CHAPTER 1: THE CONTEXT AND PURPOSE OF FINANCIAL REPORTING

LEARNING OUTCOME

At the end of the chapter, you should be able to:

TLO A1a	**:**	**Define** financial reporting – recording, analysing and summarising financial data.
TLO A1b	**:**	**Identify** and **define** types of business entity –sole trader, partnership, Limited Liability Company.
TLO A1c	**:**	**Recognise** the legal difference between a sole trader, partnership, limited liability company.
TLO A1d	**:**	**Identify** the advantages and disadvantages of operating as a limited liability company, sole trader or partnership.
TLO A1e	**:**	**Understand** the nature, principle and scope of financial reporting.
TLO A2a	**:**	**Identify** the users of financial statement and **state** the differentiate between their information needs.
TLO A4a	**:**	**Understand** the role of the regulatory system including the roles of the IFRS Foundation (IFRSF), the International Accounting Standards Board (IASB®), the IFRS Advisory Council (IFRS AC) and the IFRS Interpretations Committee (IFRIC®).
TLO A4b	**:**	**Understand** the role of International Financial Reporting Standards.
TLO A5a	**:**	**Explain** what is meant by governance specifically in the context of the preparation of financial statements.
TLO A5b	**:**	**Describe** the duties and responsibilities of directors and other parties covering the preparation of the financial statements.
TLO C1e	**:**	**Understand** how the accounting system contributes to providing useful accounting information and complies with organisational policies and deadlines

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1.1 Financial Reporting

Learning Outcome (ACCA Study Guide Area A and C)

A1a: Define financial reporting – **recording** analysing and summarising financial data.

A1e: Understand the nature, principle and scope of financial reporting.

C1e: Understand how the accounting system contributes to providing useful accounting information and complies with organisational policies and deadlines.

1.1.1 Definition of financial reporting

Financial reporting is a way of **recording**, **analysing** and **summarising** transactions of an entity.

1.1.2 Purposes of financial reporting

The **purposes** or **objectives** of accounting can be described as:

- Recording all business transactions between the business entity and other entities;
- Based on evidence of transactions that have taken place
- To provide information on the business, using the financial statements

1.1.3 The need for accounting system

Why do we need Accounting System?

A business is continually making transactions, **e.g. buying and selling**. It would be too time-consuming and cumbersome if the business has to prepare the financial statements on completion of every individual transaction.

However, a business should keep a record of the transactions that it makes, the assets it acquires and liabilities it incurs. The accounting system is the system of **summarising these transactions and speeds up the provision of useful information** to the managers and so helps managers to keep to organisational deadlines **(e.g. provision of monthly sales figures)**. When the time comes for preparation of financial statements, the relevant information can be taken directly from those records.

Check Understanding

Topic 1.1: Financial Reporting

Learning Outcome (ACCA Study Guide Area A and C)

A1a: Define financial reporting – **recording** analysing and summarising financial data.

Question 1

What is the sequence of financial reporting?

