

Chapter 2 – Types of organisations and the financial reporting framework

TRUE/FALSE

- 1 Mutual agency refers to the fact that each member of the partnership form of business entity can bind the other(s) in contract within the scope of normal operations.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

2. There are several advantages to forming a partnership, including the ease with which it can be formed and the limited rules and regulations that apply to it. However, as for a company, one of the regulations is that a partnership must prepare financial statements in accordance with Accounting Standards if it is deemed to be a reporting entity.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

3. Although partnerships may have a tax advantage over companies in that it is the partners that are taxed and not the partnership, a disadvantage of partnerships is that they have unlimited liability.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

4. All companies can raise funds through the general public but not all companies have limited liability.

ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

5. If a company has sales of \$8 million, assets of \$4 million and 60 employees, then it may be classified as a small proprietary company.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

6. All limited-by-shares companies must have 'Ltd' in their names, but a private company is distinguishable from a public company because it has 'Pty' as well as 'Ltd' in its name.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

7. Two companies were formed on 1 January 20X3, with the names Pluto Pty Ltd and Neptune NL. From the names of the companies, it is clear that the former is a proprietary company and the latter is a mining company.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

8. There are several differences between the financial statements of a company and those of a partnership, not least of which is the disclosure of taxation on the balance sheet as a liability. For a company, the disclosure is a single amount as it is the company that is liable and not the owners. For a partnership, the amount of taxation is split and reported separately in accordance with each partner's liability.

ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

9. The reason why company shareholders may have the advantage of limited liability rests with the entity principle in accounting, not the legal status of the company.

ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

10. The partnership form of business organisation exists where two or more carry on a business in common with a view to profit.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

11. Accounting Standards set by the Australian Accounting Standards Board (AASB) apply to both the private and public sectors in Australia.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The framework for setting accounting standards

12. Due process is primarily concerned with producing Accounting Standards that meet managers' objectives.

ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: The standard setting process

13. The *Corporations Act 2001* requires that financial statements include a directors' report, a directors' statement and an auditor's report.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The Corporations Act

14. The directors' report included with a company's financial statements contains an opinion on whether the balance sheet and income statement present a 'true and fair' view.

ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: The Corporations Act

15. Half-yearly reports contain more detailed information than annual reports.

ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: The Corporations Act

16. A conceptual framework can be defined as a set of interrelated objectives and fundamentals that is expected to lead to consistent standards, and that prescribes the nature, function and limits of financial accounting and reporting.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: What is a conceptual framework?

17. One of the objectives of a conceptual framework is that it is considered to be a defence against politicisation.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: Objectives of a conceptual framework

18. A general-purpose financial report is primarily directed toward the common information needs of a wide range of users.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

19. Users of general-purpose financial reports include investors, financial advisors, employees, lenders, suppliers and customers.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

20. A reporting entity is an entity for which there are users who rely on financial statements as their major source of information about the entity.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

21. General-purpose financial reports provide the information that is required for both internal and external user group needs.

ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

22. Accrual accounting refers to the method of measuring profit on the basis of cash flow, rather than when revenues and expenses occur.

ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

23. The going concern assumption assumes that an entity will continue to operate successfully into the foreseeable future.

ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

24. An asset must have physical qualities that can be measured reliably.

ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

25. A liability must always be a legal obligation that arises from past events.
- ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework
26. Equity is the residual interest in the assets of the entity after deduction of all its liabilities.
- ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework
27. Revenue means the gross inflows arising from normal operations plus all gains during the accounting period.
- ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework
28. The elements of financial statements are always measured using the historical cost method.
- ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: Measurement of the elements of financial statements
29. The Australian Financial Reporting Council is not able to directly influence the content of the AASB's accounting standards, but has the capacity to do so given its control of the budget and priorities of the AASB.
- ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The framework for setting accounting standards
30. The political nature of standard setting refers to the fact that, for example, preparers may lobby the standard setters to promote their own self-interest rather than the decision-making usefulness of general purpose reports.
- ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The political nature of accounting standard setting
31. The fundamental element *equity* does not require recognition criteria, because it represents the residual interest in assets, after deducting liabilities.
- ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework
32. In accordance with the IASB *Conceptual Framework*, income includes both revenue and gains.
- ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework
33. The external auditor is responsible for preparing the general-purpose financial reports of a company.
- ANS: F PTS: 1 AACSB: Knowledge, Analytical
TOP: External audits

