# Chapter 1

# The Regulatory Environment

## 1. Regulation of financial reporting

### Introduction

It's 1830, and Britain is within the firm grip of the Industrial Revolution. Smoke billows from the dark mills in major industrial centres, which are exponentially increasing in population. Rapid technological advances in manufacturing have lead to the creation of large corporations the likes of which the world has never seen before.

The key difference with these new enterprises is that they sell shares on a stock exchange, so the owners (the shareholders) re not the same people as the company's management who run the company. This creates a problem: how do we ensure that the company's managers are held accountable to the owners, since the latter are not closely involved in the running of the company?

One way to do this is to produce financial reports. These are summaries of a company's financial performance and position. With this information, a shareholder can gain an insight into how well the company is being managed. The problem is that currently (in 1830 that is!) there is no regulation of how this financial information should be produced, leaving the door wide open for inconsistency and inaccuracy in reporting.

For a long time, the issue was not significantly addressed. For obvious reasons, business managers were not keen on introducing strict regulation! However, over time, the need for regulation became evident and by the late 1900s, international

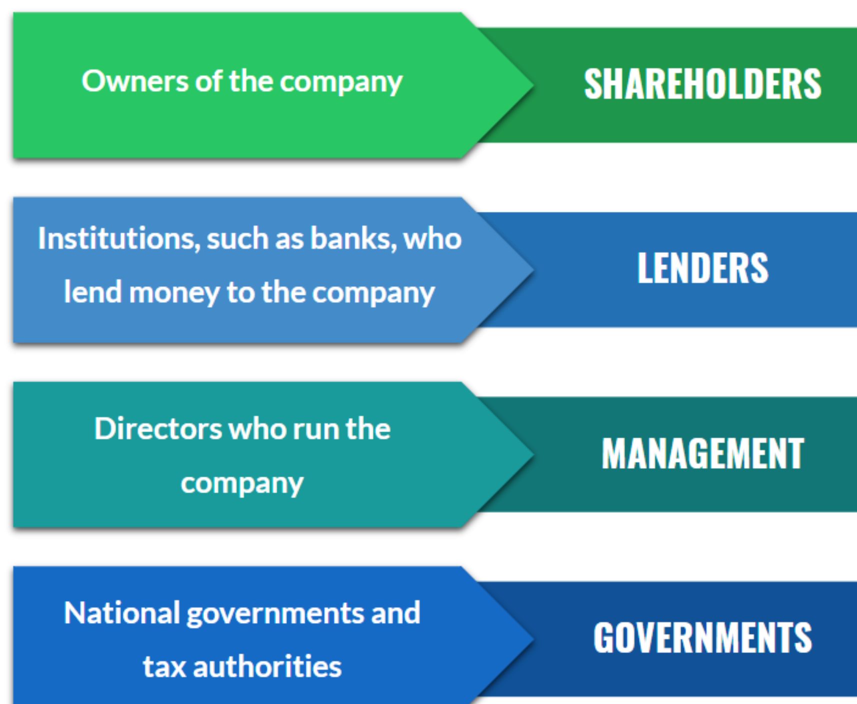
frameworks for regulating financial reporting had been developed. It is this development of the regulatory environment which we will be focusing on in this chapter.

## What is financial reporting?

In simple terms, financial reporting is **the process of producing financial information to be used by a company's stakeholders**. Financial information includes such things as a company's revenue, expenses, profit, assets held, liabilities owed and capital owned. This information is summarised in financial statements, which are used by stakeholders to make decisions about the company.

## Who uses financial statements?

Stakeholders, as mentioned above, use financial statements to gain an insight into the financial performance and position of a company. **A stakeholder is any group who has an interest, or a stake, in what the company is doing** and so a company may have many stakeholders. The main stakeholder groups who use financial statements are:



## The need for regulation

Without some form of regulation it is very difficult for financial reporting to be useful and meaningful to stakeholders. For one, **without regulation there is no way for a stakeholder to know that the financial information produced by the company is true**. Thus, regulation is essential for reliability.

