PART 2

Regulatory framework – an attempt to achieve uniformity

CHAPTER 5

Financial reporting – evolution of global standards

5.1 Introduction

The main purpose of this chapter is to describe the movement towards global standards.

Objectives

By the end of the chapter, you should be able to:

- describe the UK, US and IASB standard setting bodies;
- critically discuss the arguments for and against standards;
- describe the reasons for differences in financial reporting;
- describe the work of international bodies in harmonising and standardising financial reporting;
- explain the impact on financial reporting of changing to IFRS;
- describe the progress being made towards a single set of global international standards;
- describe and comment on the ASB approach to financial reporting by smaller entities;
- describe and comment on the IASB approach to financial reporting by small and medium-sized entities.

5.2 Why do we need financial reporting standards?

Standards are needed because accounting numbers are important when defining contractual entitlements. Contracting parties frequently define the rights between themselves in terms of accounting numbers.[1] For example, the remuneration of directors and managers might be expressed in terms of a salary plus a bonus based on an agreed performance measure, e.g. Johnson Matthey's 2009 Annual Report states:

> Annual Bonus – which is paid as a percentage of basic salary under the terms of the company's Executive Compensation Plan (which also applies to the group's 170 or so most senior executives). The executive directors' bonus award is based on consolidated underlying profit before tax (PBT) compared with the annual budget. The board of directors rigorously reviews the annual budget to ensure that the budgeted PBT is sufficiently stretching.
>
> An annual bonus payment of 50% of basic salary (prevailing at 31st March) is paid if the group meets the annual budget. This bonus may rise on a straight line basis to 75%

> of basic salary if the group achieves PBT of 105% of budget and a maximum 100% of basic salary may be paid if 110% of budgeted PBT is achieved. PBT must reach 95% of budget for a minimum bonus of 15% to be payable. The Committee has discretion to vary the awards made.

However, there is a risk of irresponsible behaviour by directors and managers if it appears that earnings will not meet performance targets. They might be tempted to adopt measures that increase the PBT but which are not in the best interest of the shareholders.

This risk is specifically addressed in the Johnson Matthey Annual Report as shown in the following extract:

> The Committee has discretion in awarding annual bonuses and is able to consider corporate performance on environmental, social and governance issues when awards are made to executive directors. The Committee ensures that the incentive structure for senior management does not raise environmental, social and governance risks by inadvertently motivating irresponsible behaviour.

This would not preclude companies from taking typical steps such as **deferring discretionary expenditure**, e.g. research, advertising, training expenditure; **deferring amortisation**, e.g. making optimistic sales projections in order to classify research as development expenditure which can be capitalised; and **reclassifying** deteriorating current assets as non-current assets to avoid the need to recognise a loss under the lower of cost and net realisable value rule applicable to current assets.

The introduction of a mandatory standard that changes management's ability to adopt such measures **affects wealth distribution** within the firm. For example, if managers are unable to delay the amortisation of development expenditure, then bonuses related to profit will be lower and there will effectively have been a transfer of wealth from managers to shareholders.

5.3 Why do we need standards to be mandatory?

Mandatory standards are needed, therefore, to define the way in which accounting numbers are presented in financial statements, so that their measurement and presentation are less subjective. It had been thought that the accountancy profession could obtain uniformity of disclosure by persuasion but, in reality, the profession found it difficult to resist management pressures.

During the 1960s the financial sector of the UK economy lost confidence in the accountancy profession when internationally known UK-based companies were seen to have published financial data that were materially incorrect. Shareholders are normally unaware that this occurs and it tends only to become public knowledge in restricted circumstances, e.g. when a third party has a **vested interest** in revealing adverse facts following a takeover, or when a company falls into the hands of an administrator, inspector or liquidator, **whose duty it is to enquire and report** on shortcomings in the management of a company.

Two scandals which disturbed the public at the time, GEC/AEI and Pergamon Press,[2] were both made public in the restricted circumstances referred to above, when financial reports prepared from the same basic information disclosed a materially different picture.

5.3.1 GEC takeover of AEI in 1967

The first calamity for the profession involved GEC Ltd in its takeover bid for AEI Ltd when the pre-takeover accounts prepared by the old AEI directors differed materially from the post-takeover accounts prepared by the new AEI directors.

AEI profit forecast for 1967 as determined by the old AEI directors

AEI Ltd produced a **profit forecast of £10 million** in November 1967 and recommended its shareholders to reject the GEC bid. The forecast had the blessing of the auditors, in as much as they said that it had been prepared on a fair and reasonable basis and in a manner consistent with the principles followed in preparing the annual accounts. The investing public would normally have been quite satisfied with the forecast figure and the process by which it was produced. Clearly, AEI would not subsequently have produced other information to show that the picture was materially different from that forecast.

However, GEC was successful with its bid and as a result it was GEC's directors who had control over the preparation of the AEI accounts for 1967.

AEI profit for 1967 as determined by the new AEI directors

Under the control of the directors of GEC the accounts of AEI were produced for 1967 showing **a loss of £4.5 million**. Unfortunately, this was from basic information that was largely the same as that used by AEI when producing its profit forecast.

There can be two reasons for the difference between the figures produced. Either the facts have changed or the judgements made by the directors have changed. In this case, it seems there was a change in the facts to the extent of a post-acquisition closure of an AEI factory; this explained £5 million of the £14.5 million difference between the forecast profit and the actual loss. The remaining £9.5 million arose because of differences in judgement. For example, the new directors took a different view of the value of stock and work-in-progress.

5.3.2 Pergamon Press

Audited accounts were produced by Pergamon Press Ltd for 1968 showing a profit of approximately £2 million.

An independent investigation by Price Waterhouse suggested that this profit should be reduced by 75% because of a number of unacceptable valuations, e.g. there had been a failure to reduce certain stock to the lower of cost and net realisable value, and there had been a change in policy on the capitalisation of printing costs of back issues of scientific journals – they were treated as a cost of closing stock in 1968, but not as a cost of opening stock in 1968.

5.3.3 Public view of the accounting profession following these cases

It had long been recognised that accountancy is not an exact science, but it had not been appreciated just how much latitude there was for companies to produce vastly different results based on the same transactions. Given that the auditors were perfectly happy to sign that accounts showing either a £10 million profit or a £4.5 million loss were true and fair, the public felt the need for action if investors were to have any trust in the figures that were being published.

The difficulty was that each firm of accountants tended to rely on precedents within its own firm in deciding what was true and fair. This is fine until the public becomes aware that profits depend on the particular firm or partner who happens to be responsible for the audit. The auditors were also under pressure to agree to practices that the directors wanted because there were no professional mandatory standards.

This was the scenario that galvanised the City press and the investing public. An embarrassed, disturbed profession announced in 1969, via the ICAEW, that there was a majority view supporting the introduction of Statements of Standard Accounting Practice to supplement the legislation.

5.4 Arguments in support of standards

The setting of standards has both supporters and opponents. In this section we discuss credibility, discipline and comparability.

Credibility

The accountancy profession would lose all credibility if it permitted companies experiencing similar events to produce financial reports that disclosed markedly different results simply because they could select different accounting policies. Uniformity was seen as essential if financial reports were to disclose a true and fair view. However, it has been a continuing view in the UK that standards should not be a comprehensive code of rigid rules – they were not to supersede the exercise of informed judgement in determining what constituted a true and fair view in each circumstance.

Discipline

It could be argued that if companies were left to their own devices without the need to observe standards, they would eventually be disciplined by the financial market, for example, an incorrect capitalisation of research expenditure as development would eventually become apparent when sales growth was not as expected by the market. However, this could take a long time. Better to have mandatory standards in place to protect those who rely on the annual accounts when making credit, loan and investment decisions.

