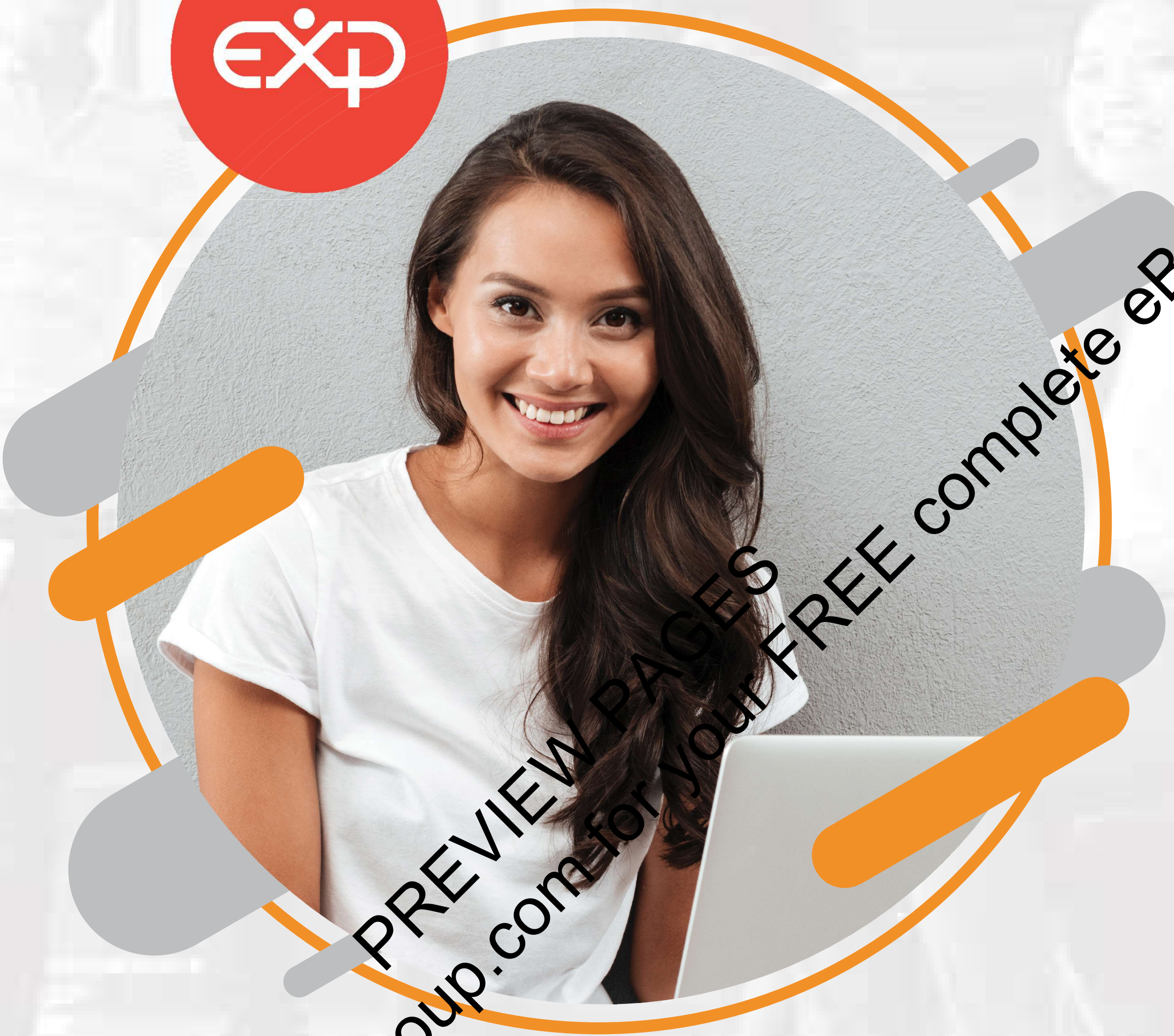

The ExP Group

ACCA FA | ExPress Notes

Financial Accounting

SBL SBR AFM APM ATX AAA

BT MA FA LW PM TX FR AA FM

Valid for FA exams from 1 September 2024 to 31 August 2025

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Hello

Thank you for downloading a copy of these ExPress notes and I hope you find them useful for your studies.