Secondly, **regulation enables consistency of information across multiple companies**. This means that a stakeholder can meaningfully compare the financial information of one company to another and ultimately come to a decision. This would be useful for an investor, for example, who was looking for the best company to invest in.

Therefore, the regulation of financial reporting is essential. However, we haven't solved the problem just yet! Regulations have been developed over time in different countries and in some cases the **regulation can vary from country to country** (more on this later). Hence, the development of **international regulations which aim to overcome this issue**. We will look at approaches to international regulation in the second half of this chapter.

# Financial statements

We will begin by looking at where the magic of financial reporting happens – the financial statements. The financial statements of a company will come as part of an 'Annual Report' and **their aim is to provide a range of information about the performance of the business**, particularly its financial performance. The key statements of financial performance are:

**FINANCIAL STATEMENTS**

**AKA 'Balance Sheet'**

Shows the **assets**, **equity** and **liabilities** of a company

**AKA 'Income Statement' and 'Statement of Profit and Loss'**

Shows the **revenue** and **expenses** of a business over a period of time

**AKA 'Cash Flow Statement'**

Shows the **cash usage** of the business over a period of time

## The Statement of Financial Position

The Statement of Financial Position (SOFP), also known as the 'Balance Sheet', **is the statement that shows the assets, equity and liabilities of a company.** Within this statement, the company's assets are 'balanced' against the combined total of equity and liabilities (hence 'balance sheet').

- **Assets** are things such as **buildings**, **machinery** and **inventories**
- **Liabilities** include such things as **loans**, **debts** and **money owed**
- **Equity** is the part of the entity **owed to the shareholders** and is equal to what we call '**net assets**', which is **assets – liabilities**

## The Statement of Comprehensive Income

The Statement of Comprehensive Income (SOCI), also known as the 'Income Statement' and 'Profit and Loss', **shows the revenue and expenses** of a business over a period of time (often a year). It is different to the SOFP in that it measures and compares income (revenue) and outgoings (expenses) to **give an overall profit for the period**, whereas the SOFP gives a measure of the overall value of the business as a whole.

## Statement of Cash Flows

The Statement of Cash Flows (SOCF), also known as the 'Cash Flow Statement', shows the **cash usage of the business over a period of time** (often a year). The statement is broken down generally into **three sections of cash flow: operating activities, investing activities and financing activities**, and thus aims to give a more detailed picture of the movement of cash within the company.

## Notes to the accounts

The notes to the accounts are **additional calculations and explanations** that **detail where the information in the financial statements comes from and the basis of its calculation**. Though it isn't really a 'statement' in the same way as the first three, it's still a vital and required part of the annual report.

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**

As all of this information is subject to regulation, let's consider what makes good financial statements.

