CHAPTER 2: REGULATORY FRAMEWORK

LEARNING OUTCOME

At the end of the chapter, you should be able to:

TLO A3a	**:**	**Explain** why a regulatory framework is needed including the advantages and disadvantages of IFRS over a national regulatory framework
TLO A3b	**:**	**Explain** why accounting standards on their own are not a complete regulatory framework
TLO A3c	**:**	**Distinguish** between a principles based and a rules based framework and discuss whether they can be complementary
TLO A3d	**:**	**Describe** the IASB's Standard setting process including revisions to and interpretations of Standards
TLO A3e	**:**	**Explain** the relationship of national standard setters to the IASB in respect of the standard setting process

2.1 The Needs for Regulatory Framework

Learning Outcome (ACCA Study Guide Area A)

A3a: **Explain** why a regulatory framework is needed including the advantages and disadvantages of IFRS over a national regulatory framework

A3b: **Explain** why accounting standards on their own are not a complete regulatory framework

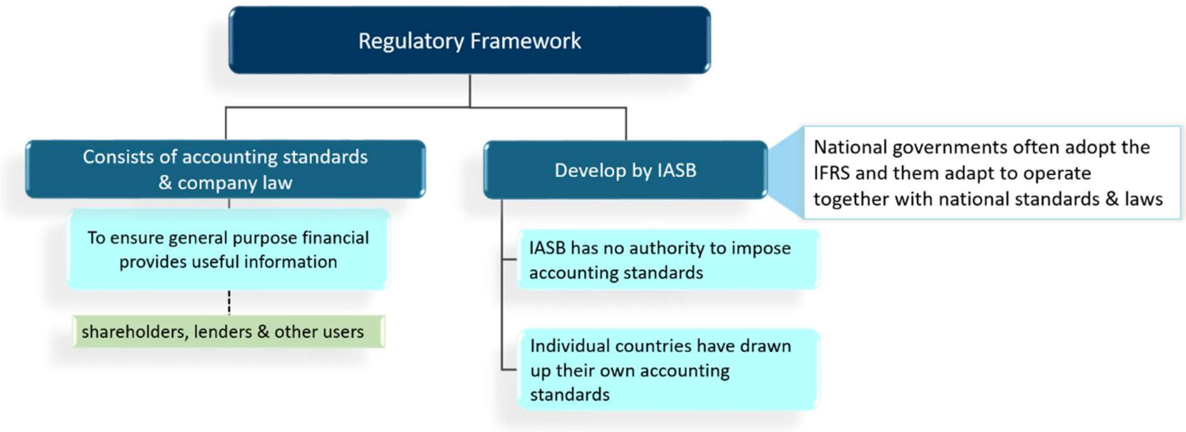
A3c: **Distinguish** between a principles based and a rules based framework and **discuss** whether they can be complementary

Regulation in financial reporting practice is important to ensure an entity adopts accounting treatment that is consistent in preparing and presenting financial statements that provide information that is useful to a wide range of users, to assists their decisions making.

Regulatory bodies set accounting standards to ensure that entities adopt similar accounting treatments for similar items and account for similar transactions in the same way over time. This makes it possible to compare the financial statements of different entities and to compare an entity's performance for the current year with its performance in previous years.

2.1.1 Purpose of a Regulatory Framework

Diagram 2.1.1: Regulatory Framework Overview



A regulatory framework is required **to ensure that relevant and reliable financial reporting** is achieved to meet the needs of shareholders and other users.

Accounting standards alone would not be a complete regulatory framework. In order to **fully regulate the preparation of financial statements** and the obligations of companies and directors, legal and market regulations are also required.

Without regulation, management would adopt whichever accounting treatment presented its results and position in the best possible light. Sometimes management might deliberately mislead users of the financial statements.

2.1.2 Advantages and disadvantages of IFRS

Diagram 2.1.2: Advantages and disadvantages of IFRS

Advantages	Disadvantages
Comparability, transparency and consistency of financial statement and information disclosed	Lack of knowledge and experience of preparers and users of financial statements
Entities applying IFRS are better prepared to access the capital markets because IFRS based financial statements are an essential expectation of foreign investors	Cost of IFRS implementation is relatively high
Reduce administrative burdens for entities that form part of an international group because often these entities can avoid preparing different sets of financial statements.	For small size companies the benefits of implementation do not offset the costs of implementing and maintaining IFRS
IFRS is principle based, and not a rule based set of accounting standards, better reflects complex transactions and is updated regularly in response to market changes.	

