R16 Financial Reporting Standards

Version 1.0

1. Introduction

Financial reporting standards provide principles for preparing financial reports. They also determine the types and amount of information that must be provided to users of financial statements. There are several financial reporting standards but the most prominent ones are the U.S. generally accepted accounting principles (US GAAP) and International Financial Reporting Standards (IFRS). This reading focuses on the context within which these standards are created.

2. The Objective of Financial Reporting

The following paragraph is an excerpt from the *Conceptual Framework for Financial Reporting 2010* formulated by IASB:

"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, where those decisions relate to equity and debt instruments, or loans or other forms of credit, and in influencing management's actions that affect the use of the entity's economic resources." The providers of resources include investors, lenders, and other creditors.

For the users of financial statements, financial reporting standards facilitate comparison across companies (cross sectional analysis) and over time for a single company (time-series analysis). The accounting standards must be flexible enough to recognize that differences exist in the underlying economics between businesses. The financial transactions that companies aim to disclose are often complex and often require accruals and estimates, both of which necessitate judgment. Accordingly, the accounting standards must also be flexible enough to achieve some consistency in these judgments.

Let us consider some simple examples. Suppose two companies buy similar equipment for long-term use. One company expenses (shows the entire amount as an expense on the income statement) and the other company capitalizes the cost of the equipment (creates an asset on the balance sheet). For an analyst, this represents a challenge when comparing the two companies. The different accounting treatment will lead to two very different income statements and balance sheets for the two companies. Financial reporting standards address such a challenge by creating accounting standards which ensure that both companies record similar transactions in a similar manner. For example, the standards might require that both companies create an asset on the balance sheet.

However, suppose one company will make extensive use of the equipment while the other will not use it so extensively. How do financial reporting standards allow for such a difference? The answer is that financial reporting standards retain some flexibility in giving companies the discretion to decide on the estimated useful life of an asset. The cost of the machine is then apportioned over this useful life as an expense – this expense is known as depreciation. Financial standards allow companies to record different amounts of depreciation every period based on the usage of the machines. For example, the company that uses the asset extensively will show a higher depreciation expense each year for a shorter number of years. Whereas, the company that uses the asset less extensively will show a lower depreciation expense each year but for a longer number of years.

3. Accounting Standards Board

Standard-setting bodies

Standard-setting bodies are private sector organizations that help develop financial reporting standards. The two important standard-setting bodies are:

- Financial Accounting Standards Board (FASB) – For the U.S. The standards developed by FASB are called U.S. GAAP (Generally Accepted Accounting Principles).
- International Accounting Standards Board (IASB) – For the rest of the world. The standards developed by IASB are called IFRS (International Financial Reporting Standards).

Standard-setting bodies simply set the standards but they do not have the authority to enforce the standards.

4. Regulatory Authorities

Regulatory authorities are government entities that have legal authority to enforce the financial reporting standards. The two important regulatory authorities are:

- Securities and Exchange Commission (SEC) – For the U.S.
- Financial Services Authority (FSA) – For the UK

Regulatory authorities are also responsible for the regulation of capital markets under their jurisdiction.

The International Organization of Securities Commissions (IOSCO)

Technically not being a regulatory authority, IOSCO still regulates a significant portion of the world's financial markets. (Think of it as an umbrella organization of regulatory authorities). This organization has established objectives and principles to guide securities and capital market regulation.