We provide these ExPress notes free of charge to individual students as part of our CSR initiatives. The notes are designed to help students assimilate and understand the most important areas for the exam as quickly as possible.

A word of warning though in that they have not been designed to cover everything in the syllabus so you should only use these notes for either an overview of the key areas before you start your main studies or as part of your final revision in the run up to your exams.

Importantly though, we want you to be successful in your exams so good luck with your studies and please do let us know how you get on.

All the best,

Steve

About The ExP Group

We were born with one passion, with one aim, with one desire. To use technology the way it should be used. To use technology to open up education, and in particular financial education, to whoever needs it regardless of their income, wealth, race, sex, religion or location.

We wanted to use technology to empower individuals to develop themselves through financial expertise, organisations to improve their performance through enhanced human capital and ultimately communities and families to benefit as a result.

We're on target and since our birth we have had the privilege of working with and learning from inspirational individuals and organisations from all 4 corners of the world in countries as varied as the UK in the north, Singapore in the east, South Africa in the south and the Cayman Islands in the west.

We're only part way through our journey but we're doing better than we expected. The best is yet to come though,

Education + Technology = Ethical Empowerment.

Thank you for being part of our story.

01 Financial Statements

The Big Picture

Financial statements (more colloquially called accounts) are a crucial part of managing a business and reporting to shareholders. A set of financial statements will need to be produced at least annually for presentation to external stakeholders, but generally much more frequently for management control within the business.

Frequent and accurate financial statements can add a great deal to the efficient running of a business.

A set of financial statements is produced periodically (often once a year for smaller businesses but as frequently as the users want them). A full set of financial statements for a limited company comprises a number of statements:

- A **statement of financial position**, referred to by some people as a balance sheet. This lists all the assets and liabilities of the business plus the equity of the business (which explains where the assets and liabilities came from). The statement of financial position is a snapshot of the assets and liabilities of a business at a moment in time.

- A **statement of profit or loss and other comprehensive income**. This shows all the gains and losses that the business has experienced in the period. The statement of comprehensive income is a record of what happened over a period to the net assets of a business.

- A **statement of cash flows**, which shows where the cash and short-term assets very similar to cash came from and went do during the period. Income isn't always the same as cash, as we'll see later.

- **Notes to the financial statements**, which give further detail to readers who want to know more than the summary story.

Statement of financial position of Sole Trader X at 30 June 20x1

ASSETS	**$**	**$**
Non-current assets		
License to operate		10,000
Land and buildings		35,000
Office equipment		20,000
Motor vehicles		30,000
Fixtures and fittings		10,000
		105,000
Current assets		
Inventory		20,000
Trade receivables	13,000	
Less: allowance for doubtful receivables	(1,000)	
		12,000
Prepayments		4,000
Cash at bank		3,000
Cash in hand		2,000
Total assets		146,000
EQUITY AND LIABILITIES		
Capital		
Initial capital introduced		30,000
Total cumulative comprehensive income at 1 July 20x0		85,700
Less: Cumulative withdrawals at 1 July 20x0		(24,000)
Total equity at 1 July 20x0		91,700
Total comprehensive income in the current period		16,000
Withdrawals in the current year		(8,000)
Total equity at 30 July 20x1		99,700

Non-current liabilities

Bank loans	32,000

Current liabilities

Bank overdraft	3,300
Trade payables	8,000
Accruals	3,000
Total liabilities	46,300
Total equity and liabilities	146,000

Principal features of the statement of financial position:

- It balances, with the total assets equaling equity (i.e. owner's interest) plus liabilities
- Each section is conventionally written in terms of increasing liquidity
- Non-current assets and liabilities are ones that are expected to remain on the SOFP next year. Current assets and liabilities are expected to be used up or paid within the coming year.

