ACCA FR Section A Mind Map

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# The conceptual and regulatory framework for Financial Reporting

Discuss and apply a conceptual and regulatory frameworks for financial reporting

## 1. Conceptual Framework

Conceptual framework states that: 'The objective of general purpose financial reporting is to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.'

Going concern is the underlying assumption in preparing financial statements.

The Conceptual Framework states that qualitative characteristics are the attributes that make financial information useful to users.

Transactions and other events are grouped together in broad classes and in this way their financial effects are shown in the financial statements. These broad classes are the elements of financial statements.

## 2. Recognition & measurement

IASB published a new set of Conceptual Framework in March 2018.

Items which meet the definition of assets or liabilities may still not be recognised in financial statements because they must also meet certain recognition criteria.

Going concern is the underlying assumption in preparing financial statements.

A number of different measurement bases are used in financial statements. They include:

– Historical cost

– Current cost

– Realisable (settlement) value

– Present value of future cash flows

## 3. Regulatory Framework

The regulatory framework is the most important element in ensuring relevant and faithfully presented financial information and thus meeting the needs of shareholders and other users.

Without a single body overall responsible for producing financial reporting standards (the IASB) and a framework of general principles within which they can be produced (the Conceptual Framework), there would be no means of enforcing compliance with GAAP. Also, GAAP would be unable to evolve in any structured way in response to changes in economic conditions.

A principles-based system works within a set of laid down principles. A rules-based system regulates for issues as they arise. Both of these have advantages and disadvantages

IFRSs are developed through a formal system of due process and broad international consultation involving accountants, financial analysis and other users and regulatory bodies from around the world.

## 4. The concepts and principles of groups and consolidated financial statements

Many large businesses consist of several companies controlled by one central or administrative company. Together these companies are called a group. The controlling company, called the parent or holding company, will own some or all of the shares in the other companies, called subsidiaries.

IFRS 10 requires a parent to present consolidated financial statements.

It is important to distinguish between the parent company individual accounts and the group accounts.

Consolidated financial statements. The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Non-controlling interest. The equity in a subsidiary not attributable, directly or indirectly, to a parent.

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# Accounting for Transactions in Financial Statements

Account for transactions in accordance with International accounting standards.

## 1. Revenue

IFRS 15, Revenue from Contracts with Customers replaced IAS 18 on revenue recognition.
The **core principle** of IFRS 15 is that an entity shall recognise revenue from the transfer of promised good or services to customers at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services.

## 2. Taxation

**Current tax** is the amount payable to the tax authorities in relation to the trading activities during the period. It is generally straightforward.
**Deferred tax** is an accounting measure, used to match the tax effects of transactions with their accounting impact. It is quite complex.

## 3. Foreign currency transactions

IAS 21 sets out the accounting treatment for foreign currency transactions.

There are two distinct types of foreign currency transaction, **conversion** and **translation**.

## 4. Reporting financial performance

IAS 8 deals with changes in accounting estimates, changes in accounting policies and errors.

IFRS 5 requires assets 'held for sale' to be presented separately in the statement of financial position. It sets out the criteria for recognising a **discontinued operation**.

## 5. Tangible non-current assets

IAS 16 covers all aspects of accounting for property, plant and equipment. This represents the bulk of items which are 'tangible' non-current assets.

Where assets held by an entity have a limited useful life it is necessary to apportion the value of an asset over its useful life.

## 6. Intangible Material variances

Intangible assets are defined by IAS 38 as non-monetary assets without physical substance.

Intangible assets should initially be measured at cost, but subsequently they can be carried at cost or at a revalued amount.

## 7. Impairment of assets

Impairment is determined by comparing the carrying amount of the asset with its recoverable amount.
This is the higher of its fair value less costs of disposal and its value in use.
When it is not possible to calculate the recoverable amount of a single asset, then that of its cash generating unit should be measured instead.

## 8. Inventory & biological assets

IAS 2 lays out the required accounting treatment for inventories. The use of LIFO is prohibited under IAS 2.

IAS 41 applies the requirements of IFRS to the treatment of biological assets, it demonstrates fundamental differences in its nature and characteristics to other business activities.

## 9. Financial instruments

A financial instrument gives rise to a financial asset of one entity and a financial liability or equity instrument of another.

IAS 32 is to help users understand how financial instruments may have affected the entity's financial position, financial performance and cash flows.

IFRS 7 replaces the disclosure requirements which were previously in IAS 32

## 10. Leasing

IFRS 16 defines a lease as "A contract, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration".

The user of the asset needs to have the right to:

- Obtain substantially all of the economic benefits from the use of the asset.
- The right to direct the use of the asset.

## 11. Provisions & events after the reporting period

According to IAS 37, 3 criteria are required to be met before a provision can be recognised. These are:

1. There needs to be a present obligation from past event
2. There needs to be a reliable estimate
3. There needs to be a probable outflow

IAS 10 sets out criteria for recognising events occurring after the reporting date.

## 12. Government grans

IAS 20 requires grants to be recognised as income over the relevant periods to match them with related costs which they have been received to compensate.