A. Analyse, Record, Summarise
B. Summarise, Analyse, Record
C. Record, Summarise, Analyse
D. Record, Analyse, Summarise

1.2 Types of Business Entity

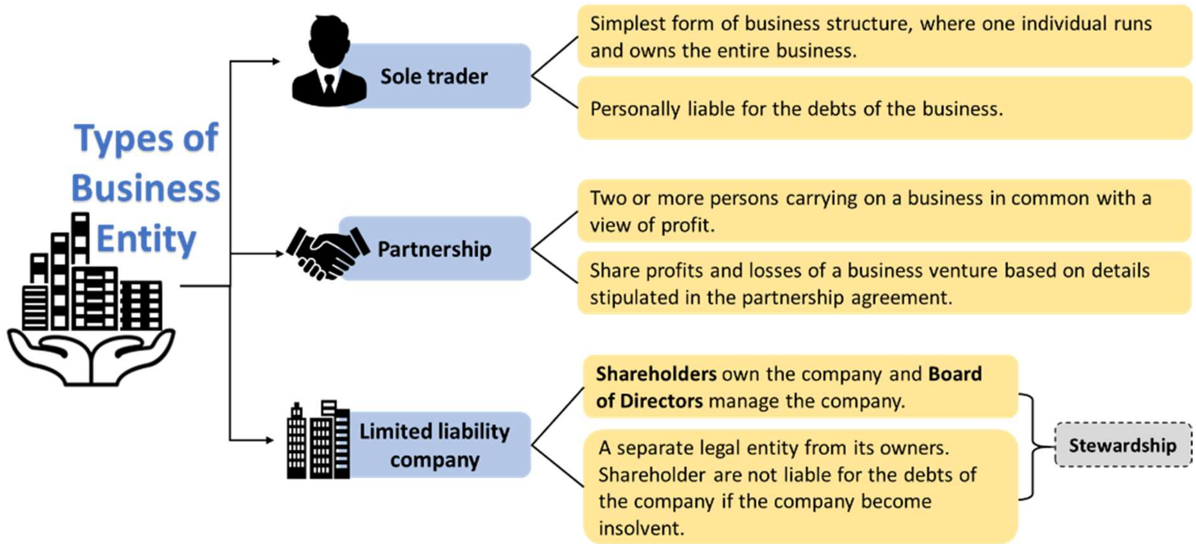
Learning Outcome (ACCA Study Guide Area A)

A1b: **Identify** and **define** types of business entity –sole trader, partnership, limited liability partnership.

A1c: **Recognise** the legal difference between a sole trader, partnership, limited liability company.

A1d: **Identify** the advantages and disadvantages of operating as a limited liability company, sole trader or partnership.

Diagram 1.2: Type of Business Entity



1.2.1 Types of business entity

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- Sole traders
- Partnerships
- Limited liability companies

1.2.2 Definition of each type of business entity

Types of Business Entity	Explanation
Sole Traders (Sole Proprietorship)	• A sole trader is the simplest form of business structure, where one individual runs and owns the entire business. • A sole trader is personally liable for the debts of the business.
Partnership	• A partnership can be defined as a relationship, which subsists between persons carrying on a business in common with a view of profit. • A partnership is an arrangement in which two or more individuals share the profits and losses of a business venture. Details of the partnership arrangement will be stipulated in the partnership agreement.

Types of Business Entity	Explanation
Limited Liability Company	Shareholders own the company but most of the time the Board of Directors manage the company on their behalf. This relationship is called stewardship. The annual report is prepared by the directors for shareholders to show their performance during the year.

1.2.3 Legal differences between the types of business entity

In the eye of law, a sole trader and partnership are not legally separate from the business they operate. This means that sole traders and partners are personally liable for the amounts owed by their businesses.

Hence, limited liability companies are incorporated to take advantage of 'limited lability' for the owners (shareholders).

A limited liability company is legally a separate entity from its owners. The shareholders are not personally liable for the amounts owed by the company if the company becomes insolvent.

However, they may lose the amount invested in the company if such circumstance arises.

1.2.4 Advantages and disadvantages of operating as a sole trader, partnership and limited liability

Table 1.2.4.1: Advantages and disadvantages of sole trader

Advantages	Disadvantages
• Full control over the operations of the business and owner is free to make own decisions.	• Owner has unlimited liability, i.e. the owner is responsible for all liabilities of the business.
• Easier to set up due to lower cost of establishment and limited paperwork.	• Difficult to raise large sums of capital to financially fund the business.
• Owner is entitled to all business profits.	• Business may come to an end in the event of death or illness of the owner.
• Less stringent reporting requirements as there is no legal requirement to make financial accounts publicly available.	

Table 1.2.4.2: Advantages and disadvantages of partnership

Advantages	Disadvantages
• Sharing of risk and losses between more people.	• Partners have unlimited liability, i.e. they are jointly and personally liable for all dents.
• Access to wider pool of skill and knowledge.	• Delay in decision making due to the need for consensus between all partners.
• Additional capital can be raised when there is more than one owner.	• Risks of dissolution if one partner leaves or withdraws from the business or dies.
• Less stringent reporting requirements as there is no legal requirement to make financial accounts publicly available.	

