FINANCIAL REPORTING
IN COURSE ASSIGNMENT

Required:

Write a report of non more than 2,500 words which examines the developments in financial reporting which have lead to the issue of FRED 21.

(a) Detailed examination of how FRED 21 has updated and changed the requirements of SSAP 2.

In December 1999, the ASB published FRED 21 "Accounting Policies", which set out proposals on the selection, applicat ion and disclosure of accounting policies. In March 1999, the Accounting Standards Board added a supplement to the FRED, proposing disclosures relating to compliance with the statements of recommended practice. Most respondents were broadly supportive of t he proposals set out in the two documents, but a number of issues of detail were raised. The Accounting Standards Board has been considering how best to address these in a standard based on the FRED, and expects to issue an FRS before the end of the year.

The issue of ASB's Statement of Principles for Financial Reporting represents the most significant step to date in the process of developing a coherent framework for the preparation and presentation of financial statements. ASB also proposes that the guidance on accounting policies contained in SSAP 2 Disclosure of accounting policies should now be updated, to be consistent with the Statement of Principles and other recent pronouncements, including FRS 12 (provisions) and FRS 5 (substance of transactions). FRED 21 Accounting Policies has been issued for this purpose.

The ASB regards SSAP 2 as broadly satisfactory in other respects, and proposes retaining that standard's disclosure requirements in respect of accounting policies. However, the opportunity has been taken to clarify some of the other aspects of SSAP 2 and, as a result, the FRED:

- Sets out the objectives and constraints to be considered by directors when selecting and changing accounting policies

- Sets out clearly a requirement, implied but not explicit in SSAP 2, that an entity should adopt those accounting policies that are, in the opinion of its directors, most appropriate to its particular circumstances for the purpose of giving a true and fair view.

- sets out the circumstances in which an entity should also disclose details of the estimation techniques used in applying its accounting policies.

Background

ASB has deemed it to be an appropriate time to take another look at guidance contained in SSAP 2 Disclosure of accounting policies. The SSAP was issued in November 1971 and defined the four fundamental accounting concepts underlying financial statements as being going concern, accruals, consistency and prudence. However, since then numerous accounting standards have been issued and certain of these would suggest that a revision of these concepts is necessary. The emergence of the new Statements of Principles to act as a basis for such a revision makes such a review particularly timely.

The FRED develops the key principles of SSAP 2 in most areas:

Prudence

Under SSAP 2, revenue and profits are only recognised when realised, whereas provision is made for all known expenses an losses (whether their amount is certain or a best estimate based on currently available information). Changes in the nature and complexity of markets have caused the definition of realisation in SSAP 2 to fall out of date and FRED 21 proposes that, in future, a gain should be recognised of there is sufficient evidence that it exists and it can be measured reliably.

The concept of prudence is, however, maintained by the FRED's acknowledgement that greater evidence of existence and reliability of measurement will be required to recognise a gain or asset, than a loss or liability. This change in emphasis is consistent with the recent standard concerning provisions, FRS 12, which prohibits a provision being made if there is no obligation to transfer economic benefits.

Accruals

While there is no fundamental change to this concept, a slightly different interpretation is proposed. Under SSAP 2, revenues and costs are matched with one another so far as their relationship can be established or assumed. The FRED, in accordance with the Statement of Principles, emphasises that both revenues and costs (in common with any effect of a transaction or other event) should be recognised in the period to which they relate. Revenues and costs arising from the same transaction or event would still, therefore, be recognised simultaneously. Such a change would bring the approach into line with FRS 5 Reporting the substance of transactions, in terms of recognition of assets and liabilities.

Consistency

The FRED views comparability, rather than consistency, as the key criteria – as indicated by the Statement of Principles. While comparability will usually require consistency, there may be circumstances where this is not the case. Information in financial statements should be prepared and presented in a way that enables users to discern and evaluate similarities in, and differences between, the natures and effects of transactions and other events taking place over time and across different reporting entities. Although comparability is usually achieved through consistency, the latter is not an end in itself and there will be circumstances in which it needs to be sacrificed. In particular, whilst consistency is important, it should not prevent improvements in accounting. It should not be used to justify retaining an existing accounting policy when a new policy is more appropriate to a entity's particular circumstances.

