UU-ACG-1010-MW
INTERMEDIATE FINANCIAL ACCOUNTING
WEEK 1

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Learning Objectives

1. **Discuss the importance of the conceptual framework for financial reporting and explain the assumptions, implementations principles and constraints underlying the generally accepted accounting principles. Explain who the users of accounting information are and why they need financial reports.**

2. **Apply the accounting cycle steps leading to the preparation of the financial statements.**

Conceptual framework for Financial Reporting and GAAP

Definition: According to FASB (2021) a conceptual framework is a statement of generally accepted theoretical principles, which form the frame of reference for a particular field of enquiry.

A conceptual framework for the development of accounting standards has been defined as:

'a constitution, a coherent system of interrelated objectives and fundamentals which can lead to consistent standards and which prescribe the nature, function and limits of financial accounting and financial statements' (FASB, 2021).

Purpose

It provides a basis for the development of new reporting practices, and the evaluation of existing ones.

Advantages

- ✓ Leads to consistent and standardized accounting practices.
- ✓ The development of standards is less subject to political pressure.
- ✓ A consistent balance sheet driven or income statement driven approach is used.

Disadvantages

- ✓ Not all users' needs can be considered.
- ✓ Different purposes or uses may require different conceptual bases.
- ✓ A conceptual framework may obstruct the development of accounting standards.

Generally accepted accounting practice (GAAP)

- Reeve et al (2011) explain that GAAP does not have any statutory or regulatory authority or definition.

Components

According to Reeve et al (2011) the below are components of GAAP:

1. National accounting: Many countries have their own standard setting bodies, i.e. the Financial Accounting Standards Board (FASB) in the USA and the Accounting Standards Board (ASB) in the UK.
2. National company law: In some countries accounting is regulated by statute law.
3. Stock exchange: Companies quoted on a recognized stock exchange must comply with the requirements of the exchange disclosure requirements.
4. Regional bodies: Regional bodies such as the European Union and Mercosur in Latin America can require implementation of legislation across member states.

<u>The IASB's Framework</u>

According to Ernst & Young (2018), IFRSs are based on the Framework for the Preparation and Presentation of Financial Statements, which addresses the concepts underlying the information, presented in general purpose financial statements.

- ✓ Objective: to facilitate the consistent and logical formulation of IFRSs and provide a basis for the use of judgment in resolving accounting issues.

<u>NB:</u> The Framework is not an International Financial Reporting Standard and therefore does not define standards for any particular measurement or disclosure issue. It does not override any IFRS, but instead forms the conceptual basis for the development of IFRS.

<u>Ernst & Young (2018) discuss the 7 Sections to which the Framework is broken into:</u>

–The objective of financial statements

–Underlying assumptions

–Qualitative characteristics of financial statements

–The elements of financial statements

–Recognition of the elements of financial statements

–Measurement of the elements of financial statements

–Concepts of capital and capital maintenance.

1. **<u>The objective of financial statements</u>:** To provide information about the financial position, performance and changes in financial position of an entity- useful to a wide range of users in making economic decisions.

- ✓ The needs of users will generally be satisfied normally by a balance sheet, income statement and cash flow statement, but additional information may also be beneficial to some users (Ernst & Young 2018)

2. **<u>Assumptions</u>**

- ✓ <u>Accruals basis</u>

The effects of transactions and other events are recognized when they occur, **<u>not</u>** when cash is received or paid, and they are recorded in the accounting records and reported in the financial statements of the period to which they relate.

- ✓ Going concern

The financial statements are normally prepared on the assumption that an entity is **a going concern** and will continue in operation for the foreseeable future (it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed (Ernst & Young 2018).

3. Qualitative characteristics of financial statements

- ✓ *Understandability*: Users must be able to understand financial statements and complex matters should not be excluded if they represent relevant information.
- ✓ *Relevance*: information is relevant when it has the quality of influencing users' economic decisions. The manner of presenting information will enhance the ability to make predictions. The relevance of information id affected by its **nature and materiality.**

  Materiality: Information is material when its omission or misstatement could influence the economic decisions of users of financial statements.
- ✓ *Reliability*: information has the quality of reliability when it is free from material error and bias and can be depended upon the users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

(Ernst & Young 2018)

Characteristics of reliable information (Ernst & Young 2018):

- Faithful representation
- Substance over form
- Neutrality
- Prudence
- Completeness

- ✓ *Comparability*: Users must be able to compare an entity's financial statements through time to identify trends, and also with other entities' financial statements.

