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Financial Accounting



CHAPTER 1: REGULATION IN FINANCIAL ACCOUNTING**LEARNING OUTCOMES**

Upon completion of this chapter you should be able to:

1. Understand the difference between management and financial accounting
2. Understand why accounting regulations are important and required
3. Understand the need for and the structure of professional regulation, company law, stock exchange legislation and EU Directives
4. Understanding how the different aspects of regulation work together and complement each other
5. Understand the process through which an accounting standard comes into being

REVISION RESOURCES

SEMINAR: This topic will be reviewed and discussed in **Revision Seminar 1**.

EXAM QUESTIONS: **Pilot and Past papers** are available from the website of Accounting Technicians Ireland and are essential aides when studying Financial Accounting II topics.

1.1 Introduction

Welcome to Financial Accounting II. Having successfully completed Financial Accounting I you will be aware of some financial accounting terminology. Financial accounting terminology differs between that used in the UK/Ireland professional regulations and that used under International professional regulations, although the underlying item/event is the same. For example under UK/Irish professional regulation the term given to an entity who owes our company monies is a **debtor**, under international regulation the term used is **receivables**. In both cases the underlying item is the exact same – an entity who owes monies to our company.

Globally there has been a significant shift away from local professional accounting regulation towards international regulation – the reasons for this are explained in detail later in this chapter. The Financial Accounting II syllabus (and this manual) by the Accounting Technicians Ireland has been written and will be examined under international professional regulations. As a student of the Accounting Technicians Ireland you are training for a professional qualification and therefore using the appropriate terminology and format, in this case **International Accounting Standards and terminology is expected by your examiner**. This is an important point to note as you prepare to commence your studies. Therefore before proceeding, the international professional terminology outlined below should be reviewed to ensure that you are familiar with it and understand it.

Terminology

Ireland/UK	International
Profit and Loss Account	Income Statement
Turnover/Sales	Revenue
Taxation	Income Tax
Fixed Assets	Non-Current Assets
Tangible Fixed Assets	Property, Plant and Equipment
Stock	Inventory
Debtors	Receivables
Creditors	Payables
Shareholders Funds	Equity
Capital and Reserves	Equity

1.2 The Function of Financial Accounting

While there are many definitions of accounting worldwide, provided by various accounting bodies, all tend to have the following elements in common. That is that financial accounting is a process which is undertaken with the ultimate aim of:

- identifying
- measuring
- communicating

information to the users of accounting information, in order to allow them to make informed judgements and decisions. The information which is identified, measured and communicated is largely financial in nature.

The identification of information is undertaken in the bookkeeping process - covered in Financial Accounting I. Here transactions are identified and recorded in the books and record of the business entity via the double entry system of bookkeeping.

At year end or month end information is extracted from the double entry bookkeeping system and is measured, presented and communicated in a manner that is more understandable to the users of accounting information – for example in the Income Statement the prime piece of information measured and communicated is whether the entity made a profit/loss in the period covered by the income statement. While in the Balance Sheet information relating to the assets and liabilities and the ultimate financial position of the business entity is measured and communicated.

Financial Accounting I focused on the following areas:

- *Identification* and recording of financial information – this is achieved via the double entry bookkeeping system which records transactions. Accounting procedures such as the preparation of control accounts and

bank reconciliation statements ensured that the information contained in the double entry system is accurate. Errors therein are corrected via a suspense account.

- *Measuring* the financial performance of a sole trader via the income statement and the balance sheet.

In Financial Accounting II the knowledge gained in Financial Accounting I will be built upon and expanded. The preparation of an income statement and balance sheet for a partnership and limited company will be examined. A new financial statement that measures the cash position of a business entity will also be examined. Therefore while Financial Accounting I focused on identification and measuring financial information Financial Accounting II will focus on the communication of this information to users of accounting information. How this information is communicated is extremely important as the ultimate aim of the financial accounting process is to produce financial information about an entity that is understandable, relevant, reliable and comparable to aid the users of financial information make decisions about the business entity.

Take for example the financial information of a limited company – this is potentially of interest to a wide variety of users of accounting information. All of these users have different needs and requirements. Therefore the manner in which financial information is communicated is important. A significant body of professional regulation and Company Law requirements seek to ensure that this is the case. These rules and regulations are discussed in detail in Financial Accounting II.