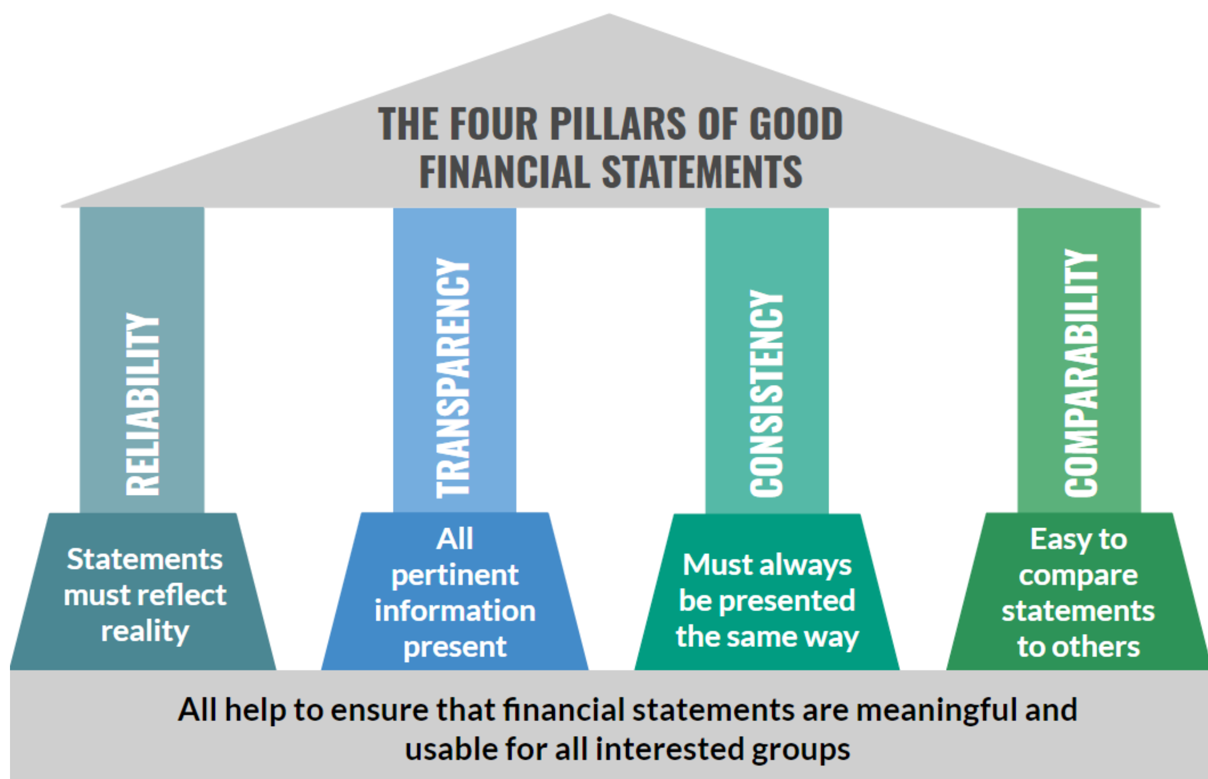
## The four pillars of good financial statements

As we have noted, there are many different stakeholder groups that will be interested in seeing the financial statements of a company, each group having specific things they are looking for.

**Potential investors**, for instance, 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.**

In order to make sure that financial statements are meaningful and usable by all interested groups, there are four key qualities that financial statements must have, which will henceforth be know as **The Four Pillars of Good Financial Statements:**




## Reliability

A financial statement isn't much use at all if it doesn't show the truth of the financial position or performance of the company. A company may be on the verge of bankruptcy, yet could arrange their statements in a way that makes them look profitable. This is totally unreliable, since potential investors will be duped into buying stock in a company about to go under! Therefore, **a key element of a good financial statement is that it must be true and reflect the reality of the company**.

## Transparency

**The pillar of transparency is the principle of openness**. If your business is a room, then the financial statements are the window into that room and the clearer they are, the better that your potential investors can see your business as it really is. There must also be **no deliberate attempt to mislead or confuse**, as this can lead to serious legal action if found to be deliberate misrepresentation. Therefore, the **information contained within the statements must be presented clearly according to the existing regulations**.

## Consistency

Imagine you work at a company in a country where there are very few accounting rules. The accounting policy is to record all expenditure costs as expenses. This means that all the money the company spends is shown in the income statement, which will be deducted from revenue and mean low profits.

The company decides to change the accounting policy so that expenditure on assets (e.g. purchasing new machinery) is included in the cost of the asset rather than shown as an expense in the income statement. This means fewer expenses are shown in the income statement and will result in higher profits and higher equity than in the previous year.

Investors will look at the company’s financial statements, see the big increases in profits and consider the company to be a good investment. However, in reality, the overall position hasn't actually changed that much over the year; it's just that the way the information is presented has been changed.

This is why it's so important that the approach to producing financial statements is consistent each year. **If different techniques and methods are used each time a statement is produced, then the statements may show significant changes that don't actually represent real life changes**! Consistency is important to make sure that the same approach is used in all periods.

## Comparability

Let's consider how useful the statements of a company would be if it was a company policy to produce financial statements every 47 weeks rather than annually like everyone else. All comparisons between this company and the rest of the industry would be a waste of time, since the information does not cover the same time period.

Now, what about a company that produces statements for a 6 month period, then a 7 month period, then a 9 month period. How are they going to compare current performance with previous performance without some common point of reference?

And so we quickly see how **financial statements that do not support comparison are not of much use to anyone; company nor stakeholders**.

All **this means is 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.