4. The elements of financial statements

- ✓ Asset: A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- ✓ Liability: A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- ✓ Equity: The residual interest in the assets of an entity after deducting all its liabilities:

EQUITY = NET ASSETS = SHARE CAPITAL + RESERVES

- ✓ Income: Increases in economic benefits during the accounting 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 participants.
- ✓ Expenses: Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or increases of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

(Ernst & Young 2018)

NB: IFRS is based on a *balance sheet approach* to recognition, i.e. income and expenses are defined as *changes in assets and liabilities*, rather than the other way round.

Recognition of the elements of financial statements

Recognition is the process of showing an item in the financial statements, with a description in words and a number value.

An item is recognized in the balance sheet or the income statement when:

- ✓ It meets the definition of an element of the financial statements; and
- ✓ It is probable that any future economic benefit associated with the item will flow to or from the entity; and
- ✓ The item has a cost or value that can be measured with reliability.

5. Measurement of the elements of financial statements

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statement (Ernst & Young 2018).

Choices available for measurement:

- Historical cost
- Realisable value
- Current cost
- Present value

6. Concepts of capital and capital maintenance

✓ *True and fair view*: 'fair presentation' in IFRS:

Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework (Ernst & Young 2018).

In order to achieve 'fair presentation' under International GAAP, an entity must comply with: International Financial Reporting Standards which consist of:

- ✓ International Financial Reporting Standards (IFRS)
- ✓ International Accounting Standards (IAS)
- ✓ Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC); and
- ✓ The Framework for the Preparation and Presentation of Financial Statements.

A fair presentation also requires an entity to select and apply appropriate accounting policies, present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information, and provide additional disclosures when compliance with the specific requirements of IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (Ernst & Young 2018).

True and fair override: Non-compliance with IFRSs may lead to a modified auditor's report.

CASES: when management concludes that compliance with a requirement in a Standard/Interpretation would be so misleading that it would conflict with the objective of financial statements set out in the Framework-Rare case

Such departures must be disclosed in full including the reason for the departure and the quantified effect of the departure on the financial statements.

Users of Accounting Information

As Weygant et al (2011) discuss the users are different under each category of accounting:

Information to external parties

- Provides information that would be helpful in attracting capital (investors).

Investors need to know how well their investment is performing and primarily rely on the financial statements published by companies to assess the profitability, valuation and risk of their investment. Investors use accounting information to determine whether an investment is a good fit for their portfolio and whether they should hold, increase or decrease their investment.

- Providers of Financing

Lenders use accounting information of borrowers to assess their credit worthiness, i.e. their ability to pay back any loan. They then offer loans and other credit facilities on terms that are based on the assessment of financial health of borrowers.

Good financial health is indicated by the borrower's ability to pay its liabilities on time, high profitability, substantial securable assets and liquidity.

Poor liquidity, low profitability, lack of assets that can be secured and an inability to pay liabilities on time demonstrate poor financial health of borrowers.

- Suppliers

Just like lenders, suppliers need accounting information to assess the credit-worthiness of its customers before offering goods and services on credit.

Some suppliers only have a handful of customers. These customers could be very large businesses themselves. Suppliers need accounting information of its key customers to assess whether their business is in good health which is necessary for sustainable business growth.

- Customers

Industrial consumers need accounting information about its suppliers in order to assess whether they have the required resources that are necessary for a steady supply of goods or services in the future. Continuity in supply of quality inputs is essential for any business.

- Employees

Employees are interested in knowing how well a company is performing since this has direct implications for their job security and income.

Many employees review accounting information in the annual report just to get a better understanding of the company's business.

In recent years, the increase in number of shares and share options schemes for employees particularly in startups has fostered a greater level of interest in accounting information by employees.

Moreover, potential employees are also interested to learn about the financial health of the organization they aspire to join in the future.

- Tax authorities and government

Tax authorities determine whether a business declared the correct amount of tax in its tax returns. Occasionally, tax authorities conduct audits of the tax returns filed by businesses in order to verify the information with the underlying accounting records.
Tax authorities also cross reference accounting information of suppliers and consumers in order to identify potential tax evaders.
The Government ensures that a company's disclosure of accounting information is in accordance with the regulations that are in place to protect the interest of various stakeholders who rely on such information in forming their decisions.
It also defines and monitors accounting thresholds such as sales revenue and net profit to determine the size of each business for the purpose of ensuring that it complies with the relevant employee, consumer and safety regulations.

Information to internal parties

- Information for Financial Performance and Risks

Shareholders need to assess how well their business is performing.

Financial statements provide information to owners about the profitability of the overall business as well as individual products and geographic segments.

Shareholders are also interested in knowing how risky their business is.

Accounting information helps them in assessing the level of stability in business over the years and to what extent have changes in economic factors affected the bottom line of the business.

- Internal investment decisions

Such information helps shareholders decide if they should invest any further in the business or if they should use their financial resources elsewhere in more promising business ventures.