Core objectives

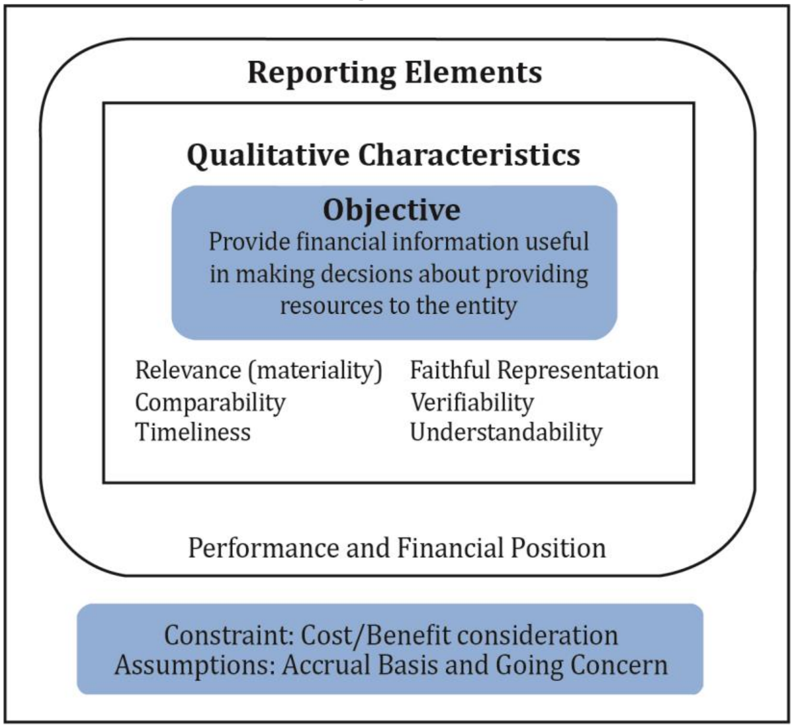
- Protect investors.
- Ensure fairness, efficiency, and transparency in markets.
- Reduce systemic risk.

Principles

- There should be full, accurate, and timely disclosure of financial results and risks.
- Financial statements should be of a high and internationally acceptable quality.

5. The International Financial Reporting Standards Framework

The IFRS has prepared a framework for the preparation and presentation of financial reports. The framework is shown in the diagram below.



Objective of financial statements

At the center of the framework is the objective of financial statements. As per the IFRS framework, the objective of financial statements 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.'

The IASB Conceptual Framework for Financial Reporting 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; and
- assist users in interpreting financial statement information. "

Qualitative characteristics

Surrounding the objective are the desirable qualitative characteristics of financial statements.

The two fundamental qualitative characteristics are:

- <u>Relevance</u>**:** Financial statements should be useful, both for making forecasts as well as to evaluate past forecasts. They should be timely and sufficiently detailed and important facts should not be omitted.

- Faithful representation: Information presented should be complete, neutral, and free from errors.

The four supplementary qualitative characteristics are:

- Comparability: Financial statements should be consistent over time and across firms to facilitate comparisons.
- Verifiability: Independent observers should be able to verify that information reflects true economic reality.
- Timeliness: Information should be available in a timely manner.
- Understandability: Information should be presented in a simple manner, such that even users with basic business knowledge can understand it.

6. The Elements of Financial Statements

Surrounding the qualitative characteristics are the reporting elements used to present information.

Elements related to measurement of financial position are:

- Assets
- Liabilities
- Equity

Elements related to measurement of financial performance are:

- Revenue
- Expenses

Below the reporting elements are the constraints faced and the assumptions made while preparing financial statements.

