

# Essential Building Blocks to Accounting Competency

INTRODUCTION TO ACCOUNTING

# Accounting



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## General Purpose Financial Reports

# Accounting



Providing information to decision makers is the primary service of financial accounting. Information is presented to users through financial statements prepared in accordance standards and generally accepted accounting principles. These financial statements are also referred to as general purpose statements, which provide most of the common information needs of a broad range of users. General-purpose statements have limitations, but they are still the most cost-effective means to provide financial information about a reporting entity.

- ≡ Primary users of general purpose financial reports
- ≡ Purpose, nature, and limitations
- ≡ Key aspects in the objective of general purpose financial reports
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## Primary users of general purpose financial reports

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General purpose financial reports are prepared for primary users of information.

*(Paragraph 1.6, IFRS Conceptual Framework for Financial Reporting, 2018)*

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Primary users are those who provide resources to the reporting entity. They rely on general purpose financial reports for much of the financial information they need.



The objective of general purpose financial reporting refers to important concepts like users, their information needs, the usefulness of information and decisions to make.


## Others not primary users

The management of a reporting entity is also interested in financial information about the entity, but it has access to internal reports and therefore relies less on general purpose financial reports than primary users do.

Other parties like regulators, labor unions, industry groups, and the public may also find general purpose financial reports useful. However, they are not the primary users for which general purpose reports are intended.

# Purpose, nature, and limitations

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“ 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 relating to providing resources to the entity.

*(Paragraph 1.2, IASB Conceptual Framework for Financial Reporting 2018)*

## Nature

General purpose reporting is broader in scope than financial statements. Most, but not all, of the common information needs of most investors, lenders, and other creditors can be covered by general purpose financial reports. It is the most practical and convenient alternative to preparing different sets of reports for diverse groups of users who may have separate needs for information.



Some parties speculate that general purpose financial reporting can become obsolete with technology, which has the capability to process and summarize information in different formats to suit specific information needs, quickly and in real time. However, it will still be certainly expensive for users to assemble their own custom-made reports.

They also need to possess or learn broader skills in and understanding of accounting than they may have. That may not be a reasonable expectation for a broad number of users. Many will find difficulty repurposing those reports. General purpose financial reporting is still the most efficient and cost-effective way to provide information to a variety of users.

## Limitations of general purpose reports

### Does not have all information

General purpose financial reports do not and cannot provide all the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks. *(Par. 1.6, IASB Conceptual Framework for Financial Reporting, 2018)*



### Does not show value of reporting entity

General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity. *(Par. 1.7, IASB Conceptual Framework for Financial Reporting, 2018)*



## Use of judgment and models

Information in financial reports are often based on estimates, judgments, and models rather than exact depictions. Full accuracy and precision in reported information are very seldom possible. The Conceptual Framework establishes the concepts that underlie those estimates, judgments, and models. Judgments should be based on reasonable, logical, and credible assumptions



## Key aspects in the objective of general purpose financial reports

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The objective focuses on information about resources, the claims to those resources, and the decisions to be made based on the information.














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### Primary users of information

There are many parties interested in financial information. The framework identifies primary users as existing or potential investors, lenders and other creditors. Primary users provide capital and make the decisions contemplated in the objective. A primary user could be one individual or a larger group. There can be no enterprise if there are no resources and the information needs of primary users are fundamentally similar. These information requirements determine the relevant contents to be included in general purpose reports. Primary users are outsiders to the enterprise and do not have ready access to information or closeness to the day-to-day operations as a manager or any insider would.

Quit

Click icon for details



**Providing resources**

The production of goods or services requires resources, which are always limited and in many instances even scarce or unavailable. When an investor or lender provides resources, the growth and safety of the resources are important considerations. Growth and safety are results of efficient use and management. Entrusting resources to others involve a stewardship function that assumes a level of trust in the integrity and competence of managers. Efficient use of resources attracts investors, lenders, and other creditors who are motivated by the prospect of profits from and increase in value of, the resources. Acquiring and using resources are the main activities of any enterprise. Providers of capital can evaluate efficiency and responsible stewardship through useful information. Providing this information is the objective of general purpose reporting.

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**Decisions to make**

Decisions involving the commitment of resources usually start with an evaluation of the entity's financial position, performance, and potential cash inflows. Providers of capital decide on the form and methods of investment or credit to extend. These will also depend on certain factors, including expectations about returns, terms and marketability of the financing instruments, and degree of ownership control desired.

Quit

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## Information needs

Investors and creditors are interested in information pertaining to the entity's current financial position and performance, as well as its future prospects. Financial position is an indicator of a company's stability at a certain point in time, and the adequacy of present and future resources to pay debts as they fall due.

Future earnings may be assessed through the company's performance. Both financial position and performance provide information useful in evaluating the reasonableness of expectations about returns, and the amount, timing, and uncertainty of (or the prospects for) future net cash inflows.





