

Discuss the Need for Regulation in Financial Reporting

There is a need for regulation in financial reporting because of a number of reasons. There are several major user groups of financial reporting, some of which include equity investor groups, employee groups, analyst adviser group, the government, the public and other stakeholders. These different stakeholders however, need to be able to interpret and use financial information in a systematic way in order to make the necessary financial decisions. If these different user groups created financial reports, it will be prepared in diverse ways which would suit their various requirements. If this is the case, then different groups will interpret different financial reports in different ways. There are international differences in accounting practices. Accounting practices differ from country to country and so do the regulatory frame work and the balance between the public and private regulation. Over the years, bodies like the EU have been formed. There is need for accounting regulation as all these different countries coming together may have different accounting standards, thus there will be the need for financial reports regulation. In the UK, the accountancy profession dominates the regulatory framework. There are at least two main reasons why financial report regulation is needed both within a country and internationally.

The first reason is that of *information asymmetry*. Assuming managers are responsible for preparing financial information. Whereas managers have access to information about all aspects of the firm's activities, other participants do not. Managers therefore, could exploit their position within the firm to further their own goals at the expense of others. For instance, some companies might adjust their

liability figures in order to secure a loan or reduce their profit figures in order to pay less corporate tax. For this reason, there is a need for financial regulation.

The second reason is that of *comparability*. Supposing the managers could be relied upon to provide accounting information on items and transactions of interest to other participant groups. What is the best or right way in which the information could be reported? Let us assume that the managers of B&Q and Homebase decide to buy a motorvan. If the manager of B&Q decides to depreciate its value over the years and the Homebase manager choose to write off the value in the year of purchase. Without some form of standardized accounting, it would be very difficult for other external users to compare the performances of these companies as different methods of accounting process have been used for the same transactions, that is, the purchasing of an asset. To avert these problems and to have a synchronized form of financial reports, certain concepts and conventions have being set up by certain accounting bodies, these are briefly discussed below

The Accounting standard boards (ASB) which is responsible for setting and issuing accounting standards, the ASB is part of a broader structure including the Financial Reporting Council, the review panel and the Urgent Issues Task Force (UITF). The Financial reporting Council (FRC) is the body charged with the broad overview of the standard setting system. Although the FRC oversees the process of producing accounting standards, it has no input into the detailed rules. Conversely the principle sources of such regulation are *The Law* and the *Accountancy Profession*.

The Law consists of certain Acts. Much of the legislation governing the UK's preparation of accounts is personified in the companies Act 1985 and companies Act 1989. They are mainly concerned with the accounts of limited liability companies. These Acts state that all financial statements constructed under the Act must present a *true and fair view*. The Act also deals mainly with minimum disclosure requirements and is foremost concerned with the protection of shareholders and creditors. It provides a framework for general disclosure by requiring that certain financial statements such as the profit and loss accounts and the balance sheet, should be prepared and presented to the shareholders and requires the specific disclosure of certain items such as depreciation and so on. These disclosure requirements resolve some of the problems associated with the asymmetry of information between the directors and some user groups. They also enable user groups to compare the level of their inducements with those received by the other groups. The Act also requires that the directors not only present the financial statements to the shareholders each year but also that independent auditors are appointed to examine the financial statements and report their findings to the shareholders.

The law addresses the problem of information asymmetry by requiring the disclosure of certain key items of interest to user groups. The Accountancy Profession also recommend the same but in this role as regulator. The accountancy profession is more influential in achieving a significant increase in the comparability of financial statements. Whereas the law provides the general framework for what is to be accounted for in the financial reports, the accountancy profession provides detailed rules in the form of accounting standards about how items and transactions should be accounted for.

In regulating financial reporting, there is a conceptual framework. This has no specific definition for a conceptual framework. Thus a conceptual framework is theoretical in nature, and used a guide in regulating financial reports. However it can be described as “ a set of basic principles that command general support and can be used to help with detailed decisions by in increasing the likelihood of consistency and reducing the costs of analysis.”:- *B.Carsberg, external financial reporting, 1984*. There are number of ways in which this conceptual framework can be used in regulating financial reports. Some of these include:- guide standard setters in establishing accounting standards; providing a frame of reference for resolving accounting problems which are not addressed currently in legislation or accounting standards; increase the level of comparability by reducing the number of acceptable, alternative accounting methods; help reduce the influence of personal biases and political pressures on accounting judgements; reduce the costs of analysis and the effort involved in resolving accounting problems; increasing the level of user confidence in, and understanding of, financial reporting by clarifying the basis on which all accounts are prepared and presented. It should be noted however, that there is no single agreed conceptual framework for financial reporting to guide accounting regulators in the difficult task of standardising accounts on the basis of best practice.

There are also practical frameworks used in regulating financial statements. These include the different accounting concepts and conventions. There are four main concepts and several conventions. These concepts and conventions all help in regulating financial reports.

The going concern concept enables the preparers of accounts under normal circumstances to look beyond the immediate short term but it also requires them to inform users should there be any doubt over the firm's ability to survive in its present form.

The accruals concept recognises costs and revenues as they are earned, not necessarily when the cash flow relating to them is paid or received. Therefore this concept recognises the business practices of buying and selling on credit and the purchasing of long-term assets.

The consistency concept refers to the accounting treatment of like items that should be consistent both within each accounting period and from one accounting period to the next. If this concept is not applied, the users of financial report would be unable to assess changes in the measures of accounting performances.

The prudence concept states that revenue and profits should not be predictable; they should be included in income only when realized in cash or in the form of other assets. This is to prevent exaggeration of profit. Provisions should be made for all known liabilities using the best estimate available for the size of the liability.

The conventions include the business entity which states that the business must have a separate identity from its owners; duality convention which enforces the principle of double entry; monetary measurements which states that all recordings must only include monetary transactions; historical cost which states that all resources must be recorded with their original price and accounting period recognises that profit occurs

over the time and can only be defined as profit depending on the accounting period.

Other conventions include the materiality convention the realisation of revenue convention and objectivity.

There are several criteria and objectives which are useful when choosing your accounting method. The choice of accounting method must always be ***relevant, reliable, comparable and understandable*** to all parties involved. If these are met then the accounting method will be favourable to all accounting users.

Accounting standards may however have some undesirable consequences. This may limit the extent to which the preparers of accounts are able to prepare the financial statements to meet both the needs of different user groups. It may also discourage the preparers of account from experimenting new ways of describing accounting transactions. There is no assurance though that a standard procedure will provide the information required by the various financial user groups.

Nevertheless there is the need for financial reports being regulated because it would be comparable and it would save both time and money adjusting them to a common format.