

### A principled approach

## FSA should avoid 'lengthy rule book' says ICAEW

**Paul Grant**

The Financial Services Authority needs to avoid drawing up a 'lengthy rule book' in response to the financial crisis and instead adopt a principles-based approach in its reform of banking regulation.

In its submitted response to the Turner Review, the ICAEW said the City regulator should instead address operational failings as well as weaknesses in system design and regulatory policy. It should also strive to avoid losing the positive aspects of the work it had previously undertaken from the pressure to change.

'The arguments that the FSA should move towards a more principles-based approach remain valid not least in that such an

approach deals better with changing financial markets than a lengthy rule book,' said PwC partner and chair of the ICAEW Financial Service Faculty's Risk and Regulation Committee, John Tattersall.

Iain Coke, head of Financial Services Faculty, added: 'Communication, cooperation and coordination between the tripartite authorities can, and should, be improved. It is vital, however the system is structured, that it is made to work effectively at both policy and operational levels. Part of the solution here is for there to be closer dialogue between the FSA and the audit profession on systematic risks.'

*Accountancy Age, 17 June 2009.*

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Questions relating to this news story can be found on page 41 ➔

### About this chapter

In this chapter we outline the conventional accounting rules that are commonly adopted in practice and the legislation that governs accounting. We then examine the role of the UK's Accounting Standards Board along with the International Accounting Standards Board in the preparation of financial statements. The chapter closes with a review of the attempts made to develop a framework of accounting based on generally accepted principles.

## Learning objectives

By the end of this chapter you should be able to:

- identify fourteen conventional accounting rules;
- summarize the UK legal requirements covering financial reporting;
- outline the role of the Accounting Standards Board in that process;
- examine the legal authority the International Accounting Standards Board has in UK financial reporting.

## Why this chapter is important

This chapter is important for non-accountants for the following reasons.

- 1 It underpins almost the entire contents of this book. So if you are to understand what accountants do and why they do it, you must be familiar with the rules and regulations that they adopt.
- 2 You need to have some familiarity with the legal requirements governing accounting in the UK.
- 3 Similarly it is necessary to have some knowledge of the quasi-legal role that the Accounting Standards Board and the International Accounting Standards Board play in UK financial reporting.
- 4 You must have a grasp of the attempts made to base accounting practice on generally accepted accounting principles (GAAP).

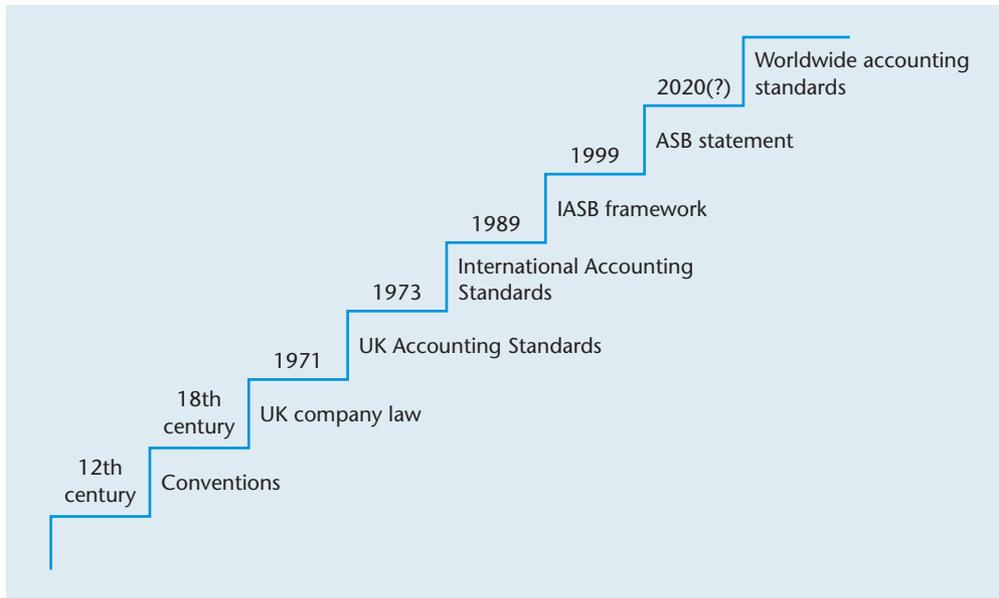
## The need for rules

Most games have an agreed set of rules. Rules define the game and they provide a structure that every player is expected to follow. If you are a footballer, for example, you are expected to follow the rules that apply to football. Without them football (as we know it) would just become a totally uncoordinated and chaotic kick-about.

Unlike football or any other game, no one actually sat down and devised a set of accounting rules. What happened was that over a long period of time entities (mainly sole traders) gradually adopted similar procedures for recording their transactions and assessing how the business had performed at a regular and fixed interval. In other words, such procedures eventually became generally accepted and they became the rules that virtually everyone adopted. The development of accounting rules over the centuries to where we are today is shown in Figure 2.1.

There was nothing indisputable about such rules, of course, in the sense that if you drop an apple it falls to the ground. The accounting rules that evolved were man-made and you could argue against them. You were also free to choose whether to adopt them or follow your own rules. If you did, of course, you might cause a great deal of confusion (just as you would in football if you adopted your own rules) but that would be up to you.

Many accountants these days do not like to describe conventional accounting procedures as ‘rules’ because that gives the impression that they are prescriptive. So you will come across a bewildering number of different terms such as assumptions, axioms,



**Figure 2.1** The development of accounting rules

concepts, objectives, policies, postulates, principles and procedures. It is quite easy to have an argument about each of these descriptions. For example, if you are told that ‘this procedure is a *principle* of accounting’ it sounds as though there is a moral code underpinning how that procedure should be dealt with, like being told that ‘murder is wrong’ and ‘hanging is the answer’. Whereas in accounting all we are really saying is that ‘this is the way that we usually do it’, i.e. it is a convention.

We do not believe that it is necessary to get bogged down in such arguments so, in this book, for convenience and to avoid repetition we will generally refer to conventional accounting practices as ‘accounting rules’. But why do we need some rules? Surely there is nothing more to accounting than the equivalent of adding 2 and 2 together and making sure that the answer is 4? Well, not quite.