Directors are under pressure to maintain and improve the market valuation of their company's securities. There is a temptation, therefore, to influence any financial statistic that has an impact on the market valuation, such as the trend in the earnings per share (EPS) figure, the net asset backing for the shares or the gearing ratios which show the level of borrowing.

This is an ever-present risk and the Financial Reporting Council showed awareness of the need to impose discipline when it stated in its annual review, November 1991, para. 2.4, that the high level of company failures in the then recession, some of which were associated with **obscure financial reporting**, damaged confidence in the high standard of reporting by the majority of companies.

Comparability

In addition to financial statements allowing investors to evaluate the management's performance i.e. their stewardship, they should also allow investors to make predictions of future cash flows and comparisons with other companies.

In order to be able to make valid inter-company comparisons of performance and trends, investors need relevant and reliable data that have been standardised. If companies were to continue to apply different accounting policies to identical commercial activities, innocently or with the deliberate intention of disguising bad news, then investors could be misled in making their investment decisions.

5.5 Arguments against standards

We have so far discussed the arguments in support of standard setting. However, there are also arguments against. These are consensus-seeking and overload.

Consensus-seeking

Consensus-seeking can lead to the issuing of standards that are over-influenced by those with easiest access to the standard setters – particularly as the subject matter becomes more complex, as with e.g. capital instruments.

Overload

Standard overload is not a new charge. However, it takes a number of conflicting forms, e.g.:

- There are too many/too few standards.
- Standards are too detailed/not sufficiently detailed.
- Standards are general-purpose and fail to recognise the differences between large and small entities and interim and final accounts.
- There are too many standard setters with differing requirements, e.g. FASB, IASB, ASB, and national Stock Exchange listing requirements.

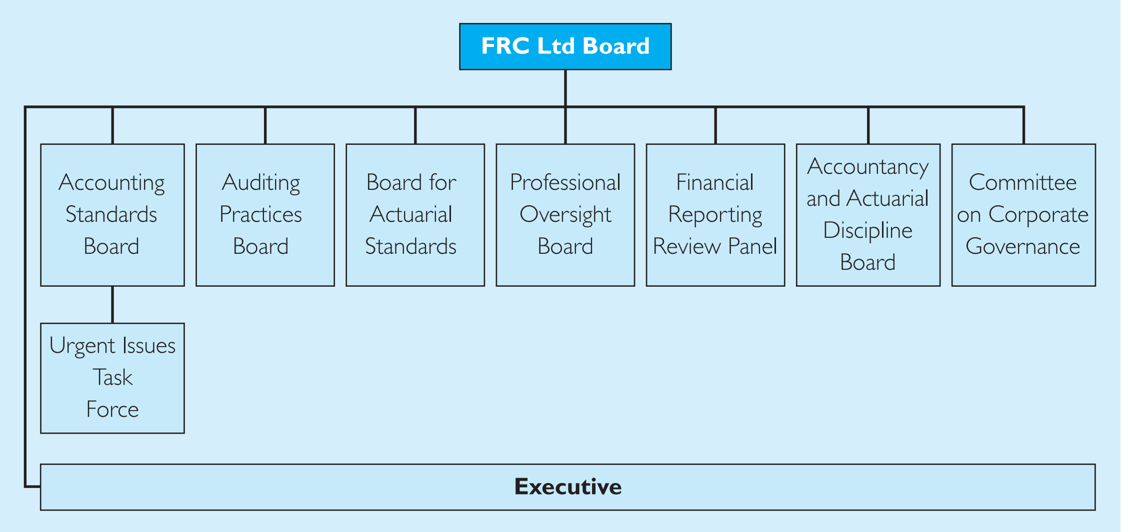
5.6 Standard setting and enforcement in the UK under the Financial Reporting Council (FRC)

The FRC was set up in 1990 as an independent regulator to set and enforce accounting standards. It operated through the Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP) to encourage high-quality financial reporting. Due to its success in doing this, the government decided, following corporate disasters such as Enron in the USA, to give it a more proactive role from 2004 onwards in the areas of corporate governance, compliance with statutes and accounting and auditing standards.

The FRC structure has evolved to meet changing needs. This is illustrated by two recent changes. For example, its implementation of the recommendation of the Morris Review[3] in 2005 that the FRC should oversee the regulation of the actuarial profession by creating the Board for Actuarial Standards and then by its restructuring of its own Council and Main Board by merging the two into a single body to make the FRC more effective with regard to strategy.

The FRC's structure in 2009 is shown in Figure 5.1.

Figure 5.1 The Financial Reporting Council organisation chart



5.7 The Accounting Standards Board (ASB)

The ASB issues mandatory standards (SSAPs and FRSs), confirms that SORPs are not in conflict with its mandatory standards and issues statements of best practice (such as those on OFR and Interim Reports).

5.7.1 SSAPs and FRSs

There are a number of extant standards relating to each of the financial statements. For example, there are standards relating to the measurement and disclosure of assets in the statement of financial position covering goodwill, research and development, tangible non-current assets and inventories and of liabilities covering deferred tax, current tax and pension liabilities.

A full list of current standards is available on the FRC website http://www.frc.org.uk/asb/technical/standards.cfm

5.7.2 Statements of Recommended Practice (SORPs)

SORPs are produced for specialised industries or sectors to supplement accounting standards and are checked by the Financial Sector and Other Special Industries Committee and the Committee on Accounting for Public-benefit Entities to ensure that they are not in conflict with current or future FRSs.

There are SORPs issued by specialised industry bodies such as the Oil Industry Accounting Committee and the Association of British Insurers and by not-for-profit bodies such as the Charity Commission and Universities UK.

5.8 The Financial Reporting Review Panel (FRRP)

The FRRP has a policing role with responsibility for overseeing some 2,500 companies. It is completely independent of the ASB. It has a solicitor as chairman and the other members include accountants, bankers and lawyers. Its role is to review material departures from accounting standards and, where financial statements are defective, to require the company to take appropriate remedial action. Where it makes such a requirement, it issues a public statement of its findings. It has the right to apply to the court to make companies comply but it prefers to deal with defects by agreement.

The FRRP cannot create standards. If a company has used an inappropriate accounting policy that contravenes a standard, the FRRP can act. If there is no standard and a company chooses the most favourable from two or more accounting policies, the FRRP cannot act.

A research study[4] into companies that have been the subject of a public statement suggests that when a firm's performance comes under severe strain, even apparently well-governed firms can succumb to the pressure for creative accounting, and that good governance alone is not a sufficient condition for ensuring high-quality financial reporting. The researchers compared these companies with a control group and a further interesting finding was that there were fewer Big Five auditors in the FRRP population – the researchers commented that this could be interpreted in different ways, e.g. it could be an indication that the Panel prefers to avoid confrontation with the large audit firms because of an increased risk of losing the case or a reflection of the fact that these audit firms are better at managing the politics of the investigation process and negotiating a resolution that does not lead to a public censure.

5.8.1 Criticism of the FRRP for being reactive

The FRRP has, since its establishment in 1988, been a reactive body responding to issues appearing in individual sets of accounts to which it is alerted by public or specific complaint. This led to the criticism that the FRRP was not addressing significant financial reporting issues and was simply dealing with disclosure matters that had readily been detected. The Panel consequently commissioned a pilot study in 2000 which reviewed selected companies for non-compliance. The pilot study revealed no major incidents of non-compliance and in November 2001 the FRRP decided that a proactive approach was unnecessary.

5.8.2 Investor pressure for a more proactive stance

However, regulatory bodies have to be responsive to a material change in investor attitudes and act if there is likely to be a loss of confidence in financial reports which could damage the capital markets. Such a loss of confidence arose following the US accounting scandals such as Enron. Regulators could no longer be simply reactive even though there had been no evidence in the UK of material non-compliance.

