CIMA F1 Course Notes

Chapter 1

Regulation of Accounting and Financial Reporting

1. Regulation of published accounts

Financial Statements

The annual report and financial statements (or published accounts) provide a range of information about the performance of the business, particularly its financial performance. The key statements of financial performance are:

- **The financial position of the business**, the Balance sheet, showing the assets (e.g. buildings, materials, and cash) and liabilities (e.g. bank loans and amounts owed to suppliers) of the business.

- **The income statement, or Profit and Loss account** – showing the income and costs over a period of time (often a year).

- **Cash flow statements**, showing the cash usage of the business over a period of time (often a year).

- **Notes to the accounts** – providing more detailed accounting information.

Accounts often also include a range of other information that the company may wish to provide to external parties such as:

- **Chairman's statements**, providing an overview of the business and its recent performance

- **Strategic review**, focused on the business' strategic performance and future plans.

- **Sustainability/environmental review**

- **Governance review/statement**

The need for regulation of financial statements

A number of different categories of stakeholder are interested in reading the annual report and financial statements of a company. These include:

- shareholders;
- employees;
- creditors;
- banks and other loan creditors;
- investors;
- tax authorities;
- other government departments; and
- the general public.

Potential investors may want to compare the performance of the business with that of other similar enterprises within the same industrial sector or more widely with other investments. They need to ensure that they can interpret the information contained in the financial statements and find meaningful information to help them make an investment decision.

Financial statements therefore need to be:

- Reliable;
- Transparent;
- Consistent; and
- Comparable.

Investors and other users must be confident that financial statements of different companies are comparable. This means **that there must be some regulation of financial statements** to ensure a level of consistency across the board that makes comparison of the financial performance of different companies meaningful to the various stakeholders. Transparency and full disclosure of relevant information are important to all users.

Regulatory regimes differ from country to country

From country to country, regulatory regimes differ. This can be for a number of reasons.

Differences in law and tax

Differences in national laws give rise to some differences in the way financial statements are put together. Each country can have its own company law or tax regimes meaning that each country will need a different regulatory approach. In systems such as those on the continent of Europe much of the detail of these regulations is contained in the national law.

The nature of the political system may affect the degree of control exerted by the government over accounting information and the extent to which different factors need to be disclosed. For example, policies pursued by the government on the environment may lead to a requirement for companies to disclose the impact of their business on the countryside or to make detailed disclosures in respect of carbon emissions.

History and culture

The general culture of the country, and in particular the business culture, may also affect disclosure requirements. Countries with highly developed capital markets may require more information that will be useful to potential investors on those markets. This information will need to be made publicly available to satisfy the demands of potential investors for sufficient information to enable them to make realistic investment decisions.

The nature of the shareholding public

Different countries tend to have different types of shareholders. In countries like the UK or US the majority of shareholders are large institutions, while elsewhere there can be more concentrated ownership with more owner involvement in management. In many Spanish speaking countries and many parts of Asia more large companies are owned by families or individuals. There may be greater requirements for accountability where a company is owned by a large number of investors rather than by a family or a small group of individuals. As such, these countries are likely to require a higher level of regulation.

Problems with differences in accounting requirements

Different accounting policies in respect of items such as financial instruments, leasing, foreign currency or intangible assets can lead to very different accounting results which makes it difficult for **investors to interpret and compare** results.

The differences are also an **obstacle to trade** because they make it more difficult for companies to begin trading in other countries. A multinational group of companies has a much greater administrative burden owing to this disparity between national accounting requirements. The multinational must produce reports in different countries on the basis of different requirements.

For multinational companies this creates the following problems:

- Financial statements may need to be prepared on a different basis in different countries.
- Difficulties for the company's investors to interpret and compare results.
- Greater administrative burden and compliance costs.
- A potential obstacle to expanding to new markets due to potential bureaucracy.
- Difficult to fairly assess potential companies to acquire during overseas expansion programmes.