34. The responsibilities of the Australian Financial Reporting Council include advising the government on the process of setting accounting standards.
- ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The framework for setting accounting standards
35. In Australia the overriding responsibility for the preparation and presentation of general-purpose reports resides with the directors of a company.
- ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: The corporations act
36. An external auditor seeks to provide reasonable assurance that the financial statements of a company are true and fair, not a guarantee that every error in the financial statements of the entity has been detected.
- ANS: T PTS: 1 AACSB: Knowledge, Analytical
TOP: External audits

MULTIPLE CHOICE

1. Which of the following is not true of sole traders?
- A. They are one-owner businesses.
B. They are not normally reporting entities.
C. They are separate legal entities.
D. They usually have limited funds at their disposal.
- ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations
2. Which of the following is not true for a partnership?
- A. Creditors can supply goods on credit to a partnership.
B. Debtors can purchase goods on credit from a partnership.
C. Partnerships have to pay their tax yearly.
D. Partnerships can enter contracts on behalf of the partnership.
- ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations
3. Which of the following statements regarding partnerships is incorrect?
- A. There are no legal formalities required to form a partnership and it can be an oral agreement.
B. Partnerships have unlimited liability not subject to the amount contributed by each partner.
C. The partnership is subject to income tax, not the individual partners.
D. Each partner has the authority to enter contracts on behalf of the partnership, provided the contracts relate to normal operations.
- ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations
4. Which of the following would not be considered a disadvantage of forming a partnership?
- A. Limited life
B. Unlimited liability
C. Ease of formation
D. Mutual agency

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

5. Jack and Jill Repairers is founded by partners Jack, Jill and Jolly. Jack, Jill and Jolly contributed \$3000, \$5000 and \$8000 respectively. For the year ending 20X2, Jack and Jill Repairers produced a profit of \$12,000. If the profits are distributed in accordance with the initial investment which of the following is true?
- A. Jack gets \$2250 and Jill gets \$6000.
 - B. Jack gets \$3750 and Jolly gets \$6000.
 - C. Jack gets \$2250 and Jill gets \$3750.
 - D. Jack gets \$2250 and Jolly gets \$8000.

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

6. Which of the following items of information would not be found in the balance sheet of a partnership?
- A. Assets
 - B. Liabilities
 - C. Dividends payable
 - D. Distribution of profits to partners

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

7. Which of the following is true of companies? All companies:
- A. are limited liability companies.
 - B. are separate legal entities.
 - C. have a limited life.
 - D. are bound by the contracts signed by shareholders.

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

8. A large proprietary company must have its financial statements audited and lodged with the:
- A. Australian Securities Exchange.
 - B. Australian Securities and Investments Commission.
 - C. Financial Reporting Council.
 - D. Australian Accounting Standards Board.

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

9. Which of the following types of business organisation has a legal identity separate from those of the owners?
- A. Sole proprietorships
 - B. Companies
 - C. Partnerships
 - D. All of the above.

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

10. Limited liability is a feature of what form(s) of business organisation?
- A. Company
 - B. Sole proprietorship
 - C. Partnership
 - D. Both a company and a partnership

ANS: A PTS: 1 AACSB: Knowledge, Analytical

TOP: Types of organisations

11. It can be determined that Alpha Pty Ltd is a proprietary company as its records show that:
- A. no approach has been made to the public for funds.
 - B. it has fewer than 50 employees.
 - C. it is a family company.
 - D. it has 'Pty Ltd' in its name.

