Chapter 13

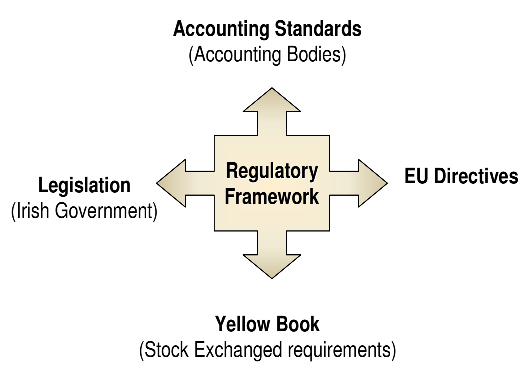
Solution 13.1

Outline the elements of the regulatory framework

The term regulation implies the imposition of rules and requirements. In an accounting context this would relate to the preparation and presentation of reports and statements for external parties.

The objective of an accounting regulatory framework is to ensure adequate relevant disclosure, objectivity and comparability of accounting information to the external users of financial reports. Accounting and the preparation of financial statements and reports is therefore regulated through the following.

1. The government, through the relevant legislation. In Ireland, this relates to the Companies Acts of 1963 and 1990, and the Companies (Amendment) Acts of 1983, 1986
2. Regulation through the European Union. The EU issues directives to its member states to help ensure greater harmony in the presentation of financial statements. An EU directive requires the government of each member state to incorporate that directive into their laws. The EU's 4th directive concerned the preparation and presentation of the accounts of companies and this was made law in Ireland through the Companies (Amendment) Act 1986.
3. The Stock Exchange listing requirements (yellow book) for companies listed on a publicly quoted exchange.
4. The accounting standards issued by the accounting bodies.



Solution 13.2

The role of accounting standards and FRC

The purpose of accounting standards is to reducing the range of diverse accounting methods in operation as each method of accounting could lead to the presentation of a completely different profit figure. The accounting standards provide a unifying code of practice in preparing and presenting accounting information.

In July 2012 the financial reporting council (FRC) took over the role of setting accounting standards from the ASB. The FRC collaborates with accounting standard setters in other countries as well as the international accounting standards board (IASB) in order to influence the development of international standards and to ensure its standards are developed with due regard to international developments.

Solution 13.3

Accounting concepts are broad basic assumptions, which form the basis of the financial accounts of a business. They help ensure transactions are recognised and measured on a uniform basis.

The Accruals Concept requires that the effects of transactions should be accounted for when they occur and are included in the statements for the periods they relate to. The accruals concept requires two things

1. When calculating net profit, expenses should be matched against related revenues.
2. Net profit is the difference between revenues earned (not necessarily received) and expenses charged (not necessarily paid).

The Realisation Concept clarifies when a business accounts for a transaction and thus the related profit or loss on the transaction. It states that profits or losses on transactions can only be accounted for when realisation has occurred. Realisation occurs when goods or services have been provided to the buyer who accepts liability for them

Materiality Concept recognises that some transactions are not sufficiently important to waste time and effort in ensuring the correct accounting treatment. Information is considered material if its omission or misstatement could influence the economic decisions of the various user of account. The deciding factor is, if the cost of accounting for a transaction in the correct manner is greater than the value of the transaction, then the amount in question would not be considered material.

Going concern requires that in preparing the accounts we assume the business will continue into the foreseeable future. This ensures that the basis of measuring and valuing assets and liabilities will remain at either cost or current value. If the accounts were to be prepared on the basis that the business was to be sold or about to go into liquidation, then an alternative basis for valuing the assets would have to be considered including the break-up or liquidation values for assets. Thus unless the business entity is in liquidation or the directors have no alternative but to cease trading, then the going concern basis will apply and all assets and liabilities will be valued at historic cost or current value, whichever is appropriate.

Solution 13.4

The relationship between the prudence and realization concepts

The intention of the prudence concept is to see that all asset values and profit figures are realistic rather than optimistic or pessimistic. The essence of the concept is to insist that revenue or profit should not be accounted for until the business is virtually certain to get it, but that a loss in an assets value is accounted for as soon as it is probable or likely. The realisation concept tells us when to recognise the profits or loss on a transaction. It states that profits or losses on transactions can only be accounted for when realisation has occurred. Realisation occurs when goods or services have been provided to the buyer who accepts liability for them. It is at this point that the business accounts for the transaction as it is virtually certain it will receive the revenues earned. Both concepts seek to ensure that transactions are accounted for on realization and hence assets and profit figures are realistic.