It should be clear that the information presented in Financial Accounting I and Financial Accounting II combined describe in detail the financial accounting process. Students should be aware that the information presented in Financial Accounting I is assumed knowledge and is built upon over the course of Financial Accounting II. It is quite possible that the Financial Accounting II examination will incorporate areas covered in Financial Accounting I.

1.3 The Need for Accounting Regulation

When an individual chooses to set up a business that business can be carried on through the medium of either: a sole trader business, a partnership or a limited company. The decision as to which medium to carry on a business through depends upon several factors. Conducting business through each type of business entity has both advantages and disadvantages. These were examined in Financial Accounting I and are assumed knowledge.

The need and importance of accounting regulation only becomes apparent when one examines key characteristics of the various mediums through which a business venture can be carried on through.

Sole Trader

A sole trader business as the name suggests is a business where one person owns the business. A sole trader business tends to be small and operates on an informal basis. Further and critical to understanding the need for professional regulation the following two traits of a sole trader business must be understood:

- A sole trader will usually undertake an active role in the management and running of the business. Therefore on a daily basis a sole trader will know how the business is performing in financial terms. The income statement and balance sheet produced at the end of each month/year will just formalise in financial terms what the sole trader is already aware of.

Sole traders are only required to produce financial information for the tax authorities and where a loan is being sought they may be required to produce this information for the lending institution.

- The sole trader and the business are not recognised as separate legal entities and because of this sole traders have unlimited liability.

Unlimited liability means that there is no distinction between the sole trader's personal wealth and that of the business. If the business runs into financial difficulty and cannot meet its debt repayments, the businesses creditors (to whom the money is owed) have recourse to the personal assets of the sole trader. The sole trader bears all the risks and receives all the return from the businesses operations. This feature reduces the risk of interacting on a business level with sole traders as not only do creditors have access to the wealth of the business but to the personal wealth of the sole trader, should the business fail.

Partnerships are business entities where ownership is divided between at least two people. Usually partnerships have no more than twenty individual partners. Partnerships are discussed in detail in Chapter six. However for the moment the most important feature of a partnership business is that like a sole trader business, partners in a partnership tend to be involved in the day to day operation of the business. Partnerships are not required to produce financial information for any other users of accounting information except the partners of the partnership, the tax authorities and a lending institution where applicable. Like sole traders, partners in a partnership (in the majority of situations) do not enjoy limited liability.

Limited Companies

Limited Companies are very different. The term limited company is derived from the fact that the liability of the owners of a limited company is limited to the funds which they have invested in the company. Thus a key advantage of a limited company is that they offer greater protection of the personal wealth of the owners than either a sole trader or partnership business. However from the point of view of those that interact with limited companies this increases the risk that they face.

A limited company can either be a Private Limited Company which does not sell its shares to the general public or a Public Limited Company which sells

its shares to the public. As discussed in detail in Chapter four the possession of an ordinary share in a limited company gives the holder the right of partial ownership of the company.

These two key features of limited companies are very important and help to explain why limited companies are regulated and governed in the manner set out in the remainder of this chapter.

- Limited liability – these implies that those who interact with the company on a daily basis, for example suppliers who supply goods and services on credit, risk that the company will go out of business. In such a situation the supplier only has recourse to the assets of the business in order to secure payment for debts and not to personal assets of the owners of the business. This implies that those who interact with limited companies take on a high level of risk. The risk can be mitigated by examining the financial statements of a limited company prior to commencing transacting with that limited company.
- Ownership of limited companies tends to be much broader and more dispersed than that of either a sole trader or partnership business. In most cases in public limited companies the shareholders (owners) will not be involved in the day to day running of the business at all. Thus shareholders require information as to the financial performance and position of the public limited company. This is achieved by making the financial statements of a Plc widely available.

The preceding discussion has attempted to highlight an important point: that is for a variety of reasons the financial statements of limited companies (both private and public) are available to a much wider population of users than those of either a sole trader or partnership business. Many of these users have no involvement in the day to day running of the company, yet they still need to be able to rely upon and understand the information contained in the financial statements. Over time a wide body of professional regulation and

statutory legislation has been developed to this end. The remainder of the chapter is devoted to examining the various sources of regulation in financial accounting in Ireland and the UK presently.

1.4 The Regulatory Framework under which Financial Statements are Prepared

The users of financial information are a wide and diverse group as discussed in Financial Accounting I. The users of financial information require this information for a wide variety of reasons. Nonetheless every user of financial information has a common requirement that the information is relevant, reliable, understandable and comparable. To this end a wide variety of regulation has developed around the preparation of a set of financial statements, combined these are referred to as the Regulatory Framework or GAAP.