A SOFP may be rearranged into a number of ways. As above shows:

Total assets = Equity + total liabilities

Equally validly therefore:

Total assets – total liabilities = Equity

Given that equity = capital + cumulative profit – cumulative withdrawals, then the equation could be written in any number of ways such as:

Total assets – total liabilities = Capital + cumulative profit – cumulative withdrawals

Or

Cumulative profit = Total assets – total liabilities – capital + cumulative withdrawals.

This is sometimes called the "accounting equation" and often comes up in the FA exam. The task is to drop in the figures that you know and find the missing figure, whatever it might be.

Statement of profit or loss and other comprehensive income for the year ended 30 June 20x1

	$	$
Sales revenue		154,000
Cost of sales		(100,000)
Gross profit		54,000
Distribution costs		(11,000)
Admin and selling expenses		(22,000)
Operating profit		21,000
Less: Finance costs		(1,000)
Profit before tax		10,000
Tax		(2,000)
Profit for the year		8,000
Other comprehensive income:		
Revaluation gain on property		2,000
Total comprehensive income in the period		10,000

You may be required in the exam to calculate revenue, cost of sales, gross profit and total comprehensive income from given data.

Unusual items

Sometimes, it is necessary for one-off items to be disclosed separately in the financial statements if they are very large or arise from an unusual, often non-recurring, source. Typical examples might be write-off of an unusually large debt as irrecoverable, or business relocation costs. Disclosing it separately allows readers of the accounts a more in-depth understanding of what the business is doing.

Key Knowledge - Elements of financial statements

There are five elements of financial statements, from which all financial statements are produced. These definitions are very useful throughout your ACCA studies and could easily be part of a question in paper FR.

Elements of the statement of financial position:

- An **asset** is a resource that is controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

- A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

- **Equity** is the residual interest in the assets of the entity after deducting all its liabilities. Depending on the type of business, this may be called just capital (sole trader), partners' current account (partnership) or share capital and reserves (for a limited company). For a limited company, reserves show the net cumulative gains above cumulative losses, less all dividends paid. This therefore explains the difference between what the net assets were when the share capital was originally paid in and what the net assets are at the reporting date.

Elements of the statement of comprehensive income:

- **Income** is an increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

- An **expense** is a decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Note that income and expenditure are defined effectively as the reason that a change in net assets happened.

Key Knowledge – Relationship between the statements: the business equation

An increase in net assets of a business will come from a mixture of these sources:

- Total comprehensive income made in the period (a profit will increase net assets)
- New capital introduced by the owner (will always increase net assets)
- Withdrawals made in the period (will always reduce net assets).

This is sometimes called the accounting equation or the business equation. It can be summarised:

Closing net assets = Opening net assets + total comprehensive income in the period + new capital introduced in the period – withdrawals in the period.

This is also a frequent exam question, with some figures given and the others having to be deduced.

Remember that net assets = equity + liabilities, by definition. So net assets may be given in a question separately as equity and liabilities.

Separate accounting entity

Even with a sole trader (a person who runs a business on their own, but the business has never been set up formally to be a separate legal identity), there is a distinction between personal income/ expenses and business income/ expenses. The accounts will largely be maintained so that the sole trader can report business profits to the tax authority. Personal expenditure such as personal holidays is not deductible against tax! The accountant will therefore only record transactions that are considered to be legitimate business transactions; personal transactions will be ignored. In smaller businesses, one of the first steps when producing accounting records for clients is to separate the business transactions from the personal, as the latter will not be recorded anywhere.

