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FINACIAL REPORTING REGULATION IN PRACTICE

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Abstract

Financial reporting is the branch of accounting that deals with the preparation of financial statements. These statements provide information about the financial performance and financial position of the business to which they relate and are of value to a wide range of user groups. More specifically, the term "financial reporting is most often used to refer to the preparation of financial statements for a limited company". In this case, the main users of the statements are the company's shareholders. However, the information contained in the financial statements may also be of use to other user groups such as lenders, employees and the tax authorities.

The purpose of this paper is to explain the rules which govern the preparation of financial statements for organizations which comply with international standards. This paper introduces the regulatory framework within which financial statements are prepared.

By the end of this paper, the reader should be able to:
- List the main sources of accounting regulations and explain the need for regulation
- Explain the term "generally accepted accounting practice" (GAAP)
- Outline the structure and functions of the International Accounting Standards Board (IASB) and its associated bodies
- Explain the purpose of an accounting standard and list the main steps in the standard-setting process adopted by the IASB
- Outline the structure of an international financial reporting standard or international accounting standard
- Explain the main features of IFRS1 First-time Adoption of International Financial Reporting Standards

1. INTRODUCTION

Small business organizations are usually managed by their owners. This is generally the case for a sole trader, where the business is run by a single owner-manager, and for partnerships, where the business is owned and managed by its partners. Similarly, small private limited companies are often managed by their

shareholders, who might all be members of the same family. In these circumstances, the owner or owners of the business clean considerable amounts of financial information from their day-to-day involvement in managing its affairs and so do not depend solely upon formal financial statements to provide them with this information.[1]

In contrast, large business (which are usually limited companies) are generally owned by one group of people but are managed by a different group. A large public company is owned by its shareholders, of whom there may be many thousands, but is managed by a small group of directors. Although some of the shareholders may also act as directors, it is likely that the large majority of the shareholders have no direct involvement in managing the company which they own. Such shareholders are almost entirely reliant upon the company's financial statements for information regarding the company's financial performance and position and to help them to determine whether or not the company is being properly managed. Other external user groups (such as the company's creditors) are also dependent to a large extent upon the information contained in financial statements when trying to make economic decisions relating to the company.[2]

If the form and content of financial statements were not regulated, it would be possible for incompetent or unscrupulous directors to provide shareholders and other users with financial statements which gave a false or misleading impression of the company's financial situation. This would inevitably cause users to make poor economic decisions and so undermine the whole purpose of preparing financial statements. Therefore it is vital, especially in the case of larger companies, that financial reporting should be subject to a body of rules and regulations.

The rules and regulations which apply to financial reporting may be collectively referred to as the "regulatory framework". In practice, most of this framework applies only to companies, but it is important to realise that financial reporting regulations could be made in relation to any class of business entity. Indeed, the international standards which are the subject of this paper generally refer to "entities" rather than "companies" However, it may be assumed for the remainder that we are dealing primarily with financial reporting by companies. The regulatory framework which applies to financial companies consists of the following main components:

a) Legislation
b) Accounting standards
c) Stock exchange regulations

Each of this is explained below.

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[1] Glazer, M (1983) Ten whistleblowers and how they fared, The hasting Center Report, 13 (6) pp. 33-41

[2] Alan Melville (2009) International financial reporting, a practical guide, Prentice Hall, pp. 4

1.1 Legislation

Most of the developed countries of the world have enacted legislation which governs financial reporting by limited companies. This legislation does of course differ from one country to another. In the UK, for example, the Companies ACT 2006 contains rules relating to such matters as:

- The accounting records which companies must keep
- The requirement to prepare annual accounts (i.e. financial statements)
- The requirement that these accounts must give a “true and fair view”
- The requirement that the accounts must be prepared in accordance with either international standards or national standards
- The circumstances in which group accounts must be prepared
- The circumstances in which an audit is required
- The company’s duty to circulate its accounts to shareholders and to make the accounts available for public inspection.

Some of these rules have arisen as a result of European Union (EU) Directives and this is also true of the legislation in other member states of the EU.

1.2 Accounting standards

With legislation generally sets out the broad rules with which companies must comply when preparing financial statements, detailed rules governing the accounting treatment of transactions and other items shown in those statements are laid down in accounting standards. Many of the developed countries of the world have their own standard-setting bodies, each of which is responsible for devising and publishing accounting standards for use in the country concerned. In the UK this is the Accounting Standard Board (ASB). The USA has a Financial Accounting Standards Board (FASB) and there are standards board in other countries such as Germany, Japan, Australia etc.

