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ACCA FR | ExPress Notes

Financial Reporting

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Valid for September 2024, December 2024, March 2025 and June 2025 exam sittings

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Steve Crossman
CEO The ExP Group

"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

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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.

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01 The Conceptual Framework

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The Big Picture

IFRS provides a series of accounting rules that should enhance understandability and consistency of financial statements. However, these rules cannot possibly cover every type of accounting transaction that could ever happen.

To give guidance on what to do with situations that are not covered by a standard, the Framework exists.

The Framework document does not have the status of an IFRS and if there is any conflict between the Framework and a specific provision in an IFRS, the IFRS prevails.

The Framework also provides an underlying logic for the development of new IFRS. This means that each IFRS should define an asset or a gain in the same way, for example. This is a marked difference from the historical tendency for accounting standards to be developed in a piecemeal way, sometimes called a "patchwork quilt".

The Framework document starts by discussing what characteristics financial information needs to have and defining some of these key concepts.

Key Definitions

Qualitative characteristics of financial information help make the information included within financial statements useful to others. They are:

(i) Fundamental qualitative characteristics
- Relevance
- Faithful representation

(ii) Enhancing qualitative characteristics
- Comparability
- Verifiability

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- Timeliness
- Understandability

Elements of financial statements

There are five elements of financial statements. These definitions are worth knowing well, as their application comes up again and again in understanding IFRS.

Asset	A present economic resource controlled by the entity as a result of past events. An economic resource is the right that has a potential to produce economic benefits
Liability	A present obligation of the entity to transfer an economic resource as a result of past events.
Equity	The residual interest in the assets of the entity after deducting all its liabilities. **Note: Assets – liabilities = equity = capital + reserves** This mathematical identity comes in very handy when preparing group financial statements.
Income	Increases in assets or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.
Expenses	Decreases in assets or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

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True and fair view

This phrase is not defined by the IASB in any IFRS or the Framework document, although it is a core concept. This is probably to allow a little latitude in its interpretation between companies.

Broadly, it means that if an entity complies with all extant IFRS, then its financial statements will give a true and fair view.

True tends to be more objective (e.g. did the reported transaction actually happen?) and fair tends to mean neutral and unbiased. For example, an allowance for doubtful debts cannot logically be described as true, since it's an estimate and it involves opinion. It can, however, be described as fairly stated.

Valuation of assets and profit

For the FR paper, you need only a brief overview of the limitations of historical cost accounting.

Historical cost accounting has these principal advantages:

- Relatively easy to understand;
- Easy to audit;
- Simple to apply.

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In times of low inflation, this means that historical cost accounting works well. However, in periods of higher inflation, or for transactions with a long life (eg plant with a 40 year life) it has some significant limitations, including:

- Matching today's revenues with yesterday's costs, thus overstating profit;
- Giving out of date asset valuations;
- Not recording gains where companies are able to hold net trade payables (assuming the payables don't bear interest);
- Comparatives are misleading, since not expressed in a stable monetary unit;
- Long-term apparent growth can be overstated, due to the compounding effect of inflation.

Capital maintenance concepts

Capital maintenance means preserving the initial value of an investor's investment. This is done using either the financial capital maintenance concept, or the physical capital maintenance concept. Historical cost accounting is the simplest form; being financial capital maintenance with no adjustment for inflation.

Financial capital maintenance means preserving the general purchasing power of an investor's initial investment. Adjustments will be made using the general rate of inflation.

Physical capital maintenance means preserving the ability of the business to continue trading at its current level. Inflation adjustments are specific to the industry in which it operates. Current cost accounting (also known as "replacement cost accounting") uses this method of capital maintenance.

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02 Presentation of Financial Statements

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The Big Picture

IAS 1 is a cornerstone accounting standard that includes:

- Components of financial statements;
- Core concepts;
- True and fair override.

Components of financial statements

A full set of IFRS financial statements comprises the following primary statements (ie statements that must be shown with equal prominence as each other):

- Statement of financial position (previously called balance sheet);
- Either:
  - A statement of profit or loss and other comprehensive income, or
  - A statement of profit or loss plus a statement showing other comprehensive income.
- Statement of changes in equity;
- Statement of cash flows;
- Accounting policies and explanatory notes.

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Core concepts

IAS 1 includes a number of core concepts, with some overlap with the Framework document.

- Fair presentation – fair, neutral description of transactions.
- Going concern – entity assumed to continue operating into the foreseeable future.
- Accruals (matching) basis of accounting – match costs with associated revenues and items to the time period incurred.
- Consistency of presentation – present similar transactions the same way within the current year and year by year.
- Materiality and aggregation – no need to present information about immaterial transactions, but aggregate transactions with similar characteristics instead.
- Offsetting - an entity shall not offset assets and liabilities or income and expenses,
- unless required or permitted by an IFRS.
- Frequency of reporting – at least annually.
- Comparative information – comparative information must be provided and presented in such a way as to make comparison easy (eg use the same accounting policies in both years).

