Accounting (Basics) - Lecture 1

Concepts and principles

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Objective of financial statements of SME

- The **objective of financial statements** of SME is to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. Financial statements also show the results of the stewardship of management, that is, the accountability of management for the resources entrusted to it.

Qualitative characteristics of info in financial statements

- **Understandability** – the information provided in financial statements should be presented in a way that makes it comprehensible by users who have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.
- **Relevance** – the information provided in financial statements must be relevant to the decision-making needs of users. Information has the quality of relevance when it is capable of influencing the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.
- **Materiality** – information is material - and therefore has relevance - if its omission or misstatement could influence the economic decisions of users made on the basis of the financial statements.

Qualitative characteristics of info in financial statements

- **Reliability** – the information provided in financial statements must be reliable, that is, it should be free from material error and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent.
- **Substance over form** – transactions and other events and conditions should be accounted for and presented in accordance with their substance and not merely their legal form. This enhances the reliability of financial statements.
- **Prudence** – it is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.

Qualitative characteristics of info in financial statements

- **Completeness** – to be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.
- **Comparability** – users must be able to compare the financial statements of an entity through time to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities to evaluate their relative financial position, performance and cash flows.
- **Timeliness** – providing the information within the decision time frame. If there is undue delay in the reporting of information it may lose its relevance.
- **Balance between benefit and cost** – the benefits derived from information should exceed the cost of providing it.

Financial position

- **The financial position of an entity is the relationship of its assets, liabilities and equity as of a specific date as presented in the statement of financial position**. These are defined as follows:
  a) **Asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
  b) **Liability** is a present obligation of the entity arising from past events, settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
  c) **Equity** is the residual interest in the assets of the entity after deducting all its liabilities.
- The expectation that future economic benefits will flow to or from an entity must be sufficiently certain to meet the probability criterion before an asset or liability is recognized.

Financial position

- IFRS for SMEs **guidance for assets** to be recognized as assets:
  a) The future economic benefit of an asset is its potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. Those cash flows may come from using the asset or from disposing of it.
  b) Many assets, for example property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset. Some assets are intangible.
  c) In determining the existence of an asset, the right of ownership is not essential. Thus, for example, property held on a lease is an asset if the entity controls the benefits that are expected to flow from the property.

Financial position

- IFRS for SMEs **guidance for liabilities** to be recognized as liabilities:
    a) An essential characteristic of a liability is that the entity has a present obligation to act or perform in a particular way. The obligation may be either a legal obligation or a constructive obligation:
        i. A legal obligation is legally enforceable as a consequence of a binding contract or statutory requirement.
        ii. A constructive obligation is an obligation that derives from an entity's actions when by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept particular responsibilities, and, as a result, the entity has created a valid expectation on the part of those other parties that it will discharge (fulfill) those responsibilities.

Financial position

b) The settlement of a present obligation usually involves the payment of cash, transfer of other assets, provision of services, the replacement of that obligation with another obligation, or conversion of the obligation to equity. An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

- IFRS for SMEs **guidance for equity** to be recognized as equity:
  a) Equity is the residual of recognized assets minus recognized liabilities.
  b) It may be subclassified in the statement of financial position. For example, in a corporate entity, subclassifications may include funds contributed by shareholders, retained earnings and gains or losses recognized directly in equity.

Performance

- **Performance is the relationship of the income and expenses of an entity during a reporting period**. IFRS for SMEs permits entities to present performance in a single financial statement (a statement of comprehensive income) or in two financial statements (an income statement and a statement of comprehensive income).
- Total comprehensive income and profit or loss are frequently used as measures of performance or as the basis for other measures, such as return on investment or earnings per share.
- IFRS for SMEs defines **income and expenses** as follows:
  a) **Income** is increases in economic benefits during the reporting 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 investors. The definition of income encompasses both revenue and gains:

Performance

i. **Revenue** is income that arises in the course of the ordinary activities of an entity and is referred to by a variety of names including sales, fees, interest, dividends, royalties and rent.

ii. **Gains** are other items that meet the definition of income but are not revenue. When gains are recognized in the statement of comprehensive income, they are usually displayed separately because knowledge of them is useful for making economic decisions.

b) **Expenses** are decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity investors. The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity.

