

# ACCG224- NOTES

## Week 1- Introduction to the Regulatory Environment

### Accounting Regulation

- Financial reporting practice in Australia is determined by the application of accounting standards set by the AASB
- They are set within the context of the IFRS set by the IASB
- The AASB are the Australian equivalent of the IFRS's

### Key Sources of financial reporting regulation in Australia

1. Corporations Act 2001
2. Australian accounting standards
3. Conceptual framework
4. ASX listing rules

### What is an accounting standard?

- Accounting standards are authoritative statements that guide the preparation of financial statements to ensure information contained in those statements are accurate and assists user to make economic decisions
- **They are not law themselves but are imbedded in the corporations Act 2001 (i.e. it is a requirement to follow the accounting standards)**

### When is an entity required to comply with the Australian accounting standards

- An entity is required to comply with Australian accounting standard if it classified as a reporting entity and is required under the Corporations act 2001 to prepare financial reports

### Reporting entity

- SAC 1 defines a reporting entity as an entity in which is it reasonable to expect the existence of users who depend on general purpose financial reports for information to enable them to make economic decisions
- Indicators of a reporting entity:
  1. Separation of management from economic interest (owners)
    - Greater the separation the more likely users will depend on reports
    - Creates agency risk whereby reports become essential to ensure this risk is mitigated
  2. Economic and political influence
    - Greater the social impact the more likely users will depend on reports
  3. Financial characteristics
    - Greater the size and resource more likely users will depend on reports

**NOTE:**

- **Non-reporting entities are not required to follow accounting standards**

Australian Accounting Standards (Tier 1 and Tier 2)

Tier 1:

- Full international financial reporting standards as adopted by the AASB
- Companies that must follow tier 1 requirements include
  - For profit entities in the private sector (such as companies, disclosing entities and registered schemes) that are **publically accountable**
  - Federal, state and local governments

Tier 2:

- Recognition, measurement and presentation requirements of the IFRS (tier 1) and reduced disclosure requirements
- Companies that can follow tier 2 requirements include:
  - For profit entities that are not **publically accountable**
  - Non for profit entities
  - Public sector entities such as clubs and charities

NOTE: Public accountability refers to entities with debt and equity instruments that are traded on a public market and those that hold monetary assets on behalf of its customers (e.g. banks, insurance companies, brokers and investment banks)

**Regulatory bodies involved in regulating accounting standards**

Financial reporting Council (FRC)

- Overseer and advisory body to the AASB
- Determines strategic direction of AASB

Australian accounting standards Board (AASB)

- Responsible for development and transformation of IFRS and IAS into Australian standards that correspond to the Australian business context
- Responsible for the development of a conceptual framework in order to adapt international accounting standards to suit the Australian environment
- Contributes to a set of worldwide standards

Australian Securities investment commission (ASIC)

- Monitors the implementation of corporations act and ensures companies comply with AASB accounting standards

Australian Securities exchange (ASX)

- Sets rules public listed companies must follow such as trading and listing rules

### Australian Prudential regulation authority (APRA)

- Is the prudential regulator of the Australian financial service industry

### International accounting standards Board (IASB)

- Is an independent, privately funded accounting standard setter

### IFRS interpretations committee

- Helps to interpret international accounting standards in order for countries to adopt these standards within their own context
- Reviews global accounting issues arising within context of the IFRS and provides guidance and appropriate accounting treatment of those issues

### **Rules based vs. Principal based standards**

#### Rules based standards

- Are sets of detailed rules that MUST be followed when preparing financial statements

#### Advantages:

- Increased comparability with financial statements
- Improved guidance when there is a lack of a clear and appropriate principle
- Reduced imprecision that leads to aggressive reporting choices by management

#### Disadvantages:

- Can be complex and may not be applicable to every situation leading to unfavourable reporting e.g. ENRON

#### Principle based standards

- Are not specific and based on a conceptual framework that provides a broad framework for which to follow
- Focuses on professional judgement and expertise of those preparing the reports
- IASB follows a principal based approach to standard setting

#### Advantages:

- Are simpler
- Broad guidelines that can be applied to many situations
- Allow accountants to use professional judgements
- Improve representational faithfulness of financial statements

#### Disadvantages:

- Professional judgement and choice may mean comparability of financial statements are reduced

- Managers and auditors must have the required desire for unbiased reporting and expertise otherwise benefits can evaporate.

### **Theories of regulation**

- Regulation involves an exercise of control by a party independent of those directly involved in the activity
- There are theories regarding the need for intention of regulation of financial information

### **Signalling theory**

- Argues whether accounting information needs to be regulated since reporting entities have incentives to distinguish themselves from other entities
- Reporting entities can increase their value through financial reporting
  - Companies face competitive markets with sophisticated investors thus in order to maximise value they have an incentive to disclose information
  - Remaining entities perceived to be poorer thus incentive for them to provide information

### **Public interest theory**

- Argues that regulation is supplied to correct inefficient market practices
- Without regulation information would be either under or over-produced

### **Capture theory**

- Argues that regulation is supplied in response to demands of self-interest groups who attain the benefits created through legislation in order to maximise their income and investment goals

### **Bushfire theory**

- Argues that accounting is regulated to overcome the stigma for accounting created by crises such as unexpected cooperate collapses

### **Advantages of Regulation:**

- Increased efficiency in allocating capital
- Reduces search cost since all information is provided
- Public confidence
- Standardisation which reduces variances in financial reports

### **Disadvantages**

- Determining optimal quantity of information is problematic
- Regulation is difficult to reverse if it is deemed ineffective
- Stifles innovation in presenting reports and communication is restricted
- Reporting entities are different are forces different cases into the same mould

### **Political nature of standard Setting**

- There is a mix of private and public participation in the standard setting process
- Various parties have conflicting interest in reporting entities
  - Management is more likely to want accounting choices that allow it to produce a favourable picture of its performance as possible
  - External stakeholder are more likely to want to see the 'real performance'
  - Auditors may like auditable (objective) reporting

### **Lobbying**

- Those effected by regulation in form of accounting standards have an incentive to lobby standards setters to achieve a favourable outcome since they can affect the transfer of wealth from one party to another
- Lobby groups include:
  - Industry management
  - Auditors
  - Academics
  - Full-time professional users