In recent years, the increasing globalization of business has fuelled the search for a single set of accounting standards. These standards would apply throughout the world and would greatly improve the consistency of financial reporting. To this end, the International Accounting Standards Board (IASB) has developed and is continuing to develop a set of international standards which it hopes will attain global acceptance. A major step forward in this process was taken in 2002, when the EU issued a regulation requiring all listed companies in the EU to prepare their group accounts in accordance with international standards as from 1 January 2005.[3]

Most of the remainder of this paper is concerned with the international standards and an introduction to the work of the IASB is given later.

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[3] Beaver, W (1981), Financial reporting on Accounting Revolution, Englewood Cliffs, NJ: Prentice – Hall

1.3 Stock exchange regulations

A company whose shares are listed (or quoted) on a recognized stock exchange must comply with the regulations of that stock exchange, some of which may relate to the company's financial statements. A stock exchange may, for example, require its member companies to produce financial statements more frequently than required by law (e.g. to publish interim financial reports at quarterly of half-yearly intervals) or to provide a more detailed analysis of some of the items in its financial statements than is required by law or by accounting standards.

2.GENERALLY ACCEPTED ACCOUNTING PRACTICE

The term "generally accepted accounting practice" (GAAP) refers to the complete set of regulations from all sources which apply within a certain jurisdiction, together with any general accounting principles or conventions which are usually applied in that jurisdiction even though they may not be enshrined in regulations. Since accounting rules and regulations currently differ from one country to another, it is correct to use terms such as "UK GAAP", "US GAAP", and so forth. At present, there is no internationally accepted set of accounting regulations and principles but the IASB is working towards that end and is trying to achieve convergence between the various regulations which are in force through-out the world. A distinction is sometimes drawn between big GAAP and little GAAP, as follows:

a) The term "big GAAP" refers to the accounting regulations which apply to large companies. The financial affairs of these companies can be very complex and therefore the regulations which comprise big GAAP need to be correspondingly complex. Some of the international standards described in this paper appear to have been written mainly with large companies in mind.
b) The term "little GAAP" refers to the simpler accounting regulations which apply to smaller companies. In the UK, for example, small companies may choose to adopt the Financial Reporting Standard for Smaller Entities (FRSSE) rather than complying with accounting standards in full.

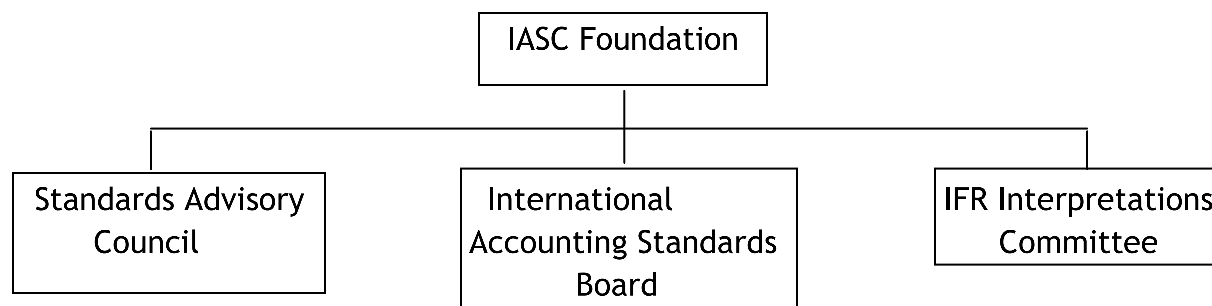
At the international level, the IASB has published a draft of an international financial reporting standard for "private entities" This draft standard is essentially a simplified version of the full set of international standards and is intended for use by small and medium-sized entities which are not listed on a stock exchange. It was expected that the finalized standard would be published in mid-2009.

3. THE INTERNATIONAL ACCOUNTING STANDARDS BOARD

International standards are developed and published by the International Accounting Standards Board (IASB) which was formed in 2001 as a replacement for the International Accounting Standards Committee (IASC). Standards published by the IASB are known as International Financial Reporting Standards (IFRSs). Standards which were originally published by the IASC are known as International Accounting Standards (IASs) Many of the IASs, are still in force, since they were adopted by the IASB on its inception.

