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Study Unit 1

Introduction to the Preparation of Financial Statements

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Study Unit 1 (1.3)

International Financial Reporting Standards

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INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)?

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Lecture notes

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International Financial Reporting Standards (IFRS)

- IFRS = **I**nternational **F**inancial **R**eporting **S**tandards.
- The IASB (International Accounting Standards Board) is the regulatory board for accounting (worldwide except for a few countries such as America)
  - IASB develops a set of rules (standards) detailing how different transactions, events and circumstances should be accounted for in the financial statements.

International Financial Reporting Standards

- There is also another set of standards developed for smaller non public businesses called IFRS for Small to Medium sized Enterprises (SMEs). In your studies at UNISA you will focus on full IFRS as IFRS for SMEs is similar, albeit a smaller set of rules and requirements.
- The Companies Act 71 of 2008 requires that South African Companies prepare financial statements using IFRS or IFRS for SMEs. For your purposes you will assume that the companies you study in this course use full IFRS. Remember that Sole Proprietors and Partnerships are not Companies and do not have to apply IFRS, but they may choose to do so if they wish.

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IFRS SUMMARY

- In summary,
  - IFRS are a set of rules developed to make sure that financial statements are prepared consistently for companies so that:
    - users can compare the financial results and performance from the current year to prior years for the same company,
    - as well as making it possible for users to compare the financial position and performance of one company with another.

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Study Unit 1 (1.2)

Conceptual Framework for Financial Reporting

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INTRODUCTION AND OVERVIEW OF THE CONCEPTUAL FRAMEWORK

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Overview

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Important

- Objective
- Qualitative characteristics
- Accrual basis and going concern
- Elements definition
- Recognition criteria

Objective

The objective of ***general purpose*** financial reporting is to provide financial 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

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Qualitative Characteristics

FUNDAMENTAL

- Relevance
- ***Faithful representation***

ENHANCING

- Comparability
- Verifiability
- Timeliness
- Understandability

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Qualitative Characteristics

- Fundamental Qualitative Characteristics:
  - Relevance
    - Appropriate for the users to base their decisions on
  - Faithful representation
    - The information should represent what really happened, (Ie: Relevant information should not be manipulated or omitted)

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Qualitative Characteristics

- Enhancing Qualitative Characteristics:
  - – Comparability
    - Over time, within industries, similar businesses
    - Different entities should disclose (present) similar transactions the same way
  - – Verifiability
    - Different people (analysts, observers, finance experts) should come to the same conclusions if they looked at the same information

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Qualitative Characteristics

- Enhancing Qualitative Characteristics:
  - Timeliness
    - The longer it takes to provide the users with the information, the less useful the information will be
  - Understandability
    - The financial statements should be drawn up in such a way that average users can get value from the information and understand it
    - It doesn't mean that information should be omitted purely because it's difficult to understand!

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NB assumptions underlying IFRS

Preparing general purpose financial reports under IFRS requires application of the following:

- ***Accrual basis***
- ***Going Concern assumption***

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Accrual Basis

- Effects of transactions & other events are recognised when they ***occur*** (NOT when cash flows!).
- ***Recorded*** in accounting records and reported in AFS of the ***periods to which they relate***.
- *Take note:*
    - *Always note the reporting date (year end)*
    - *Compare transaction date (when recognition criteria etc met) with reporting date – don't recognise in wrong period!*

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Going Concern

- Going Concern basis
  - Entity assumes that they will be able to continue operating in the forseeable future
  - 'Forseeable future' = 12 months
  - 'Continue operating' = able to realise assets and settle liabilities in the normal course of business
    - Ie: Is your business going to continue trading? (Make money from buying and selling goods)
    - Or: Is your business going to close down

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1.2 – The Conceptual Framework for Financial Reporting

ELEMENTS DEFINITIONS & RECOGNITION CRITERIA (FRAMEWORK)

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What are financial statements?

