

TOPIC 4:

CRITERIA AND REQUIREMENTS FOR INFORMATION APPEARING IN A PUBLISHED FINANCIAL STATEMENTS AS PER INTERNATIONAL REPORTING FRAMEWORK.

DEFINITION OF FINANCIAL STATEMENTS.

Financial statements are a set of documents that show a company's financial status (Financial Performance and Financial Position) at a specific point in time.

COMPONENTS OF FINANCIAL STATEMENTS.

According to IAS 1, a complete set of financial statements includes.

- ⇒ A statement of financial position (balance sheet) at the end of the period
- ⇒ A statement of profit or loss and other comprehensive income for the period (presented as a single statement, or by presenting the profit or loss section in a separate statement of profit or loss, immediately followed by a statement presenting comprehensive income beginning with profit or loss)
- ⇒ A statement of changes in equity for the period
- ⇒ A statement of cash flows for the period
- ⇒ Notes, comprising a summary of significant accounting policies and other explanatory notes
- ⇒ Comparative information prescribed by the standard.

OBJECTIVES OF FINANCIAL STATEMENTS.

1. Provide Useful Information for Decision-Making.

Financial statements are crucial for decision-making, providing reliable information to stakeholders. They help investors evaluate an entity's financial position, assess performance indicators, and assess liquidity and solvency ratios. They also help creditors and lenders assess an entity's financial sustainability and ensure compliance with accounting standards and legal requirements.

2. Assess the Financial Position of an Entity.

The balance sheet is a financial statement that outlines an entity's assets, liabilities, and equity, assessing liquidity and solvency. It is crucial for investors and creditors to assess a company's net worth, growth potential, and risk of default. Evaluating financial ratios helps stakeholders make informed decisions.

3. Evaluate Financial Performance and Profitability.

The income statement provides a detailed overview of a company's financial performance, outlining revenues, expenses, and net profit. It evaluates operational efficiency, profitability trends, and helps stakeholders assess earnings growth, predict future profitability, and make informed decisions. It is crucial for investors and creditors to ensure financial stability and debt repayment.

4. Provide Insights into Cash Flows and Liquidity.

The statement of cash flows outlines an entity's cash generation and utilization, categorized into operating, investing, and financing activities. Operating activities show cash from core business operations, investing shows cash from asset acquisitions, and financing activities highlight capital structure and financial strategy.

5. Support Stewardship and Accountability.

Financial statements are crucial for promoting stewardship and accountability by providing a transparent record of management's resource utilization, evaluating management's actions in the company's best interests, promoting trust in governance, and ensuring compliance with legal and accounting standards through regular audits and disclosures.

6. Facilitate Comparability and Transparency.

Standardized financial statements, like IFRS or GAAP, enable comparability and transparency in financial reporting. This ensures consistent presentation, enhancing investor confidence and reducing misinformation risk. This transparency also contributes to efficient financial markets, promoting economic stability and growth.

7. Aid in Forecasting Future Performance.

Financial statements provide a historical record of an entity's financial health, profitability, and risk exposure, aiding in forecasting future performance. Key ratios like ROE and EPS evaluate long-term growth prospects. Analysing financial statements aids in strategic decision-making, risk management, resource allocation, and future business opportunities.

STRUCTURE AND CONTENT OF FINANCIAL STATEMENTS.

Disclosure and presentation.

IAS 1 requires particular disclosures on the face of the statement of financial position, the statement of profit or loss and other comprehensive income or in the statement of changes in equity. (IAS 7) sets out requirements for the presentation of a statement of cash flows.

IAS 1 sometimes uses the term 'disclosure' in a broad sense, encompassing items presented on the face of the statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity and cash flow statement, as well as in the notes. Disclosures are also required by other standards and interpretations. Unless specified

to the contrary elsewhere in the standards or an interpretation, such disclosures are made either on the face of the statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity or cash flow statement (whichever is relevant), or in the notes.

Each component of the financial statements should be identified clearly. In addition, the following information should be displayed prominently and repeated when it is necessary for a proper understanding of the information presented.

- ⇒ The name of the reporting entity or other means of identification.
- ⇒ Any change in that information from the preceding balance sheet date.
- ⇒ Whether the financial statements cover the individual entity or a group of entities.
- ⇒ The date of the end of the reporting period or the period covered by the set of financial statements or notes.
- ⇒ The presentation currency, as defined in [IAS 21](#) and
- ⇒ The level of rounding used in presenting amounts in the financial statements.

These requirements can be met by presenting appropriate headings for pages, statements, notes, columns and the like. Judgement is required in determining the best way of presenting such information. For example, when an entity presents the financial statements electronically, separate pages are not always used, so headings can be presented to ensure that the information included in the financial statements can be understood.

Financial statements are often made easier to understand by rounding and presenting information in thousands or millions of units of the presentation currency. This is acceptable as long as the entity discloses the level of rounding and does not omit material information.

REPORTING PERIOD AND COMPARATIVE INFORMATION.

REPORTING PERIOD.

There is a presumption that financial statements will be prepared at least annually. If the annual reporting period changes and financial statements are prepared for a different period, the entity must disclose the reason for the change and state that amounts are not entirely comparable.

COMPARATIVE INFORMATION.

IAS 1 requires that comparative information to be disclosed in respect of the previous period for all amounts reported in the financial statements, both on the face of the financial statements and in the notes, unless another Standard requires otherwise. Comparative information is provided for narrative and descriptive where it is relevant to understanding the financial statements of the current period.