ANS: D PTS: 1 AACSB: Knowledge, Analytical

TOP: Types of organisations

12. Gamma Pty Ltd would be a small proprietary company as its records show:
- A. assets of \$15m, sales of \$26m and 40 employees.
 - B. assets of \$6m, sales of \$26m and 60 employees.
 - C. assets of \$15m, sales of \$9m and 55 employees.
 - D. assets of \$4.5m, sales of \$12m and 45 employees.

ANS: D PTS: 1 AACSB: Knowledge, Analytical

TOP: Types of organisations

13. An advantage that a company typically has over a partnership is:
- A. mutual agency.
 - B. access to greater amounts of capital.
 - C. avoidance of moral hazard.
 - D. smaller size.

ANS: B PTS: 1 AACSB: Knowledge, Analytical

TOP: Types of organisations

14. The advantages of the corporate form of business organisation do not include:
- A. ready transferability of shares.
 - B. limited liability.
 - C. mutual agency.
 - D. continuity of existence.

ANS: C PTS: 1 AACSB: Knowledge, Analytical

TOP: Types of organisations

15. Which one of the following is not an advantage of a company?
- A. Separate legal entity
 - B. Access to capital
 - C. Continuous existence
 - D. No regulation

ANS: D PTS: 1 AACSB: Knowledge, Analytical

TOP: Types of organisations

16. In which section of a balance sheet would a general reserve be found?
- A. Current Assets
 - B. Current Liabilities
 - C. Non-current Assets
 - D. Shareholders' Equity

ANS: D PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

17. Equity on the balance sheet of a sole proprietorship is normally referred to as:
- A. owner's equity.
 - B. shareholders' equity.
 - C. reserves.
 - D. ordinary shares.

ANS: A PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

18. A small proprietary company is one that has:
- A. less than \$25 million sales and fewer than 50 employees.
 - B. less than \$5 million liabilities and fewer than 50 employees.
 - C. less than \$5 million expenses and less than \$12.5 million assets.
 - D. less than \$10 million equity and less than \$12.5 million assets.

ANS: A PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

19. Which of the following items does not appear on the balance sheet of a partnership?
- A. Debtors
 - B. Equipment
 - C. Creditors
 - D. Income tax payable

ANS: D PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

20. The ability of a partner to enter into a contract on behalf of all partners is called:
- A. voluntary association.
 - B. mutual agency.
 - C. the partnership agreement.
 - D. unlimited liability.

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

21. The separation of ownership and control is normally a characteristic of:
- A. companies.
 - B. partnerships.
 - C. sole traders.
 - D. partnerships and companies.

ANS: A PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

22. The factors that should be considered before forming the partnership and company forms of entity would include:
- A. income taxation implications.
 - B. the liability of the equity participants for the debts of the business.
 - C. the scale/magnitude of the operations involved and the access to finance.
 - D. all of the above.

ANS: D PTS: 1 AACSB: Knowledge, Analytical

TOP: Types of organisations

- 23 Due process involves:
- A. the maximum opportunity to comment on proposed accounting standards.
 - B. the selection and discussion of emerging issues of accounting.
 - C. a process of fast-tracking the implementation of accounting standards.
 - D. adequate consultation between the FRC and the AASB before an accounting standard is issued.

ANS: A PTS: 1 AACSB: Knowledge, Analytical

TOP: The framework for setting accounting standards

24. The principle purpose of an audit is to:
- A. assure investors of the wealth of the entity.
 - B. assure investors of the future profitability of the entity.
 - C. express an opinion on the truth and fairness of the entity's financial statements.
 - D. detect fraud by the entity's employees.

ANS: C PTS: 1 AACSB: Knowledge, Analytical

TOP: External audits

25. If the conceptual framework sets out the concepts that underlie the preparation and presentation of financial statements for external users, which of the following questions is the conceptual framework not attempting to answer?
- A. Who are the users of general-purpose financial reports?
 - B. Which entities should prepare special-purpose financial reports?
 - C. How should the elements of the financial statements be measured and displayed?
 - D. What are assets, liabilities, income, expenses and equity?