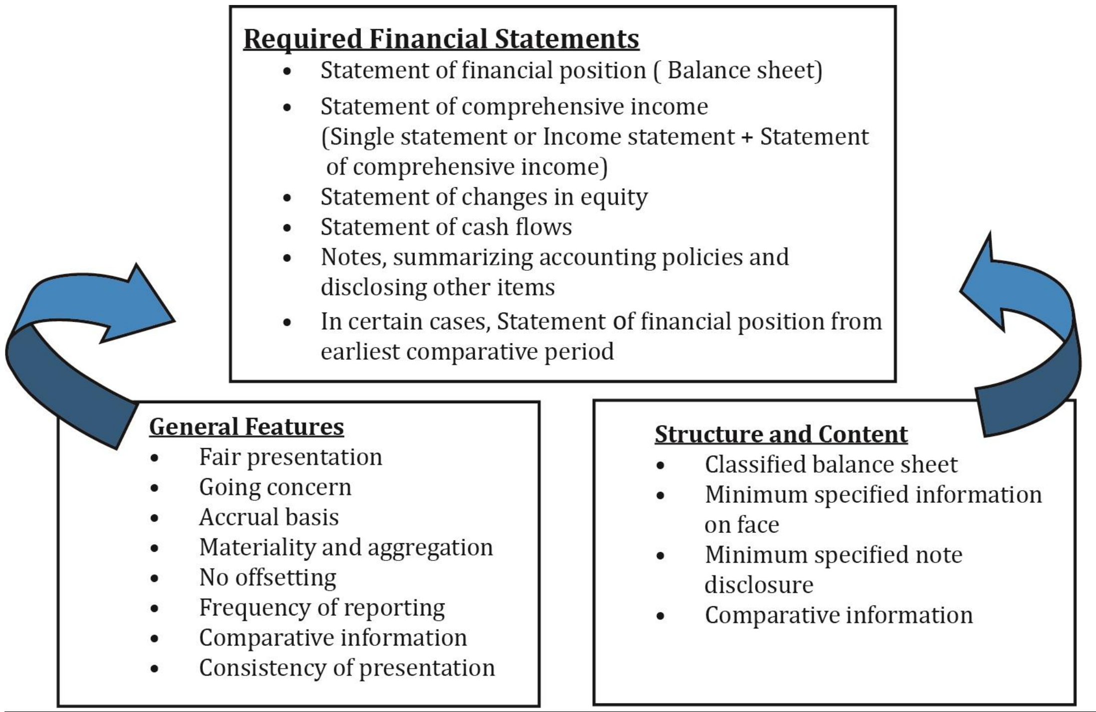
Constraints

- Tradeoff between reliability and timeliness: If a firm tries to make statements that have no errors and are highly reliable it will need a lot of time. Similarly, if a firm tries to make statements in the least amount of time they will more errors and be less reliable.
- Cost: The benefit that the users gain from using the reports should be more than the cost of preparing the reports.
- Intangible aspects: Intangible information such as brand name and customer loyalty cannot be captured directly in financial statements.

Assumptions

- Accrual basis: Revenue should be recognized when earned and expenses should be recognized when incurred, irrespective of when the cash is actually paid.
- Going concern: Assumption that the company will continue operating for the foreseeable future.

7. General Requirements for Financial Statements (IASB)



<u>Required financial statements</u>
The required financial statements are:

- Balance sheet.
- Income statement.
- Cash flow statement.
- Statement of changes in owners' equity.
- Explanatory notes.

<u>General features for preparing financial statements</u>
The general features for preparing financial statements are:

- <u>Fair presentation</u>: Faithful representation of transactions.
- <u>Going concern</u>: Assume firm will continue to exist for the foreseeable future.
- <u>Accrual basis</u>: Recognize revenue when earned and expense when incurred.
- <u>Materiality and aggregation</u>: Important information should not be omitted. Similar information should be grouped together.
- <u>No offsetting</u>: Assets and liabilities, and revenue and expenses should not be offset against each other.
- <u>Frequency of reporting</u>: Prepare statements at least annually.
- <u>Comparative information</u>: Comparable information for prior periods should be included.
- <u>Consistency</u>: Prepare reports in the same manner for every period.

<u>Structure and content requirements</u>

Firms should use the classified balance sheet structure (which shows current and non-current assets and liabilities separately.) Certain minimum information must be presented in the notes and on the face of the financial statements.

8. Comparison of IFRS with Alternative Reporting Systems

A significant percentage of listed companies use either IFRS or US GAAP. An analyst must be cautious when comparing financial measures between companies reporting under IFRS and companies reporting under US GAAP. If needed, specific adjustments need to be made to achieve comparability.

US GAAP uses standards issued by FASB while IFRS uses standards issued by IASB. While the two organizations are working towards convergence, significant differences still remain.

Differences between IFRS and US GAAP:

Basis for Comparison	US GAAP	IFRS
Developed by	Financial Accounting Standard Board (FASB).	International Accounting Standard Board (IASB).
Based on	Rules	Principles
Inventory valuation	FIFO, LIFO and Weighted Average Method.	FIFO and Weighted Average Method.
Extraordinary items	Shown below (at the bottom of the income statement).	Not segregated in the income statement.
Development cost	Treated as an expense	Capitalized, only if certain conditions are satisfied.
Reversal of Inventory	Prohibited	Permissible, if specified conditions are met.