Sole traders and limited companies - We'll look at these in more detail in each chapter, but here's a summary:

	Sole trader	**Limited company**
Number of investors	1 (the sole trader!)	Can be between 1 and an unlimited large number
Must produce accounts for the tax authority	Yes	Yes
Must produce accounts to file with the commercial register	No	Yes
Business name	Normally just the name of the owner "trading as" the name of the business	Must end Ltd (if private limited company) or plc (if public limited company)
Can offer shares to the public	No	Yes, if a plc. No if Ltd.
Equity part of the SOFP	Initial capital Cumulative profit Cumulative withdrawals	Share capital Reserves: (revaluation reserve, retained earnings, etc).

02 Objectives of financial reporting

The Big Picture

Financial reporting is the business of collecting financial information, analysing, summarising it and presenting it in a useful form to a wide range of different users. Different users will have different objectives and therefore slightly different needs. Financial statements are aimed at giving useful information to a wide range of different users, though the investor is the most significant user.

For financial information to be useful, it must exhibit a number of characteristics.

Qualitative characteristic	Our definition
Fair presentation	Items are described in accordance with their true nature. For example, loans repayable within six months are classified as current rather than non-current.
Going concern	The business is expected to trade into the foreseeable future. This means that assets will not have to be sold in a hurry, which would be likely to result in significant impairments in value.
Accruals	A key concept. It means recording transactions in the period when they happened; not necessarily when the cash was settled. It also means matching costs and associated revenues.
Consistency	Items should be reported the same way between periods, so that it's possible to make meaningful comparisons between years. Similar transactions must be reported the same way within the same accounting period.
Materiality	Materiality means large enough to influence the user's opinion on the financial statements. Immaterial information should not be disclosed, as it's a distraction. Material information must be presented accurately and fairly.

Relevance	Irrelevant information is a distraction and should not be presented.
Reliability	Information is useless if it's not considered to be reliable. E.g. an external valuation of property is more reliable than a biased director's valuation.
Faithful representation	Items should be described in accordance with their true nature. E.g. an expense for repairs should not be classified as research costs, even though research costs are more favourably viewed by investors.
Substance over form	Items should be reported in accordance with their commercial substance, rather than their legal form. E.g. if a sale is made on credit but legal title remains with the seller until the goods are paid for, it should still be recorded as a sale/ purchase at the time of the transaction, since this is when the obligation arises.
Neutrality	Unbiased – neither excessively optimistic nor excessively prudent.
Prudence	Conservatism. This is no longer a core concept in IFRS accounting, but broadly losses should be recognised more readily than gains.
Completeness	All information that needs to be presented in order to give a full picture has been presented.
Comparability	Financial statements this period should be presented using similar principles to previous years, so that valid comparisons may be made. Company accounts should be comparable with each other. This means that if a company changes its accounting policy, it must restate its previous years' accounts using the new accounting policy, in order to facilitate comparison between years.
Understandability	Information should be presented in a way that users can understand. Excessive complication reduces usefulness.
Business entity concept	Even if there is no separate legal entity, as with a sole trader, the business is still considered to be separate to its owners for accounting purposes.

Sometimes it's not possible to deliver all of these desirable characteristics. For example, an investor is principally interested in future profits, so this is what is relevant to them. However, estimates of future profit are unreliable, so historical information is given, even though it is less relevant.

Key Knowledge - Historical accounting

Accounting is derived from recording information about transactions that have happened. This means that assets are recorded at their historical cost; i.e. what the business paid for them. This has the advantage of being objective and relatively easy, but has a number of disadvantages, including:

- It can give out of date asset valuations for long-lived assets
- This can result in an unrealistically low depreciation charge
- Profit trends can be misleading (e.g. a profit growth of 10% per year isn't so impressive as it first seems if inflation is 12% per year!)
- Where there's significant inflation and inventory is held for a long time, profit can be reported simply by matching today's revenues with yesterday's costs.

Key Knowledge - Regulation of financial reporting

Some entities have to report under regulated accounting standards. Different countries may have their own systems of GAAP (generally accepted accounting practice) or may follow International Financial Reporting Standards (IFRS) or IFRS for SMEs (SME means smaller and medium sized enterprises).