Performance

i. **Expenses** that arise in the course of the ordinary activities of the entity include, for example, cost of sales, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, or property, plant and equipment.

ii. **Losses** are other items that meet the definition of expenses and may arise in the course of the ordinary activities of the entity. When losses are recognized in the statement of comprehensive income, they are usually presented separately because knowledge of them is useful for making economic decisions.

Recognition and measurement of assets, liabilities, income and expenses. Accrual basis

- **Recognition is the process of incorporating in the financial statements an item that meets the definition of an asset, liability, income or expense and satisfies the following criteria**:
    a) it is **probable** that any future economic benefit associated with the item will flow to or from the entity
    b) the item has a cost or value that can be **measured reliably**
- **Measurement is the process of determining the monetary amounts at which an entity measures assets, liabilities, income and expenses in its financial statements**. Measurement involves the selection of a basis of measurement. Two common measurement bases are:
    a) **Historical cost**:

Recognition and measurement of assets, liabilities, income and expenses. Accrual basis

i. for assets - it is the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire the asset at the time of its acquisition.
ii. for liabilities - it is the amount of proceeds of cash or cash equivalents received or the fair value of non-cash assets received in exchange for the obligation at the time the obligation is incurred, or in some circumstances (for example, income tax) the amounts of cash or cash equivalents expected to be paid to settle the liability in the normal course of business.

Amortized historical cost is the historical cost of an asset or liability plus or minus that portion of its historical cost previously recognized as expense or income.

Recognition and measurement of assets, liabilities, income and expenses. Accrual basis

b) **Fair value** – it is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

- An entity shall prepare its financial statements, except for cash flow information, using the **accrual basis of accounting**. On the accrual basis, **items are recognized as assets, liabilities, equity, income or expenses** <u>**when they satisfy the definitions and recognition criteria**</u> **for those items**.

Recognition in financial statements

- An entity shall **recognize an asset in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.** An asset is not recognized when expenditure has been incurred for which it is considered not probable that economic benefits will flow to the entity beyond the current reporting period. Instead such a transaction results in the recognition of an expense in the statement of comprehensive income.
- An entity **shall not recognize a contingent asset as an asset**. However, when the flow of future economic benefits to the entity is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate.
- An entity **shall recognize a liability in the statement of financial position when**:

Recognition in financial statements

a) the entity has an obligation at the end of the reporting period as a result of a past event,
b) it is probable that the entity will be required to transfer resources embodying economic benefits in settlement, and
c) the settlement amount can be measured reliably.

- A **contingent liability** is either **a possible but uncertain obligation** or **a present obligation that is not recognized** because it fails to meet one or both of recognition conditions.
- The **recognition of income results directly from the recognition and measurement of assets and liabilities**. An entity shall recognize income in the statement of comprehensive income when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.

Recognition in financial statements

- The **recognition of expenses results directly from the recognition and measurement of assets and liabilities**. An entity shall recognize expenses in the statement of comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.
- **Total comprehensive income is the arithmetical difference between income and expenses**. It is not a separate element of financial statements, and a separate recognition principle is not needed for it.
- **Profit or loss is the arithmetical difference between income and expenses other than those items of income and expense** that IFRS for SMEs classifies as items of other comprehensive income. It is not a separate element of financial statements, and a separate recognition principle is not needed for it.

Initial and subsequent measurement in financial statements

- At **initial recognition** an entity shall measure assets and liabilities at **historical cost**.
- During **subsequent measurement** it is necessary to distinguish between **financial and non-financial assets and liabilities**. Basic **financial assets and basic financial liabilities** are subsequently measured at **amortized cost less impairment**.
- Most **non-financial assets that an entity initially recognized at historical cost** are subsequently measured on other measurement bases. For example:
  a) An entity measures property, plant and equipment at the lower of depreciated cost and recoverable amount.

Initial and subsequent measurement in financial statements. Offsetting

b) An entity measures inventories at the lower of cost and selling price less costs to complete and sell.

c) An entity recognizes an impairment loss relating to non-financial assets that are in use or held for sale.

- Measurement of assets at those lower amounts is intended to ensure that an asset is not measured at an amount greater than the entity expects to recover from the sale or use of that asset.
- Most liabilities other than financial liabilities are measured at the best estimate of the amount that would be required to settle the obligation at the reporting date.
- An entity shall not offset assets and liabilities, or income and expenses, unless required or permitted by IFRS for SMEs.