Source: CFAI Curriculum 2020; https://keydifferences.com/difference-between-gaap-and-ifrs.html

9. Monitoring Developments in Financial Reporting Standards

Analysts must be aware that reporting standards are evolving rapidly. They need to monitor developments in financial reporting and assess their implications for security analysis and valuation.

A financial analyst can remain aware of developments in financial reporting standards by monitoring three sources:

- new products or transactions
- actions of standard setters and groups representing users of financial statements
- company’s disclosures regarding critical accounting policies and estimates.

Summary

LO.a: Describe the objective of financial reporting and the importance of financial reporting standards in security analysis and valuation.

"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, where those decisions relate to equity and debt instruments, or loans or other forms of credit, and in influencing management's actions that affect the use of the entity's economic resources."

Financial reporting standards ensure that there is consistency in the preparation of financial reports. This ensures that financial reports of different firms are comparable to one another. A firm's management uses some estimates and assumptions to prepare financial reports. Financial reporting standards ensure that the assumptions and estimates are within a narrow reasonable range.

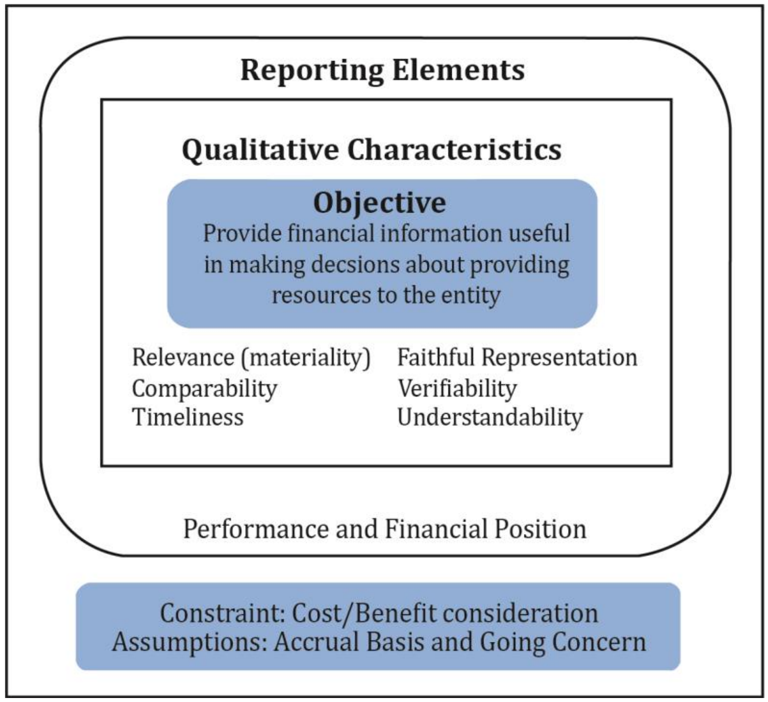
LO.b: Describe the roles of financial reporting standard-setting bodies and regulatory authorities in establishing and enforcing reporting standards.

Standard Setting Bodies	Regulatory Authorities
Private sector organizations.	Government entities.
Self-regulated organizations.	Country specific: SEC, FSA.
Set standards but do not have the authority to enforce.	Authority to enforce financial reporting requirements.
Board members are experienced accountants, auditors, analysts, and academics.	Can overrule private sector standard-setting bodies and establish standards in their jurisdiction.
Major ones: FASB and IASB.	Regulate capital markets in general.