This should be done on a systematic basis. Grants should not, therefore, be credited directly to equity.

ACCA FR Section C Mind Map

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# Analysing and interpreting the financial statements of single entities and groups

Analyse and interpret financial statements.

**Limitations of financial statements**

Financial statements are affected by the obvious shortcomings of historical cost information and are also subject to manipulation. Examples are:

1. Problems of historical cost information;
2. Creative accounting;
3. Intragroup transactions;
4. Seasonal trading;
5. Asset acquisitions;
6. Acquisitions and disposals.

**Limitations of interpretation techniques**

The choice of accounting policy and the effect of its implementation are almost as important as its disclosure in that the results of a company can be altered significantly by the choice of accounting policy:

1. The effect of choice of accounting policies
2. Changes in accounting policy
3. Limitations of ratio analysis –
   i. Ratios based on historical cost accounts;
   ii. Ratios are influenced by the choice of accounting policy;
   iii. Comparison against industry averages may not be the revealing.

**Specialised, not-for-profit and public sector entities**

The accounting requirements for not-for-profit and public sector entities are moving closer to those required for profit-making entities. However, they do have different goals and purposes.

There is a general move to get public bodies reporting under the accruals system. Many private not-for-profit organisations still use cash accounting.

Not-for-profit and public sector entities are required to manage their funds efficiently but are not expected to show a profit. Their performance is measured in terms of achievement of their stated purpose.

**Calculation and interpretation of accounting ratios and trends to address users' and stakeholders' needs**

Performance appraisal requires good interpretation and a good understanding of what the information means in the context of the question.

You will often be required to make use of ratios to aid interpretation of the financial statements for the current year and to compare them to the results of a prior period, another entity, or against industry averages.

<u>Profitability</u>:
1. Return on Capital Employed (ROCE); 2. Asset Turnover; 3. Profit Margins

<u>Liquidity</u>:
1. Current Ratio; 2. Quick Ratio; 3. Receivable Collection Period; 4. Payable Collection Period; 5. Inventory Days; 6. Gearing

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# Preparation of financial statements

Prepare and present financial statements for single entities and business combinations in accordance with International accounting standards.

**Preparation of single entity financial statements**

IAS 1 covers the form and content of financial statements. The main components are:
– Statement of financial position
– Statement of profit or loss and other comprehensive income
– Statement of changes in equity
– Statement of cash flows
– Notes to the financial statements

IAS 1 suggests a format for the statement of financial position. Certain items are specified for disclosure on the face of the financial statements.

In June 2011 the IASB published an amendment to IAS 1 called 'Presentation of items of other comprehensive income'. This changed the name of the 'statement of comprehensive income' to 'statement of profit or loss and other comprehensive income'.

IAS 1 offers two possible formats for the statement of profit or loss or separate profit or loss section – by function or by nature. Classification by function is more common.

IAS 1 requires a statement of changes in equity. This shows the movement in the equity section of the statement of financial position. A full set of financial statements includes a statement of changes in equity.

IAS 1 suggests a certain order for notes to the financial statements. This will assist users when comparing the statements of different entities.
(a) Statement of compliance with IFRSs
(b) Statement of the measurement basis (bases) and accounting policies applied
(c) Supporting information for items presented in each financial statement in the same order as each line item and each financial statement is presented
(d) Other disclosures, eg: (i) Contingent liabilities, commitments and other financial disclosures; (ii) Non-financial disclosures

**Preparation of consolidated financial statements including an associate**

*Consolidated statement of financial position*

- IFRS 10 lays out the basic procedures for preparing consolidated financial statements
- In consolidated statement of financial position it needs to distinguish **non-controlling interests** from those net assets attributable to group & financed by shareholders' equity.
- **Goodwill** is the excess of the amount transferred plus the amount of non-controlling interests over the fair value of the net assets of the subsidiary.
- Intra-group trading gives rise to **unrealised profit** which is eliminated on consolidation.
- When a parent company acquires a subsidiary during its accounting period the only accounting entries made at the time will be those recording the **cost of the acquisition in the parent company's books**. At the end of the accounting period the consolidation adjustments will be made.

*Consolidated statement of profit or loss*

- Only **post-acquisition** profits of ubsidiary are brought into onsolidated profit or loss.
- Intra-group sale & purchase are eliminated from consolidated statement of profit or loss.
- In the consolidated statement of profit or loss, non-controlling interest is brought in as a one-line adjustment at the end of the statement.
- The consolidated statement of profit or loss will include the results of the subsidiary disposed of up to the date of disposal.

*Accounting for Associates (This is covered by IAS 28 Investments in associates)*

- The investing company does not have control, but it does have significant influence.
- In consolidated statement of profit or loss the investing group takes credit for its share of the after-tax profits of associates, whether or not they are distributed as dividends.
- In the consolidated statement of financial position the investment in associates should be shown as: 1) Cost of the investment in the associate; plus 2) Group share of post-acquisition profits; less 3) Any amounts paid out as dividends; less 4) Any amount written off the investment