- Recognition vs Disclosure?
- Financial Statements include:
  - Statement of Financial Position (*balance sheet*)
  - Statement of profit or loss and other comprehensive income (*income statement*)
  - Statement of changes in equity
  - Statement of cash flows
  - Notes to the financial statements (disclosures)

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Position vs Performance

- Financial Position =
  - Wealth Concept
  - Cumulative
    - (Financial position at 30 December 20X5)
- Financial Performance =
  - Income concept
  - For a fixed period
    - (Profit or loss for the period ending 30 December 20X5)

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RECOGNITION of elements?

- FINANCIAL POSITION ELEMENTS
  - A
  - L
  - E
- FINANCIAL PERFORMANCE
  - I
  - E
- WHEN?
  - DEFINITION + RECOGNITION CRITERIA (x2)

Definition of elements

Financial position

- Asset:
  - Resource controlled by entity;
  - Resulting from past event;
  - Expected inflow of future economic benefits
- Liability:
  - Present obligation
  - Resulting from past event
  - Expected outflow of economic resources to settle
- Equity:
  - Residual interest, ie
  - Assets - Liabilities

Financial performance

- Income:
  - Increase in assets; or
  - Decrease in liabilities
  - Other than contributions by equity participants (shareholders)
- Expenses:
  - Increase in liabilities; or
  - Decrease in assets
  - Other than drawings / distributions to equity participants (shareholders)

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Prioritise Assets & Liabilities

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Recognition criteria

- First meet the definition of one of the elements!

- Then ***2 recognition criteria***:

1. PROBABLE that FUTURE ECONOMIC BENEFITS will flow to or from the entity.

2. COST OR VALUE that can be MEASURED with RELIABILITY

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ELEMENTS : MEASUREMENT

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Measurement ?

- Process of determining monetary amounts at which the elements of financial statements are to be recognised and carried.
- Involves selection of measurement bases.
- Framework does NOT prescribe a measurement bases.

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Measurement bases:

Some of the measurement bases noted include:

a) Historical cost (most common)

b) Current cost

c) Realisable (settlement) value

d) Present value

a) Historical cost

- Assets recorded at the amount of
  - cash paid, or
  - fair value of consideration given
- Liabilities are recorded at
  - Amount of proceeds received in exchange for the obligation, or
  - At the amounts of cash expected to be paid to satisfy the liability in the normal course of business.

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b) Current cost

- Assets
  - The amount of cash to be paid to acquire the same or an equivalent asset.
- Liabilities
  - Undiscounted amount of cash that would be required to settle the obligation currently.

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c) Realisable (settlement) value

- Assets
  - Amount of cash that could currently be obtained by selling the asset in an orderly transaction.
- Liabilities
  - Their settlement values: the undiscounted amount of cash expected to be paid to satisfy the liabilities in the normal course of business.

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d) Present value

- Assets
  - Present discounted value of the future net cash inflows that the item is expected to generate
- Liabilities
  - Carried at the present discounted value of the future cash outflows that are expected to be required to settle the liabilities

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CONCEPT OF CAPITAL MAINTENANCE

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Capital Maintenance

- The issue – how does an entity define the concept of *CAPITAL* that it seeks to maintain?
- Companies should only pay dividends out of profits in order to maintain a companies capital and therefore protect providers of capital (shareholders and providers of finance).
- So how do we define profit and do we take into account the effect of changing prices?

Financial capital maintenance

- Financial capital maintenance:
  - Profit is only earned if the financial (monetary) amount of net assets at the end of the period exceeds the financial net assets at the beginning of the period.

- Physical capital maintenance:
  - Profit is only earned if the physical productive capacity of the entity at the end of the period exceeds the physical productive capacity at the beginning of the year.