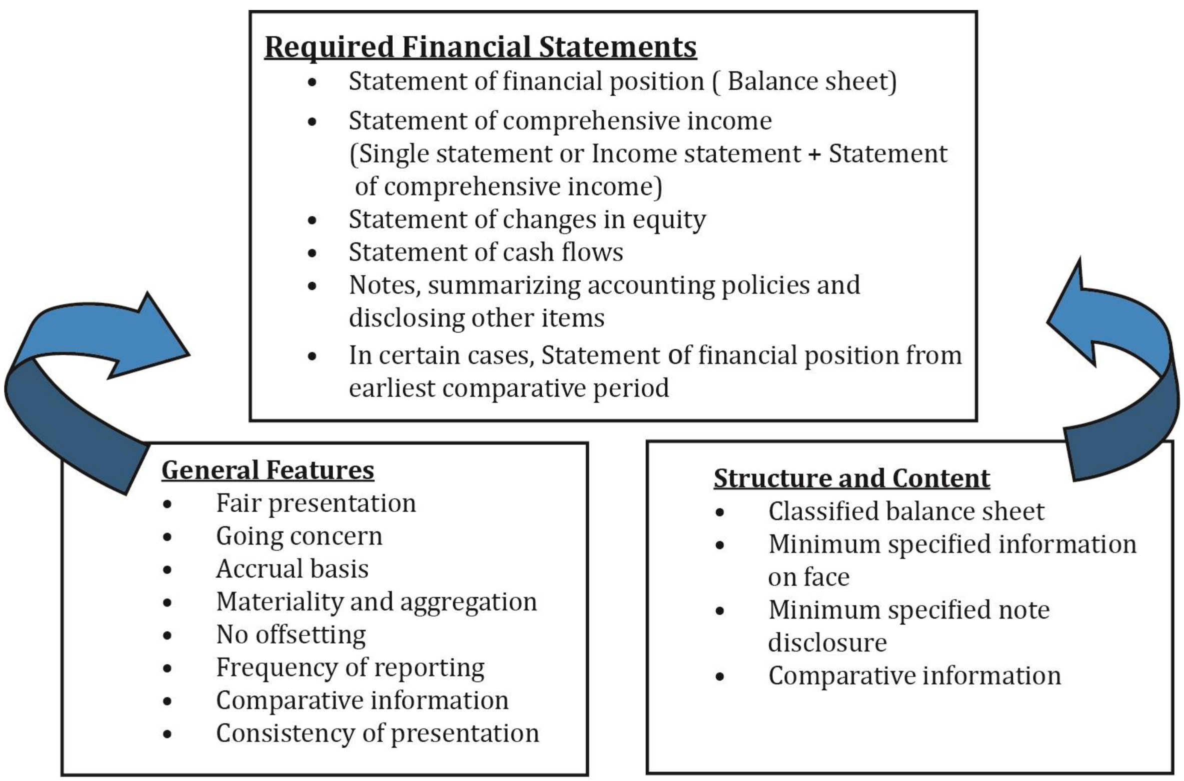
Technically not being a regulatory authority IOSCO still regulates a significant portion of the world's financial markets. The following are the core objectives of IOSCO:

- Protect investors.
- Ensure fairness, efficiency, and transparency in markets.
- Reduce systematic risk.

LO.c: Describe the International Accounting Standards Board's conceptual framework, including qualitative characteristics of financial reports, constraints on financial reports, and required reporting elements.



LO.d: Describe the general requirements for financial statements under IFRS.



LO.e: Describe implications for financial analysis of alternative financial reporting systems and the importance of monitoring developments in financial reporting standards.

Analysts must be aware that reporting standards are evolving rapidly. They need to monitor developments in financial reporting standards and assess their implications for security analysis and valuation.

To do this, an analyst can monitor three sources:

- New products or transactions in capital markets.
- Actions of standard-setting bodies.
- Company’s disclosures regarding critical accounting policies and estimates.

Practice Questions

1. Which of the following statements about the objective of financial statements is true?

   Statement 1: "The objective of financial statements is to provide information about the financial performance of an entity."
   Statement 2: "The objective of financial statements is to provide information about the changes in the financial position of an entity."
   A. Statement 1.
   B. Statement 2.
   C. Both Statements 1 and 2.

2. Which of the following is the *least* desirable attribute of accounting standards board?
   A. Is guided by a well-articulated framework.
   B. Is funded by companies for which the standards are being developed.
   C. Does not concede to external forces like political pressure.

3. Which of the following entities are currently responsible for developing International Financial Reporting Standards (IFRS) and US Generally Accepted Principles (US GAAP)?

