The Regulatory Framework of Financial Reporting
Chapter Learning Objectives

When you have completed this chapter, you should be able to:

😊 Explain the influence of legislation and accounting standards on published accounting information.

😊 Explain the principles which underpin the form and content of statement of financial position and the statement of profit or loss.

😊 Classify assets and liabilities as either current or non-current.

😊 Explain and calculate gross and net profit.
Introduction

The Regulatory Framework

- Elements of regulation
- IFRS
- Format of financial statements
- The Framework for Integrated Reporting
This Chapter relates and includes:

- The need for, and elements of, regulation
- International financial reporting standards
- Format of financial statements
- The accounting equation and statement of financial position
- The statement of profit or loss.
- The legal and regulatory framework
- Application of the accounting equation
- The content and format of financial statements.
This Chapter relates and Includes (continued):

- The elements of the financial statements
- The accounting equation, including classification of transactions
- The qualitative characteristics of financial information
- The historical cost convention and other valuation bases
- The explanation of accounting concepts and fundamental terms, and a glossary of accounting terms.
Why do we need regulation?

Regulation is needed because:

- it **ensures the financial statements can be relied upon** by a variety of users when making decisions and
- it **promotes consistency** and **comparability** of accounting information to help users interpret the financial statements

Different **countries** will be subject to **variety of economic, social and political factors**. As a result, the way in which published financial accounts are regulated will **vary from country to country**.

However, it may be said that **there are common themes to this regulation**, even if the detail may vary between countries.
Elements of regulation

A **Regulatory Framework** may consist of any or all of the following elements:

- Local or national corporate law.
- Local or national accounting standards published by an appropriately authorised body.
- International accounting standards published by the International Accounting Standards Board ('IASB')
- A theoretical or conceptual framework
- Requirements of international bodies, i.e. EU.
International Accounting Standards ('IAS') (Older up to 2000) are also referred to as International Financial Reporting Standards ('IFRS') (Recently issued after reorganization of the regulation structure) and the terms are often used interchangeably.

In many cases, reference is simply made to ‘IFRS Standards’ to include all relevant IAS and IFRS.
Many countries have legislation applying to corporate entities and this is generally known as ‘company or corporate law’. The extent of detail in corporate law will vary between countries but in general they cover broad issues rather than detailed aspects of accounting.

Examples of issues that may be covered by corporate law in a particular jurisdiction include the following:

- The format of financial statements and information disclosures required (sometimes more detailed than accounting standards)
- Which companies are required to have their financial statements audited by a professionally qualified and appropriately registered auditor
- Which individuals are excluded from appointment as a corporate entity director
National Accounting Standards

- Since the 1960s many countries have developed their own accounting standards as a means of regulating the reliability and content of annual financial statements.
- In some countries, this has been achieved by adopting a law-based approach, whilst in other countries, the accountancy profession has been at the forefront to develop generally accepted accounting practices applied by those who prepare financial statements.
- These professional accounting bodies normally have some form of recognition as a supervisory or regulatory body with appropriate authorisation to issue new or revised accounting standards, and to apply sanctions when accounting standards have not been properly applied.
In more recent years, the procedure to develop a new or updated accounting standard has become a more formalised and rigorous process to ensure that they are relevant to the needs of preparers and users of financial information.

There has also been a move towards convergence or harmonisation of accounting standards on an international basis.

This increases the consistency and comparability of accounting information and is a direct consequence of the development of multi-national business entities and international capital markets.
The accountancy profession

- Many countries have their own professional accountancy qualification. In the USA for example, professional accountants are known as Certified Public Accountants ('CPA').
- Some countries do not have their own professional accountancy qualification in which case trainee accountants study to achieve the professional qualification of another country or of an international accountancy body.
- Some professional accountancy bodies which were originally domestic qualifications in the UK have expanded their membership to become internationally recognised qualifications. These include:
  - The Chartered Institute of Management Accountants (CIMA)
  - The Association of Chartered Certified Accountants (ACCA).
The IASB Conceptual Framework for Financial Reporting (the 'Framework')

- **Accounting is a social science** not a natural science, like physics and chemistry, it had to **develop its own ‘laws’ or principles**.
- It is important that **IFRS Standards** published by the **IASB** are **consistent with the conventions** and that the accounting standards are consistent with each other.
- To ensure that this occurs a **framework** was developed within which all standards are developed and published.
- This document **underpins all accounting standards** and provides the **platform from which all future standards will be developed**.
- The **Framework deals with the fundamental issues** in financial reporting.
International accounting standards

The influence of IFRS Standards on this publication has three main effects:

- **Terminology.** This text uses the words, phrases, definitions and so on used in IFRS Standards.