Going Concern

The proposals of the FRED would not have any effect on the interpretation of the going concern presumption – still viewed as a fundamental concept in preparing financial statements.

Accounting policies and estimation techniques

ASB have recognised the difficulty in distinguishing between a change in accounting policy and a change in estimate and, as a result, have developed more specific definitions of both. The major implication of this would be greater clarity as to when prior year adjustments should be made for changes in the measurement of assets, liabilities and other items. It is also made clear that accounting policies should be reviewed regularly to ensure that they remain the most appropriate available.

Significance

Increasingly complex markets and the pressure for further global harmonisation are resulting in frequent revisions to accounting standards and it is important that this should occur in a consistent and coherent manner. An understanding of the principles underlying ASB's approach should enable directors to understand the current, and likely future direction of standard setting, as well as assist their interpretation of existing reporting standards.

(b) Consideration of the impact of the ASB's 1999 revision of its Statement of Principles

There were plenty of comments from the hold economic and accountancy world on the topic above. The matter is that the revised Statement of Principles, which the ASB is consulting on, amounts a little more than a judicious rewording of the first draft - and that was condemned the stage. So it remains to be seen whether what is basically an exercise in increasing clarity will give the ASB the consensus it needs to publish the SOP as an FRS. Until now it seems that the quest for this accounting problem is no longer – even if it ever was – about setting out basic principles from which the work of the accounting standard setter can proceed. Instead it is more to do with the politicking of the international accounting standard-setting process. The UK belongs to a premier league club of international standard setters called G4+1(there are actually five members of G4, plus the International Accounting Standards Committee), and all the other countries have conceptual frameworks. In other words if the ASB is to stay in the premier league – which it desperately wants to do as internationalisation becomes more important – it needs to be able to point to the existence of its own SOP framework. Academics suggest that having the SOP in place will give the ASB and the standard-setting process greater authority and legitimacy. This line of thinking links in with the way that the ASB's sister body, the Financial Reporting Review Panel (FRRP) behaved in the years while it was establishing itself. But while that tactic may have been necessary early on for the FRRP, it is hard to see how the SOP will make the ASB stronger in the eyes of its domestic audience. Over the years it has assiduously and skilfully fought and won battles on various issues – off-balance-sheet financing, goodwill, big bath provisions, the difference between debt and equity, etc – and, in doing so, has already established its reputation and authority. In fact, if the SOP does anything, it is likely to diminish the ASB in the eyes of UK preparers and users. At the same time, the success and acceptance of the ASB's standards has diminished the need for a SOP. Dr. Pelham Gore of Lancaster University describes one political function of an SOP as providing a "defensive shield". In the early days, it promises to bring benefits, and later on it can be used to defend standards by claiming consistency. But to the pragmatic British mind, it seems odd that the ASB has succeeded in publishing 15 standards before completing the framework on which that work purports to be based. The ASB knows this and is trying its best to distance itself from its own SOP. Apart from the need to compete internationally, the most compelling reason why the ASB is still chasing an SOP is because the Dearing Report gave the new body three main tasks:

1. To stamp out accounting abuses,
2. To harmonise with international standards and
3. To develop a conceptual framework

But even if there was any great enthusiasm among the ASB for this particular project at first, it has withered now.