Table 1.2.4.3: Advantages and disadvantages of limited liability company

Advantages	Disadvantages
Owners have limited liability. This means that the liability of the owners is limited to the amount of their investments.	There are legal requirements to publish annual financial statements and some may require to be audited.
Limited liability company has perpetual existence, i.e. the company continues to exist regardless of the death or withdrawal of the owners.	Increased costs of compliance with legal requirements and accounting standards.
	Shareholders (Owners) and Board of Directors (Management) may not agree on how the business is operated.

Check Understanding

Topic 1.2: Types of Business Entity

Learning Outcome (ACCA Study Guide Area A)

A1b: **Identify** and **define** types of business entity –sole trader, partnership, limited liability partnership.

A1c: **Recognise** the legal difference between a sole trader, partnership, limited liability company.

A1d: **Identify** the advantages and disadvantages of operating as a limited liability company, sole trader or partnership.

Question 1

Which **TWO** of the following business entities, an owner has the obligation to repay debts of the business entity using his/her personal property if the business goes into bankruptcy?

A. A sole trader
B. A partnership
C. A private limited liability company
D. A public limited liability company

1.3 Information Needs by Different Users

Learning Outcome (ACCA Study Guide Area A)

A2a: Identify the users of financial statement and **state** the differentiate between their information needs.

1.3.1 User Groups and their information needs

Table 1.3.1: Users groups and their information needs

	Users	Information Needs
Internal	Owners	• Analysing the viability and profitability of their investment. • Determining any future course of action.
	Management	• Analysing the organization's performance and position. • Taking appropriate measures to improve the company results.
	Employees	• Stability and profitability. • Job security (Ability to provide remuneration) • Employment opportunities and retirement benefits.
External	Suppliers and Other Creditors	• Determining the credit worthiness of the organization. • Negotiate the credit terms.
	Lenders	• Short-term liquidity (pay interest) and long-term solvency (repay debt).
	Investors	• Assessing the performance of management. • Assess the risk and return of their investment. • Assess the ability to pay dividends. • Decide whether to buy, hold or sell.
	Customers	• Continuance, particularly if they need a stable source of supply in the long-term.
	Government, Tax Authorities and their Agencies	• Regulation of activities. • Assess taxation liabilities. • Provide a basis for national statistics.
	The Public	• Contribution to the local community (employment, using local suppliers). • Range of activities, recent developments.

Check Understanding

Topic 1.3: Information Needs by Different Users

Learning Outcome (ACCA Study Guide Area A)

A2a: Identify the users of financial statement and **state** the differentiate between their information needs.

Question 1

The IASB Framework identifies user groups. Which of the following is not an information need for the 'Investor' group?

A. Assessment of repayment ability of an entity.
B. Measuring performance, risk and return.
C. Taking decisions regarding holding investments.
D. Taking buy/sell decisions.