Proactive stance – European initiative

The Committee of European Securities Regulators (CESR), at the request of the European Commission, has developed proposals which would require enforcement bodies to take a proactive approach. In its *Proposed Statement of Principles of Enforcement of Accounting Standards in Europe* issued in 2002, it proposed that there should be a selection of companies and documents to be examined using a risk-based approach or a mixed model where a risk-based approach is combined with a rotation and/or a sampling approach – a pure rotation approach or a pure reactive approach would not be acceptable.[5]

Proactive stance – UK initiative

The Coordinating Group on Accounting and Auditing Issues recommended in its Final Report in 2003 that the FRRP should press ahead urgently with developing a proactive element to its work.[6]

The FRRP response to the new requirement for a proactive approach

The Panel proposed that there should be:

- a stepped implementation with a minimum of 300 accounts being reviewed from 2004;
- the development of a risk-based approach to the selection of published accounts taking account of the risk that a particular set of accounts will not give a true and fair view of market stability and investor confidence.

Reviews should comprise an initial desk-check of selected risk areas or whole sets of accounts followed, where appropriate, with correspondence to chairpersons.

Whilst adopting a proactive approach, the FRRP has raised concerns that stakeholders might have a false expectation that the Panel is providing a guarantee that financial statements are true and fair, stressing that no system of enforcement can or should guarantee the integrity of a financial reporting regime.

5.8.3 The Financial Reporting Review Panel Activity Report

The Panel reported in its 2008 Report that it had reviewed 300 sets of accounts, been approached by 138 companies for further information or explanation and 88 companies had undertaken to reflect the Panel's comments in their future reporting. Most of this occurred pre-June 2007, before the dislocation in the markets.

Since June 2007, there have been major uncertainties that affect management's estimates of assets and liabilities in the Statement of Financial Position and the amount of revenue to recognise in the Statement of Comprehensive Income where measurement may be unreliable.

The Panel continues to take a consensual approach but it is important that directors, if they are to reduce the risk of Panel questioning, are transparent about specific risks and uncertainties that their companies are likely to experience.

The FRRP has announced (FRRP PN 123) the sectors on which it will be focusing in 2010/11. These are Commercial property, Advertising, Recruitment, Media and Information technology. These sectors have been selected because, as companies come out of recession and experience possible cash flow difficulties, discretionary spending might be reduced or delayed. The FRRP is planning to pay particular attention to the accounts of those companies which appear to apply aggressive policies compared with their peers.

5.9 Standard setting and enforcement in the US

Reporting standards are set by the Financial Accounting Standards Board (FASB) and enforced by the Securities Exchange Commission.

5.9.1 Standard setting by the FASB and other bodies

The Financial Accounting Standards Board (FASB) is responsible for setting accounting standards in the USA. The FASB is financed by a compulsory levy on public companies, which should ensure its independence. (The previous system of voluntary contributions ran the risk of major donors trying to exert undue influence on the Board.) FASB issues the following documents:

- Statements of Financial Accounting Standards, which deal with specific issues;
- Statements of Concepts, which give general information;
- Interpretations, which clarify existing standards.

There are other mandatory pronouncements from the Emerging Issues Task Force, the Accounting Principles Board (APB) which publishes Opinions and the American Institute of Certified Public Accountants (AICPA) which publishes Accounting Practice Bulletins and Opinions.

5.9.2 Enforcement by the SEC

The Securities and Exchange Commission (SEC) is responsible for requiring the publication of financial information for the benefit of shareholders. It has the power to dictate the form and content of these reports. The largest companies whose shares are listed must register with the SEC and comply with its regulations. The SEC monitors financial reports filed in great detail and makes useful information available to the public via its website (www.sec.gov). However, it is important to note that the majority of companies fall outside of the SEC's jurisdiction.

5.10 Why have there been differences in financial reporting?

Although there have been national standard-setting bodies, this has not resulted in uniform standards. A number of attempts have been made to identify reasons for differences in financial reporting.[7] The issue is far from clear but most writers agree that the following are among the main factors influencing the development of financial reporting:

- the character of the national legal system;
- the way in which industry is financed;
- the relationship of the tax and reporting systems;
- the influence and status of the accounting profession;
- the extent to which accounting theory is developed;
- accidents of history;
- language.

We will consider the effect of each of these.

5.10.1 The character of the national legal system

There are two major legal systems, that based on common law and that based on Roman law. It is important to recognise this because the legal systems influence the way in which behaviour in a country, including accounting and financial reporting, is regulated.

Countries with a legal system based on common law include England and Wales, Ireland, the USA, Australia, Canada and New Zealand. These countries rely on the application of equity to specific cases rather than a set of detailed rules to be applied in all cases. The effect in the UK, as far as financial reporting was concerned, was that there was limited legislation regulating the form and content of financial statements until the government was required to implement the EC Fourth Directive. The directive was implemented in the UK by the passing of the Companies Act 1981 and this can be seen as a watershed because it was the first time that the layout of company accounts had been prescribed by statute in England and Wales.

English common law heritage was accommodated within the legislation by the provision that the detailed regulations of the Act should not be applied if, in the judgement of the directors, strict adherence to the Act would result in financial statements that did not present a true and fair view.

Countries with a legal system based on Roman law include France, Germany and Japan. These countries rely on the codification of detailed rules, which are often included within their companies legislation. The result is that there is less flexibility in the preparation of financial reports in those countries. They are less inclined to look to fine distinctions to justify different reporting treatments, which is inherent in the common law approach.

However, it is not just that common law countries have fewer codified laws than Roman law countries. There is a fundamental difference in the way in which the reporting of commercial transactions is approached. In the common law countries there is an established practice of creative compliance. By this we mean that the spirit of the law is elusive[8] and management is more inclined to act with creative compliance in order to escape effective legal control. By creative compliance we mean that management complies with the form of the regulation but in a way that might be against its spirit, e.g. structuring leasing agreements in the most acceptable way for financial reporting purposes.

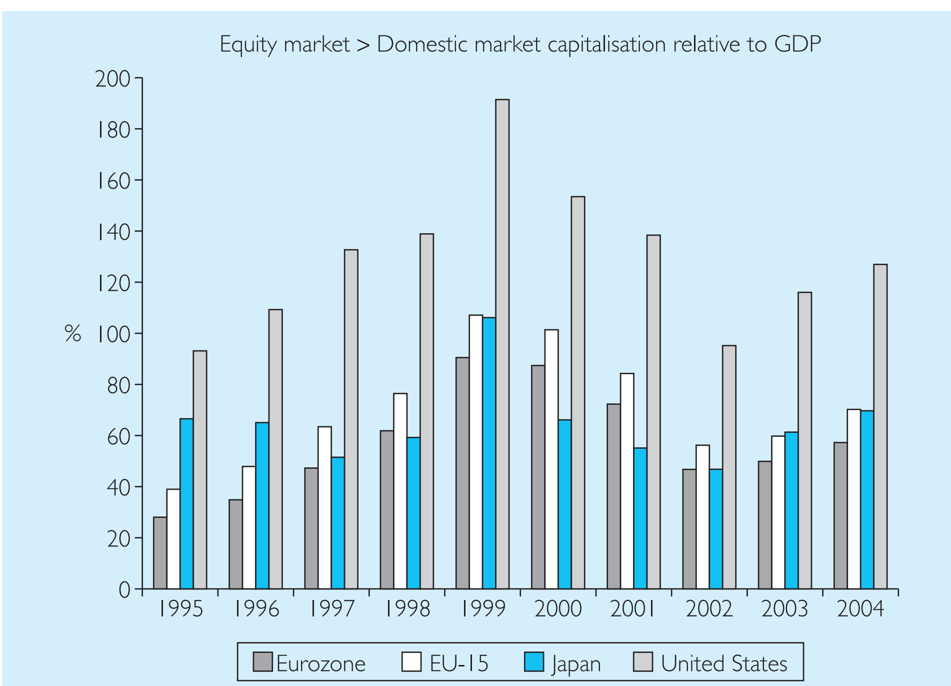
5.10.2 The way in which industry is financed

Accountancy is the art of communicating relevant financial information about a business entity to users. One of the considerations to take into account when deciding what is relevant is the way in which the business has been financed, e.g. the information needs of equity investors will be different from those of loan creditors. This is one factor responsible for international financial reporting differences because the predominant provider of capital is different in different countries.[9] Figure 5.2 makes a simple comparison between domestic equity market capitalisation and Gross Domestic Product (GDP).[10] The higher the ratio, the greater the importance of the equity market compared with loan finance.

