied upon by users to make economic decisions and should, therefore, faithfully report what is expected to be reported in GPFs.
- 2.12 ED 192's proposal to change the focus of application of Standards from reporting entity to GPFs essentially meant that no SPFs would fall within the ambit of Australian Accounting Standards and it would be up to the users of SPFs and regulators of entities preparing SPFs to identify the relevant reporting requirements.
- 2.13 The proposed clarifications targeted three areas:
 - (a) There is a variety of references made in legislation/regulations and in financial statements themselves to preparation 'in accordance with Australian Accounting Standards'. The following considers some implications of such references:
 - (i) a reader of legislation/regulations or financial statements that include such a reference might logically conclude that the legislation/regulations require the application of all applicable Australian Accounting Standards and the financial statements imply the use of all applicable Australian Accounting Standards in preparing those statements. If entities subject to the legislation/regulations interpret the requirement differently, a user of financial statements might be misled, as the label 'preparation in accordance with Australian Accounting Standards' indicates that the financial statements are of the quality that can be relied upon for economic decision making;
 - (ii) financial statements prepared 'in accordance with Australian Accounting Standards' and made available to users, are reasonably seen as being in the nature of GPFs. Thus, if it is otherwise intended, a policymaker should be clear as to which standards it wants applied by entities in its jurisdiction. Similarly, SPFs would need to be clear as to the extent of application of standards in their preparation; and
 - (iii) some policymakers might require the preparation of financial statements in accordance with accounting standards and require that they be lodged, without having given sufficient consideration to the

4 Under the definition proposed in ED 192, paragraph 24, the phrase 'Preparation in accordance with Australian Accounting Standards' means 'application of all applicable Australian Accounting Standards in a particular Tier and not a subset of them'.



nature of the information they require and the needs of any external users, thus creating an unjustified reporting burden for some entities.

- (b) A user or a wide range of users (parties who are currently known to be users or who could reasonably be expected to be users) would be expected to use financial statements that are held out by entities as GPFs for economic decision making. Any difference between what is held out and the actual nature of the financial statements would make those financial statements misleading.
- (c) There is an implication that policymakers have determined there is a wide range of users of financial statements that are required to be made publicly available, such as on a public register. If so, it is valid to test the extent to which publicly available financial statements are in the nature of SPFSs. If SPFSs are being made publicly available, it might indicate the need to consider policy changes, on the basis that a regulator's objective in requiring lodgement may not have been fully achieved. Policy considerations might also arise in relation to financial statements made publicly available voluntarily.

Users and potential users

- 2.14 Some of the issues relating to the nature of lodged financial statements arise from different interpretations that exist about users of financial statements. Some interpret that the existence of dependent users is limited to 'actual' users and do not consider the effect of potential users on the nature of financial statements made publicly available. Others have a narrow interpretation of actual users and do not include some categories of users such as employees or creditors in their thinking.
- 2.15 'Expectation of the existence of users' as opposed to just 'existence of users' is an important aspect of the definition of the reporting entity in the Australian context, which sometimes appears to be overlooked. In defining the reporting entity, SAC 1, AASB 101 and AASB 1053 are clear that the 'expectation of the existence of users' is the basis for determining whether an entity is a reporting entity. Therefore, both existing and potential users are the target audience for GPFs. The IASB proposals in relation to the reporting entity concept issued in 2010 also include potential users in describing the concept.⁵

3. The future role of the reporting entity concept

- 3.1 In essence, under the proposals in ED 192 (outlined in paragraph 2.10 above), in applying Australian Accounting Standards, judgement would no longer need to be made about whether an entity is a reporting entity to determine whether the entity should prepare GPFs. This is because GPFs would be the focus of application

⁵ IASB Exposure Draft ED/2010/2 *Conceptual Framework for Financial Reporting, The Reporting Entity*, March 2010, paragraph RE2, describes a reporting entity as a "circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided".



paragraphs of Australian Accounting Standards.⁶ Under the proposals, it was also intended that the reporting entity concept be used as a benchmark for other regulators to identify entities that should prepare GPFs and those that need not.⁷

- 3.2 However, the reporting entity concept would still be expected to be used by the AASB as the underpinning concept for the AASB's deliberations on GPFs requirements. Other regulators would also be able to apply the concept in identifying entities that should be required to prepare GPFs (whether under Tier 1 or Tier 2).
- 3.3 The modified role of the reporting entity concept would also be expected to affect the status and content of SAC 1. One possibility would be that the guidance in SAC 1 would be available in a different form to be used by other regulators in identifying entities within their jurisdictions that should be required to prepare GPFs.

4. Research results

- 4.1 Pursuant to the AASB's decision to carry out further research (see paragraph 2.9 above), a research project was commissioned utilising the services of external researchers. The thrust of the research is to profile the characteristics of lodging entities and their accounting policies with a view to shedding further light on (i) whether there is consistency in the current treatment of entities as either reporting entities or non-reporting entities; and (ii) the nature of the accounting policy choices being made by non-reporting entities.
- 4.2 The data samples used in the research were drawn from the populations of entities that lodge financial statements with the ASIC under the *Corporations Act 2001* and with a number of state registries under legislation relating to Cooperatives and Incorporated Associations.
- 4.3 A Research Report is expected to be finalised and published in the second quarter of 2014. That Research Report, among other matters, will look at the extent to which financial statements lodged with the ASIC are GPFs or SPFs and the accounting policies applied in preparing SPFs.

Policy implications

- 4.4 The research findings are expected to have policy implications for the AASB and other regulators. Discussions are underway with representatives of the Federal Treasury and ASIC with a view to coordinating efforts in dealing with the issues emerging from the research. Similar liaison is expected with other relevant regulators, including state-based regulators.
- 4.5 As indicated above, if the ED 192 proposals were fully implemented, the focus of Australian Accounting Standards (Tier 1 and Tier 2) would be GPFs only. This could, as an initial step, involve amending the application paragraphs of those Australian Accounting Standards that currently apply to corporate non-reporting entities, to only apply to entities preparing GPFs.

⁶ Consultation Paper, paragraph 9.9.

⁷ Consultation Paper, paragraph 9.10.