Factors affecting financial reporting quality

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Financial Reporting Standards

Financial Reporting Standards (FRSs) and Accounting concepts influence the production and presentation of financial statements. The FRSs that influence the production of financial statements are:

- FRS 3 Reporting Financial Performance

The FRS sets out the basis for presentation of general purpose financial statements in a manner that ensures comparability. As the FRS requires reporting entities to highlight financial performance to aid the users in understanding the performance achieved, it sets out the overall framework for the presentation of financial statements. It also lays down the guidelines for the structure of financial statements and defines the overall considerations for financial statements, such as fair presentation, accrual basis of accounting, consistency of presentation, materiality and aggregation, and comparative information.

This impacts the way profit and financial performance is reported and also the valuation of the assets and liabilities. It helps the users of accounts compare financial statements both with the entity's financial statements of previous periods and with the financial statements of other entities.

- FRS 15 Tangible Fixed Assets

FRS 15 sets out the principles of accounting for initial measurement valuation and depreciation. It ensures that tangible fixed assets are accounted for on a consistent basis. It requires residual values to be reviewed at each balance sheet date.

This impacts the valuation of tangible fixed assets.

- IAS 2 Valuation of Inventories

This accounting standard sets out the accounting treatment for inventories. It provides guidance for determining the cost of inventories. It is due to this standard a loss due to damaged goods is excluded from inventory cost.

The three concepts that have influenced the production of the financial statements are:

Accrual concept

The financial statements have been prepared on an accruals basis. The accrual concept, also known as matching principle, requires that transactions are reflected in the accounts of the period to which they relate to and not in the period in which payments are made or received.

- *Impact of Accrual Concept on Profit*

When a trading and profit & loss account for a period is compiled, the cost of goods sold relevant to the sales made during the period should be recorded accurately and in full in that account. Costs and incomes concerning a future period such as prepaid expenses and pre-received income must be carried forward as a prepayment for that period and not charged in the current profit statement. For example, prepaid general administrative expenses would be carried forward to the period they relate to. Similarly, expenses accrued or income accrued will be included in the current period's profit statement by means of an accruals adjustment. For example, manufacturing wages accrued will be added to manufacturing wages for the current period.

- *Impact of Accrual Concept on Assets / Liabilities*

All prepaid expenses and accrued income will be treated as assets and accrued expenses and pre-received incomes will be treated as liabilities.

Going Concern Concept

Going concern concept is a part of UK statute law. This concept assumes that the business under consideration will remain in existence for the foreseeable future. Without this concept, accounts will have to be drawn up on the basis of what the business is likely to be worth if it is sold gradually at the date of the accounts.

- *Impact of Going Concern Concept on Profit*

When an entity has a history of profitable operations and has a ready access to financial resources, one can conclude that the organisation will remain in existence for the foreseeable future. For example, as Appleby Oakley and Company has regularly been making profits, one can comfortably draw a conclusion on going concern concept.

- *Impact of Going Concern Concept on Assets / Liabilities*

Going concern concept impacts the valuation of assets and liabilities. Due to the going concern concept, the values placed on continuing business assets and liabilities are different from the value placed on the assets and liabilities of a closing business. For example, stock is normally valued at cost price but if business were about to close down trading then it will be more relevant to use resale value of stock.

- *Impact of Going Concern Concept on Users of Accounts*

Going concern concept impacts the decision making of users of accounts. For example, management may need to consider a wide range of factors relating

to current and expected profitability, potential sources of replacement financing etc. while taking decisions.

Consistency Concept

The concept of consistency has been applied because the methods employed in treating certain items such as depreciation within the accounting records may be varied from time to time. According to consistency concept, once a business has decided which accounting methods it is going to apply and how it is going to interpret the various rules of accounting, it should be consistent in all matters from year to year. This is necessary to enable comparison of the results of the business from year to year.

- *Impact of Consistency Concept on Profit*

If the consistency concept is not there, a business can merely change an accounting method to vary the profits. For example, if a business wishes, it may vary the depreciation rates or method of depreciation at and alter the reported profits. Consider the effects on profit of charging depreciation at 15% this year on £10, 000 worth of fixed assets and then charging depreciation at 10% next year on the same £10, 000 worth of fixed assets. This year you would charge £1, 500 against profits and next year it would be only £1, 000, using the straight line method of providing for depreciation.

- *Impact of Consistency Concept on Assets / Liabilities*

If there is no consistency in the accounting methods, the assets and liabilities reported in different years will not be comparable.

- *Impact of Consistency Concept on Users of Accounts*

Users of accounts including investors, management etc. can make more meaningful comparisons of financial performance of the organization from year to year.