# 2. Elements of the regulatory environment

## Introduction

As we noted earlier on, regulation has developed in various ways in different places. For example, the UK regulatory environment has developed along a different path to the US regulatory environment, leading to significant differences in approach (more on this later).

When looking at the regulatory environment, therefore, we need to consider the range of **elements that make up the overall regulatory environment** in a particular jurisdiction. These elements can generally be divided into **local and international** factors.

So, for example, the UK regulatory environment will be influenced by local elements (such as UK law and regulation) and international elements (such as International Financial Reporting Standards). Let's take a closer look at these elements.

## Local elements of a regulatory framework

The regulatory framework within a particular country is governed by three main factors. We'll take the UK as an example to highlight the relevant local elements:

| Element | Description | Example (UK) |
|---|---|---|
| **Local law** | Corporate and accounting requirements of the national government/legislature. | UK Companies Act 2006 sets legal requirements for UK businesses. |
| **Local accounting standards** | Accounting standards applying in that jurisdiction as set by, and monitored by, the local accounting regulators. | The Financial Reporting Council (FRC) sets Financial Reporting Standards (FRS). |

| Element | Description | Example (UK) |
|---|---|---|
| **Local stock exchange requirements** | Accounting requirements set by that country's stock exchange for companies listed on that exchange.<br>Aim to help investors compare different companies listed on the exchange.<br>Includes disclosure requirements of previous performance to enable year-on-year comparison. | A company listed on a stock exchange (such as the London Stock Exchange) is required to apply International Financial Reporting Standards (IFRS). |

## International elements of a regulatory framework

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

- The requirements of **relevant international accounting bodies**
- **International financial reporting standards**
- 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.

For example, in the UK, the local framework is set by the **Financial Reporting Council (FRC);** however, UK companies listed on a stock exchange will also have to abide by the international standards set by the **International Financial Reporting Standards (IFRS) Foundation**.

Countries like the UK also have to take account of international organisations which they fall under the jurisdiction of and their regulatory requirements. The The **European Union (EU),** for example, issues directives that must be implemented by its member states.

Also, requirements in respect of companies listing on a stock exchange are influenced by the **International Organization of Securities Commissions (IOSCO)**.

**The influence of international accounting standards is increasing** and this is due to the convenience of having one standard for all, making international trade much less cumbersome. Most standards across the globe are becoming more and more in line with international standards and this can mean significant changes in current practice.

This also links in with the significance of 'comparability' in our four pillars of good financial statements. The more convergence there is to international standards, the easier it is to objectively compare companies across the globe.

## Gradual approach to international convergence

The process of adopting the 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. You can imagine, for example, the trouble caused for a company in a country that has never set a standard for depreciation suddenly having to apply this to all of their fixed assets!

**A gradual approach to convergence is often preferable** as it avoids some of these problems, hence this is the policy adopted by some countries moving to align their national standards with international accounting standards. **This alignment needs to be gradual enough for businesses and stakeholders to have time to adjust to the transition**.

# Generally Accepted Accounting Practice (GAAP)

Combine these factors together, and you find that, in any given country, there is a **generally agreed approach to accounting**. This accounting practice is referred to as the Generally Accepted Accounting Practice (GAAP). Let's have a look at a formal definition of GAAP:

GAAP is the standard framework of guidelines for financial reporting used in any given jurisdiction; generally known as accounting standards or standard accounting practice. These include the **standards, conventions and rules that accountants follow in recording and summarising, and in the preparation of financial statements**.

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.

For example, the UK GAAP refers to the system of accounting rules, procedures and regulations that uniquely apply in the UK. The US GAAP refers to those uniquely applicable in the United States.

Due to the gradual adoption of international standards and the introduction or updating of local standards, the **GAAP will also change over time within the same jurisdiction**. Thus, the UK GAAP in 1970 will be quite different to the UK GAAP in 2070!

# Regulation from country to country

Since accounting has been around for almost as long as civilisation itself, and given the various issues discussed earlier in this chapter, different practices have been developed in different parts of the world. Over time, these practices turn into full regulatory regimes, and so there can be a big difference from country to country. Here are a few of the key reasons for this:

## 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. The more complex the tax system, the more regulation is needed to ensure consistency of treatment and fair disclosure.

