2 Framework of accounting

this chapter covers...

The focus of this chapter is the users of financial statements, and the framework within which accountants work. The chapter covers:

- the primary users of financial statements, and why they are needed by these users
- the framework of accounting, which comprises accounting principles, accounting policies and characteristics, and ethical principles
- the application of ethical principles when preparing financial statements
USERS OF FINANCIAL STATEMENTS

The main – or primary – users of financial statements include:

- owner(s)/existing and potential investors
- lenders, eg banks
- suppliers
- employees
- customers
- government agencies, eg HM Revenue & Customs, Charity Commission
- the public

The diagram which follows shows in detail the primary users and why the financial statements are needed by these users.

<table>
<thead>
<tr>
<th>User of financial statements</th>
<th>Why the financial statements are needed</th>
</tr>
</thead>
</table>
| Owner(s)/existing and potential investors | • To see how much profit has been made  
• To see how much money can be paid out in drawings/dividends  
• To see the net asset value of the business and whether it has increased or decreased  
• To assess if the business will continue in the foreseeable future |
| Lenders, eg banks | • To see how much profit has been made  
• To check that the business will be able to pay interest on loans and make loan repayments  
• To assess how much of the business is being funded by the lender  
• To see what security is available to cover loans |
| Suppliers | • To decide whether to supply goods and services to the business  
• To assess if the business is able to pay its suppliers |
| Employees | • To assess whether the business is able to pay wages and salaries  
• To consider whether the business will continue to offer employment in the future |
| Customers | • To see if the business will be able to continue supplying its goods and services  
• To assess the ability of the business to provide service in the future, eg spare parts, and to meet warranty liabilities |
| Government agencies eg HM Revenue & Customs, Charity Commission | • To ensure that, if appropriate, the business is registered for VAT  
• To calculate the tax due – either income tax for sole traders and partnerships or corporation tax for limited companies  
• To ensure that the charity is being run correctly |
| The public | • To assess the contribution to the economy  
• To assess employment prospects |
It should be noted, however, that not all users will have access to the financial statements of all types of business. As noted in the previous chapter, the statements of sole traders and partnerships are not generally in the public domain – although a bank lending money to a business will expect to see them. For businesses that file an annual return with Companies House – ie limited liability partnerships and limited companies – information is in the public domain. Likewise, charities file an annual report to the Charity Commission where it is available for public inspection.

WHAT IS MEANT BY THE FRAMEWORK OF ACCOUNTING?

The framework of accounting sets out the conventions that underlie the financial recording and reporting of business accounts. Accounting staff work within this framework in the preparation of financial statements.

The framework consists of three main areas:

- accounting principles
- accounting policies and characteristics
- ethical principles of accounting

These are summarised in the diagram below.

<table>
<thead>
<tr>
<th>FRAMEWORK OF ACCOUNTING</th>
</tr>
</thead>
</table>
| **Accounting principles** | • business entity  
|                         | • materiality  
|                         | • going concern basis  
|                         | • accrual basis  
| **Accounting policies and characteristics** | • application of accounting policies  
|                                             | • fundamental qualitative characteristics  
|                                             | • supporting qualitative characteristics  
| **Ethical principles** | • integrity  
|                        | • objectivity  
|                        | • professional competence and due care  
|                        | • confidentiality  
|                        | • professional behaviour  |
UNDERLYING ASSUMPTIONS OF ACCOUNTING PRINCIPLES

Accounting principles (or concepts) underlie the financial recording and reporting requirements of different types of organisations. Accounting principles help to ensure that the records and statements prepared are relevant and reliable to users, and that they are comparable and understandable. In particular, accounting principles help to ensure that financial records and statements are fit to be used for:

- **internal control** – within the business to ensure that the financial records are accurate and that the financial statements show the true position of the business
- **measuring business performance** – both internally and externally – so that financial reports and statements can be compared
- **obtaining credit/financing** – providing lenders with the current financial position of the business
- **statutory requirements** – providing information for tax and other purposes when required to do so by law

The diagram below illustrates the important accounting principles – we will look in more detail at these principles over the next few pages.
business entity

This refers to the fact that financial statements record and report on the activities of one particular business or organisation. They do not include the assets and liabilities of those who play a part in owning or running the business. Thus the personal assets and liabilities of the owner/owners are kept separate from those of the business: the main links between the business and the personal funds of the owner/owners are capital and drawings.

materiality

Some items in accounts are of such low value that it is not worthwhile recording them separately, i.e. they are not ‘material’. For example, small items, such as donations to charities, the purchase of plants for the office, window cleaning, etc., may be grouped together in a sundry expenses account. Low cost non-current assets, such as a stapler or a waste bin, are treated as an expense rather than capital expenditure.

Materiality depends very much on the size of the business. For example, a large company may consider that the cost of items of less than £1,000 are not material; by contrast, a small business may use a much lower amount, perhaps £100. It is for a business to set a policy as to what amount is material and what is not.