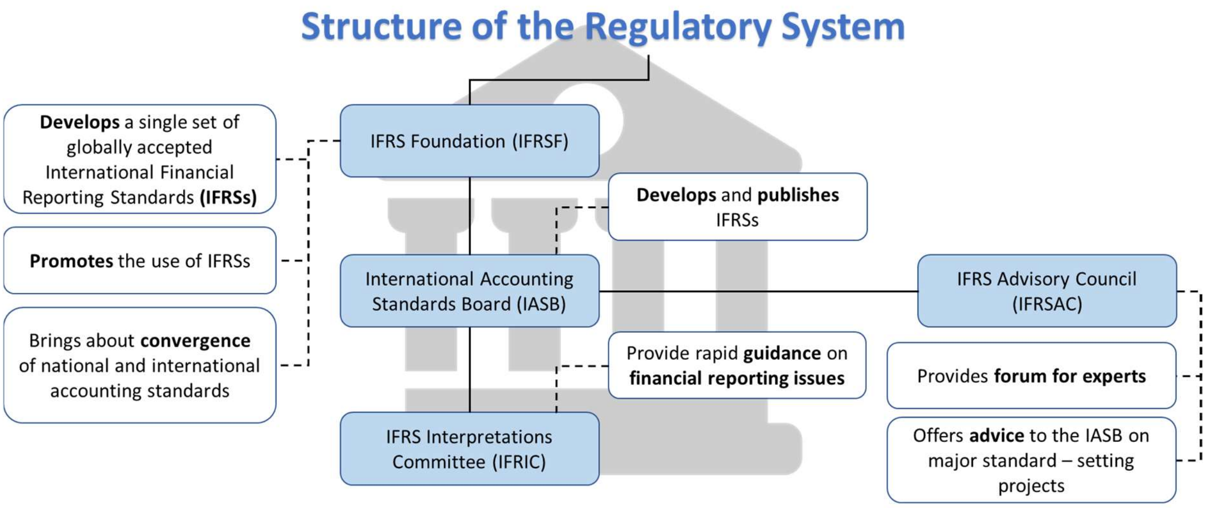
1.4 Roles of the Regulatory System

Learning Outcome (ACCA Study Guide Area A)

A4a: Understand the role of the regulatory system including the roles of the IFRS Foundation (IFRSF), the International Accounting Standards Board (IASB®), the IFRS Advisory Council (IFRS AC) and the IFRS Interpretations Committee (IFRIC®).

A4b: Understand the role of International Financial Reporting Standards.

Diagram 1.4.1: Structure of the regulatory system



1.4.1 Functions of Various Bodies of the IFRS

1. IFRS Foundation (IFRSF)

The International Financial Reporting Standard (IFRS) Foundation (formerly known as the International Accounting Standard Committee Foundation) was formed in March 2001 as a not-for-profit corporation and was the parent entity of the IASB.

In 2010 it was renamed as The IFRS Foundation is an independent organization and its trustees exercise oversight and raise necessary funding for the IASB to carry out its role as standard-setter. It also oversees the work of the IFRS Interpretations Committee [formerly called the International Financial Reporting Interpretations Committee (IFRIC)] and the IFRS Advisory Council [formerly called the Standards Advisory Council (SAC)].

The IFRS Foundation and its independent standard-setting body, the IASB, provide public accountability through the transparency of their work, the consultation with the full range of interested parties in the standard setting process, and their formal accountability links to the public.

The main objectives of the IFRS Foundation are:

- To develop, in the public interest, a single set of high quality globally accounting standards;
- To promote the use and rigorous application of these standards;
- To take account of the special needs of small and medium sized entities and emerging economies and;
- To bring about convergence of national accounting standards and international accounting standards.

2. International Accounting Standards Board (IASB)

IASB [previously known as International Accounting Standards Committee (IASC)] is responsible for the **development and publication of IFRSs**, including the IFRS for SMEs and for approving Interpretations as developed by the IFRS Interpretations Committee and reports to the IFRSF.

3. IFRS Advisory Council (IFRSAC)

Provides a forum for experts from different countries and different business sectors with an interest in international financial reporting to offer advice when drawing up new standards. Its main objectives are to **give advice to the Trustees and IASB** on agenda decisions and work priorities and on the major standard-setting projects.

4. IFRS Interpretations Committee (IFRIC)

Previously known as Standing Interpretations Committee (SIC), it **provides rapid guidance on accounting issues where divergent or unacceptable treatments are likely to arise within the context of current IFRSs.** Its pronouncements (i.e., interpretations) are important because financial statements cannot be described as complying with IFRSs unless they also comply with the interpretations.

Its role is therefore to:

- Interpret IAS & IFRS
- Issue timely guidance on issues not covered by an IAS or IFRS, within the context of the IASB Framework
- Publish draft Interpretations for public comment. After studying responses to the draft Interpretation, it will obtain IASB approval for a final (published) Interpretation.