ANS: B PTS: 1 AACSB: Knowledge, Analytical

TOP: The conceptual framework

26. Objectives of a conceptual framework include:
- A. providing a defence against lobby groups.
 - B. fewer and more consistent Accounting Standards.
 - C. improved communication.
 - D. all of the above.

ANS: D PTS: 1 AACSB: Knowledge, Analytical

TOP: Objectives of a conceptual framework

27. Which of the following statements is incorrect?
- A. Compliance with the conceptual framework is non-mandatory in general purpose financial statements.
 - B. Compliance with Accounting Standards is mandatory in general purpose financial statements.

- C. Compliance with the conceptual framework is mandatory in general purpose financial statements.
- D. Accounting Standards are more specific than the conceptual framework.

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: The framework for setting accounting standards

28. Which of the following sets of entities are not likely to meet the definition of a reporting entity?
- A. Small proprietary companies, large proprietary companies and partnerships
 - B. Small proprietary companies and sole traders
 - C. Large proprietary companies, sole traders and partnerships
 - D. Small proprietary companies and large professional accounting practices

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: The Conceptual Framework

29. An example of a reporting entity is likely to be a:
- A. public company.
 - B. partnership.
 - C. family trust.
 - D. small proprietary company.

ANS: A PTS: 1 AACSB: Knowledge, Analytical
TOP: The Conceptual Framework

30. Which of the following are likely to be reporting entities?

- I. BHP Billiton
- II. The corner store
- III. An unincorporated business with 10 employees
- IV. A large proprietary company with over 500 employees and 200 creditors

- A. I only
- B. I and IV only
- C. II, III and IV only
- D. I, III and IV only

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

31. Which one of the following groups is not generally regarded as an external user of the accounting information of an enterprise?

- A. Employees
- B. Customers
- C. Management
- D. Lenders

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

32. FeelGood Limited has been set up specifically for the building of an inner-city women's refuge. When the building has been erected and becomes operational (estimated time four months), the company will be liquidated. Which basic assumption underlying the preparation of general-purpose financial reports will not apply in preparing the reports for FeelGood Limited?

- A. The business entity principle.
- B. The principle of duality.

- C. The going-concern principle.
- D. The period assumption.

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

33. Assets are best defined as a:
- A. resource owned by the entity as a result of current event, from which future economic benefits are expected to flow.
 - B. resource owned by the entity as a result of past event, from which future economic benefits are expected to flow.
 - C. resource controlled by the entity as a result of past event, from which future economic benefits are expected to flow.
 - D. resource controlled by the entity as a result of a future event, from which future economic benefits are expected to flow.

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

34. Which of the following is not a primary characteristic of the accounting definition of an asset?
- A. The capacity to provide benefits to the entity
 - B. Control but not necessarily ownership
 - C. Representing past events
 - D. The ability to be reliably measured

ANS: D PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

35. Which of the following is not an asset?
- A. Equipment
 - B. Accounts receivable
 - C. Accounts payable
 - D. Inventory

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

36. Which of the following elements does not require recognition criteria in order to decide whether it should be recognised in the financial statements?
- A. Assets
 - B. Revenues
 - C. Equity
 - D. Expenses

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

37. In terms of the conceptual framework, an asset is recognised on a balance sheet if it:
- A. is capable of reliable measurement and it is probable that the asset will be realised.
 - B. is owned by the entity and is capable of reliable measurement.
 - C. results from a past event and is owned by the entity.
 - D. provides future economic benefits.

ANS: A PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

38. Which one of the following is not an asset?

- A. Inventory
- B. Accounts receivable
- C. Revenue
- D. Cash

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

39. Which of the following is not a liability?

- A. Accounts payable
- B. Loan payable
- C. Investment by owner
- D. Unearned revenue

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

40. Which of the following is not an attribute of a liability?

- A. Present obligation to transfer resources to another entity.
- B. The transfer is unavoidable by the entity.
- C. The transfer results in reduced economic benefits to the entity making the transfer.
- D. The event creating the responsibility has not yet occurred.