2.1.3 Sources of Regulation

The main sources of regulation are:

- Accounting standards
- Company law
- For listed companies, the listing rules of the relevant Stock Exchange

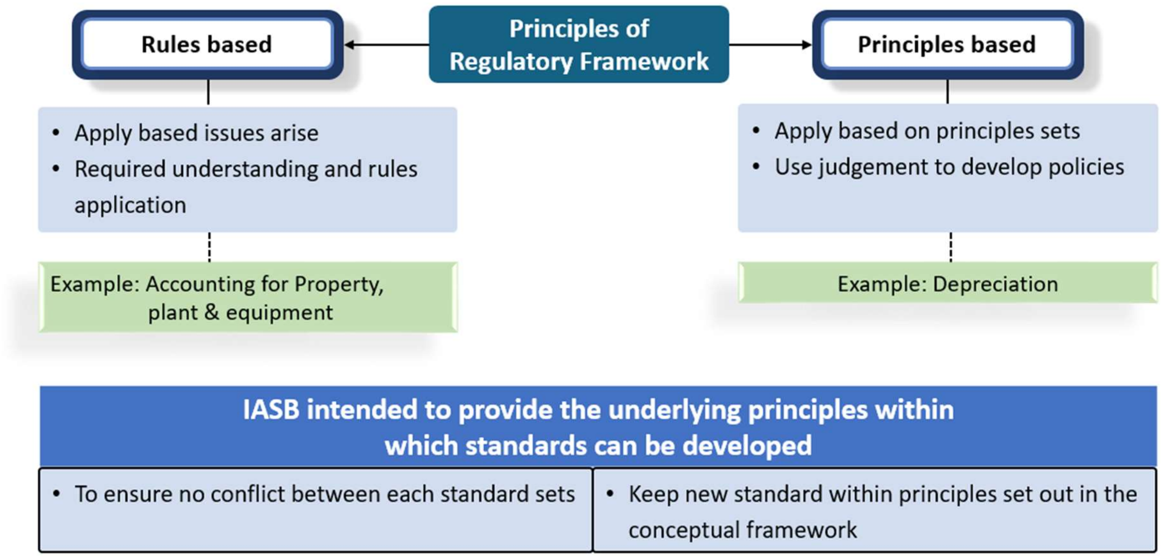
Accounting standard are authoritative statements of how particular types of transactions and events are reflected in the financial statements. In some countries they have legal authority, but in most countries they do not have the force of law.

Company law varies from country to country, but typically it sets out rules for determining profits available for distribution, issuing and redeeming share capital, the reserves that a company must have and the uses to which they can be put. In some countries example, in the European Union, company law prescribes the format of the main financial statement. These matters are not covered in accounting standards.

Listing rules set out the information which entities must supply when they apply for a listing. They also set out the information, including financial reports, which entities must prepare and provide to the market while they are listed.

2.1.4 Principles-based and rules-based framework

Diagram 2.1.4: Principles-based and rules-based framework



Conceptual Framework lies under principle-based system. It provides basic principles within the standards can developed. The main intention is to avoid any conflict in the standard set with each other. In general principles-based system works within a set of principles set.

However, for Rules-based it regulates for issues as they arise. In absence of reporting framework, more rules-based approach has to be adopted. This leads to a large mass of regulation designed to cover every eventuality, as in the US. As we have seen over the past few years, a large volume of regulatory measures does not always detect or prevent financial irregularity. One presumed advantage of rules-based systems is that the exercise of judgement is minimised. Auditors who fear litigation tend to prefer rules-based systems. It could be that a rules-based approach is appropriate for controversial areas in accounting.

2.2 Functions of Various Accounting Bodies

Learning Outcome (ACCA Study Guide Area A)

A3d: Describe the IASB's Standard setting process including revisions to and interpretations of Standards

2.2.1 International Financial Reporting Standard (IFRS)

The International Financial Reporting Standard (IFRS) Foundation formerly known as the International Accounting Standard Committee Foundation was formed in March 2001 as a not-for-profit corporation and was the parent entity of the IASB.

In 2010 it was renamed as The IFRS Foundation is an independent organization and its trustees exercise oversight and raise necessary funding for the IASB to carry out its role as standard-setter. It also oversees the work of the IFRS Interpretations Committee (formerly called the International Financial Reporting Interpretations Committee (IFRIC)) and the IFRS Advisory Council (formerly called the Standards Advisory Council (SAC)).

The IFRS Foundation and its independent standard-setting body, the IASB, provide public accountability through the transparency of their work, the consultation with the full range of interested parties in the standard setting process, and their formal accountability links to the public.