- Management strategic decisions

Managers need accounting information to plan, monitor and make business decisions, and allocate the financial, human and capital resources towards competing needs of the business through the budgeting process.

Preparing and monitoring budgets effectively requires reliable accounting data relating to the various activities, processes, products, services, segments and departments of the business.

Management requires accounting information also to monitor the performance of business by comparison against past performance, competitor analysis, key performance indicators and industry benchmarks, and thus rely on accounting data to form their business decisions such as investment, financing and pricing decisions.

In case of investment decisions for example, managers would require the return on investment calculation of a proposed project supported by reliable estimates of the costs and revenues.

(Weygant et al 2011)

The Benefits of Financial Reporting

1. Real-Time Analyses

As Weygant et al (2011) discuss, with current and historical as well as performance data available, financial analysis can help generate forecasts, reports, and data models to make informed, strategic decisions quickly and not hastily. With real-time visibility and analysis, companies can stay ahead of the competition and take advantage of opportunities for growth and investment that might otherwise pass them by.

2. Better Debt Management

Managing debts effectively is a priority for any business that wants to survive and progress in the long term. Transparency into debt-related data immensely improves the ability to manage it, and it's not just corporations looking to take advantage of the power of financial reporting and analysis. The United Nations, for example, has invested heavily in optimizing its data management and enhancing its analytics toolkit in recent years as a hedge against a growing global debt crisis.

Accurately tracking and analyzing the ratio between current assets and current liabilities, as well as the financial processes related to generating revenue and satisfying short term obligations (i.e., accounts receivable and accounts payable), makes it easier to maintain short-term liquidity, plan long-term debt management, and adjust workflows and processes to ensure you're getting the best possible return on every dollar when paying down debts.
(Reeve et al 2011)

3. Optimizing Financial Performance and Compliance

According to Meigs et al (1996), the insights from analyzing financial data have immediate value for strategic planning and decision-making. But those insights also generate long-term value by helping identify opportunities to refine processes, boosting efficiency, accuracy, and speed over time.
Even more importantly, complete and accurate financial data helps ensure complete and accurate financial statements that are fully compliant with all income tax law and financial reporting standards such as GAAP and IFRS, along with investor protection laws such as Sarbanes-Oxley and more recent data security standards such as the general data protection regulation (GDPR).

Meeting tax obligations is easier, too. Accurate and complete financial accounting and reports simplify the tax process and also take much of the pain out of the auditing and valuation processes by providing step-by-step, transparent data trails.

4. Cash Flow Management

An estimated 82% of all small businesses fail due to cash flow problems. But businesses of all sizes are susceptible to cash flow challenges and unexpected market disruptions.

By carefully reviewing KPIs, a company can analyze revenue streams and liabilities to identify current and future cash flow, create strategies to insulate against unpleasant surprises, and make sure it has the capital on hand to take advantage of opportunities when they arise (Meigs et al 1996).

5. Reducing Risk Exposure

Mitigating risk is as important to a company's financial health as process optimization and data quality, if not more so.

Financial analysis can help reduce risk in several important ways (Weygant et al 2011):

- Identifying and correcting delays, inefficiencies, and errors in your financial processes before they become crises. Over time, and with the use of artificial intelligence and process automation, iterative improvements can refine processes to improve performance and accuracy even further.
- Using predictive analytics to anticipate changes in market conditions, supply chain disruptions, etc. and develop contingencies accordingly.
- Leverage data-driven insights to make more strategically sound business decisions, investments, and business process management initiatives organization-wide.
- Mitigating the risk of financial fraud by improving data security and spend management.

Some of the most important KPIs to track when a company is looking to mitigate risk include, but are not limited to:

- ✓ Cash Conversion Cycle Time
- ✓ Return on Assets
- ✓ Return on Equity
- ✓ Operating Expenses Ratio
- ✓ Gross Profit Margin
- ✓ Net Profit Margin
- ✓ Working Capital

(Weygant et al 2011)

7. Improving Supplier Relationship Management

Reeve et al (2011) explain that paying obligations on time (or even early) is a good way to become suppliers' favorite customer. But paying early to capture vendor discounts isn't always the right choice for your cash flow management; sometimes, it might be smarter to pay as close to the due date as possible to preserve liquidity, or even request delayed payment if you have a strong relationship with your supplier.

The more accurate and timely data a company has at its disposal, the more effectively it can focus on building strong supplier relationships, add resiliency to supply chain, and identify opportunities to partner with key suppliers to develop new products, improve sustainable sourcing, or leverage economies of scale—all of which can give a significant boost to a company's competitive performance and financial health over time.