The term GAAP is used widely in relation to accounting regulation. GAAP stands for Generally Accepted Accounting Practices. These generally accepted accounting practices are made up of all the accounting rules and regulation in a particular jurisdiction. Therefore in Ireland Irish GAAP comprises of professional legislation, Irish Company Law, EU Regulations and Stock Exchange Regulation. US GAAP will be different to Irish GAAP but will still comprise of US professional regulation, US Company Law Requirements and Stock Exchange Regulation.

For Ireland and the UK the various pieces of regulation which combined constitute GAAP/Regulatory Frameworks are as follows:

- Professional Regulation (both International and Domestic)
- Company Law Requirement
- EU Directives
- Stock Exchange Regulation

1.4.1 Professional Regulation (both International and Domestic)

Domestic Regulation

Professional regulation was largely absent in Ireland and the UK prior to the 1970s. The Institute of Chartered Accountants in England and Wales issued guidance on accounting principles to its members. The guidance issued was just that, guidance and as such it was not enforceable. However in the late 1960s the accounting profession suffered a wave of adverse publicity in relation to the accounting principles widely used by companies. One such example was the GEC-AEI takeover. AEI prior to the take over had used an allowable method of valuing inventory which resulted in a forecasted profit figure for 1967 of £10m (Sterling). GEC on applying a different, but still allowable method of stock valuation to the same underlying inventory items found that the £10m profit was converted into a £4.5m loss. The fundamental issue behind the controversy was that both methods of valuing inventory were allowable at the time. The concern which this raised was that if firms were free to choose different accounting methods and these methods led to very different profit figures being reported how could the users of accounting information rely on the information contained in the annual report of companies?

A significant amount of criticism was levied against the accounting profession in this respect. Therefore in the 1970s the Accounting Standards Committee (ASC) was set up by the accounting profession in an attempt to self regulate and address the criticisms that had been levied. The committee issued accounting standards known as Statements of Standard Accounting Practices (SSAPs). Later in the 1990s the Accounting Standards Board (ASB) replaced the ASC. The ASB issues accounting standards known as Financial Reporting Standards (FRSs). Currently in the UK and Ireland both FRSs and SSAPs exist, their function is to describe and provide guidance to accounting practitioners and the users of financial information about how contentious and difficult areas where a variety of different treatments have developed over time should be treated. Thus an accounting standard is in effect a rule or a

series of rules that describes how an item in financial accounting is treated and calculated.

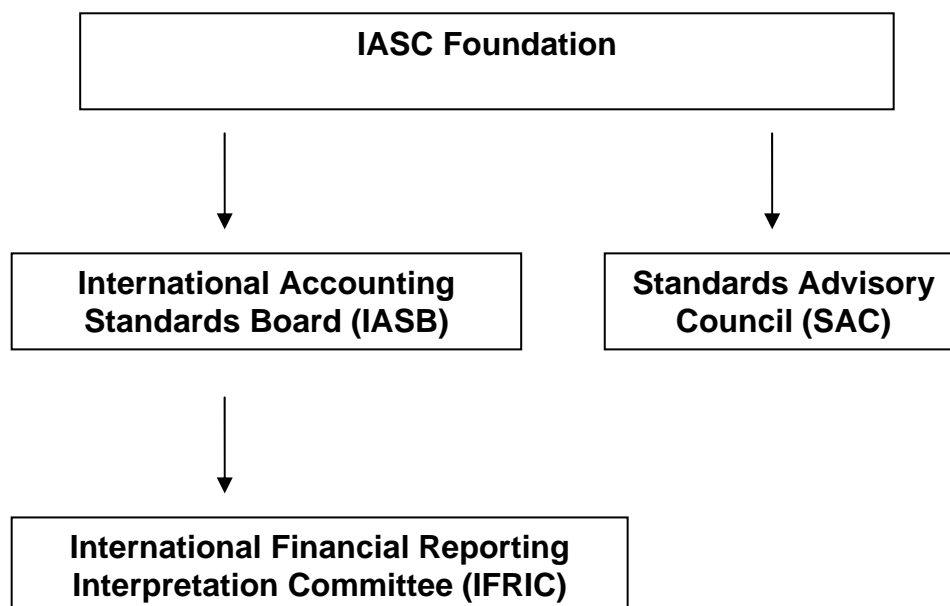
In the latter portion of the twentieth century international trade began to grow significantly. This was evidenced both through a significant increase in cross border trade between nations and through the growth of the multinational organisation. A multinational organisation is one that operates in more than one country, a significant portion of the companies which we interact with every day are multinational organisations. Many within the accounting profession were therefore of the opinion that a worldwide accounting standard body was necessary.