We see that in the USA companies rely more heavily on individual investors to provide finance than in Europe or Japan. An active stock exchange has developed to allow shareholders to liquidate their investments. A system of financial reporting has evolved to satisfy a stewardship need where prudence and conservatism predominate, and to meet the capital market need for fair information[11] which allows interested parties to deal on an equal footing where the accruals concept and the doctrine of substance over form predominate. It is important to note that whilst equity has gained importance in all areas over the past ten years European statistics are *averages* that do not fully reflect the variation in sources of finance used between, say, the UK (equity investment is very important) and Germany (lending is more important). These could be important factors in the development of accounting.

In France and Germany, as well as equity investment having a lower profile historically, there is also a significant difference in the way in which shares are registered and transferred. In the UK, individual shareholders are entered onto the company's Register of Members. In France and Germany, many shares are bearer shares, which means that they are not registered in the individual investor's name but are deposited with a bank that has the authority to exercise a proxy. It could perhaps appear at first glance that the banks have

Figure 5.2 Domestic equity market capitalisation/gross domestic product



undue influence, but they state that, in the case of proxy votes, shareholders are at liberty to cast their votes as they see fit and not to follow the recommendations of the bank.[12] In addition to their control over proxy votes, the Big Three German banks, the Deutsche Bank, the Dresdner Bank and the Commerzbank, also have significant direct equity holdings, e.g. in 1992 the Deutsche Bank had a direct holding of 28% in Daimler Benz.[13]

There was an investigation carried out in the 1970s by the Gessler Commission into the ties between the Big Three and large West German manufacturing companies. The Commission established that the banks' power lay in the combination of the proxy votes, the tradition of the house bank which kept a company linked to one principal lender, the size of the banks' direct equity holdings and their representation on company supervisory boards.[14]

In practice, therefore, the banks are effectively both principal lenders and shareholders in Germany. As principal lenders they receive internal information such as cash flow forecasts which, as a result, is also available to them in their role as nominee shareholders. We are not concerned here with questions such as conflict of interest and criticisms that the banks are able to exert undue influence. Our interest is purely in the financial reporting implications, which are that the banks have sufficient power to obtain all of the information they require without reliance on the annual accounts. Published disclosures are far less relevant than in, say, the UK.

During the 1990s there was a growth in the UK and the USA of institutional investors, such as pension funds, which form an ever-increasing proportion of registered shareholders. In theory, the information needs of these institutional investors should be the same as those of individual investors. However, in practice, they might be in a position to obtain information by direct access to management and the directors. One effect of this might be that they will become less interested in seeking disclosures in the financial statements – they will have already picked up the significant information at an informal level.

5.10.3 The relationship of the tax and reporting systems

In the UK separate rules have evolved for computing profit for tax and computing profit for financial reporting purposes in a number of areas. The legislation for tax purposes tends to be more prescriptive, e.g. there is a defined rate for capital allowances on fixed assets, which means that the reduction in value of fixed assets for tax purposes is decided by the government. The financial reporting environment is less prescriptive but this is compensated for by requiring greater disclosure. For example, there is no defined rate for depreciating fixed assets but there is a requirement for companies to state their depreciation accounting policy. Similar systems have evolved in the USA and the Netherlands.

However, certain countries give primacy to taxation rules and will only allow expenditure for tax purposes if it is given the same treatment in the financial accounts. In France and Germany, the tax rules effectively become the accounting rules for the accounts of individual companies, although the tax influence might be less apparent in consolidated financial statements.

This can lead to difficulties of interpretation, particularly when capital allowances, i.e. depreciation for tax purposes, are changed to secure public policy objectives such as encouraging investment in fixed assets by permitting accelerated write-off when assessing taxable profits. In fact, the depreciation charge against profit would be said by a UK accountant not to be fair, even though it could certainly be legal or correct.[15]

Depreciation has been discussed to illustrate the possibility of misinterpretation because of the different status and effect of tax rules on annual accounts. Other items that require careful consideration include inventory valuations, bad debt provisions, development expenditure and revaluation of non-current assets. There might also be public policy arrangements that are unique to a single country, e.g. the existence of special reserves to reduce taxable profits was common in Scandinavia. It has recently been suggested that level of connection between tax and financial reporting follows a predictable pattern.[16]

5.10.4 The influence and status of the accounting profession

The development of a capital market for dealing in shares created a need for reliable, relevant and timely financial information. Legislation was introduced in many countries requiring companies to prepare annual accounts and have them audited. This resulted in the growth of an established and respected accounting profession able to produce relevant reports and attest to their reliability by performing an audit.

In turn, the existence of a strong profession had an impact on the development of accounting regulations. It is the profession that has been responsible for the promulgation of accounting standards and recommendations in a number of countries, such as the UK, the USA, Australia, Canada and the Netherlands.

In countries where there has not been the same need to provide market-sensitive information, e.g. in Eastern Europe in the 1980s, accountants have been seen purely as bookkeepers and have been accorded a low status. This explains the lack of expertise among financial accountants. There was also a lack of demand for financial management skills because production targets were set centrally without the emphasis for maximising the use of scarce resources at the business entity level. The attributes that are valued in a market economy such as the exercise of judgement and the determination of relevant information were not required. This position has changed rapidly and there has been a growth in the training, professionalism and contribution for both financial and management accountants as these economies become market economies.

5.10.5 The extent to which accounting theory is developed

Accounting theory can influence accounting practice. Theory can be developed at both an academic and professional level, but for it to take root it must be accepted by the profession. For example, in the UK, theories such as current purchasing power and current cost accounting first surfaced in the academic world and there were many practising accountants who regarded them then and still regard them now, as academic.

In the Netherlands, professional accountants receive academic accountancy training as well as the vocational accountancy training that is typical in the UK. Perhaps as a result of that, there is less reluctance on the part of the profession to view academics as isolated from the real world. This might go some way to explaining why it was in the Netherlands that we saw general acceptance by the profession for the idea that for information to be relevant it needed to be based on current value accounting. Largely as a result of pressure from the Netherlands, the Fourth Directive contained provisions that allowed member states to introduce inflation accounting systems.[17]

Attempts have been made to formulate a conceptual framework for financial reporting in countries such as the UK, the USA, Canada and Australia,[18] and the International Standards Committee has also contributed to this field. One of the results has been the closer collaboration between the regulatory bodies, which might assist in reducing differences in underlying principles in the longer term.

5.10.6 Accidents of history

The development of accounting systems is often allied to the political history of a country. Scandals surrounding company failures, notably in the USA in the 1920s and 1930s and in the UK in the 1960s and 1980s, had a marked impact on financial reporting in those countries. In the USA the Securities and Exchange Commission was established to control listed companies, with responsibility to ensure adequate disclosure in annual accounts. Ever-increasing control over the form and content of financial statements through improvements in the accounting standard-setting process has evolved from the difficulties that arose in the UK.

International boundaries have also been crossed in the evolution of accounting. In some instances it has been a question of pooling of resources to avoid repeating work already carried out elsewhere, e.g. the Norwegians studied the report of the Dearing Committee in the UK before setting up their new accounting standard-setting system in the 1980s.[19] Other changes in nations' accounting practices have been a result of external pressure, e.g. Spain's membership of the European Community led to radical changes in accounting,[20] while the Germans influenced accounting in the countries they occupied during the Second World War.[21] Such accidents of history have changed the course of accounting and reduced the clarity of distinctions between countries.