Both Andrew Lennard, an ASB staff member and author of the first SOP, and Ken Wild, a board member, say that one of the main benefits of the SOP is for internal use. In preparing new standards the board can check from first principles what the answer should be. But it is an indication of how bored or demoralised they are by the project that they are cheerfully admitting that if the SOP comes up with an answer which they intuitively think is the wrong one, they will pick another solution. In other words, the SOP would be little more than a private guide for the standard setters, which for the reasons of openness they have chosen to publish. It will help to ensure consistency, but it will not be followed menially. According to what accountancy world says, the ASB is trying to leave itself plenty of escape routes should it need them later on. One, such for instance, is the lack of clarity over the role of current values as opposed to historical costs. One solution to this mess might be to refrain from publishing the SOP as an FRS. Instead along with a commitment to review it in 3 to 5 years time, the ASB could give it a similar status to the Financial Reporting for Smaller Entities (FRSSE) which sits alongside, but it is not part of, the canon of accounting standards. This way, the SOP would exist for political purposes but would not be a core feature of standard setting. A fudge like this is likely because the ASB can not abandon the SOP and cannot or will not substantially rewrite it.

Based on comments of Accountancy age newspaper

(c) Identification of the degree to which FRED 21 moves the UK closer towards harmonisation with international accounting standards.

The International Accounting Standards Committee deals with accounting policies in its standards IAS 1 (revised 1997) “Presentation of Financial Statements” and IAS 8 (revised 1993) “Net Profit or Loss for the Period, Fundamental Errors and changes in Accounting Policies". The general requirements for accounting policies in FRED 21 are consistent with those standards.

IAS 1 says that a compete set of financial statements includes a Balance Sheet, income statement, statement of changes in equity, cash flow statement and notes. Accounting policies should lead to relevant and reliable information. The standard provides practical guidance regarding the going concern assumption, accrual, consistency and materiality. Offsetting assets and liabilities generally is restricted to cases explicitly required or permitted by other International Accounting Standards.

Financial Statements presented in accordance with IASs should comply with the recognition, measurement, presentation and disclosure requirements of all applicable IAS and Interpretations of the Standing Interpretations Committee.

FRED 21 though requires that, where another accounting standard allows more than one treatment, the directors should use the criteria of relevance, reliability, comparability and understandability to select the policy that is the most appropriate of those allowed.

An entity should judge the appropriateness of accounting policies to its particular circumstances against the objectives of relevance, reliability, comparability and understandability. The constraints that an entity should take into account are the need to balance different objectives, and the need to balance the different objectives, and the need to balance the cost of providing information with the likely benefit of such information to users of the entity's financial statements.

Wrong or inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used, or by notes or explanatory material (i.e. good disclosure cannot cure bad accounting). In extremely rare circumstances, departure from a standard is required when compliance with a specific requirement would not result in fair presentation.

IAS 8 says that all income and expense items should be included in net profit or loss, unless an IAS requires or permits otherwise. The income statement should separately disclose income from ordinary activities and extraordinary items.

Changes in accounting policies, according to IAS 8 are appropriate only if they are required by statute, or an accounting standard-setting body, or if moving to amore relevant or reliable alternative. Fundamental errors and changes in accounting policies should be either:

- Reported by adjusting the opening retained earnings for the current period and amending comparative information for prior records where practicable (the benchmark treatment), or

- Separately disclosed in the current period income statement as part of net profit or loss. Comparative figures are not restated. Pro Forma comparative information should be also presented, giving retroactive effect to the change (the allowed alternative treatment).

The effects of changes in accounting estimates should be included in net profit or loss in the period of change if the change affects the period only, or in the period of change and future periods if the change affects both. Where the change re lates to an item previously treated as extraordinary, the change itself should be reported as extraordinary.

FRED 21, on the other hand defines estimation techniques and distinguishes them from accounting policies. It requires an entity to adopt, for all material items, accounting policies that are, in the opinion of its directors, most appropriate to its particular circumstances, subject to any restrictions imposed by other accounting standards and companies legislation.

IAS 8 defines accounting policies as the specific principles, bases, conventions, rules and practices adopted by an enterprise in preparing and presenting financial statements. The definition in FRED 21 also refers to principles, bases, conventions, rules and practices, but is more specific about the role that accounting policies play in the preparation and presentation of financial statements. Specifically, accounting policies are applied by an entity in order to reflect the effects of transactions and other events through recognising, selecting measurement bases for, and presenting assets, liabilities, gains, losses and changes to shareholders' funds.

References:

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