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The Regulatory Framework – An International Perspective

Dr Philip E Dunn

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Readers will be aware that all EU companies listed on a regulated market will be required to prepare their consolidated accounts in accordance with endorsed International Accounting Standards from 2005 onwards.

The IASB – International Accounting Standards Board issued its framework for the Preparation and Presentation of Financial Statements in 1989. This is referred to as its conceptual framework. The framework sets out the concepts that shape the preparation and presentation of financial statements for external users. The framework does not have the status of an accounting standard as also is the case with the ASB's Statement of Principles. The IASB framework assists the IASB:

- "In the development of future International Accounting Standards and in its review of existing International Accounting Standards; and

- In promoting the harmonisation of regulations, accounting standards and procedures relating presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by International Accounting Standards.

In addition, the framework may assist:

- Preparers of financial statements in applying International Accounting Standards and in dealing with topics that have yet to form the subject of an International Accounting Standard;

- Auditors in forming an opinion as to whether financial statements conform with International Accounting Standards;

- Users of financial statements in interpreting the information contained in financial statements prepared in conformity with International Accounting Standards; and

- Those who are interested in the work of IASB, providing them with information about its approach to the formulation of accounting standards."

To ensure the framework provides useful information it identifies a range of user groups which include:

- Investors
- Lenders
- Employees
- Suppliers
- Other trade creditors
- Customers
- Government agencies; and
- The public

The framework comprises seven sections from paragraph 12-110 which cover areas as:

(1) The objective of financial statements;

(2) Underlying assumptions;

(3) Qualitative characteristics of financial information;

(4) The elements of financial statements;

(5) Recognition of the elements of financial statements;

(6) Measurement of the elements of financial statements;

(7) Concepts of capital maintenance.

Objectives of financial statements

Published financial statements should provide information to a wide range of users informing a:

- financial position
- financial performance; and
- changes in financial position.

Financial statements should also portray the results of stewardship of management and the user should be able to assess the accountability of management which may influence the users' decision making process.

Information on financial position is primarily provided in a balance sheet, that of performance in the income statement and changes in financial position through the presentation of a cash flow statement (IAS7).

The statements should be viewed as a whole, for example an income statement provides an overview of performance which is incomplete without its link with the balance sheet.

It is important that financial statements should show corresponding information for preceding periods.

The statements should also be supplemented with notes and schedules to provide additional information relevant to the user.

Underlying assumptions

The framework identifies two underlying assumptions:

- accruals basis
- going concern

In order to meet their objectives financial statements are prepared on an accruals basis. Transactions and events are simply recognised at the point when they occur and are matched to the period in the financial statements to which they relate.

Financial statements are usually prepared on the assumption that the reporting entity is a going concern and is likely to operate for the foreseeable future. The assumption here is that the reporting entity has no intention to liquidate or to adversely curtail its scale of activities. If this is the case then a different basis of reporting may be necessary and the basis disclosed.

Qualitative characteristics of financial statements

The attributes that make information useful to users include:

- understandability
- relevance
- reliability
- comparability

A primary characteristic of financial information is that it should be readily understandable by the user. This assumes the user has knowledge of the business, its economic activity and accounting concepts. This should not deter the reporting entity from including complex matters in the financial reports.

Information possesses the attribute of relevance when it influences the economic decisions of users by aiding the evaluation of past, present and future events in both a predictive and confirmatory way.

For information to be useful it must be reliable. It must therefore be free from error or bias and present a faithful representation. Information could in certain circumstances be relevant but unreliable.

Preparers of financial statements need to address uncertainty for eg: collection of receivables and the provision for bad and doubtful debts, in such instances there is a need to exercise prudence in preparation of the financial statements.

Prudence is the inclusion of a degree of caution in the judgement required to raise a provision to cover elements of uncertainty.

Comparability provides the facility for the comparison of performance of the reporting entity over time. Also the analysis of performance of different entities may be considered.

Financial statements must be prepared by applying the fundamental concept of consistency and the user should be informed of the accounting policies employed.

Elements of financial statements

The elements which relate to financial position of an entity are those which comprise the balance sheet:

- assets
- liabilities; and
- equity

Those relative to financial performance comprise elements in the income statement:

- revenue
- expenses

The elements relating to financial position are defined in paragraph 49, as:

> "An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity."
>
> "A liability is a present obligation of the entity as a result of past events and from which future economic benefits are expected to flow."
>
> "Equity is the residual interest in the assets of the entity after deducting all its liabilities."

The above form the accounting equation assets – liabilities = ownership interest.

Income is defined as "encompassing both revenue and gains".

Revenue arises in the course of ordinary activities eg: sales, fees, etc. Whereas gains may or may not arrive in the course of ordinary activities and include: that arising on the disposal of non-current assets and unrealised gains on the revaluation of marketable securities or increases in the carrying value of long term non-current assets.

"Expenses encompasses losses as well as those expenses that arise in the course of ordinary activities of the entity". Expenses in the course of ordinary activities include: cost of sales, wages and salaries etc. Losses would include those arising on the disposal of non-current assets and those arising from disasters as in the case of the recent tsunami.

Recognition of the elements of financial statements

For it to be recognised an item must meet one of the definitions listed above together with a further two criteria. These criteria are: (para 83).

- It is probable that any future economic benefit related to the item will flow to or from the reporting entity.

- The item has cost or value that can be measured reliably.

The concepts of probability and uncertainty are used in the above criteria.

Measurement of the elements of financial statements

Once an item has been recognised, a decision has to be made as to how it will be measured. To be included in the financial statements a monetary value must be attached to it. The framework details a number of bases (para 100) and these include:

- historical cost
- current cost
- realisable (settlement value); and
- present value

The framework states that "the measurement basis most commonly adopted by entities in preparing their financial statements is historical cost".

This however is often used with other bases eg: IAS 2 Inventories "the lower of cost and net realisable value".

Concepts of capital and capital maintenance

The framework focuses on two concepts of capital:

- financial concept of capital
- physical concept of capital

The financial concept is linked to investment and is synonymous with net assets or equity as highlighted in the accounting equation, whereas the physical concept is relative to its operating capability or productive capacity as shown, for example in the ratio of value added to non-current assets.

If the value of net assets at the end of a period is greater than that at the start of the period than a profit has been earned (after deducting any distributions to or from the owners). This process is referred to as financial capital maintenance.

Physical capital maintenance acknowledges that a profit is earned only if the physical capacity (or operating capacity) of the entity (or resources or funds needed to achieve that capacity) at the end of the period is greater than that at the start of the period, after deducting distributions to or contributions from the owners.