1 Introduction to financial reporting

The following topics are covered in this chapter:

- Overview of accounting
- The users of financial statements
- Types of business entities
- The framework
- Qualitative characteristics
- Elements of the financial statements
- Other important accounting concepts

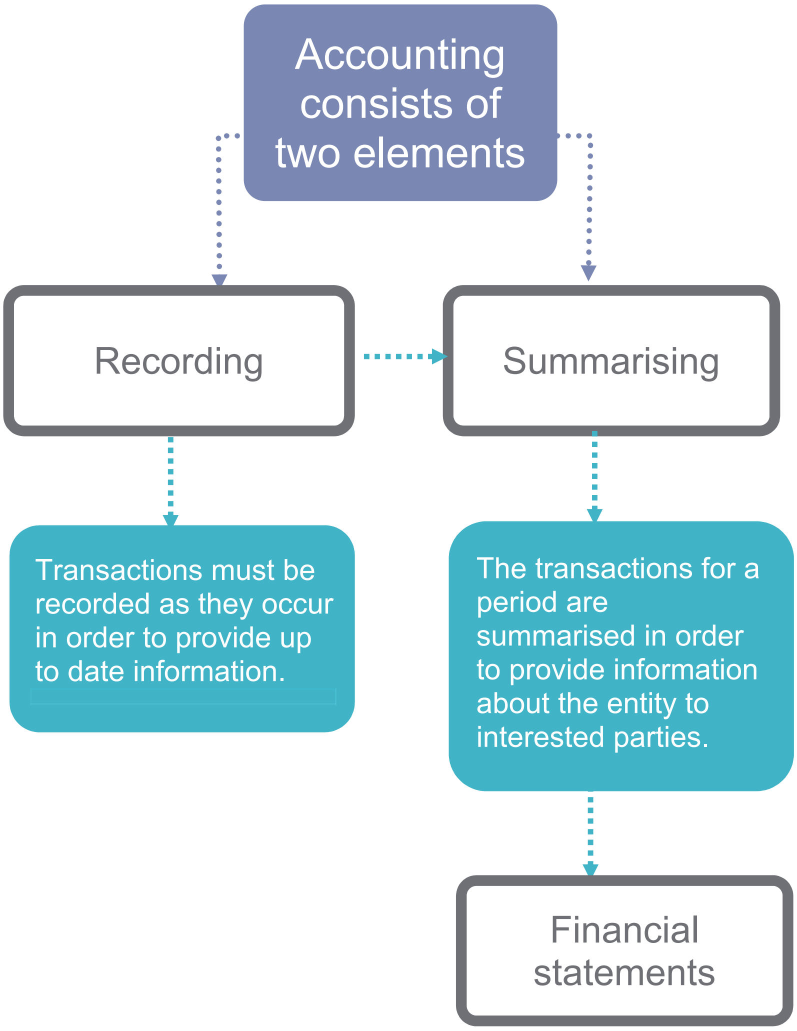
1.1 OVERVIEW OF ACCOUNTING

LEARNING SUMMARY

After studying this section you should be able to:

- outline the purpose of the accounting system and the financial statements
- identify the differences between financial and management accounting.

The accounting system of a business records and summarises the financial position and performance of the business. The summarised information is then presented in the form of financial statements.



The financial statements

Financial statements are made up of:

The statement of financial position
This statement summarises the assets, liabilities and equity balances of the business at the end of the reporting period.

The statement of profit or loss
This statement summarises the revenues earned and expenses incurred by the business throughout the reporting period.

The statement of changes in equity
This statement summarises the movement in equity balances i.e. share capital, share premium, revaluation surplus and retained earnings during the reporting period..

The statement of cash flows
This statement summarises the cash paid and received throughout the reporting period.

The notes to the financial statements
The notes to the financial statements comprise a statement of accounting policies and any other disclosures required to enable to the shareholders and other users of the financial statements to make informed judgements about the business.

The preparation of these statements is reviewed later in the text.

Financial vs management accounting

Financial accounting	Management accounting
Production of summary financial statements for external users.	Production of detailed accounts, used by management to control the business and plan for the future.
Usually prepared annually.	Normally prepared monthly, often on a rolling basis.
Generally required by law.	Not mandatory.
Reflects past performance and position.	Includes budgets and forecasts of future activities, as well as reflecting past performance.
Information calculated and presented in accordance with international accounting standards.	Information prepared and presented in order to be relevant to managers.

It is crucial to have an understanding of the two functions of financial and management accounting and their differences.

Do you understand?

1 Accounting can be described as the recording and summarising of transactions.

True or false?

2 Which one of the following sentences does NOT explain the distinction between financial statements and management accounts?

A Financial statements are primarily for external users and management accounts are primarily for internal users.