ANS: D PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

41. Which of the following accounts is a liability?

- A. Interest Expense
- B. Interest Payable
- C. Interest Revenue
- D. Interest Receivable

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

42. Liabilities are:

- A. resources under an organisation's legal control.
- B. obligations owed by an organisation to its creditors.
- C. the amount of investment made by owners in a business.
- D. the profits earned by a corporation.

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

43. Which of the following accounts is not a liability?

- A. Wages Payable
- B. Prepaid Rent
- C. Accounts Payable
- D. Notes Payable

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

44. Revenues result when a business:
- A. creates resources by selling goods or services.
 - B. borrows money.
 - C. receives money from owners of the business.
 - D. pays its employees.

ANS: A PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

45. Expenses result when a business:
- A. pays a supplier for goods purchased last month.
 - B. consumes resources during the production and sale of goods or services.
 - C. distributes money to owners.
 - D. hires employees.

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

46. Torger Associates sold business services to another organisation for cash. As a result, Torger's assets increased. Which accounting term best describes the concept involved in the other part of this transaction?
- A. Liability
 - B. Revenue
 - C. Financing activity
 - D. Dividends

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

47. Which of the following types of entities would not fit the category of a profit-making entity?
- A. Sole proprietorship
 - B. Partnership
 - C. Charitable institution
 - D. Company

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: Types of organisations

48. The *present obligation* to make a future sacrifice that is an essential criteria of the definition of a liability under the IASB *Conceptual Framework*:
- A. can only arise from legal obligations.
 - B. may arise out of moral or constructive obligations.
 - C. meets the definition of an expense.
 - D. may vary in different countries.

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

49. According to the Corporations Act, an external auditor must:
- A. have appropriate tertiary qualifications.
 - B. satisfy ASIC that he/she is capable of performing the duties of an auditor.
 - C. satisfy ASIC that he/she is a fit and proper person to be registered as an auditor.
 - D. all of the above.

ANS: D PTS: 1 AACSB: Knowledge, Analytical
TOP: External audits

50. The role of an auditor is to:
- A. review accounting systems and internal controls.
 - B. detect fraud.
 - C. ensure that every transaction is correct.
 - D. ensure that there is no fraud and that all transactions are correct.

ANS: A PTS: 1 AACSB: Knowledge, Analytical
TOP: External audits

51. The auditor's report:
- A. expresses an opinion as to the truth and fairness of the financial statements.
 - B. states that the reporting entity is in a sound financial position.
 - C. is prepared by internal auditors.
 - D. includes forecasts of future profits.

ANS: A PTS: 1 AACSB: Knowledge, Analytical
TOP: External audits

52. The relationship between the task undertaken by auditors and the understanding of the users is called:
- A. the experience gap.
 - B. the auditor's report.
 - C. the expectations gap.
 - D. the information gap.

ANS: C PTS: 1 AACSB: Knowledge, Analytical
TOP: External audits

53. What is the audit expectation gap?
- A. The auditors' ensuring that financial statements are prepared in accordance with accounting standards.
 - B. The difference between what an auditor is required to do and what is expected by users.
 - C. The auditors' ensuring that they meet the requirements of an audit.
 - D. The auditors' providing a true and fair view of the financial statements.

ANS: B PTS: 1 AACSB: Knowledge, Analytical
TOP: External audits

SHORT ANSWER

1. What is a conceptual framework from the perspective of financial reporting?

ANS:

The Financial Accounting Standards Board (FASB) in the US defined the conceptual framework as a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards and that prescribes the nature, function and limits of financial accounting and reporting.

The IASB *Conceptual Framework* sets out the concepts that underlie the preparation and presentation of financial statements for external users. The framework establishes that the purpose of financial reporting is to provide external users with useful information.

PTS: 1 AACSB: Knowledge, Analytical
TOP: What is a conceptual framework?