Partnership Salaries

All partners have a right to work in and manage the partnership business. The partners may make arrangements amongst themselves whereby a partner may be entitled to a salary. Partnership salary includes remuneration drawn by a partner from the partnership funds for acting in the partnership business. An agreement to pay a partnership salary to a partner for a special project is an internal arrangement. The effect of the arrangement is that the partner receives a fixed part of the profits of the partnership before the remaining part falls to be divided among the partners in the appropriate proportions. The impact of partnership salary is only on the way the partnership's funds are applied as between the partners. A partner drawing a salary is not an employee and any salary paid to the partner cannot be claimed as a deduction from net profits. Therefore, one can neither treat a partnership salary as a true salary, nor an expense of the partnership, but only as a distribution of partnership profits to the recipient partner.

If Appleby suggests that he receives a salary, he will still be a partner and cannot be treated as an employee of a partnership. This implies that the partnership will not be able to claim a deduction for Appleby's salary. Similarly, Appleby's salary cannot create or increase a partnership loss. In reality, Appleby's salary will be a mere allocation or advancement of profits prior to general distribution and will not be taken into account in calculating the net partnership income or loss. Appleby will need to show the amount

received as salary as his income on his tax return. The amounts distributed to Appleby will be brought into account in computing his interest in the profits or assets of the partnership. However, the amount paid as salary is still regarded as constituting part of the profits of the partnership

If Appleby gets a salary of £2, 500 per month, profit share of Oakley will reduce from £85915 to £73915 as illustrated below:

Profit & Loss Appropriation Account for the year ended 31 December 2003

	£	£
Net Profit b/d		214, 788. 00
Appleby’s Salary (£2500 per month)	30000. 00	
Appleby share (3/5)	110, 873. 00	
Oakley Share (2/5)	73915. 00	
	214, 788	214, 788

Asset Depreciation

In general, an asset can be depreciated if it meetsALLof the following requirements:

- The asset is used in a trade or business or held for the production of income as an investment property.
- The asset has a finite period of usefulness in the business that can be estimated and is longer than one year.
- The asset is susceptible to wear and tear, natural deterioration through interaction of the elements, or technical obsolescence.

GAAP specifically excludes land from computation of depreciation. Land normally has indefinite economic life and it does not decline in economic value as a consequence of wear and tear, natural deterioration through interaction of the elements, or technical obsolescence. Therefore, it fails to satisfy the second and the third conditions for an asset to be depreciated.

Land is probably the most common asset that is *not* depreciable. However, buildings may be depreciable. Generally, if such is the case then the cost of the land must be separated from the cost of the building for depreciation purposes. In the scenario under discussion, land and buildings are assumed to imply land and therefore not depreciable.

References:

1. Reporting Financial Performance, Available from: http://www. frc. org. uk/asb/technical/standards/pub0102. html,[Accessed 20 November, 2006]
2. *International Financial Reporting Standards* , Available from: http://en. wikipedia. org/wiki/International_Financial_Reporting_Standards, [Accessed 20 November, 2006]

3. Accounting Concepts and Conventions, Available from: http://www. accountingweb. co. uk/cgi-bin/item. cgi? id= 69109,[Accessed 22 November, 2006]

ANNEXURE A

Assumptions and Working Notes for Task 1-2-3

Assumptions:

1. As the scenario merely states that overheads are apportioned between the factory and the administration/other sections and does not specify a share (except in the case of insurance), following share of overheads is assumed:

- Rent: factory 1/3 administration etc. 2/3
- Light and heat: Factory 1/2, administration etc. ½
- Insurance : Factory 1/4, administration etc. 3/4 (given)

2. It is assumed that the accumulated depreciation figures in the trial balance are before taking into account the current year's depreciation.

Working Notes:

1. Cost of Raw Material Consumed = Opening Stock of Raw Material + Purchases of Raw Material – Closing stock of raw material

=£12800 +£274500 -£8500

2. Depreciation on Plant & Machinery

Plant & Machinery at Cost Price= £31000

Accumulated Depreciation=£18100

Written down value as on 31 December 2003= £31000-£18100=£12900

Depreciation = 15% on written down value

= 15% of 12900= £1935

3. Depreciation on Furniture and Fixtures

Furniture and Fixtures at Cost Price= £34700

Depreciation = 10% on straight line basis

= 10% of £34700= £3470

4. Depreciation on Motor Vehicles

Motor Vehicles at Cost Price= £28800

Accumulated Depreciation=£12600

Written down value as on 31 December 2003= £28800-£12600=£16200

Depreciation = 15% on written down value

= 20% of 16200= £3240

5. There is a 10% mark-up on manufacturing cost. As finished goods are valued at factory cost price with no adjustment for manufacturing profits, the 10% mark-up is taken as a part of the general reserve.
6. Profit share and drawings are held through current accounts. Therefore, an adjusted current account is prepared.
7. Finished goods have been adjusted for the damaged goods.

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