5.10.7 Language

Language has often played an important role in the development of different methods of accounting for similar items. Certain nationalities are notorious for speaking only their own language, which has prevented them from benefiting from the wisdom of other nations. There is also the difficulty of translating concepts as well as phrases, where one country has influenced another.

5.11 Efforts to standardise financial reports

Both the European Union (EU) and the International Accounting Standards Board have been active in seeking to standardise financial reports.

5.11.1 The European Union[22]

The European Economic Community was established by the Treaty of Rome in 1957 to promote the free movement of goods, services, people and capital. It was renamed in 1993 the European Union (the EU).

A major aim has been to create a single financial market that requires access by investors to financial reports which have been prepared using common financial reporting standards. The initial steps were the issue of accounting directives – these were the Fourth Directive, the Seventh Directive and the Eighth Directive.

The **Fourth Directive** – this prescribed the information to be published by individual companies:

- annual accounts comprising a profit and loss account and statement of financial position with supporting notes to the accounts;
- a choice of formats, e.g. vertical or horizontal presentation;
- the assets and liabilities to be disclosed;
- the valuation rules to be followed, e.g. historical cost accounting;
- the general principles underlying the valuations, e.g. prudence to avoid overstating asset values and understating liabilities, and consistency to allow for inter-period comparisons;
- various additional information such as research and development activity and any material events that have occurred after the end of the financial year.

The directive needs to be routinely updated to reflect changing commercial conditions, e.g. additional provisions relating to the reporting of off-balance sheet commitments.

The **Seventh Directive** requires:

- the consolidation of subsidiary undertakings across national borders, i.e. world-wide;
- uniform accounting policies to be followed by all members of the group;
- the elimination of the effect of inter-group transactions, e.g. eliminating inter-company profit and cancelling inter-company debt;
- the use of the formats prescribed in the Fourth Directive adjusted for the treatment of minority interests.

The **Eighth Directive** issued in 1984 defined the qualifications of persons responsible for carrying out the statutory audits of the accounting documents required by the Fourth and Seventh Directives.

Just as the Fourth and Seventh Directives have been updated to reflect changing commercial practices, so the Eighth Directive has required updating. In the case of the Eighth Directive the need has been to restore investor confidence in the financial reporting system following the financial scandals in the US with Enron and in the EU with Parmalat.

The amended directive requires:

- independent audit committees to have one financial expert as a member;
- audit committees to recommend an auditor for shareholder approval;
- audit partners to be rotated every seven years;
- public oversight to ensure quality audits;
- the group auditor bears full responsibility for the audit report even where other audit firms may have audited subsidiaries around the world.

It clarifies the duties and ethics of statutory auditors but has not prohibited auditors from carrying out consultancy work which some strongly criticise on the grounds that it compromises the independence of auditors.

5.11.2 The International Accounting Standards Board

The International Accounting Standards Committee (IASC) was established in 1973 by the professional accounting bodies of Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK, Ireland and the USA.

The IASC was restructured, following a review between 1998 and 2000, to give an improved balance between geographical representation, technical competence and independence.[23] The nineteen trustees of the IASC represent a range of geographical and professional interests and are responsible for raising the organisation's funds and appointing the members of the Board and the Standing Interpretations Committee (SIC). The International Accounting Standards Board (IASB) has responsibility for all technical matters including the preparation and implementation of standards. The IASB website (www.iasb.org.uk) explains that:

> The IASB is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. In addition, the IASB co-operates with national accounting standard-setters to achieve convergence in accounting standards around the world.

The IASB adopted all current IASs and began issuing its own standards, International Financial Reporting Standards (IFRSs). The body of IASs, IFRSs and associated interpretations are referred to collectively as 'IFRS'.

The process of producing a new IFRS is similar to the processes of some national accounting standard setters. Once a need for a new (or revised) standard has been identified, a steering committee is set up to identify the relevant issues and draft the standard. Drafts are produced at varying stages and are exposed to public scrutiny. Subsequent drafts take account of comments obtained during the exposure period. The final standard is approved by the Board and an effective date agreed. IFRS currently in effect are referred to throughout the rest of this book. The IASC also issued a *Framework for the Preparation and Presentation of Financial Statements*.[24] This continues to assist in the development of accounting standards and improve harmonisation by providing a basis for reducing the number of accounting treatments permitted by IFRS. Translations of IFRS have been prepared and published, making the standards available to a wide audience, and the IASB has a mechanism to issue interpretations of the standards.

It is interesting to see how by 2009 more than 100 jurisdictions have permitted or mandated the use of IFRS and the process is continuing throughout the world.

Position in the EU

The EU recognised that the Accounting Directives which provided accounting rules for limited liability companies were not, in themselves, sufficient to meet the needs of companies raising capital on the international securities markets. There was a need for more detailed standards so that investors could have adequate and transparent disclosures that would allow them to assess risks and opportunities and make inter-company comparisons – standards that would result in annual reports giving a fair view.

The IASB is the body that produces such standards and from 2005 the EU required[25] the consolidated accounts of all listed companies to comply with International Financial Reporting Standards. However, to give the IFRS legal force within the EU, each IFRS has to be endorsed by the EU.

Position in non-EU countries

The role of IFRSs in the following non-EU countries is:

- Australia – issues IFRSs as national equivalents.
- Canada – plans to adopt IFRSs as Canadian Financial Reporting Standards, effective 2011.
- China – all listed companies in China must comply with IFRS from 1 January 2007.
- India – plans to adopt IFRSs as Indian Financial Reporting Standards, effective 2011.
- Japan – in 2005 the Accounting Standards Board of Japan (ASBJ) and the IASB launched a joint project to establish convergence between Japanese GAAP and IFRS with full convergence to be achieved by 2011. It is important to recognise that existing Japanese GAAP financial statements are of a high standard with many issuers listed on international exchanges. The effect of convergence will give an additional advantage of being more comparable to other listed companies using global standards.
- Malaysia – plans to bring Malaysian GAAP into full convergence with IFRSs, effective 1 January 2012.
- New Zealand – issues IFRSs as national equivalents.
- Singapore – the Accounting Standards Council is empowered to prescribe accounting standards and the broad policy intention is to adopt IFRS after considering whether any modifications are required.

It is important to note that if a company wishes to describe its financial statements as complying with IFRS, IAS 1 requires the financial statements to comply with all the requirements of each applicable standard and each applicable interpretation. This clearly outlaws the practice of 'IAS-lite' reporting, observed in the 1990s, where companies claimed compliance with IASs while neglecting some of their more onerous requirements.

Extant IFRS are as follows:

IAS 1	Presentation of financial statements
IAS 2	Inventories
IAS 7	Statement of cash flows
IAS 8	Accounting policies, changes in accounting estimates and errors
IAS 10	Events after the reporting period
IAS 11	Construction contracts
IAS 12	Income taxes
IAS 16	Property, plant and equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee benefits
IAS 20	Accounting for government grants and disclosure of government assistance
IAS 21	The effects of changes in foreign exchange rates
IAS 23	Borrowing costs
IAS 24	Related party disclosures
IAS 26	Accounting and reporting by retirement benefit plans
IAS 27	Consolidated and separate financial statements
IAS 28	Investments in associates
IAS 29	Financial reporting in hyperinflationary economies
IAS 31	Interests in joint ventures
IAS 32	Financial instruments: Presentation
IAS 33	Earnings per share
IAS 34	Interim financial reporting
IAS 36	Impairment of assets
IAS 37	Provisions, contingent liabilities and contingent assets
IAS 38	Intangible assets
IAS 39	Financial instruments: recognition and measurement
IAS 40	Investment properties
IAS 41	Agriculture
IFRS 1	(Revised) First-time adoption of International Financial Reporting Standards
IFRS 2	Share-based payment
IFRS 3	(Revised) Business combinations
IFRS 4	Insurance contracts
IFRS 5	Non-current assets held for sale and discontinued operations
IFRS 6	Exploration for and evaluation of mineral resources

IFRS 7 Financial instruments disclosures

IFRS 8 Operating segments

IFRS 9 Financial Instruments (Phase 1)

5.12 What is the impact of changing to IFRS?

Making the transition to IFRS is no trivial task for companies, as comparative figures must also be restated. As the date of transition approaches many companies have published restatements reconciling previously published figures with figures computed and presented in accordance with IFRS. These reconciliations have proved a fertile ground for surveys by firms of accountants and academics.