In order to explain why, we need to re-examine what we mean by ‘accounting’. In Chapter 1 we gave you the following definition:

*Accounting is a service provided for those who need information about an entity’s financial performance, its assets and its liabilities.*

Now even with perhaps such a broad definition it is possible to spot fairly quickly some of the difficulties involved in carrying out that brief. Some of the questions we might ask are as follows.

- 1 Why is the type of information? Qualitative, quantitative or both?
- 2 Who wants it? Owners? Workers? Customers? Are their wants the same?
- 3 What is meant by an entity? Where do you draw the line?
- 4 How do you report the information that you are going to provide? On the basis of numbers, e.g. six cows and a hundred sheep? Or do you use a common measure such as translating everything into monetary values?
- 5 Do you report on a regular basis? And over what period? Every week or every five years?

It is in response to such questions that over the centuries common procedures have evolved. Unfortunately, they are no longer necessarily suitable for a fast-moving highly technological age. The questions may remain the same but we need to come up with different answers. The search is on.

However, before we set off on that journey we need to review the answers that used to be acceptable. We do so in the next section.

### Activity 2.1

Consult the most comprehensive dictionary you can find in your college/university library. Write down the meaning of the following words. They may have several meanings so extract the one that relates more to fact or truth.

(1) assumptions; (2) axioms; (3) concepts; (4) conventions; (5) postulates; (6) principles; and (7) procedures.

Consider carefully the definitions that you have extracted. Do they all have a similar meaning?

## Conventional accounting rules

Dozens of conventional rules have been adopted over the centuries but it is possible to identify fairly clearly the most common ones. We have selected fourteen for our purposes. For convenience we have grouped them into three categories: boundary rules, measurement rules and ethical rules (see Figure 2.2). We start with what we call ‘boundary’ rules, i.e. where we draw the line at what should be reported.

### Boundary rules

There are four important boundary rules: entity, periodicity, going concern and quantitative.

#### Entity

It is customary to keep strictly separate the affairs of a business from the private affairs of its owners. In practice, it is not always easy to distinguish precisely between what is ‘business’ and what is ‘private’, especially in the cases of sole trader and partnership entities. The close interrelationship between what are effectively two separate entities is shown in Figure 2.3.

#### Periodicity

The main accounting period is usually considered to be twelve months. This is an arbitrary period of time especially in the case of entities that have an unlimited life. In the western agrarian world it does reflect the four seasons of the year although this is now of little relevance to manufacturing and service entities. Indeed, in the fashion industry, for example, a much shorter accounting period might be more appropriate since fashions and tastes change quite quickly. A year is, however, a practical period of time because most people can relate to what happened last year, whereas it is much more difficult over (say) a five-year period.

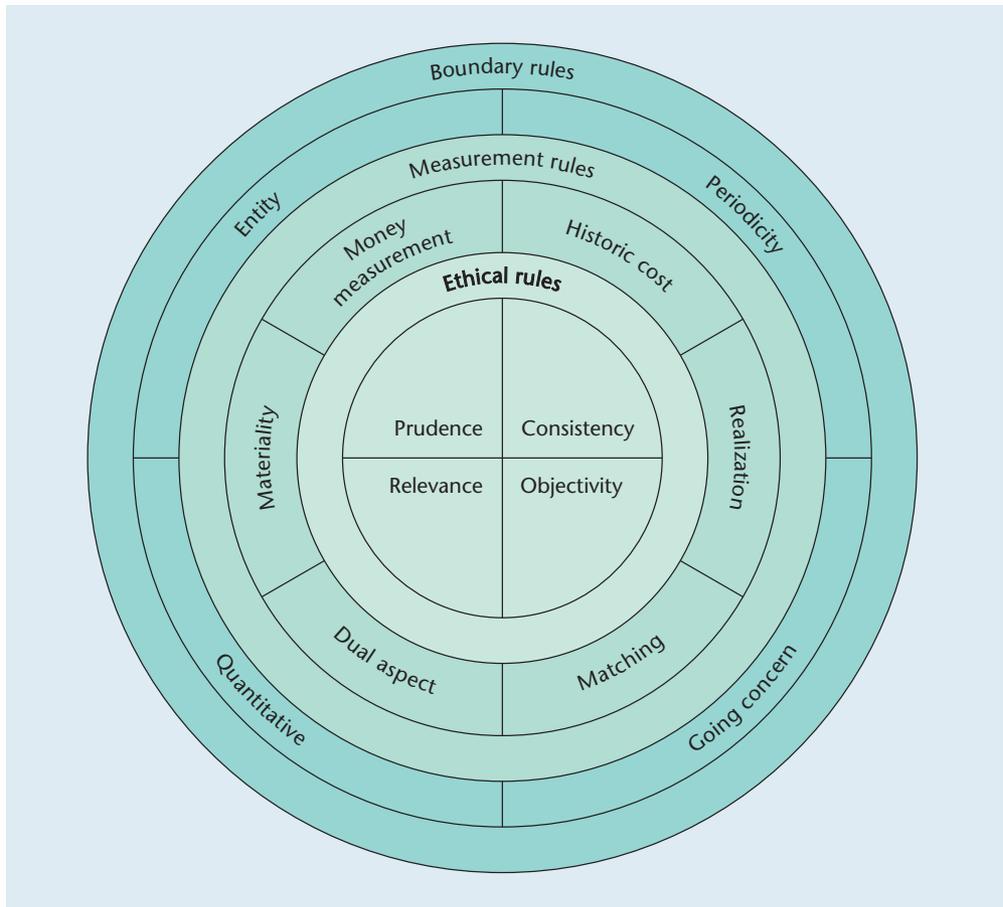


Figure 2.2 The basic accounting rules

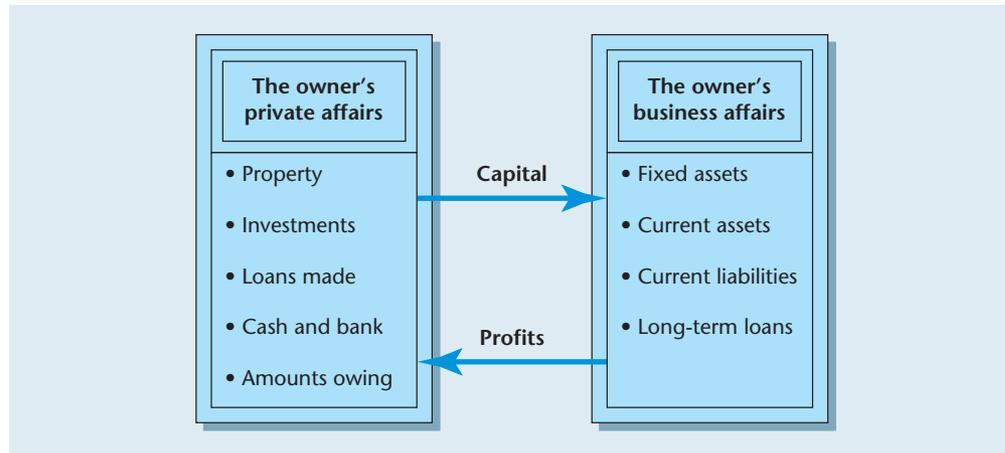
**Activity 2.2**

List three advantages and disadvantages of preparing financial accounts only once a year.