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When an enterprise is profitable, resources increase. Resources are depleted if the company is unprofitable. The first to benefit or suffer the consequence of company performance are the investors or owners.

Notice how losses eventually wipe out the investors' claims. Even if lenders' claims are maintained, the portion representing investors increases or decreases, depending on the performance of the enterprise. Income adds to resources and investors claims and vice versa. More losses will eventually wipe out resources and investor claims.

### EFFECT OF INCOME OR LOSS ON RESOURCES AND CLAIMS AGAINST RESOURCES



RESOURCES      LENDERS' CLAIMS      INVESTORS' CLAIMS

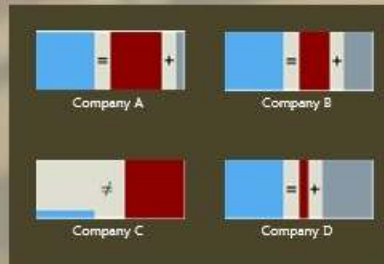
LOSS      ZERO      INCOME

MORE      ZERO      MORE

Quit

Click icon for details

Review the charts below. They depict the relative financial position of four companies. One represents the best and strongest financial position  $\oplus$ , and another represents the worst  $\ominus$ . Drag each chart to the boxes below.



RESOURCE S

CLAIMS BY CREDITORS

CLAIMS BY INVESTORS

1 BEST

2

3

4 WORST

Quit

Click icon for details

Company D has the best financial position. It has the smallest debt allowing investors more control.

Company B's capital structure is balanced between creditors and investors; may not be as good as Company D, but better than Company A.

Company A has more debt than capital. Creditors have more claims over the assets of the enterprise.

Company C has the worst situation. The investors capital has been wiped out and the resources are not enough to pay off creditors

RESOURCE S

CLAIMS BY CREDITORS

CLAIMS BY INVESTORS



Company D



Company B



Company A









Company C

Quit

# Information in general purpose financial reports

Information in general purpose financial reports covers important aspects about resources and claims useful to primary users in making economic decisions about the entity.

**Information in general purpose statements** Quit

 <p>Resources and claims to resources</p>	 <p>Changes in economic resources and claims</p>	 <p>Financial performance based on accrual accounting</p>
 <p>Financial performance reflected by past cash flows</p>	 <p>Changes not resulting from past performance</p>	 <p>Information about use of economic resources</p>

## Key decisions accounting

### Information in general purpose statements



Resources and claims to resources



Changes in economic resources and claims



Financial performance based on accrual accounting



Financial performance reflected by past cash flows



Changes not resulting from past performance



Information about use of economic resources

## Use of resources



### Information about use of economic resources

Proper stewardship and use of resources result in good financial performance. This confirms management's competence and will increase the confidence of capital providers in the future potential of the entity. They will be inclined to provide more resources if necessary. Financial performance provides an indication of how efficiently and effectively management will use the entity's economic resources in future periods. This information is useful in assessing the entity's prospects for future net cash inflows.

Responsible stewardship includes preservation and protection of resources, exploiting opportunities, and compliance with all applicable rules, laws, and regulations.

## Resources and claims



### Resources and claims to resources

Information about the nature and amounts of economic resources and claims is useful in evaluating a company's financial strengths and weaknesses. This information is derived from the firm's assets and liabilities, and gives an indication of the entity's liquidity and solvency, and its ability to raise funds if needed. The stewardship and efficient use of resources also show in the amounts of resources and claims.

The disposition of future cash flows can be identified through the claims against a firm's resources. On the other hand its resources (e.g., accounts receivables and inventories) provide an indication of future cash inflows

The information about resources and claims to resources is critical in an investor's, lender's or other creditor's confidence in deciding to provide resources to an entity.

## Changes in resources and claims



### Changes in economic resources and claims

During an accounting period resources and claims to resources will change because of an entity's financial performance and other events or transactions such as additional debt or the sale of long term assets. Users need to identify and distinguish these two types of changes.

Financial performance reflects management's stewardship of resources and how these were utilized to return profits and other benefits. The components of such returns are also important indicators of an entity's operation and future potential.

Changes resulting from investing and financing decisions indicate prudence and financial management competence, as well as a measure of capital providers' confidence.

## Accrual



### Financial performance based on accrual accounting

Accrual accounting reports income and expenses once earned or incurred, respectively, even if cash has neither been collected nor paid. Accrual accounting creates receivables and payables, and provides a better basis for assessing the entity's past and future performance. The information considers sources of future cash inflows and outflows.

Changes in resources because of performance are indicators of operational aspects like production efficiency, market viability, product acceptance and consumer satisfaction, and the entity's capacity for generating net cash inflows through its operations. Changes in resources and claims resulting from actions by owners, lenders, and other creditors are not measures of performance.