For example, corporation tax can vary significantly from country to country. Most countries have a corporate tax rate between 10% and 30%, but, in some places around the world, such as the Bahamas and the Cayman Islands (as of 2018), residents pay no income tax or corporate tax! No corporate tax means no corresponding legislation or regulation and a much simpler system.

**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. The Climate Change Act 2008 (UK) is an example of such a policy that is specific to the UK.

### History and culture

The general culture of the country, in particular, **the business culture, may also affect disclosure requirements**. Countries with highly developed stock 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 and to provide sufficient information to enable them to make realistic investment decisions.

Chinese accounting standards are an interesting example because they originated in a socialist culture in which the state was the sole owner of industry. Therefore, unlike Western accounting standards, they were less a tool of profit and loss and more an inventory of assets available to a company.

In contrast to Western standards, Chinese accounting standards did not include an account of the debts that a corporation holds. This ultimately made the financial statements of the company suitable for accounting for tax purposes, but less suitable for management control of debt.

### The nature of the shareholding public

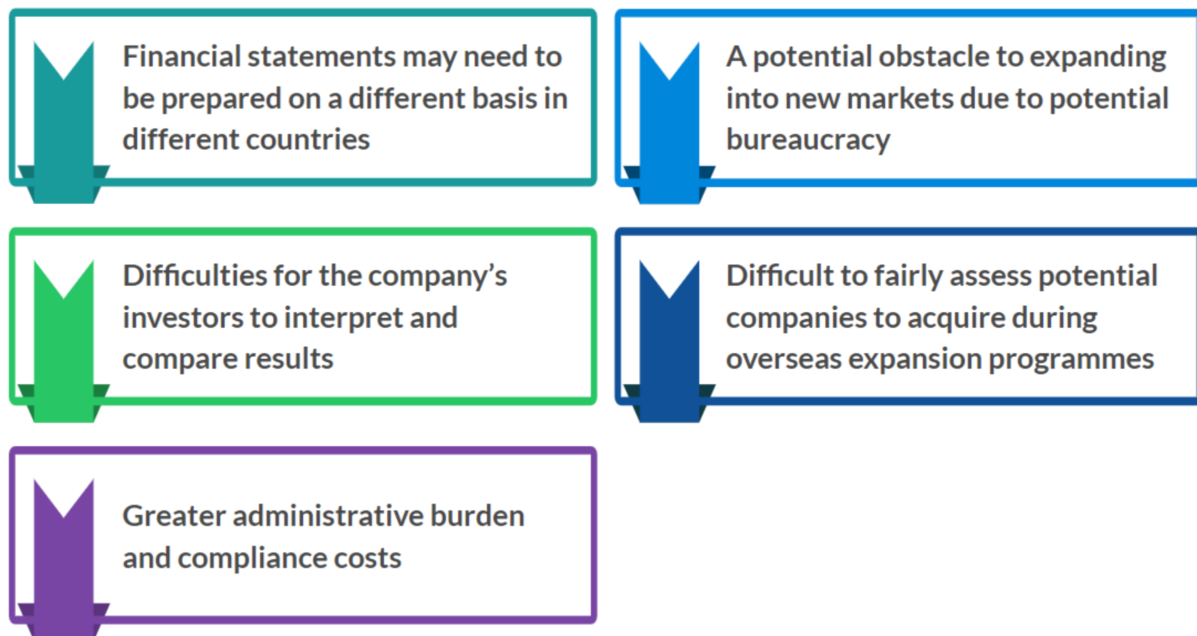
**Different countries tend to have different types of shareholders. In countries like the UK or US, the majority of shareholders are large institutions**, while elsewhere, there can be more concentrated ownership with more owner involvement in management.

In many Spanish-speaking countries and parts of Asia, many 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, the former is likely to require a higher level of regulation.

## Problems with differences in accounting requirements

Now, as we have seen, accounting policies can differ quite a bit across the globe. This 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. For multinational companies, this creates the following problems:




# Principles-based and rules-based approaches

## Principles-based approach

A principles-based approach to regulation **occurs against the backdrop of a conceptual framework for accounting**, such as the IASB Framework (more on this later). These outline broad principles to be used in accounting, such as prudence, 'substance over form', or the 'going concern' principle. These principles are covered in depth later on.