2. Describe four objectives of a conceptual framework.

ANS:

Four objectives of a conceptual framework:

1. *Fewer accounting standards.* A conceptual framework is designed to enable the resolution of accounting problems faced by the preparers of general purpose reports, thus reducing the need for an accounting standard to be issued for every occasion.
2. *More consistent accounting standards.* A conceptual framework also guides the development of accounting standards by regulatory authorities. Thus, the resulting standards should be consistent with each other, leading to improved reporting quality.
3. *Improved communication.* Improved communication between stakeholders (regulators, preparers, and users) results from the fact that the concepts that comprise the conceptual framework, including the fundamental concepts of the financial statements – assets, liabilities, income and expenses – are common to all parties.
4. *Defence against politicisation.* The politicisation of the standard setting process is reduced, as standards are grounded in the conceptual framework i.e., the framework acts as a buffer against the self-serving interests of various stakeholders involved in the standard setting process.

PTS: 1 AACSB: Knowledge, Analytical

TOP: The objectives of a conceptual framework

3. Outline the nature and purpose of general-purpose financial reports.

ANS:

Nature of GPFRs: typically statements of comprehensive income, financial positions, changes in equity, cash flows and the notes.

Purpose of GPRs: to meet the common financial information needs of a diverse set of external users who do not have the authority to have their specific information needs met.

PTS: 1 AACSB: Knowledge, Analytical

TOP: The conceptual framework

4. Under what circumstances does an entity represent a ‘reporting entity’ for the purposes of the Australian conceptual framework?

ANS:

A reporting entity is one for which there are users who rely on the (general purpose) financial statements as their major source of financial information about the entity.

PTS: 1 AACSB: Knowledge, Analytical

TOP: The conceptual framework

5. Describe the purpose of the external auditor in financial reporting.

ANS:

The purpose of the external auditor is to express an independent opinion on whether the financial statements provide a true and fair view of the company's financial position, performance and cash flows. That is, the external audit is designed to add credibility to general purpose reports.

PTS: 1 AACSB: Knowledge, Analytical

TOP: External audits

6. What is the expectation gap associated with the external audit?

ANS:

The expectation gap refers to the gap between user expectations' of the duties and responsibilities of the external auditor and the role fulfilled by the auditor in fact.

PTS: 1 AACSB: Knowledge, Analytical

TOP: External audits

PROBLEMS

1. Explain what is meant by the term *limited liability* as it relates to the shareholders of a corporation; and explain why shareholders are able to gain the benefit of limited liability whereas sole traders cannot.

ANS:

The limited liability of shareholders refers to the fact that the members' liability for the debts of the company is limited to the issue price of the shares held. Shareholders are able to gain the benefit of limited liability because a corporation is a separate legal entity. The debts of a company are at law those of the company, not the shareholders. However, in the case of a sole trader, the business is not a separate legal entity from the sole traders. Legally, the debts of a sole tradership are those of the owner, and, the assets of the business part of the individual's pool of resources all of which are available to settle the debts.

PTS: 1 AACSB: Knowledge, Analytical

TOP: Types of organisations

2. Describe three advantages of a company over a partnership and a sole trader.

ANS:

- Separate legal entity – from the owners, which, in the case of limited liability companies, leads to reduced risk for equity holders.
- Limited liability – by shares or guarantee, whichever applies.
- Greater access to capital (equity and debt).
- Ease of transfer of ownership.
- Absence of mutual agency, with respect to partnerships.
- Professional management.
- Continuous existence.

PTS: 1 AACSB: Knowledge, Analytical

TOP: Types of organisations

3. R2 and E2 have been working as employees in the fashion industry. They are considering forming a partnership designing fashion clothing, trading under the RE2 label. Advise the individuals on the advantages and the disadvantages of forming a partnership.

ANS:

Advantages:

- Ease of formation, compared to a company.
- Limited rules and regulation, compared to a company.
- Access to capital and expertise greater than in the case of sole trader.
- There may be income taxation advantages, arising out of the sharing of profits.