B Financial statements are normally produced annually and management accounts are normally produced monthly.

C Financial statements are more accurate than management accounts.

D Financial statements are audited by an external auditor and management accounts do not normally have an external audit.

1 True
2 C Both financial and management accounts should be equally accurate and reliable

1.2 USERS OF THE FINANCIAL STATEMENTS

LEARNING SUMMARY

After studying this section you should be able to:

- identify the users of financial statements and differentiate between their information needs.

User	Interest?
Investors	What are the potential profits and the security of their investment?
Customers	Can they continue to be supplied in the future?
Suppliers	Will they be paid? Can they be reassured about the financial health of a business before agreeing to supply goods?
Lenders	Will they be repaid?
Government	How is the economy performing? What is the amount of tax payable by a business?
Competitors	What strategy should be taken? How does their performance and position compare?
The public	What is the impact on the economy, local environment and local community?
Employees	Is employment secure? Is a pay rise or bonus possible?
Management	What are the operational and strategic decisions?

Each user will have their own reasons for their interest in the financial statements.

Do you understand?

1 Which one of the following user groups is likely to require the most detailed financial information?

A The management

B Investors and potential investors

C Government agencies

D Employees

1 A Management require very detailed information in order to make informed decisions with regard to operations

1.3 TYPES OF BUSINESS ENTITIES

LEARNING SUMMARY

After studying this section you should be able to:

- Identify and define types of business entity.

A **sole trader** is a business entity which is owned and operated by one individual.

- In law there is no distinction between the owner and the business.
- The sole trader has personal unlimited liability for the business debts and losses.

A **partnership** is a business entity which is owned and operated by more than one individual.

- The partners will share the profits.
- The partners have personal unlimited liability for the business debts and losses.

A **company** is an incorporated business owned by shareholders who have invested capital in return for a shareholding.

- A legal entity distinct from its owners.
- Limited liability – shareholders are not personally liable for the business debts.
- Return on their investment in the company referred to as a dividend.

1.4 THE FRAMEWORK

Regulatory bodies are reviewed in chapter 2.

LEARNING SUMMARY

After studying this section you should be able to:

- understand the purpose of the Framework.

One of the most important documents underpinning the preparation of financial statements is the Conceptual Framework for Financial Reporting ('the Framework'), which was prepared by the International Accounting Standards Board.

The Framework presents the main ideas, concepts and principles upon which International Financial Reporting Standards are based.

KEY POINT The main objective of financial reporting is to present information that users can base their decision making on.

Fair presentation

Fair presentation concerns the financial information being ‘true and fair’.

A **true and fair view**

A ‘true and fair’ view has not been formally defined but embodies:

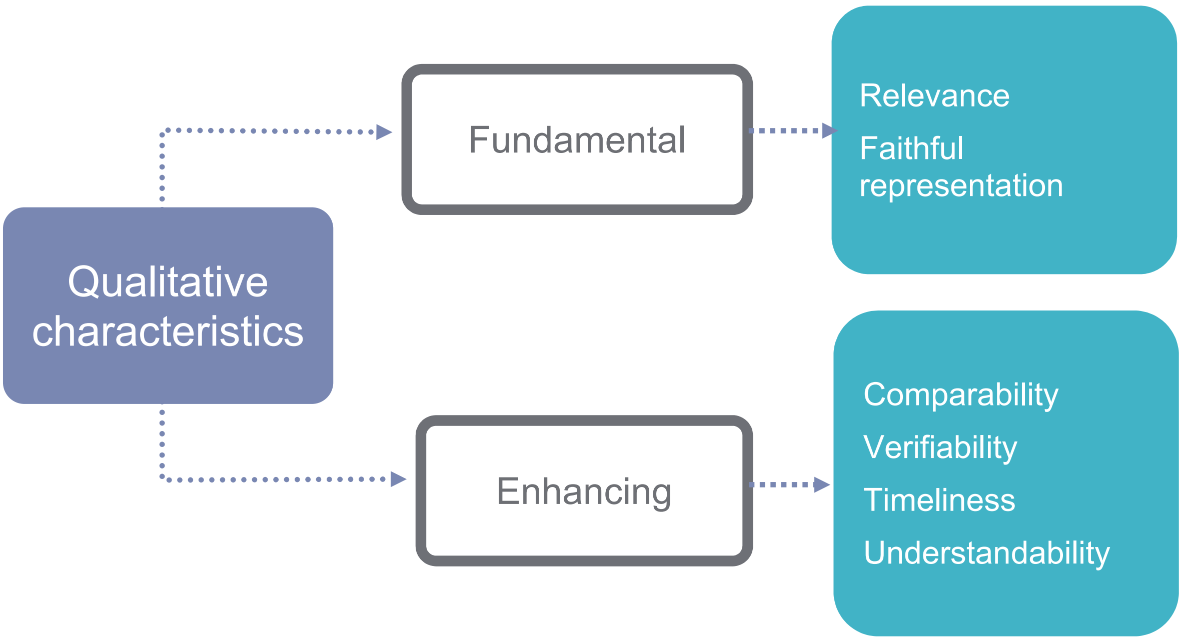
- compliance with relevant laws and regulations
- compliance with the relevant financial reporting framework
- the application of the qualitative characteristics of the Framework.