5. International Financial reporting Standards (IFRSs)

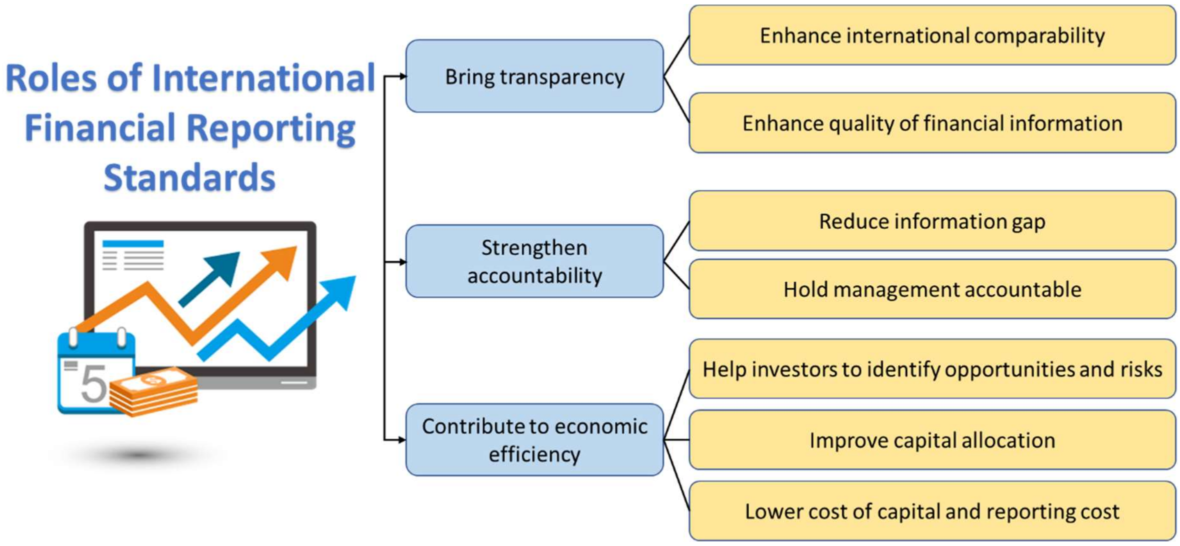
Accounting standards are a set of requirements followed by companies when they prepare their financial statements.

Standards set by the International Accounting Standards Board (the Board) are called IFRS Standards and are used by publicly accountable companies—those listed on a stock exchange and financial institutions, such as banks. Authoritative interpretations of the Standards, which provide further guidance on how to apply them, are developed by the IFRS Interpretations Committee and called IFRIC® Interpretations.

Standards set by the Board's predecessor body, the International Accounting Standards Committee, are called IAS® Standards. Authoritative interpretations of those Standards, developed by the Standing Interpretations Committee, are called SIC® Interpretations.

The Board has also developed the IFRS for SMEs® Standard, which is used by small- and medium-sized companies without public accountability. It was first issued in 2009.

Diagram 1.4.2: Roles of International Financial Reporting Standards



1.4.2 Roles of IFRS Standards

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The IFRS® Foundation and the International Accounting Standards Board:

- Bring transparency by enhancing the international comparability and quality of financial information, enabling investors and other market participants to make informed economic decisions;

- Strengthen accountability by reducing the information gap between the providers of capital and the people to whom they have entrusted their money with IFRS standards provide information that is needed to hold management to account. As a source of globally comparable information, IFRS Standards are also of vital importance to regulators around the world;

- Contribute to economic efficiency by helping investors to identify opportunities and risks across the world, thus improving capital allocation. For businesses, the use of a single, trusted accounting language lowers the cost of capital and reduces international reporting costs.

1.4.3 Advantages of Adopting IFRS

- IFRS are widely accepted as a set of high-quality and transparent global standards that are intended to achieve consistency and comparability across the world.

- They have been produced in co-operation with other internationally renowned standard setters, with the aspiration of achieving consensus and global convergence.