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Study Unit 1 (1.4)

Presentation of financial statements : IAS 1

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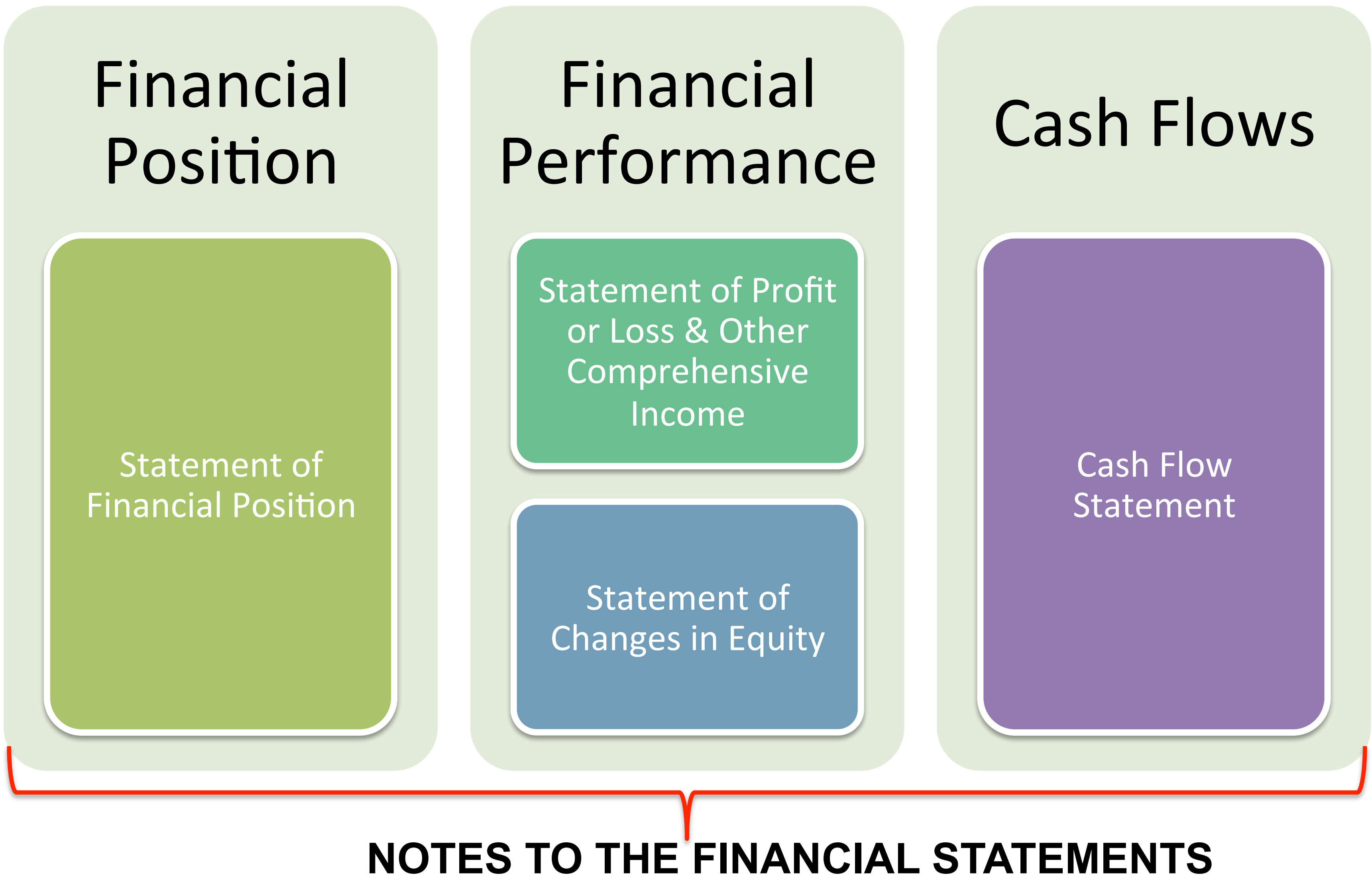
IAS 1: Presentation of Financial Statements

PURPOSE OF FINANCIAL STATEMENTS

Purpose of financial statements



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Purpose of financial statements