The IASB consist of fourteen members (twelve full-time and two part-time) chosen for their technical expertise and practical experience, However, the number of IASB members were increase to sixteen by 1 July 2012 (of whom up to three may be part-time) and these members were selected in such a way that a broad geographical balance is maintained on the Board.

The IASB is responsible to the trustees of the International Accounting Standards Committee Foundation (IASC Foundation) as shown in the following diagram:



The constitution of the IASC Foundation states that its objectives are as follows:

a) To develop, in the public interest, a single set of high-quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
b) To promote the use and rigorous applications of those standards;
c) In fulfilling the objectives associated with (a) and (b), to take appropriate account of the special needs of small and medium-sized entities and emerging economies
d) To bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.

The IASB's Preface to International Financial Reporting Standards states that these are also the objectives of the IASB.[4]

The activities of the IASC Foundation are directed by twenty-two Trustees who are appointed by a Monitoring Board and who are drawn from a diversity of geographical and professional backgrounds. The Trustees are responsible for appointing the members of the IASB and the other bodies shown in the above diagram and for establishing and maintaining the necessary funding for their work. The Trustees are also responsible for monitoring the effectiveness of the IASB. Financial support for the IASC Foundation's activities is received from:

a) Major accounting firms

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[4] Boyle, R D. (1990) A review of whistleblower protections and suggestions for change, Labour Law Journal, 41 (12) pp 821-30

b) Private financial institutions and industrial companies throughout the world
c) Central and development banks and other international and professional organizations.

The monitoring Board comprises high-level representatives of public authorities such as the European Commission and the US Securities and Exchange Commission. The Trustees and required to make an annual written report to the Monitoring Board.

The Standards Advisory Council (SAC) provides a forum for participation by organizations and individuals with an interest in international financial reporting. The SAC backgrounds and has the following objectives:

a) To offer advice to the IASB with regard to its agenda and priorities
b) To inform the IASB of Council members' views on standard-setting projects
c) To offer advice to the IASB or to the Trustees.

The Chairman of the SAC cannot be a member of the IASB or its staff.

The main role of the International Financial Reporting Interpretations Committee (IFRIC) is to interpret the application of international standards. IFRIC also provides timely guidance on financial reporting matters which are not specifically addressed in the standards. IFRIC has fourteen voting members and a non-voting Chair.

IFRIC was established in 2002 as a replacement for the Standing Interpretations Committee (SIC).

The IASB develops standards by means of a "due process" which involves accountants, users of financial statements, the business community, stock exchanges, regulatory authorities, academics and other interested individuals and organizations throughout the world. The main steps in this process (which are listed in the Preface to International Financial Reporting Standards) are as follows:

- Identification and review of all the issues associated with the topic concerned
- Consideration of the way in which the IASB's conceptual framework applies to these issues
- A study of national accounting requirements in relation to the topic and an exchange of views with national standard-setters
- Consultation with the SAC the advisability of adding this topic to the IASB's agenda publication of a discussion document for public comment
- Consideration of comments received within the stated comment period
- Publication of an exposure draft for public comment
- Consideration of comments received within the stated comment period
- Publication of the standard

If (as at present) the IASB has fewer than sixteen members, publications of an international standard requires the approval of at least nine of those members. Otherwise, the approval of at least ten members is required.

The Preface states that IFRSs and IASs are designed to apply to the general-purpose financial statements and other financial reporting of all profit-oriented entities, whether these are organized in corporate form or in other forms. For this reason, the standards refer to “entities” rather than companies. The word “entity” is also used in this paper, although in practice the international standards apply principally to companies.[5]

4. THE STRUCTURE AND PURPOSE OF AN INTERNATIONAL ACCOUNTING STANDARDS

An IFRS or IAS consist of a set of numbered paragraphs and is typically made up of some or all of the following sections:

- Introduction
- Objectives and scope of the standard
- Definitions of terms used in the standard
- The body of the standard
- Effective date and transitional provisions
- Application guidance
- Approval by IASB and any dissenting opinions by IASB members.

A standard may be accompanied by a Basis for Conclusions, which is not part of the standard itself but which sets out the considerations which were taken into account when the standard was devised. There may also be implementation guidance and/or illustrative examples.

