Zdroj: autor

University of Economics, Prague

Faculty of Finance and Accounting

Department of Financial Accounting and Auditing

FAKULTA FINANCÍ A ÚČETNICTVÍ

VŠE

EVROPSKÁ UNIE
Evropské strukturální a investiční fondy
Operační program Výzkum, vývoj a vzdělávání

MŠMT
MINISTERSTVO ŠKOLSTVÍ, MLÁDEŽE A TĚLOVÝCHOVY

The economic consequences of harmonised financial reporting

1 What is accounting harmonisation and why did it arise?

- Traditionally, accounting standards are developed by each country
- Standard-setting is influenced by:
  - economic, social, political goals of governments
  - lobbying by affected parties (companies, auditors, users)
- The existence of country-specific factors leads to incomparability of financial statements around the world
- Globalisation of capital markets pushes for harmonised accounting to increase the

Economic consequences of accounting

FFÚ

comparability of financial statements and to reduce, thus, the information risk of foreign investors (optimising returns vs risks)

- International accounting harmonisation is running through worldwide adoption of IFRS
- Despite common set of standards, the economic effects of harmonised accounting are not spread evenly → national differences in environment surrounding financial reporting, legal regime, and quality of enforcement of accounting standards are surviving

Economic consequences of accounting

FFÚ

Competition of national accounting standards

- Local orientation better addresses the specifics
- Bigger choice (high quality for high price, low quality for low price)
- Higher signalling opportunities
- Moderate lobbying, but with strong incentives and power to influence
- Quicker reaction to the changing environment

Monopoly of harmonised standards

- Global orientation provides with one standard (comparable) solution
- Quality vs price not too important, lower risk of decrease in quality
- Lower information risks
- Intensive lobbying, but many parties with divergent goals
- Positive externality from unified network

Economic consequences of accounting

FFÚ

- Competition vs monopoly in accounting has common features with trip accommodation:
  - a global chain, with standardised services regardless of location, but overpriced;
  - a family hotel, with unknown quality of services for required price
- The selection of the chain:
  - provides an agreed standard and reduces, thus, the risk of dissatisfaction
  - to remove the risk, you usually pay a higher price, and get service with less passion and with less indeed customer-oriented services
- The selection of the family-run hotel may result in:
  - unrepeatable services provided by friendly and customer-oriented staff at a lower price

Economic consequences of accounting

FFÚ

- unrepeatable services provided by friendly and customer-oriented staff at a higher price
- lower quality of services, but for reasonable price
- terrible disappointment at a high price

- Which one is better for financial reporting?

2 Regulatory framework vs conceptual framework for financial reporting

2.1 Regulatory framework

- Necessary to ensure that users of financial statements receive a minimum amount of information that will enable them to make economic decisions regarding their interest in a reporting entity
- Lowers contracting costs
- Usually establishes the goal of (reasons for) mandatory financial reporting by companies and general requirements on their financial statements as well as punishments for the non-compliance with the regulation
- A well-working regulatory framework restricts opportunities, when one group of stakeholders of financial reporting benefit at expense of other stakeholders → regulator

Economic consequences of accounting

FFÚ

needs to estimate various motivations and their strength by each group of stakeholders

2.2 Regulatory framework example: the case of EU

- Regulatory framework is driven by:
  - EU directives and regulations
  - national company and/or accounting law or generally accepted principles
  - security exchange rules
- Milestones in IFRS adoption by EU:
  - 2000: “EU Financial Reporting Strategy: the way forward”
  - 2002: “Regulation (EC) 1606/2002 on International Accounting Standards”
  - 2005: The first period of mandatory IFRS adoption by EU listed companies

Economic consequences of accounting

FFÚ

Regulation (EC) 1606/2002:

- Mandates listed companies to prepare IFRS consolidated financial statements
- Allows countries to broaden the scope to other companies/financial statements
- **Compulsory application (Article 4)** => Consolidated accounts of publicly traded companies:
  - *For each financial year starting on or after 1 January 2005, companies governed by the law of a Member State shall prepare their consolidated accounts in conformity with the international accounting standards if, at their balance sheet date, their securities are admitted to trading on a regulated market of any Member State*
- **Voluntary application (Article 5)** => Member States may permit or require:

Economic consequences of accounting

FFÚ

- *the companies referred to in Article 4 to prepare their annual accounts*
- *companies other than those referred to in Article 4 to prepare their consolidated accounts and/or their annual accounts*

- The approaches to Article 5 differ significantly across EU countries

2.3 Conceptual framework (CF)

- CF is a coherent system of interrelated objectives and fundamental principles
- CF defines the nature, function and limits of financial accounting and financial statements
- CF outlines the main ideas, on which the process of preparation of financial statements is based in order to provide users with information useful for their decision making
- Does a conceptual framework prescribe particular accounting treatments (such as depreciation methods, etc.)?
- Why CF is so important:
  - it enables accounting standards to be developed in accordance with generally agreed principles