Disadvantages

- Limited life – a partnership can be brought to an end at any time through, for example, the death, withdrawal or bankruptcy of a partner.
- Unlimited liability – each partner is jointly and severally liable for the debts of the business, and that liability is unlimited.
- Mutual agency – each partner is an agent of the other(s) when acting within the scope of the normal operations of the business. Mutual agency is essential to the efficient functioning of the business, but also has serious implications vis-a-vis each partner's liability under the partnership.

PTS: 1 AACSB: Knowledge, Analytical

TOP: Types of organisations

4. *Required:*

- (a) Does the deposit of silver meet the definition of an asset to Vanessa according to the IASB *Conceptual Framework*? Why?/Why not?
- (b) Under what circumstances may the deposit of silver be recognised in the balance sheet of Vanessa according to the IASB *Conceptual Framework*?

ANS:

- (a) The metal deposit would appear to meet the three essential characteristics of the definition of an asset: future economic benefits (viability/profitability); control (the deposit may be deployed in the pursuit of the company's objectives and the company has the exclusive legal right to mine vis-a-vis regulating/denying the access of others); and the past event (discovery).
- (b) Recognition criteria: The case study details suggest that it is probable that the future economic benefits will flow to the entity. The use of the present value measurement method may raise the question/discussion of the reliability of the value that has been placed on the asset, but the case details are not definitive vis-a-vis the reliability of the method.

PTS: 1 AACSB: Knowledge, Analytical

TOP: The conceptual framework

5. Vanessa raised a \$15,000,000 loan to fund the exploration that led to the discovery of the deposit of silver. Discuss whether the loan meets the definition and recognition criteria of a liability to Vanessa during the term of the loan, according to provisions of the IASB *Conceptual Framework*.

ANS:

The \$15,000,000 loan clearly meets the definition and recognition criteria. Vanessa has an existing legal obligation to another entity arising out of a past event. It is probable that the loan will lead to an outflow (sacrifice) of economic benefits; and the figure can be measured reliably.

PTS: 1 AACSB: Knowledge, Analytical
TOP: The conceptual framework

ESSAY

1. The opportunity for interested parties to participate in the development of accounting standards lies in the 'due process'. Discuss.

ANS:

Accounting standards refer to regulations that are to be followed by preparers in the preparation of general purpose financial statements, where applicable. The standards deal, for example, with issues such as accounting for inventory, property, plant and equipment, long-term construction contracts, agriculture assets and leases.

The development of the standards takes place within a regulatory framework, which includes a 'due process'. The due process reflects a participatory (democratic) approach to the development of regulation. Therefore, it should engender greater stakeholder 'ownership' and acceptance of the final product, including a greater willingness to comply on the part of the regulated (preparers). The due process is also an important conduit of communication between the regulatory authority and stakeholders. Diversity of opinion has the capacity to enhance the quality of the final product. The process also has the capacity to allow the regulatory authority to gain a measure of the implications that proposed regulation may hold for wealth effects.

PTS: 1 AACSB: Knowledge, Analytical, Communication
TOP: The standard setting process

2. Describe the role that the following organisations play in relation to Australian accounting standards:
 - (i) the Financial Reporting Council; and
 - (ii) the Australian Accounting Standards Board

ANS:

- (i) Financial Reporting Council (FRC). The organisation has the oversight responsibility of the AASB. Specifically, the FRC is responsible for the priorities, business plan, budget and staffing arrangements of the AASB. However, it is not able to influence the AASB's technical deliberations.
- (ii) Australian Accounting Standards Board. The organisation's responsibilities, which are specified in S227 (a) of the Australian Securities and Investments Commission Act, include the following:
 - developing a conceptual framework, not having the force of an accounting standard, for the purpose of evaluating proposed accounting standards.
 - developing and issuing accounting standards which have the force of law.
 - formulating accounting standards for other purposes
 - participating in and contributing to the development of a single set of accounting standards for worldwide use.

PTS: 1 AACSB: Knowledge, Analytical, Communication
TOP: The framework for setting accounting standards.