Regulatory frameworks for financial reporting

Discuss the reasons why we need a regulatory framework for financial reporting. What are the advantages and disadvantages of making accounting rules by law as opposed to using IASB standards?

The body of rules which determine how financial accounts will be compiled in any particular situation are known as the Generally Accepted Accounting Principles (GAAP); these are drawn from a number of sources. The first of these are legal; the main sources of these include the Companies Act 2006, as well as EU Law and the remainder of the UK common law. The second strand of this includes national and international accounting standard such as the ASB and IASB (International Accounting Standards Board) standards, as set by the Accounting Standards Board and their international equivalent; they will also work to establish public opinion on proposed new standards, and use seminars to discuss issues within accounting. The third strand is comprised of the rules of the Stock Exchanges, though these are only applicable to companies listed on the LSE or AIM.

The major argument in favour of a regulatory framework is that standardisation is encouraged and, through this, we are able to make an accurate assessment of financial health. As Alexander and Britton point out, before the introduction of these standards, " different firms in similar situations were following different accounting standards, leading to different and incompatible results" (Alexander and Britton, 2004). Indeed, when takeovers occurred, different valuations taken by accountants could potentially generate vastly different results, given the uncertainty as to what to include: this, in turn, was bad fro the reputation of the accounting profession. The framework, in the shape of both law and accounting standards, allows for the element of subjectivity to be lessened. Further advantages of the current regulatory framework include increasing level of information for the end user, through stipulating minimum standards of disclosure; in addition, the current system benefits through input both from government (in statute, for example), and from the accountancy profession, which arguably works to ensure a balance of interests.

However, within this, we then face a choice between regulation by statute and regulation through accounting standards, each with their relative merits and demerits. I shall discuss these in turn.

The first advantage is that accounting standards act as a way of reducing the disparate methods by which one may create accounts; this, in turn, makes the account of greater benefit to the end user, given that they have a document which is easily comparable to others of the same kind. Without such a standardisation, there is a risk that different firms of accountant may have chosen to classify a particular type of asset or debt in a different way. Alexander and Britton (2004) demonstrates this through the example of property – how is this to be valued? We might argue that it should retain the value for which it is bought; alternatively, we could say that the value should be this, minus depreciation; or thirdly, we could say that the value (given that prices of property will almost always be rising) should be the original price plus an inflationary multiplier. This is just one example, and taken over a large company, the potential for fluctuations is substantial. In an internationalised economy, this value is correspondingly increased; Zeff (2007) remarks that the introduction of international standards has led to " a very great increase in global comparability in relation to what we had before, namely, every country using its own national standards, which differed considerably from country to country”. Indeed, Haller and Walton (2003) describe this as “ the nub of the international accounting problem. How do companies that want to operate across national (and therefore usually cultural) boundaries convey economic information appropriate for business decisions?”

Secondly, they provide a focal point for debate over what accepted practice should be. At present, it has occasionally been argued that accounting standards are not based on any coherent conceptual framework, but rather exist simply as rules in themselves (Alexander and Britton, 2004). The IASB is a body well-poised to correct such a problem: thus, in recent years, the IASB has launched a project to “ develop an improved common conceptual framework that provides a sound foundation for developing future accounting standards”. It is difficult to imagine Parliament giving time to such a broad yet arguably essential task.

Thirdly, on much the same basis, it may be argued that accounting standards are much less rigid than relevant legislation; each change to legislation will require a separate bill to proceed through Parliament, in contrast to accounting standards. Thus, the maintenance of accounting standards provides a body of rules that create standardisation while simultaneously lacking a legalistic rigidity. In addition, the “ true and fair view” can be used when justifiable to override other accounting standards which may apply (Fearnley and Hines, 2003).

Fourthly, it can be seen that the introduction of accounting standards have encouraged companies to make available more information than they otherwise would have. Examples of this can be seen in, for example, Robins remarks that FRS 3 (on reporting financial performance), requiring companies to highlight a range of different financial performance indicators (such as the results of continuing operations and discontinued operations) which allow a greater level of information than if simply profit were indicated (Robins, 1999). Through requiring enhanced disclosure of information, it can be argued that accounting standards create a greater standard of information to the end user, and thus the value of accounting in general.