It is a matter of national regulation which financial reporting standards an entity must use when producing their financial reports. Large plc's will have to report under a much more extensive financial reporting framework than sole traders.

There are a number of bodies that you need to be aware. Their roles are given below.

IFRS Foundation	The Foundation is made up of trustees, who appoint the members of the bodies below.
IASB: International Accounting Standards Board	The IASB issues International Financial Reporting Standards and the IFRS for SMEs. It employs a permanent staff to draft new accounting standards and amendments considered necessary to extant accounting standards.
IFRS Advisory Council	This is made up of a cross section of advisors from different user groups. It advises the IASB on the IASB's work programme.
IFRS Interpretations Committee	This body is designed to respond quickly where there are significant differences in interpretation of an extant IFRS. For example, it issued guidance on how to account for loyalty programmes, where users were uncertain to follow the extant accounting standard on revenue recognition, or provisions.

03 Sources of financial information

The Big Picture

The accounting system must naturally be fed with raw source data. This data is then analysed, categorised and recorded in the accounting system itself, which may be a fully manual (paper based) system or may be maintained using software. Both use the same system of double entry bookkeeping that we will see later on.

You should be able to define the following:

Document	**Purpose**	**Often feeds the accounting information on....**
Quotation	To give a potential customer an indication of what a product or service would be likely to cost. It may be a binding quote or just an indicative quote.	Nowhere. At this stage, there has been no transaction to record; it's still at the state of being a prospective transaction.
Sales order	To record an order from a customer. Submitting a booking form for an ExP online course for example is a sales order that ExP will then process.	Sales (revenue).
Purchase order	To record an order placed with a supplier. It may require pre-authorisation to be valid.	Purchases, normally of inventory for resale.
Goods received note	To record that an order for inventory for resale has been received. It will normally only be produced once the goods have been inspected at the point of delivery to ensure that they are correct in description and quality.	Purchases of inventory for resale and payables.
Goods despatched note	To record that an order from a customer has been sent out.	Sales (revenue) and possibly also inventory management, depending on how the accounting system is set up.

Invoice	A request for payment from a supplier. Sent by the supplier to the customer.	Payables.
Statement	A summary of transactions recorded by a supplier with a customer, including amounts received from the customer. Sent by the supplier to the customer.	Does not generally instigate any recording of a transaction, since all transactions on the statement will have been recorded when goods were ordered. But useful for cross-checking our records with the supplier's records.
Credit note	Acknowledgement from a supplier that the customer has overpaid and is entitled either to a refund or free goods/ services in the future.	Payables.
Debit note	To cancel a credit note that previously existed, e.g. if goods were ordered, paid for and then returned there would initially be a credit note. The refund made would be accompanied with a debit note.	Receivables.
Remittance advice	Normally included with an invoice. A document that is included with the payment (e.g. if paid by cheque) with details that will allow the recipient of the funds to match the payment to the customer's account.	Receivables.
Receipt	Issued by the supplier for goods, to acknowledge payment of a debt.	Receivables, payables and purchases.

Key Knowledge - Data sources / data capture

When a business transaction happens, it is essential that the source data is captured immediately. This does not necessarily mean immediately writing up the books, but it does involve some record being made of the transaction happening.

In very simple accounting systems for sole traders (e.g. a self-employed builder) it may involve the proprietor keeping pocket books to record things like quotes given and a shoe box used to collect receipts for business expenses. From this source data, the accounting records can then be produced each period. The accountant is often not physically present at the time that transactions happen, so it is essential that there are simple and fool proof systems to ensure a complete and accurate record of business transactions.

Key Knowledge – Books of original entry

Alternatively called books of prime entry, these will be the bridge between the raw data (e.g. receipt for cash purchase of some building materials and the accounting system. They may be written up by the accountant, or by a semi-trained member of staff within the client's business.