- **Presentation.** The presentation of the financial statements follows IAS 1, *Presentation of Financial Statements (Revised)* and the statement of cash flows follows IAS 7 *Statement of Cash Flows*. Both IFRS Standards should be applied when preparing corporate entity financial statements.

- **Technical.** The technical requirements of the IFRS Standards have been followed.
International Financial Reporting Standards (IFRS Standards)

- Due to the **increasingly global nature of investment and business operations** there has been a move towards the 'internationalisation' of financial reporting.
- This 'harmonisation' was considered **necessary to provide consistent and comparable information** to an increasingly global audience.
- If companies use **different methods of accounting** then before any decisions can be made about different entities the accounts would have to be **re-stated so that the accounting concepts and principles applied are the same**; only then can relevant comparisons be made.
International Financial Reporting Standards (IFRS Standards)

- IFRS Standards are very important and a brief description of how they are developed and published is given below.
- There are four separate but related bodies which control the setting of IFRS Standards:

![Diagram showing the structure of IFRS Standards bodies]

- THE IFRS FOUNDATION
- IASB
- IFRS IC
- IFRS AC
International Financial Reporting Standards Foundation

- The IFRS Foundation® is the *supervisory body* for the IASB and is responsible, amongst other things, for the *promotion and rigorous application* of high-quality financial reporting standards.
The IASB is the independent standard setting body of the IFRS Foundation. Its members are responsible for the development, approval and publication of IFRS Standards and interpretations developed by the IFRS IC®.

Upon its creation the IASB also adopted all existing IAS, the forerunner to IFRS. All of the most important national standard setters are represented on the IASB and their views are taken into account so that a consensus can be reached.
The IFRS Interpretations Committee (IFRS IC)

- The IFRS IC reviews widespread accounting issues (in the context of IFRS Standards) on a timely basis and provides authoritative guidance on these issues, abbreviated as (IFRICs) e.g. following publication of a new or revised IFRS Standard.

- Their meetings are open to the public and, similar to the IASB, they work closely with national standard setters.
The IFRS Advisory Council (IFRS AC®)

- The IFRS AC is the formal advisory body to the IASB and the IFRS Foundation. It is comprised of a wide range of members who are affected by the IASB’s work.
Basic format of Financial Statements

- What is the consequence of the various elements of regulation upon financial statements?

- They provide standard formats for the financial statements which should be adopted as best practice when financial statements are prepared e.g. Statement of financial position and Statement of profit or loss.
The Accounting Equation and the Statement of Financial Position

- The statement of financial position is simply a **statement of the assets, liabilities and capital** of a business entity at a specific date.

- It is therefore nothing more than a **detailed representation of the accounting equation**.
Illustration – Accounting Equation

Nadim had the following assets and liabilities on 1 January:

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>200,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>60,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>10,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>15,000</td>
</tr>
<tr>
<td>Bank balance</td>
<td>32,000</td>
</tr>
<tr>
<td>Cash in hand</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>322,000</strong></td>
</tr>
<tr>
<td>Payables</td>
<td>17,000</td>
</tr>
<tr>
<td>Bank loan</td>
<td>240,000</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>257,000</strong></td>
</tr>
</tbody>
</table>

**Required:**
What was the balance on Nadim’s capital account at 1 January?
## Statement of financial position of Nadim as at 1 January

<table>
<thead>
<tr>
<th>Assets</th>
<th>$000</th>
<th>$000</th>
<th>Capital + Liabilities</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
<td>Capital</td>
<td>65</td>
</tr>
<tr>
<td>Land</td>
<td>200</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>60</td>
<td></td>
<td>Non-current liabilities</td>
<td></td>
</tr>
<tr>
<td></td>
<td>260</td>
<td></td>
<td>Bank loan</td>
<td>240</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
<td>Current liabilities</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>10</td>
<td></td>
<td>Payables</td>
<td>17</td>
</tr>
<tr>
<td>Receivables</td>
<td>15</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank balance</td>
<td>32</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash in hand</td>
<td>5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>62</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>322</td>
<td></td>
<td></td>
<td>322</td>
</tr>
</tbody>
</table>
### Illustration – Vertical Presentation

#### Statement of Financial Position: Vertical Format

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
<th>$000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current asset</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>Office equipment</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td></td>
<td>264</td>
</tr>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>Bank balance</td>
<td>38</td>
<td></td>
</tr>
<tr>
<td>Cash in hand</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td></td>
<td>60</td>
</tr>
<tr>
<td><strong>Total Assets &amp; Liabilities</strong></td>
<td></td>
<td>324</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital</td>
<td>65</td>
<td></td>
</tr>
<tr>
<td>Non-current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank loan</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payables</td>
<td>19</td>
<td></td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td></td>
<td>324</td>
</tr>
</tbody>
</table>
The contents of a Statement of Financial Position

- In its **simplest form** the statement of financial position is presented **horizontally** with assets shown on the left-hand side and liabilities and capital on the right-hand side.
- Consequently, the **total of each side** of the statement of financial position will be equal – hence the statement of financial position will **agree and balance**.
- When a statement of financial position is prepared, assets and liabilities are divided into two categories: **non-current and current**.
Non-current Assets

- Any asset held by an entity for **more than one accounting period** (i.e. at least twelve months) for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and therefore **not for sale in the normal course of trading**.