The main purpose of accounting standards (whether national or international) is to reduce or eliminate variations in accounting practice and to introduce a degree of uniformity into financial reporting. In particular, accounting standards usually set out requirements with regard to the recognition, measurement, presentation and disclosure of transactions and other items in financial statements. The main advantages of this standardization are as follows:

a) Faithful representation. If the preparers of financial statements are obliged to comply with a set of accounting standards, it becomes more likely that the information given in the statements will provide a complete and faithful representation of the financial performance and financial position of the organization concerned. Standards help to ensure that financial reporting is free from bias and “creative accounting” practices are outlawed.
b) Comparability. It is important that users should be able to compare the financial statements of an organization over time so as to identify trends in its financial performance and position. It is also important that users should be able to compare the financial statements of different organizations and assess their relative strengths and weaknesses. Such comparisons will not be meaningful unless all of the financial statements concerned have been drawn up on a consistent basis. This is much more likely to be the case if accounting standards have been observed.

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[5] Near J.P (1989) Whistleblowing:encourage it. Business Horizons 32 (1) pp.2-7

A more detailed explanation of these and certain other desirable characteristics of the information provided in financial statements is given in the IASB's conceptual framework.

It is the view if the IASB that standards should ensure that like items are accounted for in a like way and that unlike items are accounted for in different ways. Therefore the standards issued by the IASB do not generally permit any choice of accounting treatment. Some of the IAS's which were adopted by the IASB on its inception do allow a choice of accounting treatment but the IASB has reconsidered (and will continue to reconsider) the items for which a choice of treatment is permitted, with a view to reducing the number of choices available or eliminating choice altogether.[6]

It could, of course, be argued that accounting standards should allow some degree of flexibility and that compliance with the single accounting treatment permitted by a standard might sometimes be inappropriate. The IASB takes the view that this situation is very unlikely to occur. However, international standard IAS1 allows an entity to depart from the requirements of a standard in the "extremely rare circumstances" in which compliance would prevent the financial statements from faithfully representing transactions and other items.[7]

5. WORLDWIDE USE OF INTERNATIONAL STANDARDS

As stated above, the goal of the IASC Foundation is to develop a set of global accounting standards, promote their use and bring about convergence between national and international standards. This goal has not yet been achieved in full but the worldwide influence of international standards has increased significantly since the IASB was formed and seems likely to continue to increase.[8]

At present, nearly ninety countries require listed companies to comply with international standards when preparing their group accounts. These countries include all EU members together with countries such as Australia, South Africa and Hong Kong. More than twenty other countries, including Russia, permit (but do not require) the use of international standards when preparing the group accounts of listed companies. Furthermore:[9]

a) Canada and India have both decided to adopt international standards by 2011
b) A project has been established to reduce differences between Japanese GAAP and international standards
c) China has announced its intention of converging its own national standards with international standards

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[6] Badaracco J.L (1997) Defining Moments, Harvard Business Review,42 pp 132-33
[7] Coase, Ronald (1937), The nature of the firm, Economica, 4, 386-405
[8] Daynard, R A, Bates C. and Francey, N. (2000) Tobacco litigation worldwide, British Medical Journal, 8 January,pp. 111-13
[9]Johnson, S A, Moorman T.C and Sorescu S.M. (2009) A reexamination of corporate governance and equity prices with updated and supplemental results. The Review of Financial Studies 22 (11) pp 4753-786

d) The USA (which has been reluctant to abandon its own standards in favour of international standards) has now published a "roadmap" for convergence between US GAAP and international standards, envisaging the possible adoption of international standards in the USA between 2014 and 2016.

Perhaps understandably, international standards have made rather less impact in relation to unlisted private companies, which tend to have straightforward financial affairs and to operate in one country only. Nonetheless, the use of international standards for such companies is mandatory in some countries and is permitted in others (e.g. UK). The situation is fluid, but the development by the IASB of an IFRS for use by private entities may eventually encourage more countries to require compliance with international standards for all companies, whether listed or unlisted. [10]

6. FIRST – TIME ADOPTION OF INTERNATIONAL STANDARDS

In June 2003, the IASB issued IFRS1 First-time Adoption of International Financial Reporting Standards. A revised version of the standard was issued in November 2008. The objective of IFRS1 is to ensure that an entity's first financial statements that comply with international standards should contain high-quality information that:[11]

- Is transparent for users and comparable for all periods presented
- Provides a suitable starting point for accounting under international standards
- Can be generated at a cost that does not exceed the benefits to users.