## Cash flows



### Financial performance reflected by past cash flows

While performance reported by accrual accounting pertains to the entity's ability to generate funds from operations, there are activities that involve the receipt and payment of cash for other purposes. Information about these cash flows informs users how the reporting entity obtains and spends cash aside from its operating activities.

This includes the details of new investments or borrowings, acquisition or disposal of major assets, repayment of debt, cash dividends or other cash to investors, and other factors that may affect the entity's liquidity or solvency. Information about the cash flows from non-operating activities is useful in evaluating an entity's liquidity or solvency.



## Changes not from performance



### Changes not resulting from past performance

The reasons for changes in a reporting entity's economic resources and claims other than financial performance should be clear in the information available to users of information. These may include issuing debt or equity instruments or the disposal of assets.

Information about this type of change is necessary to give users a complete understanding of why the reporting entity's economic resources and claims changed and the implications of those changes for its future financial performance. For example, an entity's ability to continue doing business may already be doubtful if much of its working capital needs are coming from borrowings, and not from income from its regular business.



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## Various definitions of accounting

# Accounting

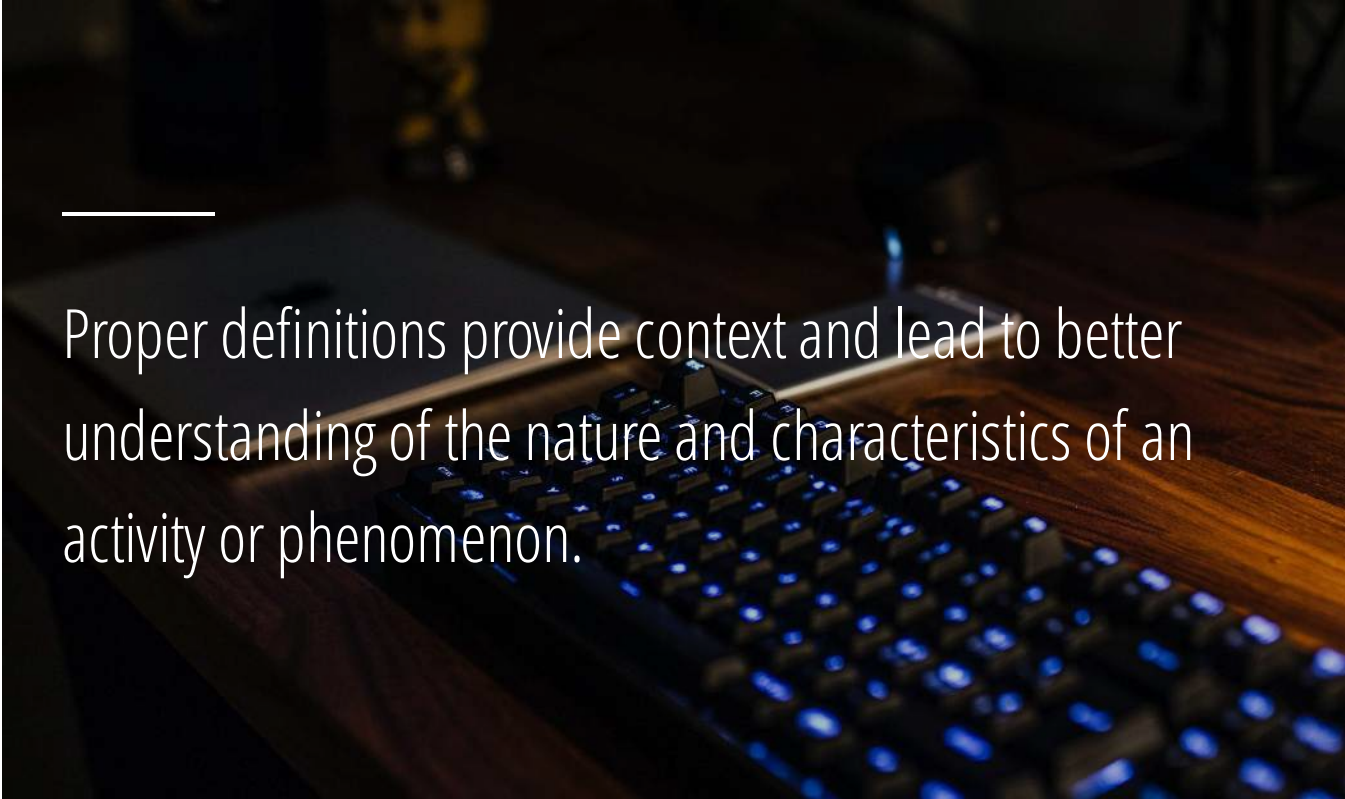


The Introduction to Accounting Course will take you through the basics of accounting--its definition, nature, and activities. At the core of this course is accounting's tenet to be of service, which is the anchor of the development of the profession's standards and practices.