Economic consequences of accounting

FFÚ

- it avoids accounting standards to be developed in a piecemeal way in response to specific problems or abuses, which may lead to inconsistencies between different accounting standards, and between accounting standards and legislation
- lack of CF may cause that certain critical issues are not addressed (e.g. Czech accounting does not contain definitions of accounting elements, such as assets and liabilities, which results in inappropriate treatment of finance leases)
- it helps preparers and auditors of accounts to deal with transactions which are not the subject of a specific accounting standard
- accounting standards based on general principles can be breached harder
- CF strengthens the credibility of financial reporting and the accounting profession

Economic consequences of accounting

- Existent CF mitigates the possibility to influence the standard-setting process by lobbying parties

- Reality:
  - CF sets up principles, which are generally accepted and believed to last "for ages"
  - however, as transactions become more complex and businesses become more sophisticated, some of principles (definitions, etc.) become old-fashioned
  - accounting treatments in new standards start to contradict CF
  - if a number of inconsistencies between standards and CF is high, the need for revision of CF is more striking
  - standard setters face to an issue, whether to stop their work on standards and to update

Economic consequences of accounting

FFÚ

CF, or whether to do both things simultaneously

- it sometimes ends up with half-solutions (e.g. current IASB's framework), which creates severe problems (e.g. during the projects on revenue recognition and leases)

Economic consequences of accounting

FFÚ

Zdroj: autor

- **Regularory framework**
  - **Regulatory system**
    - **Regulatory bodies**
      - **Standard setting**
- **Conceptual framework**
  - ***Users and objectives***
  - ***Qualitative characteristics***
    - **Fundamental:**
      relevance
      faithfull represantation
      - **Enhancing:**
        comparability, verifiability
        timeliness, understandability
  - ***Elements and recognition***
    - **Elements:**
      asset, liability, equity
      income, expense
      - **Recognition:**
        definition
        probability/measurement
  - ***Measurement and capital maintenance***
    - Historical costs
      Current costs
      Settlement value
      Present value
      - Financial capital
        Real capital
        Physical capital

3 The IASB's Conceptual Framework for Financial Reporting

3.1 The objective of general purpose financial reporting

- 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 users' decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit
- General purpose financial reports are directed to the "primary users", who cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need
- General purpose financial reports do not and cannot provide all of the information that

Economic consequences of accounting

FFÚ

users need

- General purpose financial reports are not designed to show the value of a reporting entity

3.2 Underlying assumptions

- Going concern:
  - the financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future
  - it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations
  - if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed
- Accrual basis:
  - the effects of transactions and other events are recognised when they occur (and not as

cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate

- informs not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash and of resources representing cash to be received in future

3.3 Qualitative characteristic of accounting information

- Fundamental qualitative characteristics
  - relevance
  - faithful representation
- Enhancing qualitative characteristics
  - comparability

Economic consequences of accounting

FFÚ

- verifiability
- timeliness
- understandability

Relevance:

- Relevant information:
  - has the ability to influence the economic decisions of users, and
  - is provided in time to influence those decisions
- Relevant information has predictive and/or confirmatory value
  - predictive value enables users to evaluate or assess past, present or future events

FFÚ

Economic consequences of accounting

FFÚ

- confirmatory value helps users to confirm or correct past evaluations and assessments

- Materiality is an entity specific aspect of relevance:
  - information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements
  - depends on the size of the item or error judged in the particular circumstances of its omission or misstatement
  - is a threshold that needs to be studied before considering the other qualities of that information
  - if any information does not pass the test of the threshold quality, it is not material and does not need to be considered further

KFŪA

KATEDRA FINANČNÍHO ÚČETNICTVÍ
A AUDITINGU

Economic consequences of accounting

FFÚ

Faithful representation:

- To represent faithfully the transactions and other events that it purports to represent in financial statements, transaction must be accounted for and presented in accordance with their substance and economic reality and not merely their legal form
- To be a perfectly faithful representation, financial information has to be:
  - complete (must contain all the necessary descriptions and explanations)
  - neutral/free from bias (financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome)
  - free from error (within the bounds of materiality; not perfectly accurate in all respects)

3.4 Elements of financial statements

- Elements of financial statements are basic “items”, which are presented to users on the face of financial statements
- Elements should inform on an entity’s economic resources and claims (financial position) and changes in them (financial performance measured both on accrual and cash basis)
- Assets are:
  - resources controlled by the entity
  - as a result of past events
  - from which future economic benefits are expected to flow to the entity
- Liabilities are:

Economic consequences of accounting

FFÚ

- an entity's present obligations
- to transfer economic benefits
- as a result of past transactions or events

- Equity is:
  - the residual interest in the assets of the entity after deducting all its liabilities
- Income is:
  - an increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases in liabilities
  - transactions that result in increases in equity, other than those relating to contributions from equity participants

Economic consequences of accounting

FFÚ

- Expense is:
  - an decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities
  - transactions that result in decreases in equity, other than those relating to distributions to equity participants

3.5 Recognition of the elements of financial statements

- Recognition is the process of incorporating in financial statements an item that meets the definition of an element and satisfies the criteria for recognition
- It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the financial statements totals
- The failure to recognise such items cannot be compensated by disclosure of the accounting policies used nor by notes or explanatory material
- Recognition criteria:
  - it is probable that any future economic benefit associated with the item will flow to or from the entity; and

