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Financial Accounting- The regulatory framework

Let us first understand, why a regulatory framework necessary?

A regulatory framework for the preparation of financial statements is necessary for a number of reasons:

- To ensure that the needs of the users of financial statements are met with at least a basic minimum of information.
- To ensure that all the information provided in the relevant economic arena is both comparable and consistent. Given the growth in multinational companies and global investment this arena is an increasing international one.
- To increase users' confidence in the financial reporting process.
- To regulate the behaviour of companies and directors towards their investors.

Accounting standards on their own would not be sufficient to achieve these aims. In addition there must be some legal and market-based regulation.

Source: Kaplan Publishing

National regulatory frameworks for financial reporting

There are many elements to the regulatory environment of accounting. A typical regulatory structure includes:

- National financial reporting standards
- National law
- Market regulations
- Security exchange rules

For example: The UK has the Financial Reporting Council that issues financial reporting standards in the UK. The main item of legislation affecting businesses in the UK is the Companies Act 2006. However, there are also many other pieces of UK, EU and even US legislation (the Sarbanes Oxley Act) that affect accountability in the UK. There are also numerous industry specific regulatory systems that affect accounting in the UK. For example, the Financial Services Authority, whose aim is to achieve public accountability of the financial services industry. Finally, there are regulations provided by the London Stock Exchange for companies who shares are quoted on the market.

Source: Kaplan Publishing

IFRS Standards

Due to the increasingly global nature of investment and business operation there has been a move towards the 'internationalisation' of financial reporting. This 'harmonisation' was considered necessary to provide consistent and comparable information to an increasingly global audience.

If companies use different methods of accounting then before any decisions can be made about different entities the accounts would have to be rewritten so that the accounting concepts and principles applied are the same; only then relevant comparisons be made.

Harmonisation illustration: To try and illustrate the importance of harmonisation do some research on the internet about words that have
totally different meanings in different countries. Once you have done this you will undoubtedly have a much better appreciation of the benefits of a harmonised approach to information that will be available in an International arena.

IFRS Standards are not enforceable in any country. As we will see shortly, they are developed by an international organisation that has no international authority. To become enforceable they must be adopted by a country's national financial reporting standard setter.

Source: Kaplan Publishing

The current financial reporting environment

Recent history has been dogged with examples of unreliable, and often fraudulent, financial reporting, where directors have put their own personal interests above those of the shareholders. Enron and WorldCom are just a couple of examples, albeit very high profile ones, where directors have been convicted of manipulating published results and therefore misleading shareholders, often at very significant personal gain.

These cases only serve to exacerbate the problem of shareholder confidence, creating a culture of mistrust of directors (and auditors) of large companies. This has sadly led to a loss of credibility in published financial reports. Whilst the various regulators around the world have responded, not least with the move to harmonise both financial reporting and auditing, there is still a long way to go in the fight to restore credibility to financial statements.

Source: Kaplan Publishing

What is ‘Corporate Governance’?

The Cadbury Report 1992 provides a useful definition:

• 'the system by which companies are directed and controlled’.

An appropriate expansion to this definition might include:

• 'in the interests of shareholders and in relation to those stakeholders beyond the company boundaries’.

The use of the term stakeholders suggests that companies (and therefore their management team) have a much broader responsibility to the economy and society at large. This includes concepts such as public duty and corporate social responsibility.

If directors of a company have a responsibility to these groups then they must also be held accountable to them.

Source: Kaplan Publishing

Purpose and objectives of corporate governance

The basic purpose of corporate governance is to monitor those parties within a company who control the resources and assets of the owners.

The primary objective of sound corporate governance is to contribute to improved corporate performance and accountability in creating long-term shareholder value.

The need for corporate governance

Simply put, if the stock market mechanism is to succeed then there needs to be a system that ensures publically owned companies are run in the interests of the shareholders and that provides adequate accountability of the people managing those companies.

Source: Kaplan Publishing

The basic elements of sound corporate governance include:

- Effective management
- Effective systems of internal control
- Oversight of management by non-executive directors
- Fair appraisal of director performance
- Fair remuneration of directors
- Fair financial reporting, and
- Constructive relationships with shareholders.

Source: Kaplan Publishing

The need for corporate governance (Cont):

In order to be accountable to the stakeholders of the business the directors of a company have a range of duties such as:

- A general duty of care to act in good faith for the benefit of the company and its shareholders.

- A duty of care to avoid a conflict of interest between personal interests and those of the company and its stakeholders, and to make disclosure if such a conflict arises.

Source: Kaplan Publishing

The need for corporate governance (Cont):

Directors' responsibilities that are more specific are normally imposed by law or regulation in many countries and typically include the following:

• Responsibility for establishing and maintaining an adequate system of internal controls which prevents and detects fraud and error

• Responsibility to maintain adequate accounting records that provide a basis for the preparation of the annual financial statements

• Responsibility to prepare annual financial statements that show a 'true and fair' view of financial position and performance of the company, including compliance with relevant laws, regulations and IFRS Standards

• Responsibility to approve the annual financial statements prior to their publication, and to distribute or file the annual financial statements in accordance with local law and regulations.

Source: Kaplan Publishing

Examples of corporate governance

The UK Corporate Governance Code (2018)

The UK adopts what is commonly referred to as a 'comply or explain’ approach to corporate governance. All listed companies in the UK have to submit a report stating how they have complied with the provisions of the code and a statement of compliance with the code. If they have not been compliant they have to explain why they have not complied and what alternative action they have taken.

The code provides guidance on five areas of governance:

(i) board leadership and company purpose
(ii) division of responsibilities of the board of directors
(iii) composition, succession and evaluation of the board of directors
(iv) audit, risk and internal control
(v) remuneration of the board of directors.

Source: Kaplan Publishing

The US Sarbanes Oxley Act

In the US corporate governance is enshrined in law, meaning compliance is compulsory and failure to comply could lead to criminal conviction. The Act enforces:

- Sound systems of internal control

- Clear documentation of financial processes, risks and controls

- Evidence that management have evaluated the adequacy and design of systems and controls

- Evidence that the auditor has evaluated the adequacy and design of systems and controls.

The fundamental aim of the Act is 'to provide the company, its management, its board and audit committee, and its owners and other stakeholders with a reasonable basis to rely on the company's financial statements.’

Source: Kaplan Publishing

Corporate Governance (Cont):

Purposes:
Primary:

Monitor those parties within a company who control the resources owned by investors.

Supporting:

- Ensure there is a suitable balance of power on the board of directors.
- Ensure executive directors are remunerated fairly.
- Make the board of directors responsible for monitoring and managing risk.
- Ensure the external auditors remain independent and free from the influence of the company.
- Address other issues, e.g. business ethics, corporate social responsibility (CSR), and protection of 'whistle blowers'.

Objectives:
Primary:

Contribute to improved corporate performance and accountability in creating long-term shareholder value.

Supporting:

- Control the controllers by increasing the amount of reporting and disclosure to all stakeholders.
- Increase level of confidence and transparency in company activities for all investors (existing and potential) and thus promote growth.
- Ensure that the company is run in a legal and ethical manner.
- Build in control at the top that will 'cascade' down the organisation.

Source: Kaplan Publishing

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Thank You!

For queries, write to us at: care@edupristine.com