- ⇒ An entity is required to present at least two of each of the following primary financial statements.
- ⇒ Statement of financial position*
- ⇒ Statement of profit or loss and other comprehensive income
- ⇒ Separate statements of profit or loss (where presented)
- ⇒ Statement of cash flows
- ⇒ Statement of changes in equity
- ⇒ Related notes for each of the above items.

A third statement of financial position is required to be presented if the entity retrospectively applies an accounting policy, restates items, or reclassifies items, and those adjustments had a material effect on the information in the statement of financial position at the beginning of the comparative period.

Where comparative amounts are changed or reclassified, various disclosures are required.

OVERVIEW OF ACCOUNTING IRREGULARITIES AND CREATIVE ACCOUNTING.

Introduction.

Accounting irregularities and creative accounting refer to manipulative financial reporting practices that distort an entity's true financial position and performance. While creative accounting operates within the boundaries of accounting rules (though it misleads users), accounting irregularities often involve fraud and deliberate misrepresentation.

Understanding Accounting Irregularities.

Accounting irregularities occur when companies intentionally misstate financial information to deceive stakeholders. These actions can be illegal and may violate Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS).

Types of Accounting Irregularities.

1. Fraudulent Financial Reporting.

Fraudulent financial reporting involves manipulating financial statements to deceive investors, regulators, and stakeholders. It can involve overstating revenues, understating expenses, inflating asset values, or concealing liabilities. High-profile cases like Enron and WorldCom have led to regulatory reforms. Detection and prevention require robust controls and ethical practices.

Example: Enron's scandal, where off-balance-sheet financing hid liabilities.

2. Misappropriation of Assets.

Misappropriation of assets involves theft, embezzlement, or unauthorized use of a company's resources for personal gain, often due to weak oversight and poor internal controls. Preventing this involves strong internal control measures, regular audits, employee training, and fostering a corporate culture of integrity and accountability.

Example: Inflated expense claims, unauthorized use of company funds.

3. Inappropriate Revenue Recognition.

Inappropriate revenue recognition is when a company records revenue before it is earned, often to inflate financial performance and mislead investors or regulators. This practice violates accounting principles and can lead to severe legal and financial consequences. Preventing this requires strong internal controls, independent audits, and ethical reporting practices.

Example: WorldCom's improper capitalization of expenses as assets.

4. Overstating or Understating Expenses and Liabilities.

Overstating or understating expenses and liabilities can distort a company's profitability, misleading investors and stakeholders. These fraudulent practices violate accounting standards and can lead to regulatory penalties, loss of investor confidence, and legal consequences. Preventing such manipulations requires strict internal controls, independent audits, and ethical reporting practices.

Example: Capitalizing operating expenses instead of expensing them immediately.

5. Fictitious or Inflated Assets.

Fictitious assets involve recording non-existent or artificially increasing a company's assets to deceive stakeholders about its financial position. This can lead to incorrect financial decisions, trust issues, and severe consequences. Preventing asset inflation requires rigorous internal controls, independent audits, and strict financial reporting standards.

Example: Companies exaggerating inventory values to improve financial ratios.

CREATIVE ACCOUNTING.

Creative accounting involves the use of loopholes in accounting standards to present financial statements more favourably. While it may not always be illegal, it is often ethically questionable and misleading to stakeholders.

Common Creative Accounting Techniques.

Technique	Description	Example
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Big Bath Accounting	Companies take large losses in one period to show higher profits in future periods.	Writing off huge assets in one year to inflate earnings in the following years.
Income Smoothing	Spreading out revenues and expenses to show steady growth.	Deferring revenue recognition to future periods.
Cookie Jar Reserves	Creating excessive reserves in profitable years to reduce taxable income in bad years.	Overestimating warranty expenses to reverse them in lean years.
Off-Balance-Sheet Financing	Keeping certain liabilities off the balance sheet to appear financially stronger.	Leasing assets instead of purchasing to avoid recording debt.
Manipulating Depreciation	Using different depreciation methods to manage profits.	Switching from straight-line to accelerated depreciation.

CONSEQUENCES OF ACCOUNTING IRREGULARITIES AND CREATIVE ACCOUNTING.

While creative accounting may help in the short term, it often leads to serious consequences:

- ⇒ Loss of Investor Trust – Misleading financial statements erode confidence.
- ⇒ Regulatory Penalties and Legal Consequences – Firms may face fines, lawsuits, or stock market delisting.
- ⇒ Collapse of Businesses – Fraudulent reporting can lead to insolvency. Example: Lehman Brothers' bankruptcy.
- ⇒ Reputational Damage – Affected companies may struggle to recover public trust.
- ⇒ Auditor and Regulatory Scrutiny – Companies using aggressive accounting practices often attract investigations.

PREVENTING ACCOUNTING IRREGULARITIES.

To avoid accounting fraud and unethical financial reporting, organizations should:

- ⇒ Strengthen Internal Controls – Implement strict internal audits and segregation of duties.
- ⇒ Ensure Compliance with IFRS & GAAP – Follow proper accounting standards.
- ⇒ Conduct Independent Audits – Hire reputable external auditors.
- ⇒ Enhance Corporate Governance – Establish strong oversight by independent directors.
- ⇒ Promote Ethical Accounting Culture – Train employees and management on financial ethics.