15.12.1 Net income change

In some instances the changes have a dramatic effect on headline figures, e.g. the Dutch company, Wessanen, reported an increase of over 400% in its net income figure when the Dutch GAAP accounts were restated under IFRS. In other cases, there may be some large adjustments to individual balances, but the net effect may be less obvious.

15.12.2 Asset and liability changes

In certain countries there will be major changes in specific components of equity in the year of transition as particular assets or liabilities fall to be recognised (differently) from in the past. For example, the European hotel group, Accor, reported a reduction in total assets of only 1% when its 2004 statement of financial position was restated from French GAAP to IFRS, but within this, 'other receivables and accruals' had fallen by €294 million, a reduction of over 30% of the previously reported balance. In the UK many companies have made increased provisions for deferred tax liabilities on revalued properties and Australian companies have made large adjustments to their statements of financial position through the de-recognition of intangible assets.

In the short term, these changes in reported figures can have important consequences for companies' contractual obligations (e.g. they may not be able to maintain the level of liquidity required by their loan agreements) and their ability to pay dividends. There may be motivational issues to consider where staff bonuses have traditionally been based on reported accounting profit. As a result, companies may find that they need to adjust their management accounting system to align it more closely with IFRS.

15.12.3 Volatility in the accounts

In most countries the use of IFRS will mean that earnings and statement of financial position values will be more volatile than in the past. This could be quite a culture shock for analysts and others used to examining trends that follow a fairly predictable straight line.

While the change to IFRS has been covered in the professional and the more general press, it is not clear whether users of financial statements fully appreciate the effect of the change in accounting regulations, although surveys by KPMG (www.kpmg.co.uk/pubs/215748.pdf) and PricewaterhouseCoopers (www.pwchk.com/home/eng/ifrs_euro_investors_view_feb2006.html) indicated that most analysts and investors were confident that they understood the implications of the change.

5.13 Progress towards adoption by the USA of international standards

Global standards will only be achieved when the US fully adopts IFRSs to replace existing US GAAP. This process started in October 2002 when the IASB and the SEC jointly published details of what is known as the Norwalk Agreement. This included an undertaking to make their financial reporting standards fully compatible as soon as possible and to coordinate future work programmes to maintain that compatibility and to eventually mandate the use of IFRS by US listed companies. The process started with the Norwalk Agreement, followed by the IASB carrying out a Convergence Programme and finally joint standards being issued. The detailed progress was as follows.

5.13.1 The Norwalk Agreement

At their joint meeting in Norwalk in 2002, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) committed to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting aiming to:

- make their existing financial reporting standards fully compatible by undertaking a short-term project aimed at removing a variety of individual differences between US GAAP and International Financial Reporting Standards; and
- remove other differences between IFRSs and US GAAP remaining at 1 January 2005 (when IFRS became compulsory for consolidated accounts in Europe) through coordination of their future work programmes by undertaking discrete, substantial projects on which both Boards would work concurrently.

5.13.2 The Short-term Project

The aim was for the IASB and FASB to remove minor differences by changing their standard. For example, the IASB was to change IAS 11 *Construction Contracts*, IAS 12 *Income Taxes*, IAS 14 *Segment Reporting* and IAS 28 *Joint Ventures*, and the FASB was to change Inventory costs, Earnings per share and Research and Development costs.

By 2008 a number of projects were completed. For example, the FASB issued new or amended standards to bring standards in line with IFRS, e.g. it adopted the IFRS approach to accounting for research and development assets acquired in a business combination (SFAS 141R); in others the IASB converged IFRS with US GAAP, e.g. the new standard on borrowing costs (IAS 23 revised) and segment reporting (IFRS 8), and proposed changes to IAS 12 *Income taxes*.

The SEC was sufficiently persuaded by the progress made by the Boards that in 2007 it removed the reconciliation requirement for non-US companies that are registered in the USA and accepts the use IFRSs as issued by the IASB.

5.13.3 Plans for 2009–16

The intention is for the development of agreed standards to continue with a view to US publicly traded companies being permitted on a phased basis to use IFRS for their financial reports by 2015.

However, there is uncertainty at this time whether the target dates can be achieved because:

- attention might be diverted towards reacting to the credit crunch with an emphasis on going concern considerations and a review of fair value accounting; and
- there might be a political pressure on the SEC by members in Congress to delay mandating the use of IFRS for US companies; they might perhaps consider the lead time to be over-ambitious and also question the quality and universal enforceability of IFRS standards. It has to be recognised that it is a major step for the US to move from its rule based US GAAP to the IASB principle based IFRSs.

The SEC is considering (and perhaps have to be satisfied on?) progress in a number of areas such as improvements in IFRSs, IASB funding and accountability, the interface between XBRL and IFRS and improvements in IFRS education and training. There is a risk in setting out these requirements that the process is delayed or changes/improvements are rushed through. However, it is clear that, in principle, the SEC is fully committed to all US companies being eventually mandated to start using IFRS in their SEC filings.

5.14 Advantages and disadvantages of global standards for publicly accountable entities

Publicly accountable entities are those whose debt or equity is publicly traded. Many are multinational and listed on a stock exchange in more than one country. The main advantages arising from the development of international standards are that it reduces the cost of reporting under different standards, makes it easier to raise cross-border finance, leads to a decrease in firms' costs of capital with a corresponding increase in share prices and means that it is possible for investors to compare performance.

However, one survey[26] carried out in the UK indicated that finance directors and auditors surveyed felt that IFRSs undermined UK reporting integrity. In particular, there was little support for the further use of fair values as a basis for financial reporting which was regarded as making the accounts less reliable with comments such as, 'I think the use of fair values increases the subjective nature of the accounts and confuses unqualified users.'

There was further reference to this problem of understanding with a further comment: 'IFRS/US GAAP have generally gone too far – now nobody other than the Big 4 technical departments and the SEC know what they mean. The analyst community doesn't even bother trying to understand them – so who exactly do the IASB think they are satisfying?'

5.15 How do reporting requirements differ for non-publicly accountable entities?

Governments and standard setters have realised that there are numerous small and medium-sized businesses that do not raise funds on the stock exchange and do not prepare general purpose financial statements for external users.

5.15.1 Role of small firms in the UK economy

Small firms play a major role in the UK economy and are seen to be the main job creators. Interesting statistics on SMEs from a report[27] carried out by Warwick Business School showed:

By size:

2,200,000 businesses have no employees (about 61% of SMEs).

1,450,000 businesses have an annual turnover of less than £50,000 (about 40% of SMEs).

350,000 businesses have less than £10,000 worth of assets.

By legal form:

Almost two in three businesses are sole traders (2,400,000 businesses).

Less than one in four businesses are limited liability companies (870,000 businesses).

About one in ten businesses are partnerships (including limited liability partnerships).

By age:

The majority of businesses (51%) are aged more than fifteen years (1,900,000 businesses).

About 7% of SMEs are start-ups (aged less than two years) (250,000 businesses).

By growth rate:

About 11% of businesses (320,000 businesses) are high growth businesses, having an average turnover growth of 30%, or more, per annum over a period going back up to three years.

Certain companies are relieved of statutory and mandatory requirements on account of their size.