☰ **Various definitions**

## Various definitions

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Proper definitions provide context and lead to better understanding of the nature and characteristics of an activity or phenomenon.

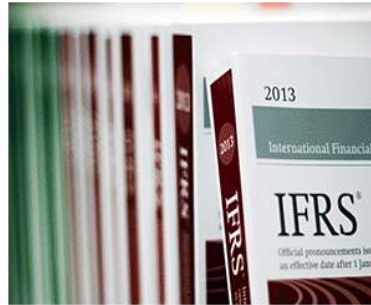
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Proper definition and identification help simplify the understanding of complex relationships and concepts and affect report quality and compliance with standards.

Art of recording



Body of knowledge



System of recording



## Art of recording



"Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof."  
Definition by American Institute of Certified Public Accountants

- One of most universally accepted and enduring definitions
- Emphasis on processes and tasks; accounting as an art

Art of recording



Body of knowledge



System of recording



## Body of knowledge



Accounting is defined as:

"Knowledge of methods for recording transactions, keeping financial records, performing internal audits, reporting and analyzing financial information to the management, and advising on taxation matters; systematic processes of identifying, recording, measuring, classifying, verifying, summarizing, interpreting and communicating financial information."

- Another definition that attempts to enumerate tasks of accounting
- Definition identifies management as only user of accounting
- Users not limited to management; primary users are in fact outsiders to organization, such as investors and creditors.

Art of recording



Body of knowledge



System of recording



## System of recording



The following is another definition:

"Accounting is the systematic and comprehensive recording of financial transactions pertaining to a business. Accounting also refers to the process of summarizing, analyzing and reporting these transactions."

- Stresses certain specific tasks of accounting (recording, summarizing, etc.)
- Lacks depth and perspective