Such a framework may not be in the form of a set of rules or guidelines, but are closer to the underlying goals that give rise to good accounting standards.

**Conceptual frameworks** will be covered in much more depth later on. For the moment, just remember that they **are a set of over-riding principles** to be applied to accounting.

### Rules-based approach

In contrast, a rules-based approach to regulation is **based on a specific set of rules** which all companies must follow. So, instead of guiding principles, there will be well-defined and mandatory rules to follow.

For example, consider any set of rules. Let's take the common rules we see at a swimming pool: no running, no deliberate splashing, no diving in the shallow end, no shouting, etc. At the 'rules-based' pool, these are the rules that everyone must follow.

However, what these rules have in common is the desire to keep people safe. This is what we might call the principle behind the pool rules. Therefore, at a 'principles-based' pool, there might be guidelines, such as no running, but if there was an instance where you needed to run, but could do it safely, you would be abiding by the principle.

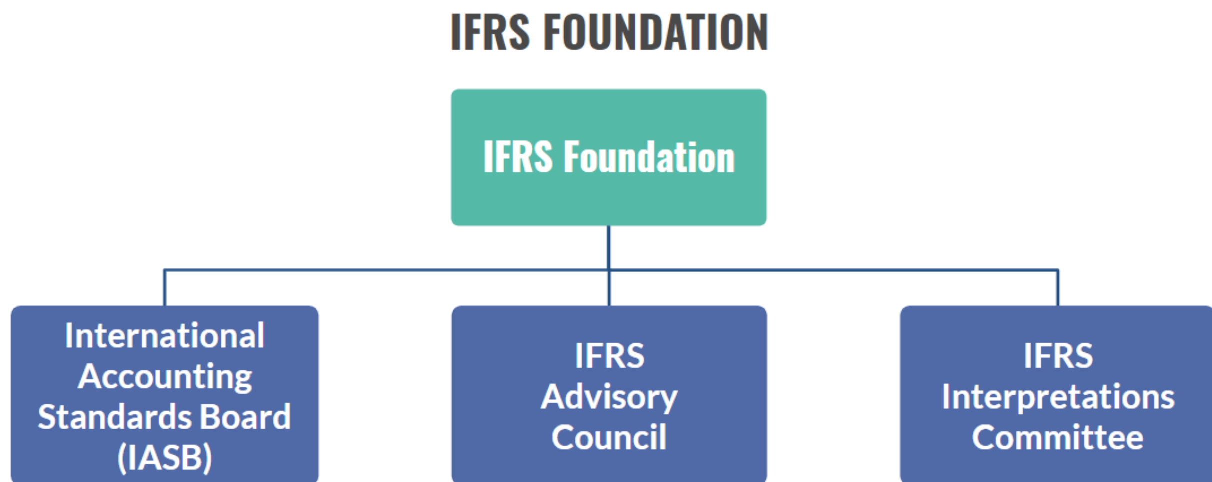
# 3. International Accounting Standards Board (IASB)

It is fairly easy to invest in companies all over the world. If you are based in India you can quite easily buy shares in Microsoft (a US company) if you have the money and engage a broker. We take such things for granted in the modern world, but it wasn't always so easy!

As we have seen, there are now international accounting standards which are increasingly being adopted worldwide to ensure consistency and comparability in the financial statements and to facilitate international investment.

In this section, we'll take a look at the key bodies involved in this process and tell you a little about how it works. It's a bit dull, but there are easy marks available here compared with some of the more complex topics we'll come to later, so it's worth your while to learn this well!

# IFRS Foundation




So, let's start at the top. **Think of the IFRS Foundation as a board of directors** at the very top of a company. They are the ones in charge. The **IFRS Foundation is the body that is given the responsibility for developing global accounting standards** to ensure transparency and comparability in published financial statements.

Its core objectives are:

- **To develop, in the public interest, a single set of high-quality, understandable, enforceable and globally accepted financial reporting standards** based upon clearly articulated principles.