	IFRS	**US GAAP**
A.	The International Accounting Standards Board (IASB)	The Financial Accounting Standards Board (FASB)
B.	The Financial Services Authority (FSA)	The Financial Accounting Standards Board (FASB)
C.	The International Accounting Standards Board (IASB)	The Securities and Exchange Commission (SEC)

4. Which of the following is the core objective of the International Organization of Securities Commissions (IOSCO)?
   A. Ensure that markets are fair, efficient and transparent.
   B. Protect all the users of financial statement.
   C. Eliminate systematic risk.

5. With respect to the IASB Conceptual Framework, which of the following are the fundamental qualitative characteristics that make financial statements useful?
   A. Relevance and faithful representation.
   B. Verifiability and timeliness.
   C. Comparability and understandability.

6. Which of the following reporting elements of financial statements are most closely related to measurement of financial position and measurement of financial performance?

	Financial Position	Financial Performance
A.	Expenses	Assets
B.	Income	Liabilities
C.	Equity	Income

7. Which of the following statements regarding the primary assumptions that are used in preparation of financial statements are *most likely* to be true?
   Statement 1: "An entity should be regarded as a going concern, i.e., it will continue to operate in the foreseeable future."
   Statement 2: "All the transactions should be recorded on an accrual basis, i.e., when the transactions occur and not when the cash flows occur."
   A. Statement 1.
   B. Statement 2.
   C. Both Statements 1 and 2.

8. With respect to IAS No. 1, which of the following is *not* a required financial statement?
   A. Statement of changes in income.
   B. Statement of comprehensive income.
   C. Statement of financial position.

9. Which of the following statements regarding differences between US GAAP and IFRS is *most accurate*?
   A. Both US GAAP and IFRS permit reversal of inventory.
   B. Under IFRS, extraordinary items are reported below net income while under US GAAP, extraordinary items are not segregated in the income statement.
   C. Under US GAAP, development cost is always treated as an expense while under IFRS, development cost can be capitalized if certain requirements are met.

10. Which of the following disclosures regarding new accounting standards is *most* useful for an analyst?
    A. Management is still evaluating the impact.
    B. The likely impact of adopting the accounting standards is discussed.
    C. The adoption of the standard is likely to have no impact.

Solutions

1. C is correct. The objective of financial statements is to provide information about an entity's financial performance and changes in the financial position.

2. B is correct. For an accounting standards board to function properly, it should be independent, should be guided by a well-articulated framework, should not concede to external forces like political pressure, and should be adequately funded.

3. A is correct. Standard-setting bodies are responsible for developing the reporting standards. The International Accounting Standards Board (IASB) is responsible for developing the IFRS reporting standard while the Financial Accounting Standards Board (FASB) is responsible for developing the US GAAP standard. Regulatory authorities enforce compliance with the reporting standards. This includes the Securities and Exchange Commission (SEC) in the US and the Financial Services Authority (FSA) in the UK.

4. A is correct. The core objective of IOSCO is to ensure that markets are fair, efficient and transparent, reduce systematic risk (not eliminate), and protect investors (not all users) that use the financial statement.

5. A is correct. The fundamental characteristics of financial statements are relevance and faithful representation. The enhancing characteristics of financial statements are verifiability, comparability, understandability, and timeliness.

6. C is correct. Reporting elements of financial statements related to measurement of financial position are assets, liabilities, and equity. Reporting elements of financial statements related to measurement of financial performance are income and expenses.

7. C is correct. The two primary assumptions that are used while preparing financial statements are the accrual basis of accounting and the going concern assumption. In accrual basis, transactions are recorded when the transactions occur and not when the cash flows occur. The entity is assumed to be a going concern, i.e., it will continue its operation in the foreseeable future.

8. A is correct. There is no statement of changes in income. The required financial statements are statement of financial position, a statement of comprehensive income, a statement of changes in equity, a statement of cash flows, and notes comprising a summary of significant accounting policies and other explanatory information.

9. C is correct. Under US GAAP, development cost is always treated as an expense while under IFRS, development cost can be capitalized if certain requirements are met. A is incorrect because only US GAAP permits reversal of inventory. B is incorrect because under IFRS, extraordinary items are not segregated in the income statement while under US GAAP, extraordinary items are reported below the net income.

10. B is correct. The discussion on the likely impact would be most useful for an analyst.