Advantages	Disadvantages
1	1
2	2
3	3

**Going concern**

Irrespective of the chosen accounting period it is usual to assume that an entity will continue in business for the foreseeable future. If this is not the case then different accounting procedures would be adopted. But how is it possible to determine with any certainty whether an entity is a ‘going concern’ especially when business is bad such as in a recession?



**Figure 2.3** The entity rule: separation of business and private affairs

### News clip

## Liverpool FC concern

Liverpool FC's parent company may not be able to continue trading as a going concern. KPMG auditors warned that it needs to refinance its £350m debt. The parent company, Kop Football Holding, suffered a £42.6m loss last year with interest payments accounting for £36.5m of that loss. The Club itself had a turnover of £159.1m and a net profit of £10.2m.

Source: Adapted from [www.accountancyage.com](http://www.accountancyage.com), 5 June 2009.

### Quantitative

Accounting information is usually restricted to that which can be easily quantified. Value considerations, such as how long the business has been in existence or the length of service of the staff are usually ignored. And yet surely these factors are worth something to a long-established entity compared with a newly created business?

### Measurement rules

Measurement rules determine how data should be recorded. There are six important ones. They are: money measurement, historic cost, realization, matching, dual aspect and materiality. First, the money measurement rule.

### Money measurement

Such information that can be easily quantified is given a monetary value. But the value of money changes over a period of time. During inflationary periods its value goes down, i.e. the same quantity of money buys fewer goods and services than the year before. Deflationary periods can also occur but they are quite rare and they are usually quite short. In inflationary and deflationary circumstances it is misleading to compare one year's results with that of another without allowing for the effect of the value of money either going up or going down.

### Historic cost

Assets (such as cars) and liabilities (such as amounts owed to a creditor) are usually valued at their historic cost, i.e. at the price paid for them when they were originally purchased or sold. However, apart from the impact of inflation or deflation, assets and liabilities may change their value owing to such factors as wear and tear and obsolescence.

### Realization

When goods are sold or purchased or sold on credit terms it is customary practice to treat them as being exchanged at the point when the legal title to the goods is transferred, i.e. when they are realized. In modern manufacturing and trading conditions that point is not necessarily obvious and it remains a major issue that the accountancy profession is still trying to sort out.

#### Activity 2.3

A contracting company divides each of its sales into five stages: (1) on order; (2) on despatch; (3) on installation; (4) on commissioning; and (5) on completion of a 12-month warranty period.

Assume that an order for Contract A for £100,000 was signed on 1 January 2011. The contract is expected to be completed on 31 December 2013 and the warranty period will end on 31 December 2014. In which year would you consider that the £100,000 has been 'realized'?

### Matching

The matching rule is illustrated in Figure 2.4.

This rule is closely related to the realization rule. Accounts are not usually prepared on the basis of cash received and cash paid during (say) a 12-month period because there is often a delay between the receipt and the payment of cash depending on the credit period given. This means that a comparison based on cash received/cash paid may

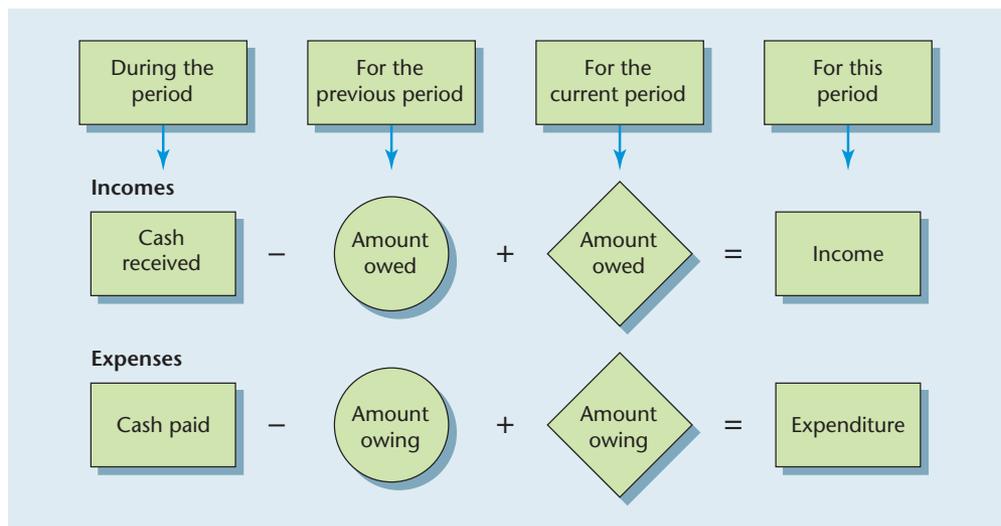


Figure 2.4 The matching rule

be misleading when one year is compared with another. When preparing the accounts at the end of a year, therefore, it is necessary to allow for what was *owed to* the entity and *owing by* it at both the beginning and the end of the year, i.e. opening and closing debtors and creditors. This procedure often involves making an estimate of the amounts due to be received and sometimes the amounts due to be paid. Any estimate, of course, can be wrong because it is likely that some debts will not be settled. If this proves to be the case then the accounts for that year will be incorrect.

### Dual aspect

Any transaction involves someone giving something and someone else receiving it. So the basic rule is: *record every transaction twice* even if it is an internal transaction. As a result a recording system known as *double-entry book-keeping* evolved. This system has many practical advantages and most entities (apart from perhaps very small ones) now adopt it.