- Companies that use IFRS and have their financial statements audited in accordance with International Standards on Auditing (ISA) will have an enhanced status and reputation. (i.e., improved credit rating)

- The International Organisation of Securities Commissions (IOSCO) recognise IFRS for listing purposes – thus companies that use IFRS need produce only one set of financial statements for any securities listing for countries that are members of IOSCO. This makes it easier and cheaper to raise finance in international markets.

- Companies that own foreign subsidiaries will find the process of consolidation simplified if all their subsidiaries use IFRS. They will also be able to transfer their accounting staff between group companies in different countries, without the need for them to deal with a new set of standards.

- Companies that use IFRS will find their results are more easily compared with those of other companies that use IFRS. This should obviate the need for any reconciliation from local GAAP to IFRS when analysts assess comparative performances.

Check Understanding

Topic 1.4: Roles of the Regulatory System

Learning Outcome (ACCA Study Guide Area A)

A4a: Understand the role of the regulatory system including the roles of the IFRS Foundation (IFRSF), the International Accounting Standards Board (IASB®), the IFRS Advisory Council (IFRS AC) and the IFRS Interpretations Committee (IFRIC®).

A4b: Understand the role of International Financial Reporting Standards.

Question 1

Which of the following statements is/are true?

1. The IFRS Interpretations Committee is a forum for the IASB to consult with the outside world.
2. The IFRS Foundation produces IFRSs. The IFRS Foundation is overseen by the IASB.
3. One of the objectives of the IFRS Foundation is to bring about convergence of national accounting standards and IFRSs.

A. 1 and 3
B. 2 only
C. 2 and 3
D. 3 only

Question 2

What is the role of the IASB?

A. Oversee the standard setting and regulatory process.
B. Develop international financial reporting standards.
C. Review defective accounts.
D. Control the accountancy profession.

Question 3

Who issues International Financial Reporting Standards?

A. The IFRS Advisory Committee
B. The stock exchange
C. The International Accounting Standards Board
D. The government

Question 4

The IFRS Advisory Council funds the International Financial Reporting Interpretations Committee (IFRIC).

A. True
B. False

1.5 Duties and Responsibilities of Directors and Other Parties

Learning Outcome (ACCA Study Guide Area A)

A5a: Explain what is meant by governance specifically in the context of the preparation of financial statements.

A5b: Describe the duties and responsibilities of directors and other parties covering the preparation of the financial statements.

1.5.1 What is governance?

Corporate governance is the system by which companies are directed and controlled.

There is a need for good corporate governance because the owners of a company are not always the same as those parties who control the resources and assets of the owners. Hence, the board of directors of a company, who are usually the top management, are **charged with governance** of that company.

1.5.2 Duties and Responsibilities of Directors and other parties

Directors are responsible for the preparation of various documents and reports, specifically, they are responsible for:

(a) The **preparation of the financial statements** of the company in accordance with the applicable financial reporting framework
(b) Ensuring that the company has an **effective internal control system** in place to prevent and detect fraud and error in order to produce financial statements that are free from material misstatements

Check Understanding

Topic 1.5: Duties and Responsibilities of Directors and Other Parties

Learning Outcome (ACCA Study Guide Area A)

A5a: Explain what is meant by governance specifically in the context of the preparation of financial statements.

A5b: Describe the duties and responsibilities of directors and other parties covering the preparation of the financial statements.

