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Digital Area for Networking Teachers and Educators

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Financial Reporting Standards

Introduction

- **The objective** of financial reporting and the importance of financial reporting standards.
- **The roles** of financial reporting standard-setting bodies and regulatory authorities in establishing and enforcing reporting standards.
- The International Accounting Standards Board's **conceptual framework**, including qualitative characteristics of financial reports, constraints on financial reports, and required reporting elements.
- **General requirements** for financial statements under International Financial Reporting Standards (IFRS).
- **Implications** for financial analysis of alternative financial reporting systems and the importance of monitoring developments in financial reporting standards.

The objective of financial reporting

- **Accounting Standards Board (IASB)** sets financial reporting standards that have been adopted in many countries.
- **The objective of financial reporting** is to provide financial information that is useful to users in making decisions about providing resources to the reporting entity.
- **Developing financial reporting standards** is complicated because the underlying economic reality is complicated.
- **Financial reports** are intended to provide information to many users, including investors, creditors, employees, customers, and others.
- The financial reports **provide important inputs** into the process of valuing a company or the securities a company issues.

Standard-setting bodies and regulatory authorities

- A distinction must be made between **standard-setting bodies and regulatory authorities**.

- **Standard-setting bodies**, such as the IASB and FASB, are typically private sector, self-regulated organizations with board members who are experienced accountants, auditors, users of financial statements, and academics.

- The requirement to prepare financial reports in accordance with specified accounting standards is the responsibility of regulatory authorities.

- Generally, standard-setting bodies set the standards and regulatory authorities recognise and enforce the standards.

- Without the recognition of the standards by the regulatory authorities, the private sector standard-setting bodies would have no authority.

International accounting standards board

- **The IASB is the independent standardsetting body of the IFRS Foundation**, an independent, not-for-profit private sector organization.

- The Trustees of the IFRS Foundation reflect a diversity of geographical and professional backgrounds.

- The Trustees appoint the members of the IASB and are **accountable to a monitoring board composed of public authorities** that include representatives from the European Commission, IOSCO, the Japan Financial Services Agency, and the US SEC, with the chairman of the Basel Committee on Banking Supervision as an observer.

The principle objectives of the IFRS Foundation are to develop and promote the use and adoption of a single set of high quality financial standards:

- to ensure the standards result in transparent, comparable, and decision-useful information while taking into account the needs of a range of sizes and types of entities in diverse economic settings

- and to promote the convergence of national accounting standards and IFRS.

Regulatory authorities

- **Regulatory authorities are governmental entities** that have the legal authority to enforce financial reporting requirements and exert other controls over entities that participate in the capital markets within their jurisdiction.
- **Regulatory authorities may require** that financial reports be prepared in accordance with one specific set of accounting standards or may specify acceptable accounting standards.

The international financial reporting standards framework

The framework is designed to:

- **assist standard setters** in developing and reviewing standards,
- **assist preparers of financial statements** in applying standards and in dealing with issues not specifically covered by standard,
- **assist auditors** in forming an opinion on financial statements,
- **assist users** in interpreting financial statement information.

The international financial reporting standards framework

- **The objective of financial reporting** is the provision of **financial information** that is useful to current and potential providers of resources in making decisions and all other aspects of the framework flow from that central objective.

- **The providers of resources** are considered to be **the primary users of financial reports and include investors, lenders, and other creditors.**

- The purpose of providing the financial information is to be useful in making decisions about providing resources.

- **Information** is needed about the company's financial position: **its resources and its financial obligations**.

- Information is needed about a company's financial performance; how and why the company's financial position changed in the past and can be useful in evaluating potential changes in the future.

- **Information need** is the need for information about **a company's cash**.

Qualitative Characteristics of Financial Reports

Flowing from the central objective of providing information identifies **two fundamental qualitative characteristics** that make financial information useful: **relevance and faithful representation**.

- **Relevance:** Information is relevant if it would potentially affect or make a difference in users' decisions. The information can have predictive value, confirmatory value, or both.

- **Faithful representation:** Information that faithfully represents an economic phenomenon that it purports to represent is ideally complete, neutral, and free from error.

The Conceptual Framework identifies **four** enhancing **qualitative characteristics: comparability, verifiability, timeliness, and understandability.**

- **Comparability:** Comparability allows users "to identify and understand similarities and differences of items."

- **Verifiability:** Verifiability means that different knowledgeable and independent observers would agree that the information presented faithfully represents the economic phenomena it purports to represent.

- **Timeliness:** Timely information is available to decision makers prior to their making a decision.

- **Understandability:** Clear and concise presentation of information enhances understandability.

Constraints on financial reports

- **A limitation of financial reporting** involves information that is not included in financial statements.
- For example, **the creativity, innovation, and competence of a company's work force** are not directly captured in the financial statements.
- **Similarly, customer loyalty, a positive corporate culture, environmental responsibility**, and many other aspects about a company may not be directly reflected in the financial statements.
- Of course, to the extent that these items result in superior financial performance, a company's financial reports will reflect the results.

Example

Companies are most likely to make tradeoffs between which of the following when preparing financial reports?

- A Relevance and materiality.
- B Timeliness and verifiability.
- C Relevance and faithful representation.

Solution:

- B is correct, because providing timely information implies a shorter time frame between the economic event and the information preparation.

The elements of financial statements

- **Financial statements** portray **the financial effects of transactions** and other events by grouping them into broad classes (elements) according to their .