1.5 QUALITATIVE CHARACTERISTICS

LEARNING SUMMARY

After studying this section you should be able to:

- define, understand and apply qualitative characteristics.



Fundamental qualitative characteristics	
Relevance	It influences the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting their past evaluations.
Faithful representation	Transactions and other events must be accounted for and presented in accordance with their substance and economic reality and not merely their legal form.
Enhancing qualitative characteristics	
Comparability	Users must be able to compare financial statements over a period of time to identify trends and to compare financial statements of different entities to be able to assess their relative financial position and performance.
Verifiability	Can be direct or indirect. Direct verification means verifying through direct observation. Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology.
Timeliness	Information made available to decision makers in time to be capable of influencing their decisions
Understandability	Readily understandable by users, although relevant information should never be excluded due to being considered too difficult for some users.

1.6 ELEMENTS OF THE FINANCIAL STATEMENTS

LEARNING SUMMARY

After studying this section you should be able to:

- identify and define the elements that make up the financial statements
- classify items as current or non-current assets or liabilities.

KEY POINT The financial statements must summarise five key elements in order to reflect the financial position and performance

Statement of profit or loss	Statement of financial position
Income	Assets
Expense	Liability
	Equity

It is important to know which elements appear in each of the financial statements.

DEFINITION An **asset** is ‘a resource owned or controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity’ (Framework, Glossary)

DEFINITION A **liability** is 'a present obligation arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits' (Framework, Glossary)

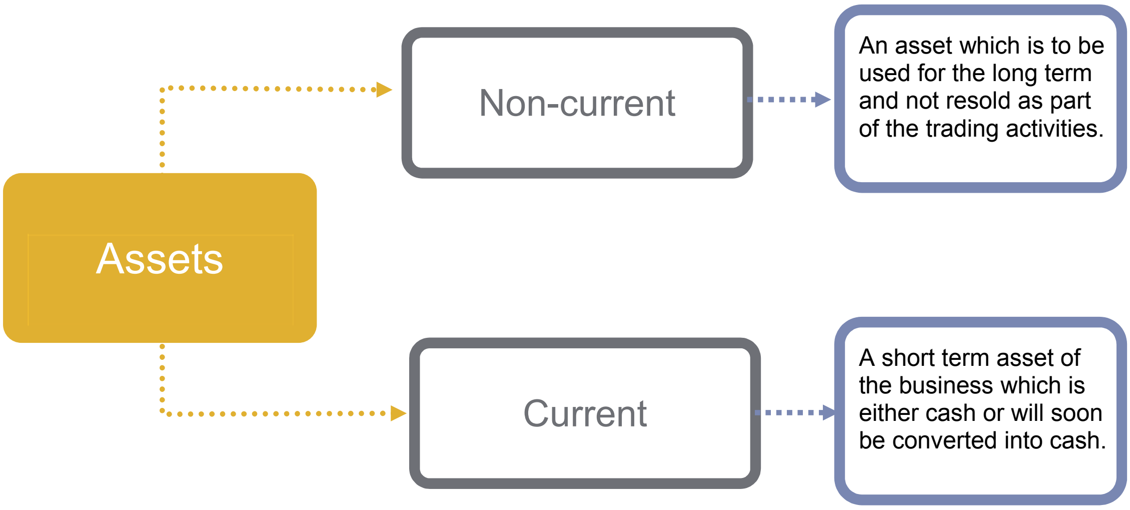
DEFINITION **Capital/equity** is a special kind of liability due to the owner(s) and is 'the residual interest in the assets of the entity after deducting all its liabilities' (Framework, para 4.4)

DEFINITION **Income** 'increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity' (Framework, Glossary)