## Accounting as a Service Activity

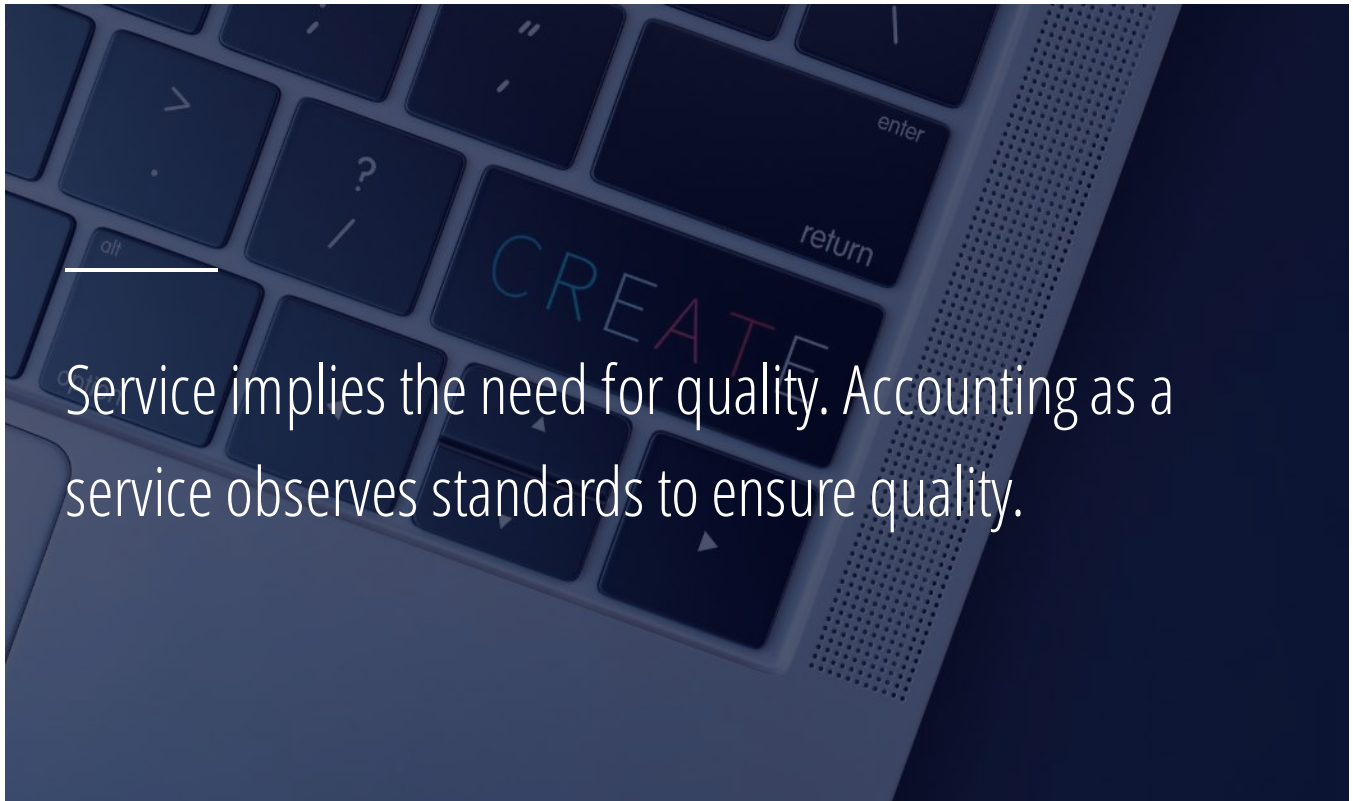
# Accounting



Recognizing accounting as a service activity drives attention away from too much emphasis on the process or the theory. Anybody who has availed of any form of service knows whether service was good or bad. Anybody who provides any form of service anticipates what customer needs and instinctively ensures that the necessary characteristics are present in a product. Even without rules, standards, or precedents the service provider knows to do to ensure quality based on common sense, logic, and feel for the customer's needs. With this perspective, the accountant can instinctively relate to many of accounting's principles and procedures understand the reasons behind them, and in the absence of such principles and procedures, formulate a new one that will achieve the objective of general purpose financial reporting.

## Accounting as a service activity

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Accounting is a service activity, which provides quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions.\*

\*Statement of Accounting Principles Board No 4



Service implies customers who expect quality from the service provider

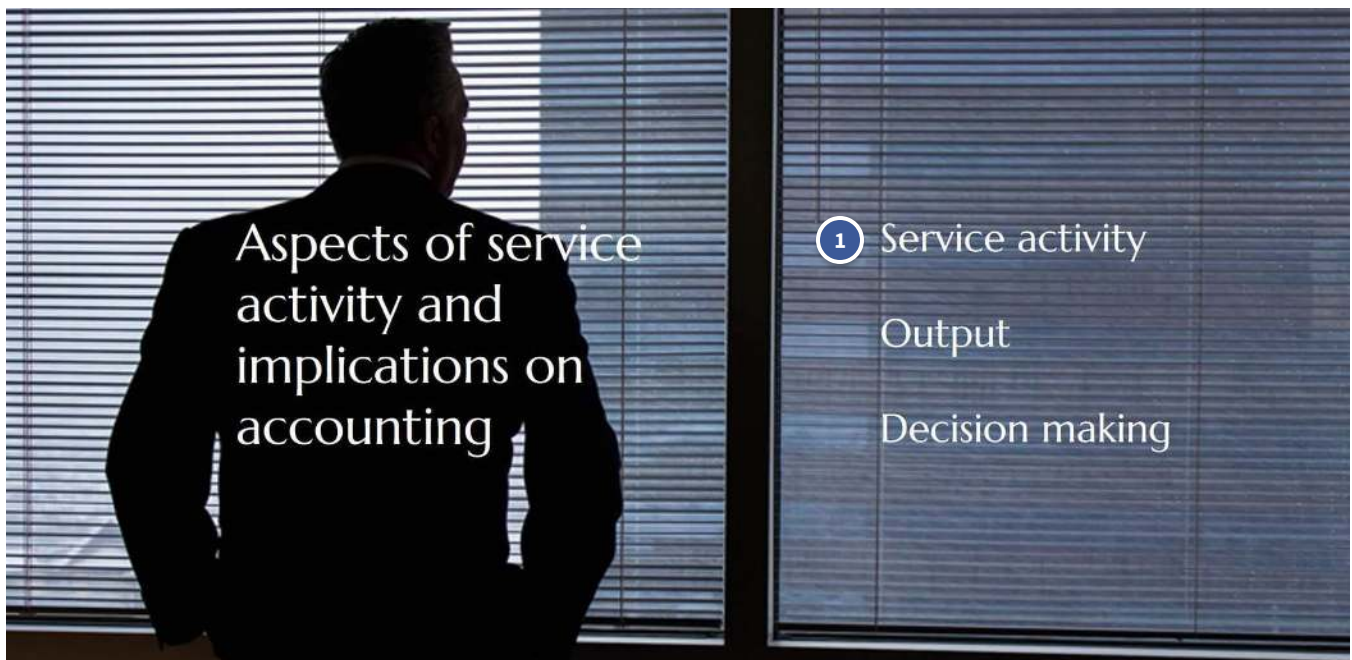
## Service activity

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As a service, accounting provides information to users. The quality of information is important and can be achieved only if certain standards and procedures are observed. The customer will judge quality by the usefulness of the information in making economic decisions. The practice, principles, standards, and processes of accounting are meant to provide the highest standards of quality.