This standard uses the term "IFRS" to refer to international standards in general (including IASs) together with interpretations originated by IFRIC or by its predecessor. The main features of IFRS1 are as follows:[12]

a) An entity's "first IFRS financial statements" are defined as the first financial statements in which the entity adopts international standards and makes an explicit and unreserved statement of compliance with those standards.
b) The "first IFRS reporting period" is defined as the reporting period covered by the first IFRS financial statements.
c) The "date of transition of IFRS" is defined as the beginning of the earliest period for which an entity presents comparative information in its first IFRS financial statements. Most sets of financial statements cover a period of one year and give comparative information for the previous year. So the date of transition to IFRS is normally the date which falls two years before the end of the first IFRS reporting period. When first adopting international standards, an entity must prepare an "opening IFRS statement of financial position" as the date of transition to IFRS. This is the starting point for

[10] Parmerlee. MA Near J.P and Jensen T.C (1982) Correlates of whistleblowers perceptions of organizational retaliation. The administrative Science Quarterly 27 (1) pp 17-34
[11] Buckley, C Cotter D, Hutchinson, M and O' Leary C (2010) Empirical evidence of lack of significant support for whistleblowing, Corporate Ownership Control & (3) Spring pp.275-83
[12] Applebaum, S.H and Mousseau, H (2006) Whistleblowing: international implications and critical cases, The Journal of the American Academy of Business, Cambridge, 10 (1) pp &-13

accounting in accordance with international standards. The opening IFRS statement of financial position must:[13]

(i) Recognize all assets and liabilities whose recognition is required by international standards, but not recognize items as assets or liabilities if this is not permitted by international standards

(ii) Reclassify items which were recognized as one type of asset or liability under previous GAAP but which are classified as a different type of asset or liability under international standards

(iii) Apply international standards in measuring all recognized assets and liabilities.

Note that the term "statement of financial position" has now replaced the term "balance sheet" throughout the international standards.[14]

a) The same accounting policies must be used in the entity's opening IFRS statement of financial position and in all periods presented in the first IFRS financial statements (i.e. the first IFRS reporting period and the comparative period or periods). These accounting policies must comply with all international standards in effect at the end of the first IFRS reporting period, even if some of those standards were not in effect at the date of the opening IFRS statement of financial position or during the comparative period(s).[15]
b) The first IFRS financial statements must include the following reconciliations:

(i) A reconciliation of equity (share capital and reserves for a company) as reported under previous GAAP with equity re-calculated under international standards, for the date of transition to IFRS and for the end of the last period in which the entity reported under previous GAAP

(ii) A reconciliation of total comprehensive income for the last period in which the entity reported under previous GAAP with total comprehensive income as it would have been calculated under international standards.

Note that the term "total comprehensive income" refers to an entity's profit or loss together with certain other gains or losses such as revaluation gains.

(a) IFRS1 grants limited exemptions from some of its requirements in cases where the cost of compliance would exceed the benefits to users of the financial statements.[16]

[13] Miller A.D.(2010) Book review, The British accounting Review 42 pp.132-33
[14] Conford A (2004) Enron and internationally agreed principles for corporate governance and the financial sector, G-24 Discussion Paper Series, No 30 June
[15] Wall Sreet Journal (2002) Elan's revenue gets a quick lift from its complicated accounting 29 January
[16] Griffiths I (1986) Creative accounting London: Unwin Hyman Limited

SUMMARY

- The regulatory framework within which the financial statements of companies are prepared consists of a mixture of legislation, accounting standards and (where applicable) stock exchange regulations.
- Legislation generally sets out the broad rules with which companies must comply when preparing their financial statements. Accounting standards provide detailed rules regarding the accounting treatment of transactions and other items.
- The increasing globalization of business has led to the establishment of the IASB and the development of international standards. These standards have not yet achieved worldwide acceptance but their influence has increased greatly in recent years.
- The term “generally accepted accounting practice” GAAP refers to the complete set of accounting regulations and principles which are usually applied within a certain jurisdiction.
- The IASB is the standard-setting body of the IASC Foundation. The SAC offers advice to the IASB with regard to its agenda and priorities. IFRIC is responsible for the interpretation of international standards and for providing timely guidance on matters not specifically addressed in the standards.
- The standard-setting process adopted by the IASB involves the publication of a discussion document and an exposure draft (with consideration of comments received at each stage) before the final standard is published.
- The main purpose of accounting standards is to reduce or eliminate variations in accounting practice and to introduce a degree of uniformity into financial reporting.
- IFRS First – time Adoption of International Financial Reporting Standards sets out the produce which must be followed when an entity adopts international standards for the first time.

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