The Accounting cycle

Accounting Cycle Steps

Reeve et al (2011) explain how we start to build financial statements from raw data or events to Financial Statements, and closing of financial years, as well as opening a new one:

1. Identifying and Analyzing Business Transactions

The accounting process starts with identifying and analyzing business transactions and events. Not all transactions and events are entered into the accounting system. Only those that pertain to the business entity are included in the process.

For example, a personal loan made by the owner that does not have anything to do with the business entity is not accounted for.

The transactions identified are then analyzed to determine the accounts affected and the amounts to be recorded.

The first step includes the preparation of business documents, or source documents. A business document serves as basis for recording a transaction (Reeve et al 2011).

2. Recording in the Journals

A journal is a book – paper or electronic – in which transactions are recorded. Business transactions are recorded using the double-entry bookkeeping system. They are recorded in journal entries containing at least two accounts (one debited and one credited).

To simplify the recording process, special journals are often used for transactions that recur frequently such as sales, purchases, cash receipts, and cash disbursements. A general journal is used to record those that cannot be entered in the special books. Transactions are recorded in chronological order and as they occur. Journals are also known as Books of Original Entry (Reeve et al 2011).

3. Posting to the Ledger

Also known as Books of Final Entry, the ledger is a collection of accounts that shows the changes made to each account as a result of past transactions, and their current balances.

After the posting all transactions to the ledger, the balances of each account can now be determined.

For example, all journal entry debits and credits made to Cash would be transferred into the Cash account in the ledger. We will be able to calculate the increases and decreases in cash; thus, the ending balance of Cash can be determined (Reeve et al 2011).

4. Unadjusted Trial Balance

A trial balance is prepared to test the equality of the debits and credits. All account balances are extracted from the ledger and arranged in one report. Afterwards, all debit balances are added. All credit balances are also added. Total debits should be equal to total credits.

When errors are discovered, correcting entries are made to rectify them or reverse their effect. Take note however that the purpose of a trial balance is only test the equality of total debits and total credits and not to determine the correctness of accounting records.

Some errors could exist even if debits are equal to credits, such as double posting or failure to record a transaction (Reeve et al 2011).

5. Adjusting Entries

Adjusting entries are prepared as an application of the accrual basis of accounting. At the end of the accounting period, some expenses may have been incurred but not yet recorded in the journals. Some income may have been earned but not recorded in the books.

Adjusting entries are prepared to update the accounts before they are summarized in the financial statements.

Adjusting entries are made for accrual of income, accrual of expenses, deferrals (income method or liability method), prepayments (asset method or expense method), depreciation, and allowances (Reeve et al 2011).

6. Adjusted Trial Balance

An adjusted trial balance may be prepared after adjusting entries are made and before the financial statements are prepared. This is to test if the debits are equal to credits after adjusting entries are made (Reeve et al 2011).

7. Financial Statements

When the accounts are already up-to-date and equality between the debits and credits have been tested, the financial statements can now be prepared. The financial statements are the end-products of an accounting system.

A complete set of financial statements is made up of: (1) Statement of Comprehensive Income (Income Statement and Other Comprehensive Income), (2) Statement of Changes in Equity, (3) Statement of Financial Position or Balance Sheet, (4) Statement of Cash Flows, and (5) Notes to Financial Statements (Reeve et al 2011).

8. Closing Entries

Temporary or nominal accounts, i.e. income statement accounts, are closed to prepare the system for the next accounting period. Temporary accounts include income, expense, and withdrawal accounts. These items are measured periodically.

The accounts are closed to a summary account (usually, Income Summary) and then closed further to the appropriate capital account. It should be noted that closing entries are made only for temporary accounts. Real or permanent accounts, i.e. balance sheet accounts, are not closed (Reeve et al 2011).

9. Post-Closing Trial Balance

In the accounting cycle, the last step is to prepare a post-closing trial balance. It is prepared to test the equality of debits and credits after closing entries are made. Since temporary accounts are already closed at this point, the post-closing trial balance contains real accounts only (Reeve et al 2011).

10. Reversing Entries: Optional step at the beginning of the new accounting period

Reversing entries are optional. They are prepared at the beginning of the new accounting period to facilitate a smoother and more consistent recording process.

In this step, the adjusting entries made for accrual of income, accrual of expenses, deferrals under the income method, and prepayments under the expense method are simply reversed (Reeve et al 2011).

Conclusion

We introduced this module with the most important subject: The Conceptual Framework. This is where it all starts in Accounting, and forms the basis for fair presentation as well as uniformity.

In addition, we discussed the Accounting Cycle process from its very start to the point that we have Financial Reports for users, who are able to see the raw information transformed into useful and insightful reports.

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