International Regulation

The International Accounting Standards Committee (IASC) was set up in 1973. The IASC issued accounting standards called International Accounting Standards (IAS). Its members were drawn from the professional bodies of accountants worldwide (including the ASC and later the ASB in Ireland and the UK). Members were encouraged to use their best efforts to get domestic standard setters, auditors, governments and stock exchanges to comply with international standards. The aim of the IASC was to promote international comparability and consistency between the financial statements prepared by companies worldwide.

In January 2001 the International Accounting Standards Board (IASB) on the recommendation of the IASC's Strategy Working Party replaced the IASC as the standard setting body. The Strategy Working Party was created in 1997 and charged with reviewing the IASC in terms of structure and process. International accounting standards do not have the force of law. They are only effective if adopted by national regulatory bodies in various countries.

The current structure of the IASB is as follows:



The IASC Foundation

The IASC Foundation is now the supervisory body within the structure. The objectives of the IASC Foundation is to develop, in the public interest a single set of high quality accounting standards, to promote the use and rigorous application of those standards and to bring about the convergence of national accounting standards (UK & Irish SSAPs and FRSs for example) and international accounting standards. The IASC are responsible for appointing members of the other three bodies although the IASC is excluded from involvement in technical matters relating to accounting standards.

The International Accounting Standards Board (IASB)

The International Accounting Standards Board is responsible for issuing new IFRS. An IAS/IFRS will sometime contain more than one permitted accounting treatment for a transaction or event. One of them will usually be designated the benchmark treatment, that is the most appropriate treatment. The other treatments, if acceptable, are classified as allowed alternative treatments. The IASB does try to minimise the amount of allowed alternative treatments –

however they have been necessary in some cases. The IASB has fourteen members, seven of which are responsible for liaising with national standard-setters in order to promote the convergence of accounting standards. Thus the importance placed on convergence of local standards with international standards is apparent.

International Financial Reporting Interpretations Committee (IFRIC)

International Financial Reporting Interpretations Committee (IFRIC) issue speedy guidance where there are different interpretations of IASs/IFRSs or where a new development in business had lead to some inconsistency arising. They report to the IASB and must obtain IASB approval for their interpretations before they are issued.

The Standards Advisory Council (SAC)

The Standards Advisory Council (SAC) exists to provide the IASB with advice on major standard projects and sets the agenda for the IASB. It has about 35 to 40 members, including representatives of national standard setters and other interested parties. The role envisaged for national standards setters (the ASB for example) going forward is for them to become part of the advisory board that will feed into the setting of new international standards.

1.4.2. Company Law

A detailed discussion of the provisions and requirements of the Companies Act is beyond the scope of the course. The Companies Acts cover all aspects relating to a company for example: the setting up (preparation of the Memorandum and Articles of Association), the rights and responsibilities of the officers of a company (for example the company directors), the manner in which financial information must be presented and disclosed to the users of accounting information and filing requirements for companies (when must the 2009 financial statements be filled with the Company Registration Office and thereby made available to the public).

From the perspective of Financial Accounting II the most relevant aspects of Company Law are the disclosure requirements – what information must be

presented in a set of financial statements. The Companies Acts as amended 1963, 1983, 1986, 1990 and 2006 combined form the minimum disclosure requirements a company must adhere to by law. When discussing disclosures we are really discussing what information must be included within a set of financial statements, examples of disclosures include the level and nature of directors remuneration and the level of the audit fee.

Company law also determines what a set of financial statements must include - this depends upon the size of the company. Company law prescribes the criteria for determining the size of a company.

In the Republic of Ireland the criteria are as follows:

Size	Small	Medium	Large
Balance sheet total up to	€1,904,607	€7,618,428	> €7,618,428
Turnover up to	€3,809,214	€15,236,856	> €15,236,856
Average number of employees	50	250	> 250

In the UK and Northern Ireland the criteria are as follows:

Size	Small	Medium	Large
Balance sheet total up to	£2,800,000	£11,400,000	>£11,400,000
Turnover up to	£5,600,000	£22,800,000	>£22,800,000
Average number of employees	50	250	> 250

Normally two out of the three criteria are required for a company to fall within a particular category.