### Materiality

The adoption of many of the conventional accounting procedures can result in a tremendous amount of work, e.g. in estimating the amount of bad debts. However, if the eventual results of that extra work are likely to be immaterial or insignificant, i.e. they do not have any meaningful effect on the overall results, then there does not appear to be much point in sticking strictly to the 'rules'. It would not be customary, for example, to estimate the value of small amounts of stationery at the year end and include them in 'stocks' or 'inventories'. But what does 'small' mean in this context? Stationery worth £200 may be material to a one-woman business but mean nothing to a multinational company. So materiality is a matter of context; it requires judgement and different people will come to a different conclusion.

### Ethical rules

Ethical rules relate to the moral code or principles expected to be adopted in the preparation of accounts. There are four main ethical rules. They are: prudence, consistency, objectivity and relevance.

### Prudence

This is perhaps a rule which has helped to preserve the cautious, careful and pernickety perception of the typical old-fashioned accountant. The rule states that if there is some doubt over the treatment of a particular transaction, then income should be underestimated and expenditure overestimated. By following this rule the overall profit is likely to be lower and so there is less danger of it being paid out to the owners and hence not being recoverable.

### Consistency

The same accounting policies and rules should be followed in successive accounting periods unless there is a fundamental change in circumstances that makes such a change justifiable. It is not usually acceptable, for example, to adopt a different accounting method simply because the profit for a particular accounting period is low.

### Objectivity

This rule requires you to avoid personal bias and prejudice when selecting and applying the accounting rules. This is not always easy, of course, but an important part of your

college or university education is to train you to argue both sides of a case irrespective of just how you feel. This training helps you to deal with problems objectively without letting your own personal feelings overwhelm a particular decision.

### Relevance

Financial statements should not include matters that prevent users from gaining what they need to know. The overall picture may be obscured if too much information or too much detail is given. So, in short, the information provided must be *relevant*. In the jargon of the accountancy profession this means that financial statements should give a true and fair view of the financial affairs of the entity.

You are going to come across all the rules that we have discussed in this section in one form or another throughout the rest of the book but we now need to examine which professional and statutory requirements cover accounting. We turn to this topic in the next section.

#### Activity 2.4

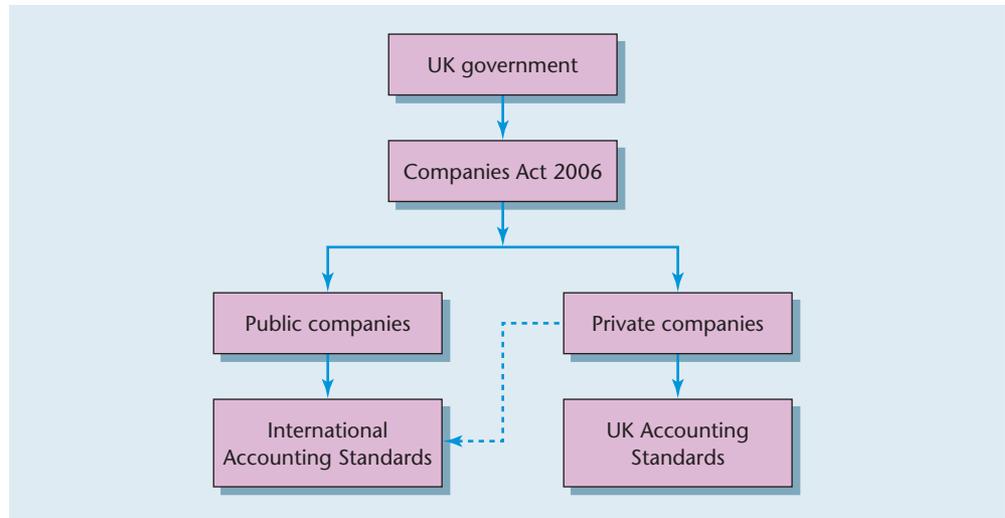
Review the 14 conventional rules we have outlined in this section. Then on the table below score each one according to whether you think that in practice it is easy to apply. Use the following scale: (1) very easy; (2) easy; (3) neither easy nor difficult; (4) difficult; and (5) very difficult.

Boundary rules	Score	Measurement rules	Score	Ethical rules
Entity		Money measurement		Prudence
Periodicity		Historic cost		Consistency
Going concern		Realization		Objectivity
Quantitative		Matching		Relevance
		Dual aspect		
		Materiality		

### Sources of authority

The application of the rules summarized in the previous section in an increasingly sophisticated banking, commercial, industrial, political, technological and social society began to cause problems for accountants and the users of financial statements as the twentieth century progressed. A number of fire-fighting solutions were then put forward in all attempt to deal with the numerous problems that began to erupt. During the 1960s it became obvious that the system had begun to break down and that something needed to be done.

What did happen was that the UK accountancy profession began to develop what are called *accounting standards*. It was not long before *international accounting standards* also began to be developed. Such standards now play a very important part in the UK regulatory framework. We shall be examining them in detail in later sections of this chapter.



**Figure 2.5 Sources of authority**

Parliament also played its part in an attempt to come up with some solutions to the financial reporting problem. It takes time to get legislation through Parliament but even so it managed to pass seven Companies Acts in 22 years (between 1967 and 1989). It then took another 17 years before another Companies Act was passed in 2006 (a massive one as it turned out). We will have a look at it a little later in the chapter.

There is also another source of authority: the London Stock Exchange (LSE). The LSE is regulated by the Financial Services Agency (FSA). The FSA is an independent non-governmental body set up by the Financial Service and Market Act 2000. It is responsible for the UK financial services industry and its powers are wide-ranging. They include rule-making, investigatory powers and enforcement powers.

The LSE plays a very important part in financial reporting but much of it is irrelevant for our purposes. This means that there are three main sources of authority governing accounting regulation in the UK that we need to examine: (1) the Companies Act 2006; (2) UK Accounting Standards; and (3) International Accounting Standards (IASs). These three sources are examined in some detail in the following sections. The relationship between these sources is shown in Figure 2.5.

### Activity 2.5

Do you think that by law shareholders should have complete freedom of information, i.e. the right to be given all the information that they want about a company in which they hold shares? What practical problems might arise if this were the case?