- Provide information about
  - financial position
  - financial performance
  - cash flows

  of an entity that is useful to wide range of users in making economic decisions
- To meet objective, financial statements provide information about entity's:
  - assets
  - liabilities
  - equity
  - income and expenses, including gains and losses
  - contributions by and distributions to owners (in their capacity as owners)
  - cash flows
- Above information, along with other information in notes,
  - assists users of financial statements in predicting entity's future cash flows AND
  - timing and certainty of cash flows

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Complete set of Financial Statements

A complete set of financial statements comprises:

a) a statement of financial position as ***at the end of the period*;**

b) a statement of profit or loss and other comprehensive income ***for the period***;

c) a statement of changes in equity ***for the period***;

d) a statement of cash flows for the period;

e) notes, comprising a summary of significant accounting policies and other explanatory information; and

f) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

- An entity may use titles for the statements other than those used in this Standard. For example, an entity may use the title ‘statement of comprehensive income’ instead of ‘statement of profit or loss and other comprehensive income’.

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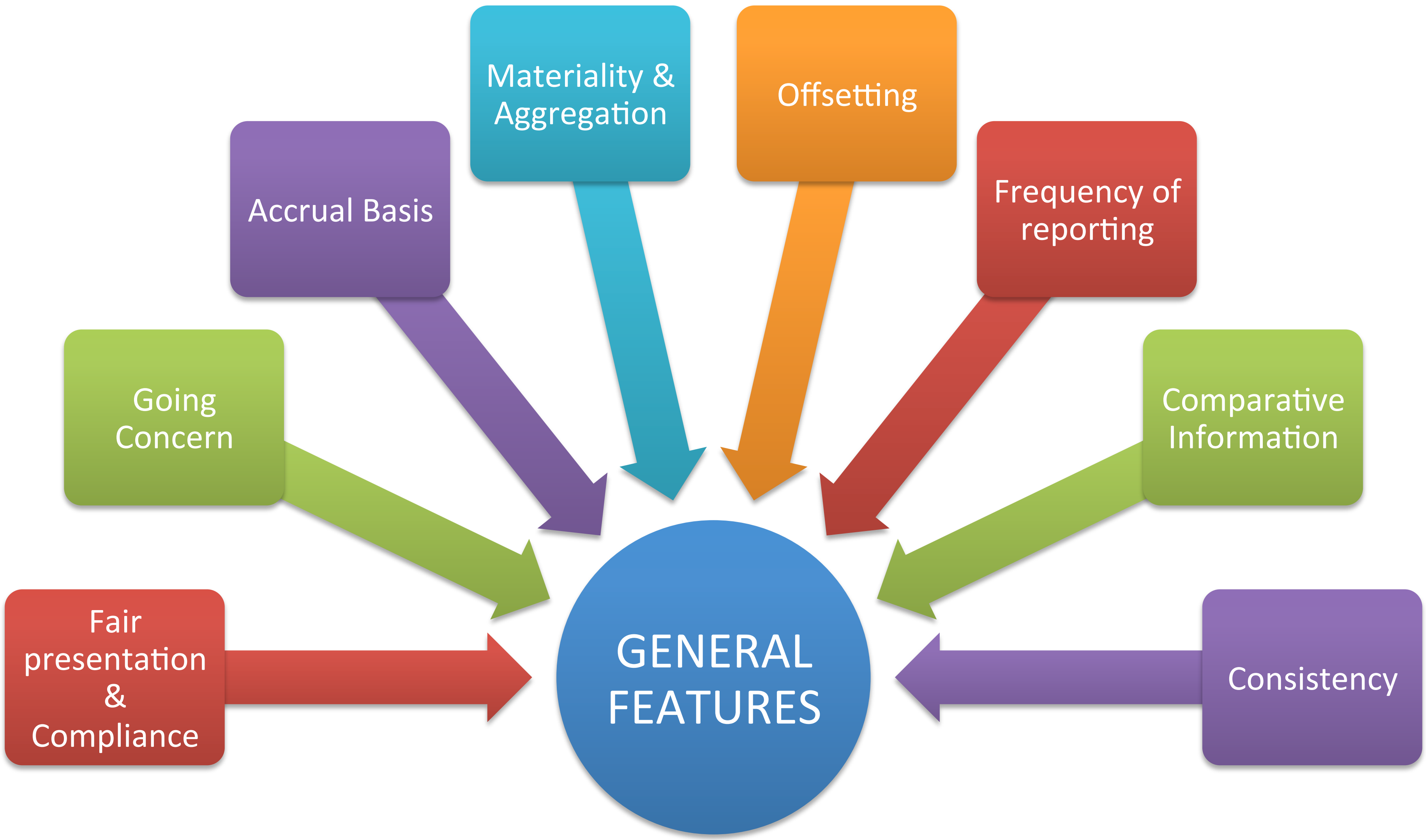
IAS 1: Presentation of Financial Statements