The following table outlines what information must be disclosed depending upon the size of a company.

Company Type	Content of Financial Statements
Small private company limited by shares	Auditor's report and an abridged balance sheet
Medium private company limited by shares	Auditor's report, an abridged income statement and an abridged balance sheet

Large private company limited by shares	Director's report, auditor's report, an income statement and a balance sheet
Public company limited by shares	Director's report, auditor's report, an income statement and a balance sheet

1.4.3 EU Directives

Both Ireland and the UK joined the European Community (formally the European Economic Community) on January 1st 1973. One of the fundamental projects which the EU has engaged in is harmonisation across member States. Financial Accounting is no different in this respect and several EU Directives were issued in the 1980s and 1990s towards this goal.

It was recognised that achieving harmonisation in this manner would prove time consuming and costly. The European Commission decided not to issue further directives concerning accounting but instead to support the accounting standards issued by the IASC (now the IASB) in its efforts to insure harmonisation of accounting policies across the EU. In June 2002, the EU issued a regulation requiring companies listed on a regulated market (stock market) to prepare consolidated accounts in accordance with international accounting standards by 2005 (including comparative figures for 2004). With respect to unlisted private companies (SMEs), the EU states that Member States either require or allow unlisted companies to prepare their accounts inline with international accounting standards.

By requiring all public companies and either allowing or requiring all private companies to report under IAS from financial year 2005 onwards the EU has in affect achieved its goal of harmonising accounting standards and treatments across the EU. This was deemed an essential ingredient in the promotion of cross boarder trade and investment between member states.

From a company's point of view the advantages of preparing financial statements under international accounting standards are significant:

- The largest capital markets (where finance to grow a business is secured) are located in the USA. Investors in these capital markets will be more inclined to invest in companies if they are prepared under accounting rules are regulations which they are familiar with.
- Similarly if all EU companies are preparing financial statements under the same regulations this should increase the level of cross boarder share ownership. For example an Irish investor is more likely to purchase the shares of a French company if that French company is preparing financial statements under regulation that the Irish investor is familiar with.
- Prior to the introduction of international accounting standards a multinational with companies operating in Ireland, France and Germany for example would have had to produce a set of financial statements for the Irish company under Irish accounting standards, the French company under French accounting standards and the German company under German accounting standards. Now all of these can be prepared under International Accounting Standards. This significantly reduces costs for the multinational organisation and therefore helps to promote cross boarder trade.

1.4.4 Stock Exchange Regulations

These regulations only apply to those companies which seek to float on a regulated market. That is to the public limited companies who issue (sell) shares and have their shares traded by the investing public on the stock exchange.

Stock exchange regulations are described in the “Stock Exchange Listing Regulations and its Admission of Securities to Listing”. These rules and regulations were one of the first publishers of rules and regulations governing financial statements. However as regulation has developed in other areas may of these requirements are now contained and have been expanded upon

in either professional or statutory requirements. This has led to a reduction in the importance of Stock Exchange regulations in some respects. Nonetheless stock exchange regulation still contains important regulations not addressed in other areas. Arguably the most important of which relates to the disclosure of price sensitive information to all shareholders at the same time, this ensures that no market participant has an unfair advantage over others. The situation where an individual has information which is not available to the public and uses that information for their own personal benefit is referred to as insider trading and is illegal.

1.5 True and Fair View

The overarching aim of the accounting regulatory environment is that the financial statements produced and relied upon by the users of accounting information give a true and fair view of the financial performance (income statement), financial position (balance sheet) and the cash flows (cash flow statement) of a company. While the term true and fair has never been defined by the courts it would appear that in order for a set of financial statements to give a true and fair view they must comply with both Financial Accounting Standards and Company Law.

Financial accounting standards tend to deal with how the various figures in the financial statements should be calculated while company law tends to focus on how the information should be presented to users. Therefore it can be seen that both accounting standards and company law requirements work together in order to achieve the overall goal that a set of financial statements are true and fair and can be relied upon by the users of accounting information as the basis for making decisions regarding the company.

1.6 The Standard Setting Process

The process through which International Financial Reporting Standards are developed involves six steps and a consultation process which involves interested individuals and organisations from around the world.