2. Elements of a framework for published accounts

Regulatory frameworks

Local regulatory frameworks

The regulatory framework within a particular country includes:

- The accounting requirements of the **national law.**

- The **accounting standards** applying in that jurisdiction, as set by and monitored by the local accounting regulators

- Accounting requirements laid out by that countries **stock exchange** as required for companies wanting listed on that stock exchange. These requirements may aim to help potential investors make comparisons between different companies listed on the exchange. There may also be requirements in respect of disclosure of the performance of past years so that potential investors can look at the performance of the same company over a number of years.

International regulation

In addition to local regulation there will be an international dimension consisting of:

- the requirements of relevant international accounting bodies;
- international financial reporting standards; and
- a conceptual framework developed at an international level.

The extent of use of international accounting standards varies from country to country. In some countries international accounting standards have been adopted as the local standards. In others a choice can be offered, and often larger companies may elect to use international accounting standards

Countries such as the UK also have to take account of international organisations and their regulatory requirements. The European Union (EU) for example issues Directives that must be implemented by its member states. Requirements in respect of companies listing on a stock exchange are influenced by the International Organization of Securities Commissions (IOSCO). In addition to this the influence of international accounting standards is increasing.

Gradual approach to international convergence

The process of moving to the adoption of international accounting standards generally involves a process of transition and adaptation for companies and governments.

Although the policy of adopting international accounting standards is convenient to implement it may lead to problems owing to a disparity between the requirements of the international standards and the traditions and level of development of the country using them.

A gradual approach to convergence is often preferable as it avoids some of these problems. Some countries are moving gradually to align their national standards with international accounting standards. This alignment needs to be gradual enough for businesses to have time to prepare for the transition.

Generally Accepted Accounting Practise (GAAP)

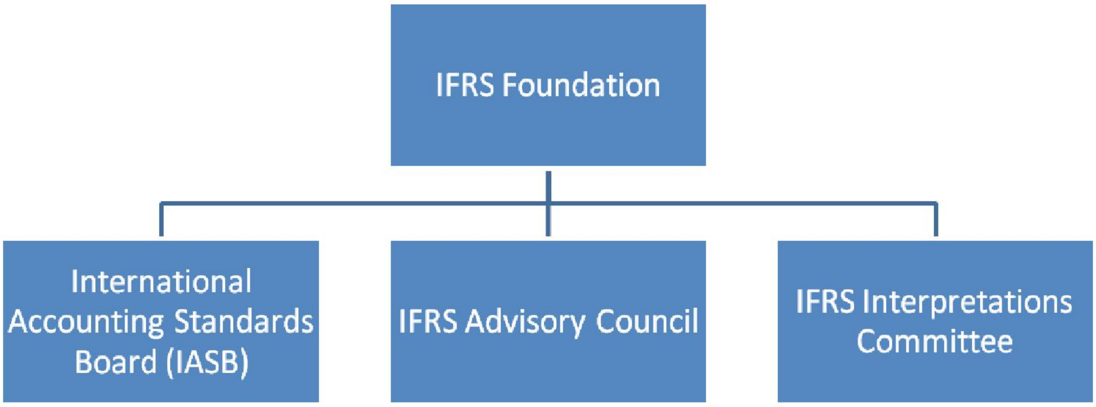
The accounting practice prevailing in a particular country at any time is referred to as the **Generally Accepted Accounting Practice (GAAP)**. This term is employed to describe the accounting rules, procedures and practices used in a country and is therefore more detailed than just the sum of the accounting standards used in that country. The GAAP also includes other regulations applicable in the jurisdiction and will therefore be different in different countries. The GAAP will also change over time within the same jurisdiction.

Conceptual Framework

Generally the process of developing accounting standards occurs against the backdrop of a conceptual framework for accounting. These outline broad principles to be used in accounting (e.g. qualities such as prudence, ‘substance over form’, or the ‘going concern’ principle).

For example the UK has developed a conceptual framework to guide the development of accounting standards. In some countries the conceptual framework developed by the International Accounting Standards Board has been adopted as the local framework.

3. International Accounting Standards Board (IASB)



IFRS Foundation

IFRS Foundation

The IFRS Foundation is the body given the responsibility of **developing global accounting standards** to ensure transparency and comparability in published financial statements.

The IFRS Foundation also has the objective of **promoting the use of international accounting standards** and ensuring that the requirements of small and medium sized businesses are taken into account.