- **To promote the use and rigorous application of those standards**.

- In fulfilling the above objectives, **to take account of, as appropriate, the needs of a range of sizes and types of entities** in diverse economic settings.

- To **promote and facilitate adoption of International Financial Reporting Standards (IFRSs),** being the standards and interpretations issued by the IASB, through the convergence of national accounting standards and IFRSs.

So, as you can see, **an important part of the role of the IFRS Foundation is** to not only develop a set of standards, but **to promote their use internationally**.



astranti

## 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.

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, which are considered by the IASB and the other bodies.

## Funding

**Funding is provided by the International Federation of Accountants (IFAC)**, the global organisation for the accountancy profession, 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**, so, think of the IASB as the production department who are in charge of producing the main product of the 'company' – the accounting standards. Their specific roles include:

### SPECIFIC ROLES OF THE IASB

1. Issuing 'exposure drafts' of new standards for debate and discussion
2. Preparing and publishing the international financial reporting standards (IFRS)
3. Approving the interpretations that are prepared by the IFRS Interpretations Committee

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

A quick note:

- **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, as the old standards, have all been adopted by the IASB. The old and new standards therefore have the same status.

This means that you during your studies you will find that some standards are IAS (e.g. IAS 2 Inventories), whilst other are IFRS (IFRS 16 Leases). Some of the older IASs (e.g. IAS 17 Leases) have been replaced by newer IFRSs (IFRS 16 Leases).

# 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 methods 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.

For example, the IFRS Interpretations Committee proposed an amendment to IAS 12 Income Taxes based on how to interpret "the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value."

As you can see, what they do is highly technical and their job is to make sure that these guidelines leave no room for ambiguity or error.

**The procedure adopted by the IFRS Interpretations Committee is as follows:**

- **Issue a draft interpretation for public comment**.

- 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.
- **Gain IASB approval and publish, at which point preparers of accounts under the IFRS must then comply** with the provisions of the interpretation.

Now, where do the interpretations committee fit in? Well, try to think of them as **quality control**, checking that rules are being applied correctly, so that financial statements are all reliable, consistent and comparable.

## IFRS Advisory Council

So, finally we come to the link between the IASB and the views of the wider public. Through the IFRS Advisory Council, **concerns and issues with the ongoing projects for new and revised accounting standards can be communicated to the IASB** by relaying feedback from accountants.

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 programme**. The IFRS Advisory Council has at least 30 members appointed for terms of three years, which can then be renewed.

So, continuing with our analogies, the advisory council are like the **customer service** team who are in touch with the wider public. They take into consideration the views of their customers and present the findings to the IASB.

# 4. International Organization of Securities Commissions (IOSCO)

The Financial Times Stock Exchange 100 Index (FTSE 100) is a share index of the top 100 companies listed on the London Stock Exchange. As of January 2018, the combined value of those 100 companies exceeded £2 trillion (yes, that's trillion). That's greater than the GDP of Brazil. With so much money at stake, the need for international regulation of stock markets should be obvious!

**Securities commissions**, which are organisations such as the Securities and Exchange Commission (SEC) in the US, **have the task of regulating stock markets. The IOSCO is responsible for promoting consistency between the stock market**

**regulations, (e.g. working with organisations such as the SEC), of different countries** as a means of facilitating international investment. **The member agencies of IOSCO cooperate with each other to**:

## 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 increased 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**
- **Obtaining important input from securities regulators in relation to time-sensitive IFRS implementation issues**

# 5. International Integrated Reporting Council (IIRC)

**The IIRC was founded in 2010 to respond to the need for a concise, clear, comprehensive and comparable integrated reporting framework (<IR> Framework)**. The IIRC say that their mission statement is:

"To establish integrated reporting and thinking within mainstream business practice as the norm in the public and private sectors"

The **aim of integrated reporting (<IR>) is to provide insight into how a business intends to create value in the short, medium and long term,** through its resources and relationships, for a variety of stakeholders. **Integrated reports will highlight a business's** utilisation of resources, like key staff skills and intellectual property and relationships with parties like customers, to create value.