## Companies Act 2006

There are no specific legal or statutory requirements dealing with sole trader and partnership accounts in the Companies Act or elsewhere. This means that the owners and managers of such entities may keep what accounting records that suit them (if any) and prepare periodic accounts when and in what form they wish. However, if they are registered for Value Added Tax they will need to keep adequate records that satisfy the somewhat severe requirements of Her Majesty's Revenue and Customs. Similarly, as the

owners of a business they will need to include any profit due to them on their own personal income tax return. As a result of such considerations most entities have to keep some basic accounting records and to compile a rudimentary profit and loss account once a year. The precise form and content of such records and accounts is up to them.

As we mentioned in Chapter 1, a new form of partnership, limited liability partnerships, was introduced in 2001. The 2006 Companies Act also covers some aspects of this type of entity but as we are not covering LLPs in this book we do not need to go into the details.

In this book we are mainly concerned with the limited liability company type of entity. The legislation dealing with the formation, management, operation (including the accounting requirements) and reporting of such entities is now contained in the new Act of 2006 although it only became fully operable in October 2009. The Act is extremely detailed and complex. It is the largest Act ever passed by Parliament. No doubt you will be relieved to know that for your purposes (at least at this stage of your career) most of it is way beyond this book. And that includes the accounting bits!

Right, so what *do* you need to know for now? We will try to give you the answer to this question as plainly and as simply as we can. The following is an extremely brief summary of what you need to know.

- 1 The Act deals with the entire operation and management of companies so it encompasses much more than simply 'the accounts'. The 'Accounts and Records' are covered in Part 15. This part forms a relatively small section of the entire Act and much of it is based on earlier legislation.
- 2 It classifies companies into 'small', 'medium' and 'large'. This classification is based on a requirement to satisfy two out of three criteria: turnover, balance sheet totals and number of employees. The respective quantitative amounts are given in the Act but they are subject to amendment from time to time by Statutory Instrument (SI), which we come back to later.
- 3 A company has a duty to keep what are referred to as 'adequate accounting records'. This means that (a) the company's transactions can be shown and explained; (b) the financial position of the company can be disclosed at any time; (c) its accounts comply with either the Act or with European Union (EU) requirements.
- 4 A company must keep a daily record of money received and paid and a record of its assets and liabilities.
- 5 Companies dealing in stocks (apart from retail traders) have to keep a record of their purchases and sales during a financial year, details of their suppliers and customers, and their year end stocks.
- 6 The Act makes a distinction between (a) publicly traded companies and (b) non-publicly traded companies. A publicly traded company is basically a company that is permitted to offer its shares to the public on a regulated market, i.e. a Stock Exchange. In the United Kingdom you should be able to recognize such companies fairly easily because they have to put PLC, plc or public limited company after their name. Similarly, non-publicly traded companies must put LTD, ltd or limited after their name.
- 7 PLCs in member states of the EU must use what are called *International Accounting Standards* (IASs) when preparing *consolidated* accounts, i.e. when all the accounts forming part of a family of closely connected companies are combined. The accounts are then known as the *group* accounts. This requirement applies to every one of the 27 member countries of the EU.
- 8 In preparing their accounts non-publicly traded companies in the UK have a choice. They can use either (a) the accounting requirements of the Companies Act 2006 plus UK Accounting Standards; or (b) just IASs.

The 'Annual Accounts' section of the Act (in Part 15) is much broader in scope than was the case in earlier Companies Acts, the precise detail being left to the Secretary of State to determine. The form, content and terminology of accounts, for example, are not set out in the legislation (as they were in the 1985 and 1989 Companies Acts). This does not mean that companies are free to decide these things for themselves. Instead the details are decided by the Secretary of State and he (it's usually a 'he') issues his instructions in the form of an SI. This is known as *secondary legislation*.

SIs enable the Secretary of State to make changes to *primary* legislation without needing to put another Bill before Parliament. Such a procedure is perfectly legitimate because Parliamentary time is short and the government's legislative programme is usually very full. The SI procedure enables changes to be made to non-controversial matters contained in legislation when circumstances change, e.g. the definition of 'small', 'medium' and 'large' companies. Turnover and balance sheet totals (in sterling) can get out of date very quickly, so it makes sense if they are kept up to date on a regular basis without having to introduce even more legislation.

An SI dealing with the form and content of accounts was issued about 18 months after the Companies Act 2006 received the Royal Assent. As it turned out the requirements were almost identical to those detailed in the 1985 and 1989 Companies Acts. This is a good example of the Act, despite its size, not having a major impact on conventional accounting practices – at least for those companies that did not have to switch to IASs.

We now turn to examine the second main source of accounting authority: UK Accounting Standards. We do so below.

### Activity 2.6

How confusing do you think it is in the UK to have two options in preparing a company's financial statements: (1) UK company law + UK Accounting Standards; and (2) IASs? Mark your score on the following scale: 1 = totally confusing; 5 = no confusion.

Totally confusing

no confusion

1

2

3

4

5

## UK Accounting Standards

It would be helpful if we first define what is meant by an 'accounting standard'. The Companies Act 2006 gives us a definition although it is not a particularly clear one. According to the Act, accounting standards are:

...statements of standard accounting practice issued by such body as may be prescribed by regulations. (CA 2006, S464(1))

In less legalistic language this means that: statements of standard accounting practice (SSAPs) are authoritative pronouncements that explain how to deal with specific accounting problems such as the valuation of closing stocks or the treatment of research expenditure. The regulations referred to above usually come in the form of SIs. In the UK there is currently one such prescribed body called the Accounting Standards Board (ASB). Many other countries have a similar body. A brief history of the ASB now follows.

## News clip

**John Varley**

John Varley, the Chief Executive Officer of Barclays Bank, has called for global consistency of accounting standards if another financial crisis is to be avoided in future.

Source: Adapted from [www.accountancyage.com/articles](http://www.accountancyage.com/articles), 23 April 2009.

During the 1960s a number of contentious company mergers and takeovers took place. These events received a great deal of publicity and they both annoyed and puzzled the general public in equal measure. What was particularly puzzling to the public was that at the beginning of the week one set of accountants could decide that a company had made a profit and then by the end of that week another set of accountants would decide that it had actually made a loss. ‘How was it possible,’ many people asked, ‘for different accountants to arrive at such conflicting results when they both used the same information?’ It then began to dawn on the public that there was much more to accounting than simply adding up a lot of figures. And when reality struck home there was outrage. The figures could be fiddled: accountants were not saints after all!