5.15.2 Statutory requirements

Every year the directors are required to submit accounts to the shareholders and file a copy with the Registrar of Companies. In recognition of the cost implications and need for different levels of privacy, there is provision for small and medium-sized companies to file abbreviated accounts.

A small company satisfies two or more of the following conditions:

- Turnover does not exceed £6.5 million.
- Assets do not exceed £3.26 million.
- Average number of employees does not exceed 50.

The company is excused from filing a profit and loss account, and the directors' report and statement of financial position need only be an abbreviated version disclosing major asset and liability headings. Its privacy is protected by excusing disclosure of directors' emoluments.

A medium-sized company satisfies two or more of the following conditions:

- Turnover does not exceed £25.9 million.
- Assets do not exceed £12.9 million.
- Average number of employees does not exceed 250.

It is excused far less than a small company: the major concession is that it need not disclose sales turnover and cost of sales, and the profit and loss account starts with the gross profit figure. This is to protect its competitive position.

5.15.3 National standards

Countries are permitted to adopt IFRS for publicly accountable entities and adopt their own national standards for non-publicly accountable entities. In the UK it is proposed to allow smaller entities to adopt the national standard Financial Reporting Standard for Smaller Entities (FRSSE) or the IFRS for SMEs issued by the IASB in July 2009.

First FRSSE issued[28]

In 1997 the ASB issued the first FRSSE. There was a concern as to the legality of setting different measurement and disclosure requirements, the ASB took legal advice which confirmed that smaller entities can properly be allowed exemptions or differing treatments in standards and UITFs provided such differences were justified **on rational grounds**.

How can rational grounds be established?

The test as to whether a decision is rational is based on obtaining answers to nine questions. If there are more negative responses than positive, there are rational grounds for a different treatment. The nine questions can be classified as follows:

Generic relevance

1 Is the standard essential practice for all entities?

2 Is the standard likely to be widely relevant to small entities?

Proprietary relevance

3 Would the treatment required by the standard be readily recognised by the proprietor or manager as corresponding to their understanding of the transaction?

Relevant measurement requirements

4 Is the treatment compatible with that used by the Inland Revenue in computing tax?

5 Are the measurement methods in a standard reasonably practical for small entities?

6 Is the accounting treatment the least cumbersome?

User relevance

7 Is the standard likely to meet information needs and legitimate expectations of the users?

8 Is the disclosure likely to be meaningful and comprehensible to users?

Expanding statutory provision

9 Do the requirements of the standard significantly augment the treatment required by statute?

How are individual standards dealt with in the FRSSE?

Standards have been dealt with in seven ways as explained in (a) to (g) below:

(a) Adopted without change

FRSSE adopted certain standards and UITFs without change.

(b) Not addressed

Certain standards were not addressed in the FRSSE, e.g. FRS 22 *Earnings per share*.

(c) Statements relating to groups are cross-referenced

If group accounts are to be prepared the FRSSE contains the cross-references required, e.g. to FRS 2 *Accounting for Subsidiary Undertakings*.

(d) Disclosure requirements removed

Certain standards apply but the disclosure requirement is removed, e.g. FRS 10 *Goodwill and Intangible Assets*.

(e) Disclosure requirements reduced

Certain standards apply but there is a reduced disclosure requirement, e.g. SSAP 9 *Stocks and Long-Term Contracts* applies but there is no requirement to sub-classify stock nor to disclose the accounting policy.

(f) Increased requirements

Certain standards are included with certain of the requirements reduced and other requirements increased, e.g. under FRS 8 *Related Party Disclosures* a new paragraph has been added, clarifying that the standard requires the disclosure of directors' personal guarantees for their company's borrowings.

(g) Main requirements included

Certain standards have their main requirements included, e.g. FRS 5 Reporting the substance of transactions, FRS 16 *Current Tax*, FRS 18 *Accounting Policies*, FRS 19 *Deferred Tax*.

The revised FRSSE

A revised FRSSE was issued in 2008 to incorporate changes in company law arising from the Companies Act 2006, which defines small companies as having an annual turnover of up to £6.5 million. No changes were made to the requirements that are based upon Generally Accepted Accounting Practice. Entities adopting the FRSSE continue to be exempt from applying all other accounting standards which reduces the volume of standards that a small entity needs to apply. They may of course still choose not to adopt the FRSSE and to comply with the other UK accounting standards and UITF Abstracts instead or, if they are companies, international accounting standards.

5.15.4 IFRS for SMEs

The IASB issued IFRS for SMEs in July 2009. The approach follows that adopted by the ASB with (a) some topics omitted e.g. earnings per share and segment reports, (b) simpler options allowed e.g. expensing rather than capitalising borrowing costs, (c) simpler recognition e.g. following an amortisation rather than an annual impairment review for goodwill and (d) simpler measurement e.g. using the cost method for associates rather than the equity method. SMEs are not prevented from adopting other options available under full IFRS and may elect to do this if they so decide.

However, in defining an SME it has moved away from the size tests towards a definition based on qualitative factors such as public accountability whereby an SME would be a business that does not have public accountability. Public accountability is implied if outside stakeholders have a high degree of either investment, commercial or social interest and if the majority of stakeholders have no alternative to the external financial report for financial information. The decision whether a business should be permitted to adopt IASB SME standards will be left to national jurisdictions subject to the right of any of the owners to require compliance with the full IFRSs.

Taking account of user needs and cost/benefit can be a complex task[29] and requires judgements to be made. For example:

User needs

Non-publicly accountable companies have a narrower range of users of their financial statements than publicly accountable companies which frequently have a detailed knowledge of the company with the facility to obtain information beyond the financial statements. This means that they may have less need to rely on the published financial statements.

However, whereas with publicly accountable companies there is a clear understanding that the primary user is the equity investor, the question remains for SMEs as to (a) the primary user, e.g. is it the non-managing owner, the long-term lender, the trade creditor or the tax authorities, and (b) what are the primary user's needs, e.g. maximising long-term growth, medium-term viability or short-term liquidity. Questions remain such as whether the financial statements need to be a stewardship report or decision-useful and, then, how are the characteristics such as relevance, reliability and comparability to be ranked and prioritised.

The approach to SME reporting has varied around the world. For example, in the USA there has not been an SME reporting regime in the sense of compliance with FRSs and IFRSs but SMEs have been permitted to prepare financial statements that are tax compliant; the IASB has only recently addressed the topic of SME reporting; in the UK the ASB has produced FRSSE, in drafting which it has taken a pragmatic approach when deciding which FRS provisions need not be applied by SMEs.

There is now a general awareness that the users of non-publicly-accountable companies are extremely diverse and steps are being taken to involve them in the standard-setting process, e.g. in Canada the Accounting Standards Board (AcSB) established a Differential Reporting Advisory Committee (DRAC) in 2000 as a standing committee to provide input to the standard-setting process by acting as a communication conduit for users, preparers and auditors of SMEs. In its response to the IASB Discussion Paper, *Preliminary Views on Accounting Standards for Small and Medium-sized Entities (SMEs)*, the AcSB restated that the approach taken by DRAC was to make a decision based on a cost/benefit approach making the interesting point that, as there were often fewer users of the financial statements, the cost per user could be excessive.

However, it appears that the research necessary to provide a rationale and conceptual approach to user needs is still some way off and the pragmatic approach taken by the ASB will inform financial reporting standards for SMEs for some time to come.

5.16 Evaluation of effectiveness of mandatory regulations

The events in the Sketchley plc takeover in 1990 suggest that mandatory regulations will not be effective.[30]

- In November 1989 Sketchley reported a fall in pre-tax profits for the half-year ended 30 December 1989 from £7.2 million to £5.4 million.
- In February 1990 Godfrey Davis Holdings made a bid to take over Sketchley.
- In March 1990 Sketchley issued a defence document forecasting pre-tax profits for the year ended 31 March 1990 of £6 million. Godfrey Davis Holdings withdrew in the light of these poor results.
- In March 1990, one week later, the Compass Group made a bid. Sketchley appointed a new management team and this second bid was defeated.