- For example, an item of plant and equipment will normally be used **by an entity for several years** to support the manufacture of goods which are then sold to earn sales revenue.
Current Assets

- **Cash or other assets** – for example inventory, receivables and short-term investments – *held for conversion into cash in the normal course of trading*.

- **Receivables** are amounts due or owing to a business entity from another person or business entity following the sale of goods or services.

- A current asset is one that is either already cash, or will be converted into cash within a *short period of time*. 
Difference between Current and Non-Current Assets

**NON-CURRENT ASSETS**
- Any tangible or intangible asset acquired on a long-term basis to be used in providing a service to the business.
- Not held for resale in the normal course of trading.
  
  *e.g.* land and buildings, motor vehicles, plant and machinery.

**CURRENT ASSETS**
- Assets which are expected to be realised in the business normal course of trading.
- Disclosed in the statement of financial position with the least liquid item first (usually inventory).
  
  *e.g.* inventory, receivables, cash.
Current Liabilities

- Liabilities that fall **due for payment within twelve months** of the statement of financial position date (often referred to as the year-end or reporting date). They include that part of non-current loans due for repayment within 1 year and payables.

- **Payables** are a person or another business entity to whom the entity owes money as a consequence of the receipt of goods or services in advance of payment, i.e. on credit.
Non-current liabilities

- Liabilities that are **due for repayment more than one year** after the statement of financial position date.

**Note:** The difference between the Current Assets and the Current Liabilities is known as the **Net Current Assets, if positive, or Net Current Liabilities, if negative.** It is also known as the **working capital** of the business.
Difference between Current and Non-Current Liabilities

- **LIABILITIES**

  - LIABILITIES ARE CLAIMS ON THE BUSINESS BY OUTSIDERS

  - **NON-CURRENT LIABILITIES**
    - Long term liabilities payable more than 12 months after the reporting date
      - e.g. loan
  - **CURRENT LIABILITIES**
    - Those liabilities which are payable within 12 months of the reporting date
      - e.g. payables, bank overdraft, loan (short-term)
The Statement of Profit or Loss

- The statement of profit or loss is a summary of income generated and expenses incurred to generate the profit over a period of time, usually a year.

Income less expenses = profit or loss for the period.

- It makes use of the two elements of the financial statements not used in the preparation of the statement of financial position.
Statement of profit or loss for the year ended 31 December 20XX

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>$X</td>
</tr>
<tr>
<td>Less: Cost of goods sold</td>
<td>$(X)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$X</td>
</tr>
<tr>
<td>Less expenses:</td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>$X</td>
</tr>
<tr>
<td>Van running costs</td>
<td>$X</td>
</tr>
<tr>
<td>Staff wages</td>
<td>$X</td>
</tr>
<tr>
<td>Other expenses</td>
<td>$X</td>
</tr>
<tr>
<td>Net profit for the year</td>
<td>$X</td>
</tr>
</tbody>
</table>
Income is the **inflow of economic benefits** to an entity over a period of time. This will consist of sales revenue generated from goods and services sold to customers, but may also include other items such as interest received or dividends received.
Expenses are the **outflow of economic benefits** from an entity over a period of time. This may include the using of resources such as heat and light, wages and salaries or office expenses. Expenses are incurred by a business entity to help it generate economic benefits such as sales revenue.
Cost of goods sold

- These are the **direct costs attributable to the production** of the goods sold by a company. This is also referred to as '**cost of sales**'. 
When calculating the cost of goods sold we can use the following formula:

<table>
<thead>
<tr>
<th>Cost of opening inventory at the start of the period</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of purchases during the period</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Less: Cost of closing inventory at the end of the period</td>
<td>(X)</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>X</td>
</tr>
</tbody>
</table>
Gross profit

- This is calculated by deducting the cost of goods sold from the sales revenue generated.
Net profit

- This is calculated by deducting any other running costs of the business entity from the Gross Profit.
The Framework for Integrated Reporting

- The International Integrated Reporting Council (IIRC) is a coalition of regulators, investors, companies, standard setters, the accountancy professional and Non-Governmental Organisations (NGOs). Its mission is to establish integrated reporting within mainstream business practice.