GENERAL FEATURES


Materiality & Aggregation
Offsetting
Accrual Basis
Frequency of reporting
Going Concern
Comparative Information
Fair presentation & Compliance
GENERAL FEATURES
Consistency

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Fair presentation

- Entity financial statements must "present fairly“
  - financial position
  - financial performance
  - cash flows
- Fair presentation requires faithful representation of effects of
  - transactions
  - other events
  - conditions

  in accordance with definitions & recognition criteria in Framework
- Application of IFRSs is presumed to result in financial statements that achieve fair presentation

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Compliance of financial statements

- AFS that claim compliance with IFRS must comply with
  - ALL standards and related interpretations

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Going concern

- Entity preparing IFRS financial statements presumed to be a going concern
- If management has significant concerns about entity's ability to continue as a going concern
  - uncertainties must be disclosed
- If management concludes that entity ≠ a going concern
  - financial statements ≠ prepared on a going concern basis
  - IAS 1 requires series of disclosures

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Accrual basis

- Entity prepares financial statements using accrual basis
  - except for cash flow information

Materiality and aggregation

- Each material class of similar items must be presented separately in financial statements
- Dissimilar items may be aggregated only if individually immaterial

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Offsetting

- Assets and liabilities, and income and expenses, may NOT be offset
  - unless required or permitted by an IFRS

Frequency of reporting

- Financial Statements must be prepared at least annually
- If the annual reporting period changes and financial statements are prepared for different period
  - entity must disclose reason for change and a warning about problems of comparability

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Comparative information

- Comparative information must be disclosed in respect of the current and the previous period (comparative period) for all amounts reported in financial statements
  – both face of financial statements and notes, unless another Standard requires otherwise
- If comparative amounts are changed or reclassified
  - various disclosures are required

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Consistency of presentation

- Presentation and classification of items in financial statements shall be retained from one period to next
  - unless a change is justified either by a change in circumstances or a requirement of a new IFRS

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IAS 1: Presentation of Financial Statements

STRUCTURE AND CONTENTS OF FINANCIAL STATEMENTS

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Structure and Contents of AFS

- Refer to illustrative financial statement download and the relevant lecture.

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IAS 1: Presentation of Financial Statements

CURRENT VS NON CURRENT CLASSIFICATION

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Classification of asset
Current or non-current?

- Lender (asset)

It is appropriate to consider intention in the case of an asset

  - Current if (IAS 1.66):
    - Expected to be realised in, or is intended for sale or consumption in, entity's
    - normal operating cycle
    - Held primarily for purpose of being traded
    - Expected to be realised within 12 months after reporting date or
    - Cash or cash equivalents (unless restricted from being used for at least 12 months after reporting date)
  - ∴ non-current if don't expect to realise within 12 months after reporting date

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Classification of liability
Current or non-current?

Why are intentions and expectations not considered?

- Borrower (liability)
- Not based on intentions or expected cash flows
  - Current if (IAS 1.69):
    - Expected to be settled in entity's normal operating cycle
    - Held primarily for purpose of being traded
    - Due to be settled within 12 months after reporting date or
    - Entity does not have unconditional right to defer settlement for at least 12 months after reporting date
  - ∴ non-current if borrower has unconditional right to defer
  - settlement for at least 12 months after reporting date