The new management team decided that the company had not made a profit of £6 million for the year ended 31 March 1990 after all – it had made a loss of £2 million.

Figure 5.3 Sketchley plc 1990 preliminary results

Sketchley plc 1990 preliminary results

(a)	Effect of more prudent accounting judgement (exercised by the new management team)	£000
	Reassessment of bad and doubtful debts	3,358
	Reassessment of stock provisions	2,770
	Write-off of fixed assets	773
		6,901
(b)	Provision for redundancy costs	554
(c)	Other items, including the effect of accounting policy changes	557
		8,012
	Profit before taxation, as forecast	6,000
	Loss before taxation, as reported	2,012

This has a familiar ring. It is very like the AEI situation of 1967, almost twenty-five years before. The adjustments made are shown in Figure 5.3.

Of course, it is not too difficult to visualise the motivation of the old and new management teams. The old team would take as favourable a view as possible of the asset values in order to resist a bid. The new team would take as unfavourable a view as possible, so that their performance would appear that much better in the future. It is clear, however, that the adjustments only arose on the change of management control, and without such a change we would have been basing investment decisions on a set of accounts that showed a £6 million profit rather than a £2 million loss.

There is often mention of the expectation gap, whereby shareholders appear to have lost faith in financial statements. The situation just discussed does little to persuade them that they are wrong. After all, what is the point of a regulatory system that ensures that the accounts present a fair view until the very moment when such a requirement is really necessary?

The area of provisioning and the exercise of judgement have finally been addressed by the regulators with the issue of national and international standards dealing with provisions.

5.16.1 Has the need for standards and effective enforcement fallen since 1990?

We only need to look at the unfortunate events with Enron and Ahold to arrive at an answer.

Enron

This is a company that was formed in the mid 1980s and became by the end of the 1990s the seventh-largest company in revenue terms in the USA. However, this concealed the fact that it had off balance sheet debts and that it had overstated its profits by more than $500 million – falling into bankruptcy (the largest in US corporate history) in 2001.

Ahold

In 2003 Ahold, the world's third-largest grocer, reported that its earnings for the past two years were overstated by more than $500 million as a result of local managers recording promotional allowances provided by suppliers to promote their goods at a figure greater than the cash received. This may reflect on the pressure to inflate profits when there are option schemes for managers.

5.17 Move towards a conceptual framework

The process of formulating standards has encouraged a constructive appraisal of the policies being proposed for individual reporting problems and has stimulated the development of a conceptual framework. For example, the standard on leasing introduced the idea in UK standards of considering the commercial substance of a transaction rather than simply the legal position.

When the ASC was set up in the 1970s there was no clear statement of accounting principles other than that accounts should be prudent, be consistent, follow accrual accounting procedures and be based on the initial assumption that the business would remain a going concern.

The immediate task was to bring some order into accounting practice. The challenge of this task is illustrated by the ASC report *A Conceptual Framework for Financial Accounting and Reporting: The Possibilities for an Agreed Structure* by R. Macve, published in 1981, which considered that the possibility of an agreed body of accounting principles was remote at that time.

However, the process of setting standards has stimulated accounting thought and literature to the point where, by 1989, the IASB had issued the *Framework for the Presentation and Preparation of Financial Statements*, IASC. In 1994, the ASB produced its exposure drafts of *Statement of Accounting Principles*, which appeared in final form in December 1999.

The development of conceptual frameworks is discussed further in Chapter 6.

Summary

It is evident from cases such as AEI/GEC and the Wiggins Group (see Question 4 in Chapter 2) that management cannot be permitted to have total discretion in the way in which it presents financial information in its accounts and rules are needed to ensure uniformity in the reporting of similar commercial transactions. Decisions must then be made as to the nature of the rules and how they are to be enforced.

In the UK the standard-setting bodies have tended to lean towards rules being framed as general principles and accepting the culture of voluntary compliance with explanation for any non-compliance.

Although there is a preference on the part of the standard setters to concentrate on general principles, there is a growing pressure from the preparers of the accounts for more detailed illustrations and explanations as to how the standards are to be applied.

Standard setters have recognised that small and medium-sized businesses are not publicly accountable to external users and are given the opportunity to prepare financial statements under standards specifically designed to be useful and cost effective.

The expansion in the number of multinational enterprises and transnational investments has led to a demand for a greater understanding of financial statements prepared in a range of countries. This has led to pressure for a single set of high quality international accounting standards. IFRS are being used increasingly for reporting to capital markets. At the same time, national standards are evolving to come into line with IFRS.

REVIEW QUESTIONS

1 Why is it necessary for financial reporting to be subject to (a) mandatory control and (b) statutory control?

2 How is it possible to make shareholders aware of the significance of the exercise of judgement by directors which can turn profits of £6 million into losses of £2 million?

3 'The effective working of the financial aspects of a market economy rests on the validity of the underlying premises of integrity in the conduct of business and reliability in the provision of information. Even though in the great majority of cases that presumption is wholly justified, there needs to be strong institutional underpinning.

'That institutional framework has been shown to be inadequate. The last two to three years have accordingly seen a series of measures by the financial and business community to strengthen it. Amongst these has been the creation of the Financial Reporting Council and the bodies which it in turn established.'[31]

Discuss the above statement with particular reference to one of the following institutions: Accounting Standards Board, Financial Reporting Review Panel, and Urgent Issues Task Force. Illustrate with reference to publications or decisions from the institution you have chosen to discuss.

4 The increasing perception is that IFRS is overly complex and is complicating the search for appropriate forms of financial reporting for entities not covered by the EU Regulation.[32] Discuss whether (a) the current criteria for defining small and medium companies are appropriate; and (b) having a three-tiered approach with FRSSE for small, IFRS SME for medium-sized, and IFRS for large private companies might alleviate the problem.

5 'The most favoured way to reduce information overload was to have the company filter the available information set based on users' specifications of their needs.'[33] Discuss how this can be achieved given that users have differing needs.

6 'Every medium-sized European company should be required to prepare their financial reports in accordance with an IFRSSE which is similar in content to the UK's FRSSE.' Discuss.

7 Research[34] has indicated that narrative reporting in annual reports is not neutral, with good news being highlighted more than is supported by the statutory accounts and more than bad news. Discuss whether mandatory or statutory regulation could enforce objectivity in narrative disclosures and who should be responsible for such enforcement.

8 How does the regulatory framework for financial reporting in the UK differ from that in the USA? Which is better for particular interest groups and why?

9 Is it appropriate that scandal should have a role in the development of accounting regulation. Compare the reaction to the Enron financial statements in the early part of the twenty-first century with the reaction to the financial statements of AEI and Pergamon Press in the 1960s.

10 'The current differences between IASs and US GAAP are extensive and the recent pairing of the US Financial Accounting Standards Board and IASB to align IAS and US GAAP will probably result in IAS moving further from current UK GAAP.'[35]

Discuss the implication of this on any choice that non-listed UK companies might make regarding complying with IFRS rather than UK GAAP after 2005.

EXERCISES

Question 1

Constructive review of the regulators.

Required:

(a) Obtain a copy of the Financial Reporting Council's Annual Review.
(b) Prepare a profile of the members of the ASB.
(c) Comment on the strengths and weaknesses revealed by the profile.
(d) Advise (with reasons) on changes that you consider would strengthen the ASB.

Question 2

Obtain the financial statements of two companies based in different countries. Review the accounting policies notes. Analyse what the policies tell you about the regulatory environment in which the two companies are operating.

Question 3

Consider the interest of the tax authorities in financial reporting regulations. Explain why national tax authorities might be concerned about the transition from domestic accounting standards to IFRS in companies' annual reports.

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