- Whilst the IIRC is not part of the IFRS Foundation, there is a Memorandum of Understanding between the IIRC and the IASB that recognises both bodies have a common interest in developing and promoting the quality and consistency of global corporate reporting.
One of the weaknesses of historical cost reporting is that it reports transactions and events that have already occurred. Whilst this information is useful, users of financial statements are often more interested in what may happen in the future.

Consequently, the need for some form of integrated report which includes elements of historical cost reporting along with some prospective or forward looking information to meet the needs of users has developed.

The principle behind integrated reporting is that such reports provide information on a range of financial and non-financial capitals to explain to providers of financial capital how value is created over time.
The Framework for Integrated Reporting - continued

- An integrated report is 'a concise communication about how an organisation’s strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term' (IIRC®).
The six capitals identified in the IR Framework are:

- **Financial** – how monetary capital has changed during an accounting period.
- **Manufactured** – this relates to production capacity – has it increased or decreased?
- **Intellectual** – this will include intellectual property, patents etc.
- **Human** – not only the numbers employed, but also its skills, training and expertise.
- **Social and relationship** – the relationship between the reporting entity and its local environment
- **Natural** – access to resources, such as raw materials.
The content of an integrated report

An integrated report should include all of the following content elements:

- **Entity overview and external environment** – ‘What does the entity do and what are the circumstances under which it operates?’
- **Governance** – ‘How does the entity’s governance structure support its ability to create value in the short, medium and long-term?’
- **Business model** – ‘What is the entity’s business model and to what extent is it resilient to commercial pressures?’
- **Opportunities and risks** – ‘What are the specific opportunities and risks that affect the entity’s ability to create value over the short, medium and long term, and how is the entity dealing with them?’
The content of an integrated report - continued

- **Performance** – ‘To what extent has the entity achieved its strategic objectives and what are its outcomes in terms of effects on the capitals?’

- **Future outlook** – ‘What challenges and uncertainties is the entity likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?’

- **Basis of presentation** – ‘How does the entity determine what matters to include in the integrated report, and how are such matters quantified or evaluated?’

Including this content should help entities to shift the focus of their reporting from historical financial performance to longer-term value creation. It also improves the quality of information available to interested parties.
Chapter summary

- The regulatory environment that underpins the preparation of accounting information.

- How to apply the accounting equation to record transactions.

- The format and classification of the statement of financial position and statement of profit or loss.

- The need for, and information in, an integrated report.
The Regulatory Framework

Elements of regulation
- Local or national law
- Accounting standards
- IASB
- Framework
- Requirements of international bodies

IFRS
- IAS 2 Inventories
- IAS 16 Property, Plant and Equipment
- IAS 38 Intangible Assets

The Framework for Integrated Reporting
- Financial
- Manufactured
- Intellectual
- Human
- Social and relationship
- Natural

Format of financial statements
Questions
**Question 2**

**Gross profit for 20X1 can be calculated from:**

A. purchases for 20X1, plus inventory at 31 December 20X1, less inventory at 1 January 20X1

B. purchases for 20X1, less inventory at 31 December 20X1, plus inventory at 1 January 20X1

C. cost of goods sold during 20X1, plus sales during 20X1

D. net profit for 20X1, plus expenses for 20X1
Drag and drop the options below into the table provided to identify whether each of the items below would change the capital of a sole proprietor.

- A payable being paid the amount due by cheque
- Raw materials being purchased on credit
- Non-current assets being purchased on credit
- Wages being paid in cash

<table>
<thead>
<tr>
<th>Change</th>
<th>No change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Question 4

In accordance with the IASB® Conceptual Framework for Financial Reporting what is the main aim of financial reporting?

A To record every financial transaction individually
B To maintain ledger accounts for every transaction
C To prepare a trial balance
D To provide financial information to users of such information
Question 5

The profit of a business may be calculated by using which one of the following formula?

A. Opening capital – Drawings + Capital introduced – Closing capital
B. Opening capital + Drawings – Capital introduced – Closing capital
C. Closing capital + Drawings – Capital introduced – Opening capital
D. Closing capital – Drawings + Capital introduced – Opening capital
Question 6

Which organisation issues IFRS® Standards?

A. The International Auditing and Assurance Standards Board (IAASB®)
B. The Stock Exchange
C. The International Accounting Standards Board (The Board)
D. The Government
The accounting equation can change as a result of certain transactions. Which one of the following transactions would not affect the accounting equation?

A. Selling goods for more than their cost
B. Purchasing a non-current asset on credit
C. The owner withdrawing cash
D. Receivables paying their accounts in full, in cash
Question 8

Which of the following items should be accounted for as capital expenditure?

A. the assets are shown in the statement of financial position at their original cost
B. The purchase of a vehicle for resale by a car dealer
C. The cost of redecorating an office
D. Legal fees incurred on the purchase of a building