Trustees

The IFRS Foundation consists of 22 Trustees who are responsible for appointing the members of the IASB, the IFRS Advisory Council and the IFRS Interpretations Committee.

The Trustees are appointed for a three year term that may be renewed only once. To ensure that the Trustees are representative of different regions of the world there are always a certain number of Trustees from North America, Europe and the Asia/Oceania region and from elsewhere in the world.

The Trustees represent various interested groups such as leading accounting firms, preparers and users of accounts, the academic world and other interested parties. They are not involved in the technical matters relating to accounting standards. These are considered by the IASB and the other bodies.

Funding

Funding is provided by the International Federation of Accountants (IFAC) and by professional accountancy organisations internationally e.g. ICAEW, CIMA, ACCA and so on. It also receives funding from financial institutions and accounting firms. Its members include more than 150 accounting organisations from more than a hundred countries worldwide.

International Accounting Standards Board (IASB)

The IASB are responsible for developing and managing the international accounting standards. Their specific roles include:

- issuing exposure drafts of new standards for debate and discussion

- preparing and publishing the international financial reporting standards (IFRS)

- approving the interpretations that are prepared by the IFRS Interpretations Committee (see below).

The IASB liaises directly with the national bodies responsible for setting local accounting standards to promote the convergence of national accounting standards.

IFRS and IAS

International Financial Reporting Standards (IFRS) are the accounting standards prepared under the current system of international regulation.

International Accounting Standards (IAS) are the accounting standards prepared under the previous system of international regulation. The IASs have all been adopted by the IASB. The IAS and IFRS therefore have the same status.

IFRS Interpretations Committee

Once standards have been set, different companies may interpret the standards differently. As a result of these different interpretations the accounting treatment of some transactions could differ widely between companies and some of these accounting policies might not be acceptable.

The IFRS Interpretations Committee therefore looks at these complex situations within the context of a particular IFRS and issues guidance. This helps to promote a more uniform practical application of the standard.

The **procedure** adopted by the IFRS Interpretations Committee is to:

- issue for public comment a draft interpretation
- after consideration of the interpretation the twelve voting members take a decision on finalising the interpretation. If only three or fewer of the voting members oppose the interpretation it goes forward to the IASB
- IASB approval and publish at which point preparers of accounts under the IFRS must then comply with the provisions of the interpretation.

IFRS Advisory Council

The IFRS Advisory Council provides the link between the IASB and the **views of the wider public**. Through the IFRS Advisory Council the wider view on the ongoing projects for new and revised accounting standards can be communicated to the IASB.

The organisation can also give other types of advice including the projects that should be on the agenda of the IASB and the most pressing priorities to be addressed in the IASB's future work program. The IFRS Advisory Council has at least 30 members appointed for terms of three years which can then be renewed.

4. International Organisation of Securities Commissions (IOSCO)

Securities commissions are organisations such as the Securities and Exchange Commission (SEC) in the US which have the task of **regulating stock markets**. The IOSCO is responsible for promoting consistency between the stock market regulations of different countries as a means of facilitating international investment. The member agencies of IOSCO cooperate with each other to:

- Ensure international standards of regulation in securities markets;
- Increase protection of investors and foster confidence in securities markets; and
- Exchange their experiences with a view to strengthening securities markets.

In May 2002 the IOSCO recommended to its members that multinational entities from outside their jurisdiction should be permitted to use international accounting standards in preparing financial statements in connection with cross-border listings and offerings.

Cooperation between IOSCO and the IFRS Foundation

In September 2013 IOSCO and the IFRS Foundation agreed on a series of protocols aiming to improve consistency in the implementation of international financial reporting standards. These protocols increase the cooperation between the two bodies to include:

- information sharing in respect of the use of IFRS in jurisdictions across the world;
- feedback on the impact of IASB standards on securities regulators;
- discussion on enforcement of IFRS; and
- obtaining important input from securities regulators in relation to time-sensitive IFRS implementation issues.

In view of the developing role of the IFRS in global capital markets the effect of the protocols will be reviewed in two years and amendments made if necessary.

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