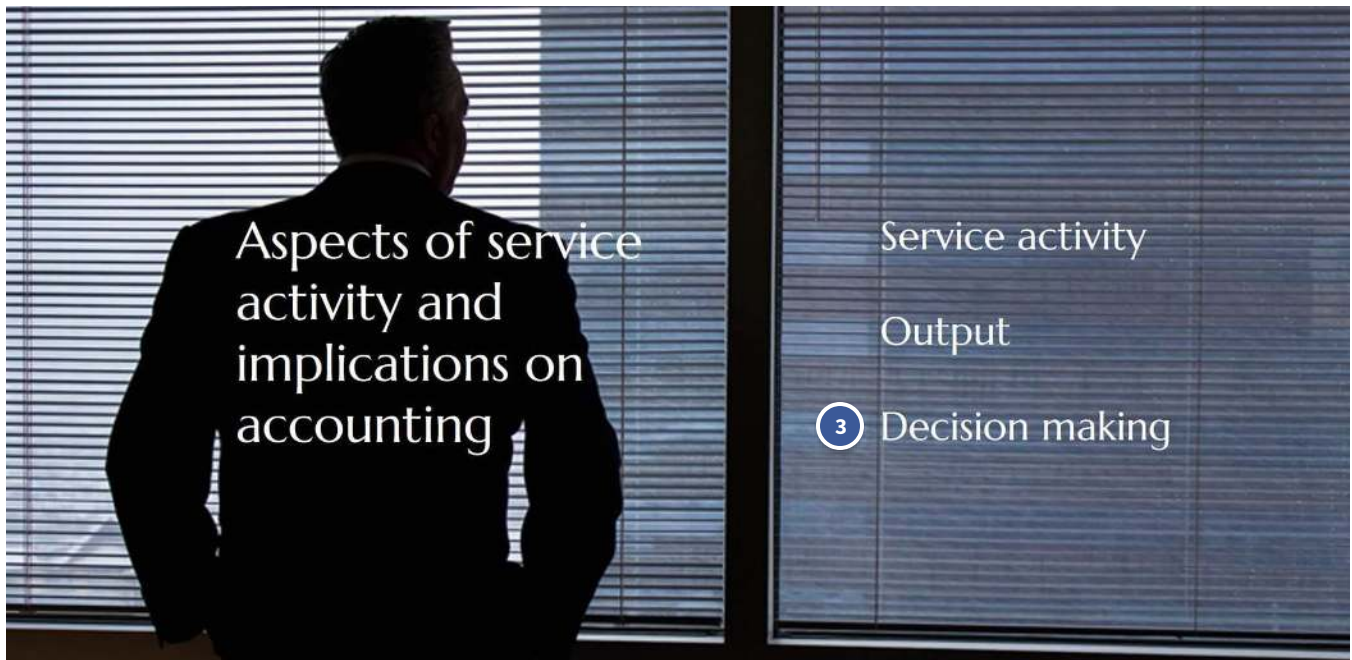
The definition highlights why accounting is done, which is to provide useful information for decision making. The definition contrasts with others in its emphasis on the service and output of accounting, and does not mention processes, which do not change significantly as long as the objective remains the same. Processes and tools can change, but the reason for doing accounting is constant.

Accounting performs a service described often as an intangible. Customers will judge the quality of the service based on certain criteria, not related to physical attributes or appearance. The primary product of accounting is information that will be used by decision makers as a basis for making economic decisions. The usefulness of information determines quality.



Accounting is an intangible activity. It has no physical characteristics that can be seen or felt. This does not mean that quality can not be determined. Accounting relies on its processes, principles, and standards to ensure that the output of this intangible activity will meet the quality expectations of its customers, the users of information. With this in mind, it is not difficult to understand the reasons behind principles, concepts, and processes, and why some are preferable over others. Those that meet the objective of financial statements and result in the most useful information prevail.





Rational decision-making relies on information, more than on pure luck or speculation. Quality information results in good decisions. While quality of information cannot be judged at face value, decision makers judge quality by the decisions they make. From this expectation does the responsibility of accounting arise. From this responsibility arises the need for standards, correct processes, and generally accepted accounting principles. Understanding this perspective explains why accounting is done instead of how it is done.