Main objectives of the IFRSF are:

- Develop, in the public interest, a single set of high quality global accounting standards
- Promote the use and rigorous application of those standards
- To take account of the special needs of small & medium sized entities and emerging economies
- To bring about the convergence of national accounting standards and the IASs

2.2.2 International Accounting Standard Board (IASB)

The IASB is responsible for developing international accounting standards. Members of IASB have a variety of backgrounds and include auditors, preparers of financial statements, users of financial statements and academics.

Main objectives of the IASB are:

- To develop, in the public interest, a single set of high-quality, understandable, enforceable and globally accepted financial reporting standards based on clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the various capital markets of the world and other users of the information to make economic decisions.
- To promote the use and rigorous application of those standards
- In fulfilling the above objectives to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings
- To promote and facilitate the adoption of IFRS through the convergence of national accounting standards and IFRSs.

2.2.3 IFRS Interpretation Committee (IFRSIC)

The role of IFRS Interpretations Committee is to issue rapid guidance where there are differing possible interpretations of an IAS. Its role is therefore to:

- Interpret IAS & IFRS
- Issue timely guidance on issues not covered by an IAS or IFRS, within the context of the IASB Framework
- Publish draft Interpretations for public comment. After studying responses to the draft Interpretation, it will obtain IASB approval for a final (published) Interpretation.

2.2.4 IFRS Advisory Council (IFRSAC)

The Advisory Council (AC) provides a forum through which the IASB is able to gather opinions and advice from different countries and industries. The AC consists of experts from different countries and different business sectors, who offer advice to the IASB.

2.2.5 International Organisation of Securities Commissions (IOSCO)

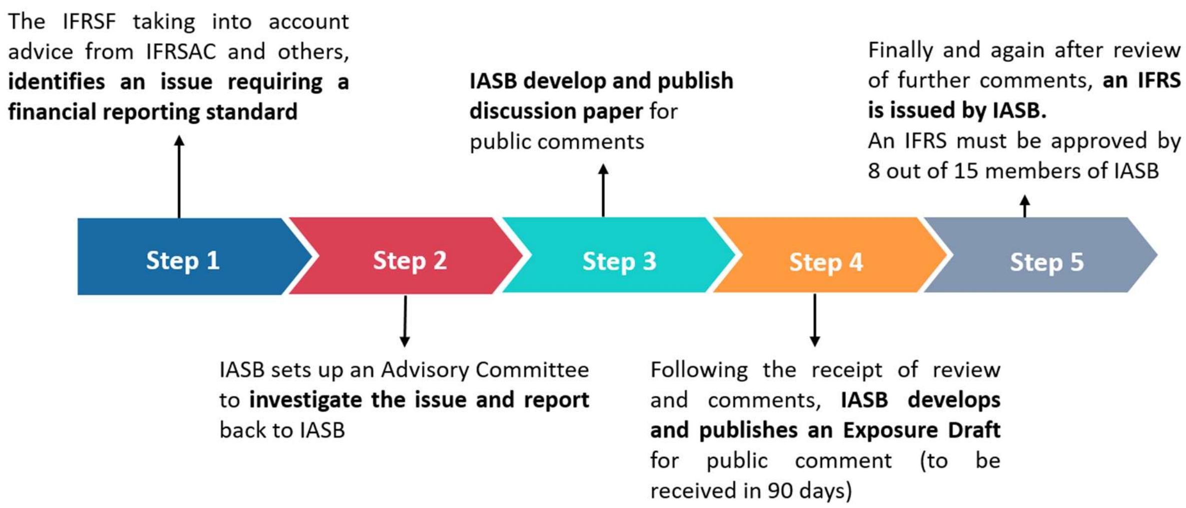
The prominence of the IASB has been enhanced by its relationship with the International Organization of Securities Commissions (IOSCO). IOSCO is an influential organization of the world's security commissions (stock exchanges). In 1995 the IFRSF agreed to develop a core set of standards which, when endorsed by IOSCO, would be used as an acceptable basis for cross-border listings. In May 2005, this was achieved. As part of its harmonization process, the European Union requires listed companies in all member states to prepare consolidated FS using IFRS from 2005.

Main objectives of the IOSCO are:

The main objective of IOSCO is to develop international investment. IOSCO views that international investment will be encouraged if all major companies use the same accounting standards for reporting their financial position and performance.

2.2.6 International Accounting Standards Setting Process

Diagram 2.2.6: International Accounting Standards Setting Process



The enforcement of IAS is in the hands of the regulatory systems of the individual adopting countries as IASB has no power to enforce international accounting standards within those countries/ companies that choose to adopt them.