The six steps are as follows:

1. Setting the agenda
2. Planning the project
3. Developing and publishing the discussion paper
4. Developing and publishing the exposure draft
5. Developing and publishing the standard
6. After the standard is issued

Setting the Agenda

Here the focus is on what area in financial accounting should be addressed through a standard, a key factor in the decision in the overarching aim to provide a better quality of information to all users of financial statements. Specifically the decision as to whether an item is added to the agenda is mainly based upon the informational needs of investors. When deciding if an item should be added to the agenda the IASB considers the following factors: the relevance of the information to users, the reliability of the information which would be provided, existing guidance in the area, whether the new item increases the possibility of convergence and resource constraints. Before deciding to place an item on the agenda the IASB will consult the SAC and other accounting standard setting bodies on proposed agenda items and setting priorities (what issues are the most urgent).

The IASB discussions on potential projects and its decision as to whether it should adopt a new project take place in public IASB meetings where the decision as to whether to add an item to the agenda is made simply by majority.

Project Planning

Once an item has been added to the agenda the next decision is whether the IASB should conduct the project alone or whether it should do so with another standard setter, the ASB in Ireland and the UK for example. Once this has

been determined a project team is assembled: this may include members from other standard setting bodies where this is deemed appropriate by the IASB.

Developing and Publishing the Discussion Paper

The function of a discussion paper is to explain the issue and solicit early comment from various interested parties. The IASB will usually issue a discussion paper on any major new topic. Normally a discussion paper will contain the following elements: a detailed overview of the issue (why a standard is required in this area), different potential approaches for dealing with the issue, preliminary views of the IASB on dealing with the issue and an invitation to comment on the issue.

Developing and Publishing the Exposure Draft

The exposure draft is an important step in the process as it sets out a specific proposal in the form of a draft standard for dealing with an issue. The development of the exposure draft is based upon the IASB considering the comments which it received from the discussion paper, research carried out by its own employees and suggestions made from other standard setting bodies.

Developing and Publishing the Standard

Once the exposure draft has been issued comments will be received by the IASB on the proposed treatment of the issue. Such comment may lead to the proposed treatment of the issue being revised, where this is the case the IASB will assess whether they need to issue the revised treatment for further public comment through issuing a second exposure draft.

Where the IASB is satisfied that it has reached a conclusion on the treatment of an issue, a draft of the IFRS is drawn up, this is referred to as the pre ballot draft. The pre ballot draft will normally be subjected to external review which is usually undertaken by the IFRIC. IASB members are then balloted and if the ballot is in favour of the publication of the standard then the IFRS is issued.

Please note that prior to being referred to as IFRSs the standards of the IASB were referred to as IASs. Both terms tend to be used interchangeably.

After the Standard is Issued

The issuing of the new standard is not the final step in the process - after the standard has been issued the IASB will hold regular meetings with interested parties, including other standard setting bodies in order to understand any unanticipated issues relating to the practical application of the standard.

As can be seen from the proceeding discussion the process through which an accounting standard is developed involves a significant amount of public consultation. This is undertaken in order to improve transparency in the standard setting process.

SAMPLE QUESTIONS & SOLUTIONS PROGRAMME

The following questions examine the key areas you are expected to know for this particular subject, and will assist you significantly in your preparation for your examination in May/August 2010. In addition to the questions below, please also refer to the Summer 2009 examination paper which is contained in this manual for your reference. Pilot papers for this subject can be downloaded from www.AccountingTechniciansIreland.ie

Question 1:

“Management accounting and financial accounting are prepared under different regulatory environments”.

- a) Outline your understanding of both management and financial accounting.
- b) Do you agree with the statement as outlined above? You are required support your answer.

Tuition note: this question draws on knowledge gained in Financial Accounting I, this is assumed knowledge in Financial Accounting II. The information is discussed here in order re-fresh student knowledge.

Question 2:

Outline why rules and regulation in financial accounting are important.

Question 3:

Outline your understanding of the current structure of International Regulation.

Question 4:

Outline the standard setting process currently in place for new international accounting standards.

Question 5:

In your opinion is there any place for local accounting standing setting bodies like the Accounting Standards Board or has their role been replaced by international developments?

Solutions to the chapter questions above will be available online for students from January 2010 (in order to have provided you with sufficient time to have covered certain parts of the course.)

For those of you of wish to attempt any of the above chapter questions (and without looking at the solutions online!), you can email your answers to solutions@accountingtechniciansireland.ie from January 11th, 2010. Detailed feedback* will be provided to you within 3 working weeks of receipt. (These questions will not in any way count towards your summer examination marks.) This is a free service to our students and you are strongly advised to avail of it as past students have noted the benefits.

**** Proof of purchase of this manual may be required.***