## Nature and Activities of Accounting

# Accounting



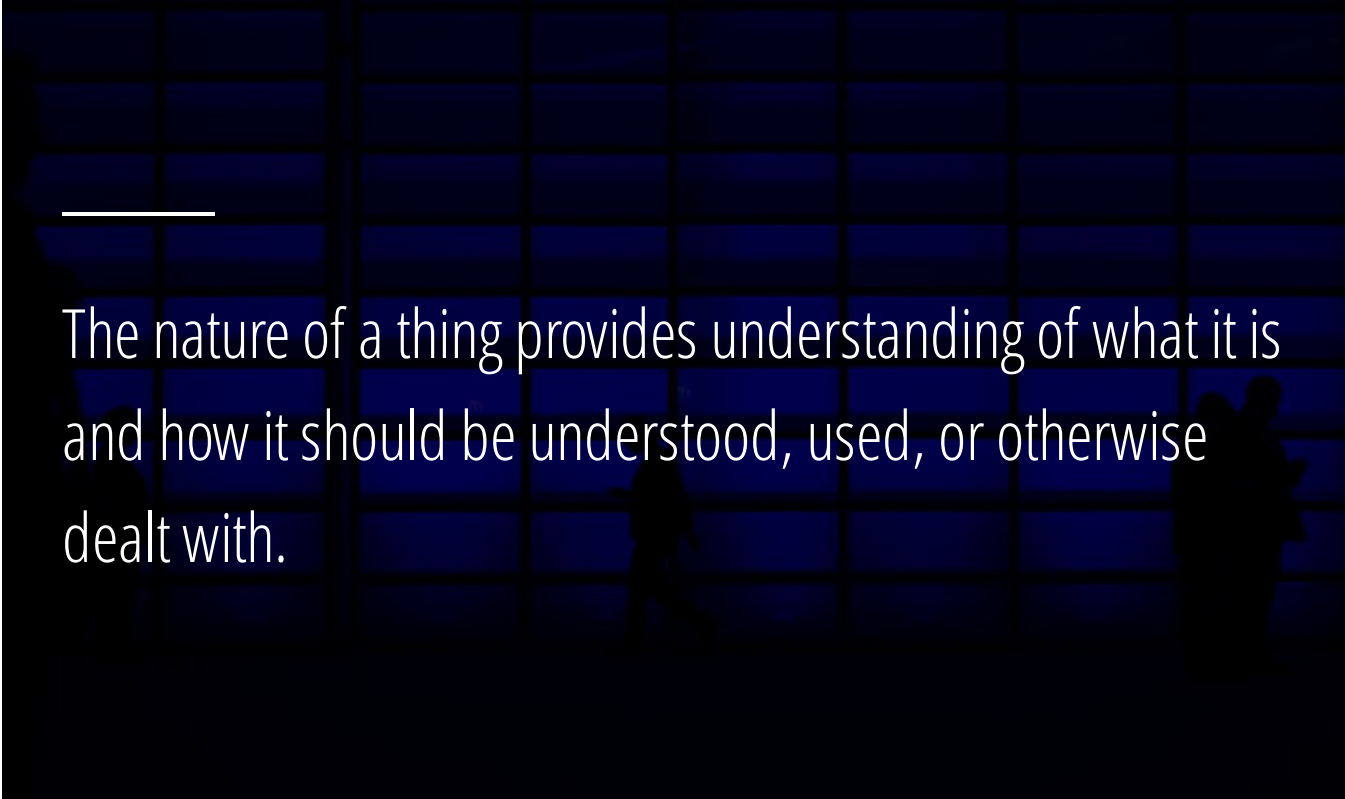
The nature and activities of accounting describe what accounting is and what it does, respectively. They explain the form and content of financial accounting information, and the various functionalities that help decision makers evaluate information to make decisions.

☰ **Nature of accounting**

☰ **Activities of accounting**

## Nature of accounting

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The nature of a thing provides understanding of what it is and how it should be understood, used, or otherwise dealt with.

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Accounting shares similarities with other professions, but also has defining features that distinguish it in some significant respects.

# Nature of accounting

Accounting shares similarities with other professions, but also has defining features that distinguish it. For example, engineering is quantitative in nature, but not financial in character like accounting is.

The natural characteristics discussed below influence how accounting is done and how analysis differs from others. These characteristics set accounting apart from other professions since no other activity shares all characteristics with equal pervasiveness and occurrence.

QUANTITATIVE NATURE

FINANCIAL CHARACTER

ANALYTIC DISCIPLINE

One of the main characteristics of accounting is its quantitative nature. Accounting deals with measurable quantitative economic information. The widespread use of numbers, since the development of Arabic numerals, made computations and calculations easier. These would have been extremely difficult if not impossible to do if information were not expressed in numbers.



QUANTITATIVE NATURE

FINANCIAL CHARACTER

ANALYTIC DISCIPLINE

Accounting information should be in part at least, of a financial nature. This means that information is expressed in terms of money, as a standard measure of value. Money is the most common denominator of value and provides comparison. Almost all economic transactions are expressed in terms of money. Even different monetary currencies can be translated to other currencies at a certain value of exchange at the time of transaction.