2.3 Understanding of National Standard Setting

Learning Outcome (ACCA Study Guide Area A)

A2d: Explain the relationship of national standard setters to the IASB in respect of the standard setting process

When the new Constitution of the IASC Foundation was set up in 2001, the IASB became the body responsible for:

- Developing and publishing accounting standards as IFRS and
- Approving and publishing Interpretations of IFRS.

Before the new Constitution was established, standards have been published as IAS and Interpretations were published as Standard Interpretative Committee (SIC) Interpretations.

The IASB decided that all IAS and SIC that had been issued previously would continue to be applicable, unless they are subsequently amended or withdrawn. This means that IAS still in issue have the same status as IFRS.

2.3.1 National Standard Setters and IASB

The IASB has no power to enforce its standards. Without the support of the **major national standard setters**, IFRS are unlikely to be adopted.

There are increasing calls for **international convergence**. International convergence means that the accounting standards of different countries are increasingly similar. As most major national standard setting bodies are represented on the IASB, they can contribute significantly in influencing the development of new standards in their own countries. **Most national standard setters are committed to the principle of international convergence**.

In addition, the IASB has been working with national standard setters on specific projects. For example:

- The IASB and the UK ASB worked together to develop IAS 36 Impairment of Assets and IAS 37 Provision, contingent liabilities and contingent assets
- Some other recent standards have been developed by a group of national standard setters and the IASB working together.
- The IASB Framework was originally based on work carried out by the US FASB; the Framework has in turn influenced the UK ASB in developing its own conceptual framework
- National standard setters sometimes carry out the research for IASB projects. For eg, the Canadian ASB has carried out work on measurement objectives and have issued a discussion paper on this topic.

2.3.2 US Financial Accounting Standard Board

The US Financial Accounting Standard Boards (FASB has a special role in developing new international standards. The IASB and the US FASB are currently working together in the following ways:

- A short term convergence project aims to reduce differences between certain IAS & IFRS and certain US standards. The IASB has issued IFRS 5 Non-Current Assets held for sale & Discontinued Operations as a result of this project.
- Several joint projects are in progress to develop new standards on business combinations, revenue recognition and performance reporting.
- The 2 standard setters are jointly developing a new conceptual framework. This will eventually replace the current IASB Framework.

2.4 Check Understanding

Learning Outcome (ACCA Study Guide Area A):

TLO A3a. **Explain** why a regulatory framework is needed including the advantages and disadvantages of IFRS over a national regulatory framework

TLO A3b. **Explain** why accounting standards on their own are not a complete regulatory framework

TLO A3c. **Distinguish** between a principles based and a rules based framework and **discuss** whether they can be complementary

TLO A3d. **Describe** the IASB's Standard setting process including revisions to and interpretations of Standards

TLO A3e. **Explain** the relationship of national standard setters to the IASB in respect of the standard setting process

Question 1 (LO A3a)

Identify three (3) advantages of IFRS implementation

Question 2 (LO A3c)

Principles-based framework is set based on ____________________ while rules-based framework is based on __________________.

Question 3 (LO A3d)

The process for developing an International Financial Reporting Standard involves a number of stages.

Following receipt and review of comments on a Discussion Paper, what will be the next step undertaken by the IASB?

A. Publication of an Exposure Draft
B. Establishment of an Advisory Committee
C. Consultation with the Advisory Committee
D. Issue of a final IFRS

Question 4 (LO A3b)

"Accounting standards alone would not be a complete regulatory framework. In order to fully regulate the preparation of financial statements and the obligations of companies and directors, legal and market regulations are also required."

Identify statement above whether it is true or false.

☐ True
☐ False

Question 5 (LO A3e)

The _____________ of accounting standards refers to the goal of establishing a single set of accounting standards that will be used internationally.

A. Divergence
B. Merging
C. Convergence
D. Coherence

2.5 Check Understanding (Answer)

Answer: Question 1 (LO A3a)

1. Entities applying IFRS are better prepared to access the capital markets
2. Reduce administrative burdens for entities that form part of an international group
3. Increase transparency

Answer: Question 2 (LO A3b)

Principles-based framework is set based on ***principles*** guideline while rules-based framework is based on ***issues arise***.

Answer: Question 3 (LO A3d)

A

Answer: Question 4 (LO A3b)

True

Answer: Question 5 (LO A3e)

C

2.6 Chapter 2 Summary

Diagram 2.6: Summary of Regulatory Framework