Solution 13.5

The main purpose of the Statement of Principles is to provide a framework from which the ASB can develop and review its accounting standards. It sets out the principles that the ASB believe should underlie the preparation and presentation of financial statements that are required to give a true and fair view.

Chapter 1 - the objectives of financial statements outlines the objective of financial statements which is to provide information about the financial performance and financial position of an enterprise that is useful to a wide range of users for assessing the stewardship of management, and for making economic decisions.

Chapter 2 - the reporting entity identified two main forms of business entities; single entities and groups. It states that an entity should prepare and publish financial statements if there is a legitimate demand for that information and the entity is a cohesive economic unit.

Chapter 3 - the qualitative characteristics of financial information identified four principal qualitative characteristics, relevance, reliability, comparability and understand ability.

Chapter 4 - the elements of financial statements sets out and discusses the definitions of the elements of financial statements assets, liabilities, ownership interest, gains and losses.

Chapter 5 - recognition in financial statements focuses on what is required to recognise a transaction that create or increases assets and liabilities, gains and losses. In order to recognise, and thus include in the accounts, any transaction that affects any of the elements of financial statements, there must be evidence of its existence so that it can be measured reliably as a monetary amount with sufficient reliability.

Chapter 6 - measurement in financial statements provides an overview of issues relevant to the measurement of assets and liabilities recognised in the balance sheet and the associated effects of gains and losses.

Chapter 7 - presentation of financial information has the objective is to communicate clearly and effectively and thus meet the objectives of Chapter 1 in the statement of principles. This chapter focuses on the way in which the information on financial performance, financial position and cash flow information is presented

Chapter 8 – accounting for interests in other entities focuses on the accounting for interests in other entities and how these interests should be fully reflected in the financial statements of the entity that has the interest and exerts the influence.

Solution 13.6

Recognition in financial statements

Chapter 5 of the statement of principles focuses on what is required to recognise a transaction that creates or increases assets and liabilities, gains and losses. In order to recognise, and thus include in the accounts, any transaction that affects any of the elements of financial statements, there must be evidence of its existence so that it can be measured reliably as a monetary amount with sufficient reliability. The relevant accounting concepts related to recognition in financial statements are the;

- Money measurement concept
- Realisation concept

Solution 13.7

Measurement in financial statements

Chapter 6 of the statement of principles provides an overview of issues relevant to the measurement of assets and liabilities recognised in the balance sheet and the associated effects of gains and losses. In preparing financial statements, the measurement basis of historic cost or current cost needs to be selected for each category of asset or liability. An asset or liability measured using historic cost is recognised at its initial transaction cost. If measured on current value basis it is recognised at its current value at the time it was acquired. Re-measurement will occur if it is necessary to ensure that assets measured at historic cost are carried at the lower of cost and the recoverable amount. For assets measured at current value, re-measurement will occur to ensure that assets and liabilities are carried at up-to-date values. Re-measurement will only be recognised if there is sufficient evidence that the monetary value of the asset or liability has changed and the new value to the asset/liability can be measured with sufficient reliability.

The relevant accounting concepts are the

- Historic cost concept
- Going concern concept
- Accruals concept
- Prudence concept

Solution 13.8

Financial reporting standard 18 states that accounting policies are those principles, bases, conventions, rules and practices applied by an entity that specify how the effects of material items are to be reflected in the financial statements. Any material item must firstly be:

1. *Recognised* in the financial statements as, either assets, liabilities, gains, losses, and changes to shareholders funds.
2. The *measurement* basis for the transaction must be selected. This monetary value can be chosen from two broad categories, current value or historic value.
3. The *presentation* of the information in the financial statements must enable the users to understand the policies adopted.

Should there be any changes to any one of the three bases (recognition, measurement and presentation) then there is deemed a change of accounting policy and that change, and the effect of the change, must be reported in the financial statements.

This is in contrast to a change of an 'estimate' or estimation technique where none of the three elements are affected and thus not required to be reported in the accounts.

The change from straight line depreciation to reducing balance depreciation involves a change in estimation technique while the change from historic cost to current value would involve a change in accounting policy.