Fifthly, it may be viewed as an advantage that the guidelines are created by people with a strong connection to the industry; that is, professional accountants. Statutes such as the Companies Act are inevitably subject to party political pressures: and, in despite their best intentions, Members of Parliament are unlikely to have the same level of expertise as people with vast experience in their field. A further point is that when Parliament drafts legislation, it will intend for it to be applied by the courts; it would therefore be more difficult to create comprehensive standards in such a way than it would be to do so through a body comprised of accountants, creating standards for accountants. We may conclude that a system based on professional considerations is more likely to provide an accurate assessment of an institution.

On the other hand, there are a number of corresponding criticisms. Firstly, requiring additional information, and for institutions to comply with certain standards, will inevitably lead to an increase in costs; checking that a set of accounts adheres to a particular set of standards will be require more work than simply taking an ad hoc approach. In addition, each new set of standards will entail its own costs – for example, in re-training accountants who had become used to different standards. Secondly, it may be argued that these guidelines are increasing in volume and complexity. Indeed, a letter from the International Corporate Governance Network to the IASB asked " whether some instruments are so complex and unstable that not only is portraying things by one number insufficient, but the users of accounts and stakeholders would be better served by the recognition that there may not an answer." Thus in certain areas, complexity will firstly make the standards more difficult to enforce, but also perhaps create inappropriate results, as they are inappropriate to the particular context. This is a particularly strong criticism if we consider that the economic case for the regulatory framework is perhaps unproven: " The case for uniformity in accounting is not based on any settled body of evidence, or literature" (Bell, 2005).

Thirdly, the fact that the guidelines are both set and disciplined by the accounting profession means that there may be no effective method of enforcing the standards – this is in contrast to any statutory system, which will be enforceable through the courts. Where professional accountants are involved, the only sanction for breach of these guidelines would appear to be through professional bodies, which have been slow to do so (Lewis and Pendrill, 2003). This is a particular problem, considering that (as seen above), part of the argument for accounting standards is in fact to uphold the reputation of the profession. In addition (and as Lewis and Pendrill point out), many accounting standards deal with issues which in a democratic society, should arguably be subject to democratic controls: the example given is that of FRS 17 (Retirement Benefits), which stated that deficits in a company pensions scheme were to be treated as expenses on the profit and loss account. This is an issue of national importance.

Finally, requiring further standardisation means that there will be a trend towards rigidity in financial reporting; it has long been feared that this will lead to accounting becoming a process of rote learning of rules, without searching for any meaning within them. (Baxter, 1962) Thus, although there will be a standardised system, this will not necessarily be one in which these rules have principled bases; at the same time, such standards remove any opportunity for individual judgment or discretion.. In addition, a rigid set of standards will not be appropriate in every situation to which they might be applied; for example, the property industry protested the application of SSAP 12 to property since its introduction (Andrew and Pitt, 2006; SSAP19 was later introduced to cover this). It may even be that an emphasis on rules over judgment distorts the realities of a given situation – " the experience of FRS5… has shown that judgement-based accounting can operate successfully to report economic reality in a situation where previously there had been an over-reliance on rules" (ICAS, 2006).

In conclusion, while there is a clear value in standardisation (in that accounts, through being created from the same standards, are more reliably comparable), it would appear that there are certain conflicts. The first is between expertise and control: to what extent should Parliament allow standards boards to create their own rules, benefitting from their own experience, and to what extent should their own political persuasions have a role? The same problem applies in enforcement – allowing the accounting industry the opportunity to enforce their own rules gives them the independence to enforce them using their own expertise, but otherwise could lead to charges of indifference to their own wrongdoing. Secondly, there is a conflict between standardisation and complexity; though the aim of standardisation would perhaps be best served by standards covering every possible eventuality, these would be so lengthy and comprehensive as to be unworkable; to some extent, we must rely on broader principles. The relative merits of each of the relevant methods will therefore depend on the approach we take towards each of these conflicts.