The Institute of Chartered Accountants in England and Wales (ICAEW) was the first professional body to act. In 1970 it founded what was initially called the Accounting Standards Steering Committee (ASSC). It was renamed as the Accounting Standards Committee (ASC) in 1976 but in 1990 it was replaced by the Accounting Standards Board (ASB). By 1996 all the other five major professional accountancy bodies had become ASB members. Throughout this entire period the basic role of the ASSC/ASC/ASB remained unchanged, i.e. to develop definitive standards for financial reporting.

The ASB’s main aim is to establish and to improve standards of financial accounting and reporting for the benefit of users, preparers and auditors of financial information. It aims to do so by achieving a number of objectives. In summary they are as follows:

- 1 To develop accounting principles.
- 2 To provide a framework to resolve accounting issues.
- 3 To issue accounting standards.
- 4 To amend existing accounting standards.
- 5 To address promptly any urgent accounting issues.
- 6 To work with other accounting standard setting bodies and institutions.

The ASB operates under the umbrella of the *Financial Reporting Council* (FRC). The FRC is a private limited company. Its main objectives are (i) to provide support for the ASB and the Financial Reporting Panel; and (ii) to encourage good financial reporting. Its funds come from a number of sources such as the accounting profession, the banking and insurance companies, the London Stock Exchange and the government.

Most of the ASB’s funds come from the FRC. This arrangement might suggest that the FRC has ultimate control over the formulation and issue of accounting standards. This is not the case. The ASB has complete autonomy over them.

ASB standards are called *Financial Reporting Standards* (FRSs). By the spring of 2010, 30 FRSs had been issued. In addition, 12 ASB standards, known as *Statements of Standard Accounting Practice* (or SSAPs) were still mandatory although they will eventually be phased out. The accounting problems covered in FRSs include acquisitions and mergers (FRS 6), goodwill and intangible assets (FRS 10), and life assurance (FRS 27).

SSAPs that have not yet been withdrawn cover topics such as stocks and long-term contracts (SSAP 9) and accounting for pension costs (SSAP 24). The SSAPs still in existence give you some indication that they deal with issues that are either less controversial or more difficult to deal with.

We now turn to have a look at the third main source of accounting regulation in the UK: International Accounting Standards.

### Activity 2.7

From what you know so far about the ASB what are your views?

- 1 Do you think that there is a need for such a body? [Yes] [No]
- 2 If yes, (a) it should be (i) state owned [ ] or (ii) privately owned [ ]? and (b) should it lay down (i) detailed rules [ ] or (ii) give just general guidance [ ]? (tick your responses).
- 3 If no, why not? Give your reasons.

## International Accounting Standards

### News clip

## ACCA backs International Accounting Standards

*Accountancy Age* has reported that the Association of Chartered Certified Accountants has called on world leaders at a forthcoming G20 summit to throw their weight behind international financial reporting standards. The Association regards it 'a major failing that IFRS are not already the global accounting language for all financial professionals'.

Source: Adapted from [www.accountancyage.com/articles](http://www.accountancyage.com/articles), 10 March 2009.

International Accounting Standards are issued by what is now called the International Accounting Standards Board (IASB). The IASB was originally created in 1973 as the International Accounting Standards Committee (IASC) but it changed its name in 2001. The main aim of the IASC was to make financial statements much more comparable on an international basis. It was hoped to achieve this aim by issuing International Accounting Standards (IASs).

The IASB's aim is similar. It is as follows:

*Our mission is to develop, in the public interest, a single set of high quality, understandable and international financial reporting standards (IFRSs) for general purpose financial statements.*

The IASB operates through a body called the International Accounting Standards Committee Foundation (IASCF). The IASCF is an independent, private, not-for-profit sector organization governed by 22 trustees from a number of different countries and professional backgrounds. It is funded by a voluntary system of donors from international

accounting firms, business associations and organizations and central banks. The IASC Foundation appoints the IASB's board of 14 members who are recruited from many wide-ranging backgrounds. It also finances, governs and oversees the IASB.

The IASB works closely with national standard setting bodies (such as the ASB in the UK) to ensure that accounting standards throughout the world are as comparable as possible. The number of countries either permitting or requiring the use of its standards continued to grow to 120 by the beginning of 2010. The big breakthrough came in 2002 when the EU decided that as from 2005 publicly traded companies should adopt its standards. The next big hurdle facing the IASB is to encourage the USA to adopt its standards. Discussions have been taking place for some years. The indications are that the USA is 'mindful' to do so (using diplomatic language) but up to date the discussions have not been successful. We return to this point later in the chapter.

The IASB's standards are called *International Financial Reporting Standards* (IFRSs). Between 2001 and the spring of 2010, eight IFRSs had been issued and were still effective. This may not seem very many but the work programme had been deliberately slowed down between 2005 and 2009 to allow more time for new IFRSs to be implemented. The topics that they deal with include such matters as insurance contracts (IFRS 4) and operating segments (IFRS 8). The slow-down meant that 29 of the original *International Accounting Standards* (IASs) were still in use in the spring of 2010. The problems that they deal with range from the presentation of financial statements (IAS 1) to one coping with agriculture activity (IAS 41). Many of these accounting standards are highly technical and are certainly way beyond what you need to know until you become a very senior manager.

Now that we have given you some idea of the importance and status of both the ASB and the IASB in accounting regulation we are in a position to examine what these two bodies have done to improve their performance. We do so in the next section.

### Activity 2.8

Log on to the IASB website.

Insert the current date:

Answer the following questions:

- 1 How many countries have now adopted IFRSs?
- 2 How many IFRSs have now been issued.
- 3 How many IASs are still in use?

## An accounting framework

### News clip

## A principled approach to standards

In a recently issued policy paper on the international accounting standard setting process, the International Federation of Accountants has argued that the key to successful standard setting is the identification of 'the underlying principles'.

Source: Adapted from *Financial Management*, February 2009, p. 7.

Until 2005 IASs and IFRSs were not a significant feature of UK financial reporting and SSAPs and FRSs took priority in the preparation of financial statements. The ASB certainly did not ignore the work of the IASB and the two bodies had a close working relationship but the ASB had a legal and professional status in the UK which the IASB did not have. That all changed in 2005 once the EU decided to adopt International Accounting Standards. As a member of the EU the UK was bound to accept the decision.