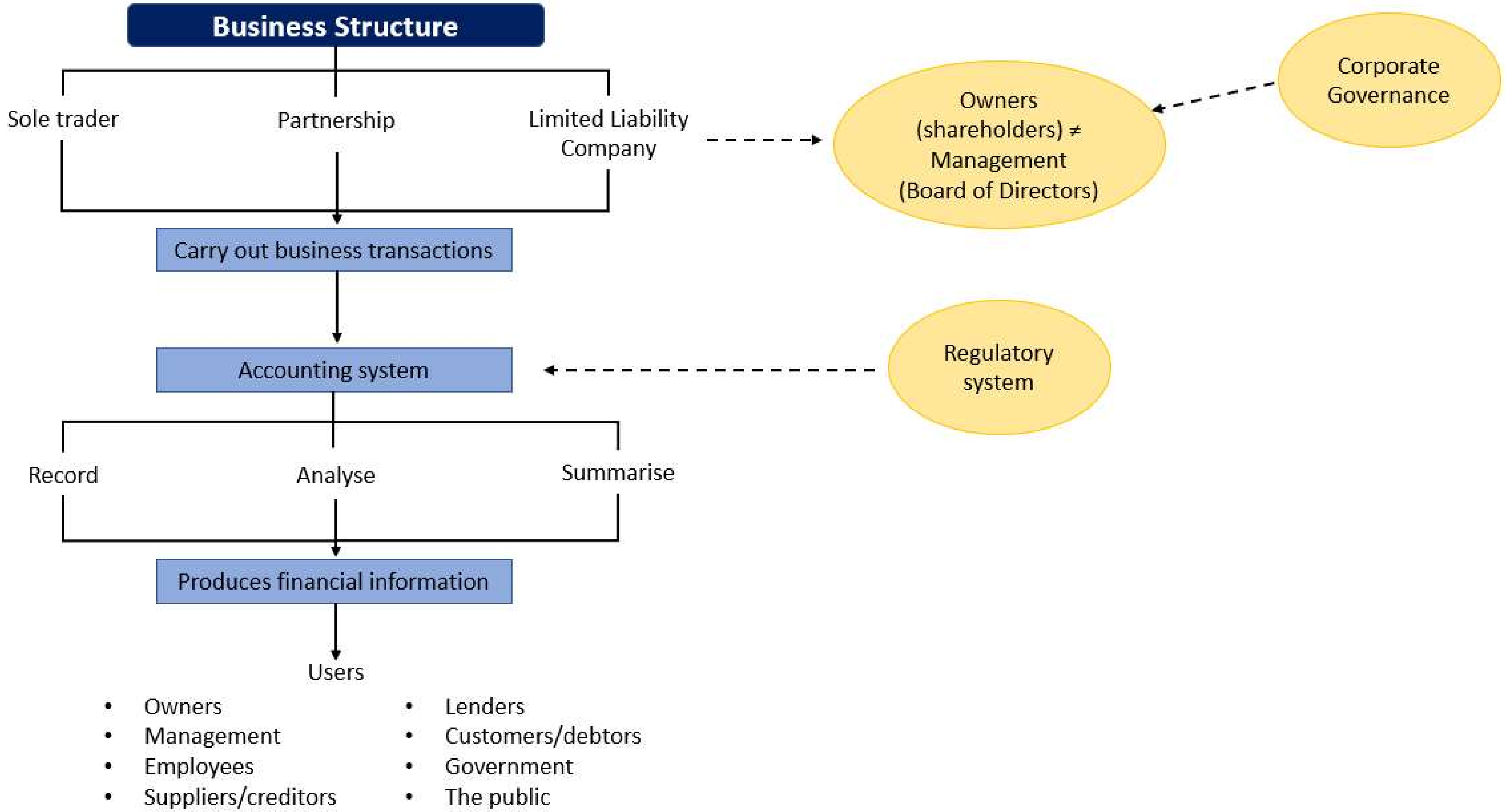
Question 1

Directors' responsibilities are unlikely to include:

A. A fiduciary duty
B. A duty of care
C. A duty to keep proper accounting records
D. A duty to propose high dividends for shareholders

1.6 Chapter 1 Summary

Diagram 1.6: Summary of context and purpose of financial reporting



1.7 Chapter 1 Check Understanding: Answer

Topic 1.1: Financial Reporting

Answer:

1. D

Topic 1.2: Types of Business Entity

Answer:

1. A, B

Topic 1.3: Information Needs by Different Users

Answer:

1. A

Topic 1.4: Roles of the Regulatory System

Answer:

1. D
2. B
3. C
4. B

Topic 1.5: Duties and Responsibilities of Directors and Other Parties

Answer:

1. D