- **Three elements of financial statements** are directly related to the measurement of financial position: assets, liabilities, and equity.

  ✓ **Assets:** A present economic resource controlled by the entity as a result of past events. Assets are what a company owns (e.g., inventory and equipment).

  ✓ **Liabilities:** A present obligation of the entity to transfer an economic resource as a result of past events. Liabilities are what a company owes (e.g., bank borrowings).

  ✓**Equity are Assets less liabilities:** Equity is the residual interest in the assets after subtracting the liabilities.

The elements of financial statements

The elements of financial statements directly related to the measurement of performance (profit and related measures) are income and expenses.

- **Income:** Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims. Income includes both revenues and gains.

- **Expenses:** Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

General requirements for financial statements

Standard (IAS) No. 1 - Presentation of Financial Statements specifies the required financial statements, general features of financial statements, and structure and content of financial statements.

IASB General Requirements for Financial Statements:

- Required Financial Stat
- General Features of Financial Statementsements
- Structure and Content Requirements

Required Financial Stat

Under IAS No. 1 - a complete set of financial statements includes:

- a statement of financial position (balance sheet);
- a statement of comprehensive income
- a statement of changes in equity, separately showing changes in equity resulting from profit or loss.
- a statement of cash flows;
- notes comprising a summary of significant accounting policies and other explanatory notes that disclose information required by IFRS.

General Features of Financial Statementsements

IAS No. 1 - specifies a number of **general features underlying** the preparation of financial statements.

- **Fair Presentation:** The application of IFRS is presumed to result in financial statements that achieve a fair presentation.
- **Going Concern:** Financial statements are prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading.
- **Accrual Basis:** Financial statements (except for cash flow information) are to be prepared using the accrual basis of accounting.
- **Materiality and Aggregation:** Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions.
- **No Offsetting:** Assets and liabilities, and income and expenses, are not offset unless required or permitted by an IFRS.
- **Frequency of Reporting:** Financial statements must be prepared at least annually.
- **Comparative Information:** Financial statements must include comparative information from the previous period.
- **Consistency:** The presentation and classification of items in the financial statements are usually retained from one period to the next.

Structure and Content Requirements

IAS No. 1 - also specifies **structure and content of financial statements**.

- **Classified Statement of Financial Position (Balance Sheet):** requires the balance sheet to distinguish between current and non-current assets, and between current and non-current liabilities.

- **Minimum Information on the Face of the Financial Statements:** specifies the minimum line item disclosures on the face of, or in the notes to, the financial statements.

- **Minimum Information in the Notes** (or on the face of financial statements): specifies disclosures about information to be presented in the financial statements.

- **Comparative Information:** For all amounts reported in a financial statement, comparative information should be provided for the previous period unless another standard requires or permits otherwise.

Monitoring developments in financial reporting standards

- Analysts need to monitor ongoing developments in financial reporting and assess their implications for security analysisand valuation.
- An accountant monitors these developments from a preparer's perspective and an analyst needs to monitor from a user's perspective.
- More specifically, analysts need to know how these developments will affect financial reports.

Summary

- **The objective of financial reporting** is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

- **Financial reporting** requires policy choices and estimates. Accordingly, standards are needed to ensure increased consistency in these judgments.

- **Private sector standard setting bodies and regulatory authorities** play significant but different roles in the standard setting process. In general, standard setting bodies make the rules, and regulatory authorities enforce the rules.

- **The IFRS framework sets forth the concepts** that underlie the preparation and presentation of financial statements for external users.

Summary

- **The objective of fair presentation of useful information is the center of the IASB's Conceptual Framework**. The enhancing characteristics identified are comparability, verifiability, timeliness, and understandability.

- **IFRS Financial Statements: IAS No. 1 -** prescribes that a complete set of financial statements includes a statement of financial position , a statement of comprehensive income, a statement of changes in equity, a cash flow statement, and notes. The notes include a summary of significant account ing policies and other explanatory information.

- **Financial statements need to reflect certain basic features**: fair presentation, going concern, accrual basis, materiality and aggregation, and no offsetting.

Summary

- **Financial statements must be prepared at least annually**, must include comparative information from the previous period, and must be consistent.
- **Financial statements must** follow certain presentation requirements including a classified statement of financial position (balance sheet) and minimum information on both the face of the financial statements and in the notes.
- Analysts can remain aware of ongoing developments in financial reporting by monitoring new products or types of transactions.

Control questions

Which of the following is most likely not an objective of financial statements?

a) To provide information about the performance of an entity.

b) To provide information about the financial position of an entity.

c) To provide information about the users of an entity's financial statements.

International financial reporting standards are currently developed by which entity?

a) A The IFRS Foundation.

b) B The International Accounting Standards Board.

c) C The International Organization of Securities Commissions.

Control questions

Which of the following is not a constraint on the financial statements according to the Conceptual Framework?

a) Understandability.

b) Benefit versus cost.

c) Balancing of qualitative characteristics.

Which of the following is not a required financial statement according to IAS No. 1?

a) Statement of financial position.

b) Statement of changes in income.

c) Statement of comprehensive income.

Control questions

Which of the following elements of financial statements is most closely related to measurement of performance?

a) Assets.

b) Expenses.

c) Liabilities.

Which of the following disclosures regarding new accounting standards provides the most meaningful information to an analyst?

a) The impact of adoption is discussed.

b) The standard will have no material impact.

c) Management is still evaluating the impact.

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