There were two basic differences between UK Accounting Standards and International Accounting Standards:

- 1 They did not always deal with the same accounting problems. This was perhaps because what was a contentious issue in the UK was not necessarily so in the rest of the world (and vice versa).
- 2 If the ASB and the IASB did issue an accounting standard dealing with the same problem, the IASB's solution tended to be more generalized (possibly because it had to be acceptable in so many different and disparate countries). This was an advantage for the UK because it meant that compliance with a UK standard almost automatically meant compliance with the equivalent IAS one.

The ASB and the IASB did have one thing in common when framing their respective accounting standards: they were largely fire-fighting exercises dealing with what happened to be a problem at that particular time. This meant that there was often little consistency in the way that the various issues were tackled. It eventually became apparent that accounting standards should be built on a basic framework or foundation. This would then enable solutions to different problems to be based on the same basic principles or rules. As a result, accounting standards would have a common theme running through them.

Academic accountants had argued for years that there was a need for such a framework. They referred to it as a *conceptual* framework which no doubt frightened the more practically trained accountants to death. Nevertheless, both the ASB and the IASB and similar standard setting bodies in many other countries were working on such a project. The IASB was the first to publish its ideas in a document called *Framework for the Preparation and Presentation of Financial Statements* (note that it did not include the word 'concept' in its title). The ideas in it relied very heavily on work done on the same subject in the USA as well as in Australia and Canada. We shall refer to it as the *Framework* from now on.

The ASB took a great deal longer to produce its own framework. It was not until 1999 that it published what it called *Statement of principles for financial reporting*. It is very similar to the Framework. As it is, in effect, a more up-to-date version of it, we will use the Statement to summarize what we need for this chapter. The relevant points are as follows.

- 1 The *objective* of financial statements is: to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions.
- 2 The *users* of financial statements are: (i) investors; (ii) lenders; (iii) suppliers and other trade creditors; (iv) employees; (v) customers; (vi) governments and their agencies; and (vii) the public. These users are depicted in Figure 2.6.
- 3 The *reporting entity* is a cohesive economic unit, its boundary being determined by what it can control both directly and indirectly.

- 4 The *qualitative characteristics* of financial information are summarized below. Note how they relate very closely to the four ethical accounting rules we discussed earlier in the chapter, i.e. prudence, consistency, objectivity and relevance.
- Relevance*. Financial statements should meet the needs of users and be *timely*, i.e. not to be so out of date that they have become irrelevant for decision making purposes. This characteristic, in effect, presupposes the incorporation of the *materiality* concept because information that is not helpful for decision making is irrelevant.
  - Reliability*. Users should be able to rely on the information contained within the financial statements. It should be free from material error, represent faithfully what it is supposed to represent, be free from bias (i.e. it should be **neutral**), and be compatible with the substance of transactions and not simply just because it is lawful. It should also be complete provided that it is material, and a *prudent* approach should be adopted when it is unclear how a particular transaction should be accounted for. So materiality, prudence and also objectivity are all inherent in this characteristic.
  - Comparability*. Financial statements containing the results for comparative periods should be prepared on a consistent basis. In other words, they should be prepared on the same basis each year. Comparability is almost the same concept as our consistency rule.
  - Understandability*. Financial statements should be capable of being understood by those users who have some knowledge of accounting, business activities and economic affairs and who are willing to study the financial statements diligently. The financial statements themselves should not, however, to be so simple that the information becomes meaningless.
- 5 The *elements* of financial information are the ‘building blocks’ used in the construction of the financial statements. They include what assets and liabilities the entity owns, what interest the owners have in the entity, what contributions and distributions the owners have made, and what has been paid out to them.
- 6 The Statement recognises that assets and liabilities need to be *measured* so that they can be included in the financial statements. They can be included at either their historical cost or at their current value. Historical cost is the more usual. Current cost is a method that relates to the loss an entity would suffer if the entity was deprived of an asset. So it is sometimes called ‘deprival value’ or ‘loss to the business’. We shall not be dealing with current value accounting in this book.



**Figure 2.6** The main users of financial statements

Source: *Statement of Principles for Financial Reporting*, ASB 1999.

- 7 Financial statements should be presented clearly, effectively, simply and straightforwardly. When you reach Chapters 8 and 9 of this book you may begin to question whether the authors of the Companies Act 2006 and the compilers of accounting standards were aware of this requirement.

You might also think that despite the fuss that we have made in this chapter about the need to develop a workable framework, the outcome so far has not been very impressive. Both the Framework and the Statement are quite vague in their requirements and perhaps they lack a more prescriptive approach.

You would be right but if the profession went down that road we would be moving to what is called a *rules-based* approach to accounting. The main problems with this approach are that (i) it is difficult to formulate rules that accommodate every eventuality and (ii) ways will always be found of getting round whatever rules are formulated. So a culture develops and creates a climate whereby the attitude becomes ‘*if it’s not in the rules you can do what you like*’. As we indicated earlier in the chapter, the USA has adopted a *rules-based* approach while EU countries all use a *principles-based* approach. This approach allows for individual circumstances to be taken into account but it can result in apparent inconsistencies in the accounts of different entities. This fundamental difference between the EU’s and the USA’s methods of accounting is the main reason why the USA has been reluctant to adopt IASs but political considerations have, no doubt, also played a part.

### Activity 2.9

UK Accounting Standards are based on generally accepted *principles*. Some other countries prefer a *rules-based system*. Which approach do you favour?

- 1 (a) principles [ ] (b) rules-based [ ] (tick which).  
2 Give three reasons for your choice.



### Questions you should ask

This is an important chapter. It not only prepares you for what follows in the rest of the book but it outlines a number of accounting issues that will face you when you become a manager in the real world. We suggest that among the long list of questions that you might well ask are the following.

- Are we subject to the Companies Act 2006?
- Do we adopt International Accounting Standards or UK (or own country’s) standards?
- What accounting rules do we follow in the preparation of our financial statements?
- Are we without doubt a going concern?
- How do we determine what is an immaterial item?
- To what extent does neutrality override the need to be prudent?

## Conclusion

In this chapter we have identified 14 conventional accounting rules and introduced you to the accounting provisions of Companies Act 2006 along with the additional semi-statutory requirements specified by the Accounting Standards Board and the International Accounting Standards Board.