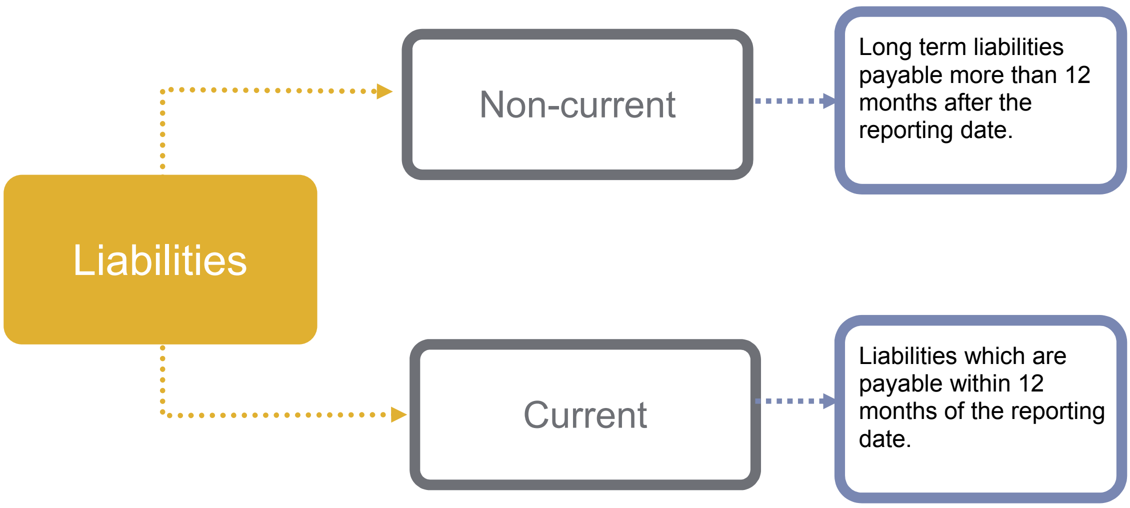
DEFINITION **Expense** 'decreases in economic benefits during the accounting period in the form of outflows or diminutions of assets or increases of liabilities that result in a decrease in equity' (Framework, Para 4.25)

Categorisation of assets and liabilities

Assets and liabilities need to be classified according to the length of time they are employed in the business.



DEFINITION A tangible asset has physical substance. A non-tangible asset has no physical substance.



1.7 OTHER IMPORTANT ACCOUNTING CONCEPTS

LEARNING SUMMARY

After studying this section you should be able to:

- define, understand and apply accounting concepts.

Materiality	An item is regarded as material if its omission or misstatement is likely to change the perception or understanding of the user of that information.
Substance over form	If information is to be presented faithfully, the economic reality must be accounted for and not just the strict legal form.
Going concern	Financial statements are prepared on the basis that the entity will continue to trade for the foreseeable future.
The business entity	Financial accounting information presented in the financial statements relates only to activities of the business and not to those of the owner.
The accruals basis	Transactions are recorded when revenues are earned and when expenses are incurred. This pays no regard to the timing of cash payment or receipt.
Fair presentation	Relates to preparation of the financial statements in accordance with applicable financial reporting standards, together with relevant laws and regulation.
Consistence	Users of the financial statements need to be able to compare the performance of a company over a number of years and so classification and presentation of items should be retained from one period to the next.

Do you understand?

1 Classify the following into whether they are non-current and current assets and liabilities.

(i) Land & buildings (ii) receivables (iii) cash in hand (iv) loan repayable in three years' time

2 The concept of materiality means that businesses will only report material transactions, balances and events. True or false?

3 Faithful representation means that the commercial effect of a transaction must always be shown in the financial statements even if this differs from legal form. True or false?

1 (i) Land & buildings – non-current asset (ii) receivables – current asset (iii) cash in hand – current asset (iv) loan repayable in three years' time – non-current liability

2 False - Businesses should report all transactions, events and balances in their financial statements. Materiality is simply a measure for determining how significant that information is to users.

3 True - Faithful representation includes the concept that transactions should reflect their economic substance, rather than the legal form of the transaction.

Exam style questions

1 What is the main purpose of financial accounting?

A To record all transactions in the books of account

B To provide management with detailed analyses of costs

C To enable preparation of financial statements that provides information about an entity's financial performance and position

D To calculate profit or loss for an accounting period

2 Which one of the following statements best defines a liability?

A A liability is an obligation arising from a past transaction or event.

B A liability is a legally binding amount owed to a third party.

C A liability is an obligation arising from a past transaction or event which is expected to be settled by an outflow of economic benefits.

D A liability is anything which results in an outflow of economic benefits from an entity.

3 Which one of the following statements best defines an asset?

A An asset is a resource owned by the entity with a financial value.

B An asset is a resource controlled by an entity from which future economic benefits are expected to be generated.

C An asset is a resource controlled by an entity as a result of past events.

D An asset is a resource controlled by an entity as a result of past events from which future economic benefits are expected to be generated.

4 Which of the following items is not an enhancing qualitative characteristic of useful financial information as stated in the IASB Framework?

A Comparability

B Timeliness

C Faithful representation

D Understandability

5 Which two of the following items are enhancing qualitative characteristics of useful financial information as stated in the IASB Framework?

A Relevance

B Comparability

C Faithful representation

D Verifiability