QUANTITATIVE NATURE

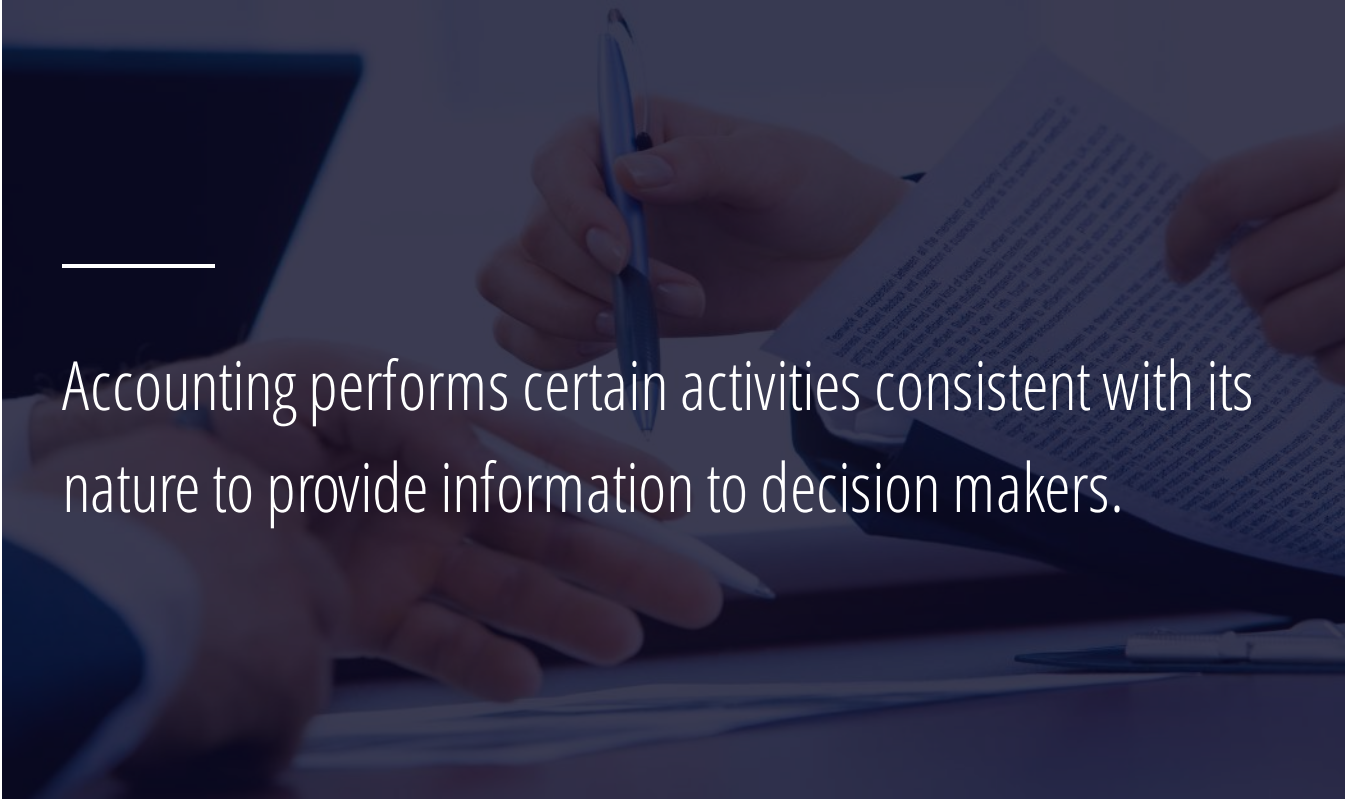
FINANCIAL CHARACTER

ANALYTIC DISCIPLINE

Financial information is routinely reduced to understandable, interrelated, and highly significant items, through an efficient system of measurement, classification, recording, and reporting. The analysis provided, together with other supplementary information, makes financial statements even more informative. This analytic discipline that accounting is known for is characterized by this constant round of information review and decision making, by both preparers and users of information. Decisions made will depend a lot on the quality of that information, and its analysis.

## Activities of accounting

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Accounting performs certain activities consistent with its nature to provide information to decision makers.

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Some activities in accounting are common in other professions, although not in the same extent, detail, and consistency.



INFORMATION SYSTEM

MEASUREMENT ACTIVITY

COMMUNICATION ACTIVITY

The quantitative nature of accounting allows measurement of economic events and their effects. Measurement considers several factors such as amounts paid or collected, current market value, or replacement cost of assets. Measurement is an expression of an item, event, or phenomenon in terms of acceptable values in accordance with certain accounting principles and standards. For example, a piece of land, or a Norman Rockwell painting could be valued differently based on appropriate measurements. Land could have been bought for a small amount but is worth a lot more many years later. Certain works of art are known to have values way beyond what it probably cost the artist to make.

Items may increase in or lose value over time because of certain external factors. It is accounting's responsibility to ensure that all items in the financial statements are stated at their proper values, in accordance with certain principles. Proper valuation is important so that decision makers will be guided in their evaluation of risks, rewards, and opportunities. Measurement in accounting involves the determination of value.



INFORMATION SYSTEM

MEASUREMENT ACTIVITY

COMMUNICATION ACTIVITY

Accounting needs to communicate to its intended audience, the users of information, who expect this to be understandable, useful, timely, relevant, and reliable. Reporting information is one of the most essential functions of accounting. It is not enough that accounting prepares information. It must communicate this properly to avoid misunderstanding, wrong conclusions, and faulty decisions. Accounting communicates through a set of financial statements following prescribed principles, systems, and procedures.