The chapter enables you to grasp the fundamentals of what accountants do, why they do it and what the law requires them to do. In subsequent chapters we will show you how to prepare financial statements based on what is required. By knowing why and how they are prepared you will find that they will be of much greater benefit to you in making and taking the types of decision that your job requires.

### Key points

- 1 In preparing financial statements, accountants use a number of conventional accounting rules (sometimes called principles); these rules have evolved over many centuries.
- 2 Such rules may be classified into boundary rules (entity, periodicity, going concern and quantitative); measurement rules (money measurement, historic cost, realization, matching, dual aspect and materiality); and ethical rules (prudence, consistency, objectivity and relevance).
- 3 The main source of legislation affecting accounting matters in the UK is the Companies Act 2006; the Act is primarily concerned with companies and limited liability partnerships.
- 4 The Act delegates much of the detail involving the preparation and reporting of financial statements to the International Accounting Standards Board (for publicly quoted group companies) and the UK Accounting Standards Board (for other companies).
- 5 The IASB issues International Financial Reporting Standards (IFRSs) and the ASB Financial Reporting Standards (FRSs) to help companies deal with contentious and difficult accounting matters. Other countries have their own accounting standards boards but many of them also use IASs.
- 6 Financial statements in the UK have always been prepared on a custom and practice basis but both the IASB and the ASB have issued a framework outlining the principles that entities are expected to follow in preparing such statements. Both frameworks are similar and they incorporate in one form or another all the 14 rules detailed in the first part of this chapter.

## Check your learning

- 1 In an accounting context name three other terms that are similar in meaning to 'rules'.
- 2 Identify three categories of accounting rules.
- 3 What accounting rule is used to describe a defined period of time?
- 4 What is a going concern?
- 5 What is matching?
- 6 What does dual aspect mean?
- 7 When is a transaction not material?
- 8 What criteria are used to determine whether items are relevant?
- 9 Name three important sources of authority governing accounting matters affecting UK companies?
- 10 What do the following initials stand for: (a) CA; (b) SI; (c) ASB; (d) IASB; (e) SSAP; (f) IAS; (g) FRS; (h) IFRS?
- 11 What is an accounting standard?
- 12 What is a conceptual framework?
- 13 What is the objective of financial statements?
- 14 List seven user groups of accounting information.
- 15 What is a reporting entity?
- 16 List the qualitative characteristics of financial information.

## News story quiz

*Remember the news story at the beginning of the chapter? Go back to that story and reread it before answering the following questions.*

This article relates back to the financial crisis that in 2007 struck the banking system in Britain and in many other countries. However, the points raised in the article are also relevant today as well as for other economic sectors.

### Questions

- 1 What is the difference between a rule book and a principles approach to accounting matters?
- 2 Why does a principles approach necessarily deal better with changing financial markets and by implication with financial statements?
- 3 Closer dialogue is seen to be partly the answer for dealing with problems of systematic risk in auditing, but what else might be needed?

## Tutorial questions

*The answers to questions marked with an asterisk can be found in Appendix 4.*

- 2.1** Do you think that when a set of financial accounts is being prepared, neutrality should override prudence?
- 2.2** ‘The law should lay down precise formats, contents and methods for the preparation of limited liability company accounts.’ Discuss.
- 2.3** The Accounting Standards Board bases its Financial Reporting Standards on what is sometimes called a ‘conceptual framework’. How far do you think that this approach is likely to be successful?

In questions 2.4, 2.5 and 2.6 you are required to state which accounting rule the accountant would most probably adopt in dealing with the various problems.

- 2.4\*** (a) Electricity consumed in Period 1 and paid for in Period 2.  
 (b) Equipment originally purchased for £20,000 which would now cost £30,000.  
 (c) The company’s good industrial relations record.  
 (d) A five-year construction contract.  
 (e) A customer with a poor credit record might go bankrupt owing the company £5000.  
 (f) The company’s vehicles, which would only have a small scrap value if the company goes into liquidation.
- 2.5\*** (a) A demand by the company’s chairman to include every detailed transaction in the presentation of the annual accounts.  
 (b) A sole-trader business which has paid the proprietor’s income tax based on the business profits for the year.  
 (c) A proposed change in the methods of valuing stock.  
 (d) The valuation of a litre of petrol in one vehicle at the end of accounting Period 1.  
 (e) A vehicle which could be sold for more than its purchase price.  
 (f) Goods which were sold to a customer in Period 1 but for which the cash was only received in Period 2.
- 2.6\*** (a) The proprietor who has supplied the business capital out of his own private bank account.  
 (b) The sales manager who is always very optimistic about the creditworthiness of prospective customers.  
 (c) The managing director who does not want annual accounts prepared as the company operates a continuous 24-hour-a-day, 365-days-a-year process.  
 (d) At the end of Period 1, it is difficult to be certain whether the company will have to pay legal fees of £1000 or £3000.  
 (e) The proprietor who argues that the accountant has got a motor vehicle entered twice in the books of account.  
 (f) Some goods were purchased and entered into stock at the end of Period 1, but they were not paid for until Period 2.

**2.7** The following is a list of problems which an accountant may well meet in practice.

- (a) The transfer fee of a footballer.
- (b) Goods are sold in one period but the cash for them is received in a later period.
- (c) The proprietor's personal dwelling house has been used as security for a loan which the bank has granted to the company.
- (d) What profit to take in the third year of a five-year construction contract.
- (e) Small stocks of stationery held at the accounting year end.
- (f) Expenditure incurred in working on the improvement of a new drug.

*Required:*

- (1) Which accounting rule would the accountant most probably adopt in dealing with each of the above problems?
- (2) State the reasons for your choice.

**2.8** *FRS 18* (accounting policies) states that profits shall be treated as realized and included in the profit and loss account only when the cash due 'can be assessed with reasonable certainty' (para. 28).

How far do you think that this requirement removes any difficulty in determining in which accounting period a sale has taken place?

**2.9** The adoption of the realization and matching rules in preparing financial accounts requires a great deal of subjective judgement.

*Required:*

Write an essay examining whether it would be fairer, easier and more meaningful to prepare financial accounts on a cash received/cash paid basis.

Further practice questions, study material and links to relevant sites on the World Wide Web can be found on the website that accompanies this book. The site can be found at [www.pearsoned.co.uk/dyson](http://www.pearsoned.co.uk/dyson)