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03 Substance over form and IFRS 15, Revenue Recognition

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The Big Picture

Substance over Form

For information to be presented faithfully, it must be reported in accordance with its commercial substance, rather than strictly in adherence to its legal form.

One example of substance over form is in the context of a lease, where a reporting entity records assets held under a lease in the SOFP as aright-of-use assets, although it's not owned by them.

In substance, the degree of control means it's "their" asset although legally it quite possibly never is.

There are a wide range of transactions where identifying the true commercial substance may be difficult. This include:

- Inventory sold on a sale or return basis ("consignment inventory")
- Debt factoring
- Loans secured on assets that will be repurchased.

In order to reach a sensible conclusion in any substance over form scenario, it is necessary to identify:

- What assets are in question?
- What are the intrinsic risks and rewards of holding that asset?
- Which party to the transaction is, on balance, more exposed to the risks and rewards of that asset?

The asset with the greater exposure to risks and rewards recognises the asset on its SOFP. If it involves initial recognition of an asset, this often generates recognition of a gain also.

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IFRS 15: Revenue from Contracts with Customers

Revenue recognition is clearly a key issue in preparation of financial statements.

To recognise revenue under IFRS 15, an entity should apply the following five steps:

1. Identify the contract(s) with a customer.

2. Identify the performance obligations in the contract.

3. Determine the transaction price.

4. Allocate the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of each distinct good or service promised in the contract.

5. Recognise revenue when a performance obligation is satisfied by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service)

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04 Predictive Value

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The Big Picture

Financial statements are historical, which means that they are backward looking.

Since the return an investor obtains from holding a share (or continuing to hold a share rather than selling it) comes from future returns rather than past returns, arguably historical data is of little or no relevance to equity investor users.

A problem with estimates about future performance is that although they may be relevant to users, they are unreliable. Conversely, historical information may be irrelevant, but it is reliable.

To try to solve this core dilemma in financial reporting, a number of disclosure based accounting standards exist, which attempt to enhance the predictive value of the financial statements.

Predictive value is one of the qualitative characteristics that makes financial information useful to users.

It is a concept of great importance and hence it silently underpins the logic of a number of accounting standards.

IAS 8 - Key Concepts

IAS 8 gives regulation on the circumstances when comparative financial statements must be restated and when they must not be restated, as well as how this is done and the associated disclosure notes.

Restatement of previous period financial statements (ie retrospective application) happens when either:

- The previous year's financial statements are found to have contained a material accounting error (see definition below), or
- When the reporting entity has changed its accounting policy.

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Prospective application (i.e. no restatement of the previous period's financial statements) applies where there is no accounting error, but instead a change to the accounting estimates.

Key Definitions

An **accounting estimate** is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities.

Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

An **accounting error** is omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- Was available when financial statements for those periods were authorised for issue; and
- Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

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Explanation to be provided

The disclosure requirements of IAS 8 are somewhat extensive, but at their core, the standard requires transparent disclosure of the particulars, reason and effect of the restatement or correction.

Financial statements presentation: retrospective application

IAS 8 requires that for both errors and changes in accounting policy, the previous period's financial statements are restated.

This is done by restating the opening balances of assets, liabilities and equity for the earliest prior period presented, or for the first period affected by an accounting error if it occurred before the earliest period presented.

For example, companies may present two years of comparative financial statements rather than the minimum of one. If there is a change in accounting policy, both comparative years will be restated.

If there was an accounting error in the immediately preceding year, only that one year will be restated.

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IFRS 5: Non-Current Assets Held for Sale and Discontinued Operations - Key Concepts

Purpose

Where an entity has discontinued part of its activities, then the value of those assets will not be recovered through its own use, but rather from sale to a third party.

This means that the accounting rules for non-current assets become less suitable for those assets than the accounting rules for inventory and current assets.

In order to maximise predictive value, it is necessary to separately identify the results that will be expected to be disposed of, as well as separately show the profit or loss arising in the current year from use of those assets.

IFRS 5 covers two largely different matters:

- Disposal groups of non-current assets
- Discontinued activities, eg subsidiaries sold.

Disposal groups

- An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

- For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable.

- For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification (unless circumstances beyond the entity's control extend this period to longer than one year).

- An entity shall measure a non-current asset (or disposal group) classified as held for sale at the **lower of its carrying amount and fair value less costs to sell.**

- An entity shall not depreciate (or amortise) a non-current asset while it is classified as held for sale or while it is part of a disposal group classified as held for sale.

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