Economic consequences of accounting

FFÚ

- the item has a cost or value that can be measured with reliability

- The recognition of assets and liabilities falls into three stages:
  - initial recognition (e.g. the purchase of a noncurrent asset)
  - subsequent remeasurement (e.g. revaluation of the above asset)
  - derecognition (e.g. sale of the asset)
- Derecognition occurs if:
  - an event occurs that eliminates a previously recognised asset or liability
  - there is no longer sufficient evidence to support continued recognition

3.6 Measurement of the elements of financial statements

3.6.1 Framework guidance

- Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in financial statements
- It requires selection of particular basis of measurement
- The Framework identifies four possible measurement bases
- Historical cost:
  - assets are recorded at the amount of cash or cash equivalents paid to acquire them
  - liabilities are recorded at the proceeds received in exchange for the obligation, or at the amounts expected to be paid to satisfy the liability

FFÚ

FFÚ

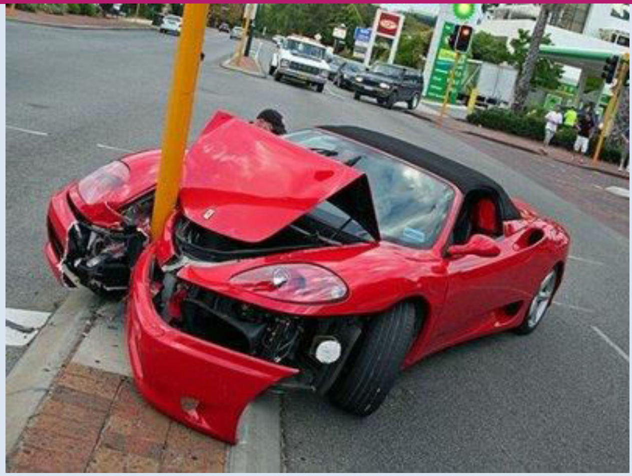
Economic consequences of accounting

- Current cost:
  - assets are carried at their current purchase price
  - liabilities are carried at the undiscounted amount currently required to settle them

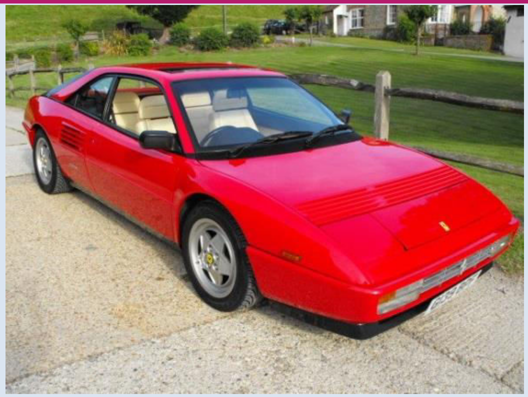
Economic consequences of accounting

FFÚ

However, the Framework does not solve what kind of current cost to use

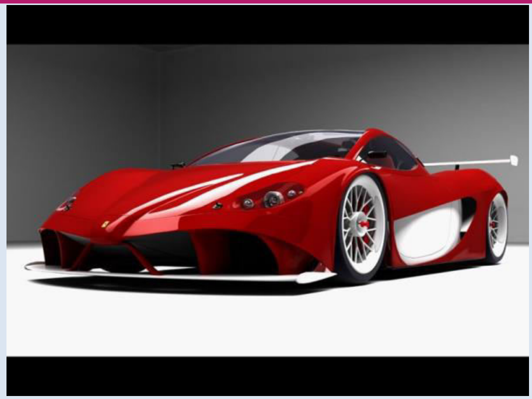


Replacement cost-used



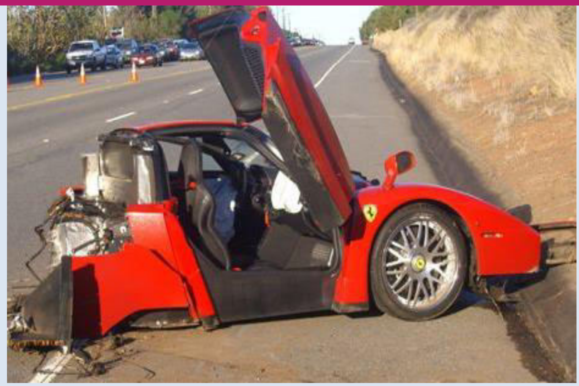
Zdroj: buyyourcar.co.uk

Replacement cost-new



Zdroj: lotustalk.com

Reproduction cost



Zdroj: wreckedexotics.com

KFŪA

KATEDRA FINANČNÍHO ÚČETNICTVÍ A AUDITINGU

Economic consequences of accounting

FFÚ

- Realisable (settlement) value:
  - assets are carried at the amount that could currently be obtained by an orderly disposal
  - liabilities are carried at their settlement values – the amount to be paid to satisfy them in the normal course of business
- Present value:
  - assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business
  - liabilities are carried at the present discounted value of the expected cash outflows necessary to settle them