Note that materiality is considered to be part of the fundamental qualitative characteristic of relevance – see next page.

going concern

Going concern presumes that the business to which the financial statements relate will continue to trade in the foreseeable future. The statement of profit or loss and statement of financial position are prepared on the basis that there is no intention to significantly reduce the size of the business or to liquidate the business. Note that, if a business is no longer a going concern, assets will have very different values, and the statement of financial position will be affected considerably. For example, a large, purpose-built factory has considerable value to a going concern business but, if the factory had to be sold, it is likely to have a limited use for other industries, and therefore will have a lower market value. Values based on liquidation amounts are the opposite of the going concern and require extra depreciation to be charged as an expense to the statement of profit or loss to allow for the reduced value of non-current assets. In a similar way, inventory that is to be sold in a clearance sale will be reduced in value.
accruals

This means that income and expenses are matched so that they relate to the same goods or services and the same accounting period. This means that the statement of profit or loss shows the amount of the expense incurred, and the amount of income earned, rather than reflecting payments and receipts when they happened. Examples of the use of accruals in accounting are:

- accruals
- prepayments
- provision for depreciation charges
- allowance for doubtful debts
- cost of inventory

ACCOUNTING POLICIES AND CHARACTERISTICS

Accounting policies are the methods used by a business to show the effect of financial transactions, and to record assets and liabilities in the statement of financial position. For example, a business may choose as its accounting policy to depreciate its office equipment, using the straight-line method, at 25 per cent per year.

In order for financial information to be useful, a business selects its accounting policies to fit in with the two fundamental qualitative accounting characteristics of:

- relevance – financial information that is useful to users of the financial statements (note that for information to be relevant, it must also be material – see the accounting principle of materiality on the previous page)
- faithful representation – financial information must correspond to the effect of transactions or events, and, as far as possible, should be complete, neutral, and free from error

The following four accounting characteristics support relevance and faithful representation:

- comparability – financial statements can be compared with those from previous years and with similar businesses
- verifiability – users of financial statements are assured that the information given is faithfully represented, e.g. inventory valuations
- timeliness – users of financial statements receive information in time to enable decisions to be made
- understandability – financial information is presented clearly and concisely so that users can understand the information given
The characteristics of useful financial information are shown in the following diagram.

**Note:** the fundamental qualitative characteristics and the supporting qualitative characteristics are taken from the International Financial Reporting Standards Framework for Financial Reporting document, which sets out the principles that underlie the preparation and presentation of financial statements.
MATERIAL MISSTATEMENT

We have seen earlier in this chapter who are the primary users of financial statements. The users rely on the accuracy of financial statements to make economic decisions – eg to invest in the business, to lend money to the business, to supply goods and services to the business. It is important that, when preparing financial statements, accounting staff should ensure that such statements are free from ‘material misstatement’.

Material misstatement can be defined as ‘when information contained in the financial statements is untrue - whether accidentally or intentionally – and could influence the economic decisions of users’.

The use of the word ‘material’ means that the amount of the misstatement must be significant in relation to the size of the business. A misstatement of £1,000 in the financial statements of a small sole trader business could well be significant but, for a large limited company, will be less significant and unlikely to affect the decisions of users.

Examples of material misstatement and the economic consequences include:

- profit is overstated – may encourage investors to buy a stake of the business
- assets are overvalued – a lender may find that security for a loan is less than expected
- profit is understated – a lower amount of tax is paid to HM Revenue & Customs than should be paid
- sales turnover is overstated – more VAT is paid to HM Revenue & Customs than should be paid

APPLYING ETHICAL PRINCIPLES WHEN PREPARING FINANCIAL STATEMENTS

When preparing financial statements, accounting staff must ensure that the statements are prepared accurately – without material misstatement – and in the public interest, without bias to any one user – for example, the owner(s). Behaving ethically is key to achieving this and consequently accounting staff should apply ethical principles when preparing financial statements.

The five fundamental ethical principles – as set out in AAT’s Code of Professional Ethics – are:
integrity – being straightforward and honest in all professional and business relationships

objectivity – being aware of conflicts of interest and not allowing the influence of others to bias or override professional judgements

professional competence and due care – maintaining professional knowledge and skill at the level required to ensure that an employer or client receives a competent service

confidentiality – information should not be disclosed to third parties (unless permission has been given or there is a legal right or duty), and should be maintained securely at all times

professional behaviour – ensuring that behaviour complies with relevant laws and regulations and avoids bringing the accountancy profession into disrepute

Examples of the application of ethical principles when preparing financial statements include:

integrity – financial statements should not contain false or misleading figures or statements, or omit or obscure information so as to be misleading

objectivity – the accountant is not influenced by the owner(s) who may want to manipulate the profit figure to suit their needs

professional competence and due care – the accountant is up-to-date with current accounting standards and legal developments and carries out his/her work carefully, thoroughly and on a timely basis

confidentiality – the profit and other information from the financial statements is not discussed with family and friends but only with the client and those work colleagues entitled to know

professional behaviour – the accountant records all aspects of the preparation of financial statements in an honest and truthful way, in compliance with relevant laws and regulations
The primary users of financial statements include:
- owner(s)/existing and potential investors
- lenders
- suppliers
- employees
- customers
- government agencies
- the public

The framework of accounting comprises:
- accounting principles
- accounting policies and characteristics
- ethical principles

The accounting principles (or concepts) of business entity, materiality, going concern and accruals are fundamental to the relevance and reliability of financial records and statements.

The fundamental qualitative characteristics that make financial information useful are:
- relevance
- faithful representation

Supporting qualitative characteristics are:
- comparability
- verifiability
- timeliness
- understandability

Material misstatement is when information contained in the financial statements is untrue – whether accidentally or intentionally – and could influence the economic decisions of users.

The ethical principles to apply when preparing financial statements are:
- integrity
- objectivity
- professional competence and due care
- confidentiality
- professional behaviour
<table>
<thead>
<tr>
<th><strong>Key Terms</strong></th>
<th><strong>Definition</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>business entity principle</strong></td>
<td>financial statements record and report on the activities on one particular business</td>
</tr>
<tr>
<td><strong>materiality principle</strong></td>
<td>items with a low value are not worthwhile recording in the accounts separately</td>
</tr>
<tr>
<td><strong>going concern principle</strong></td>
<td>the presumption that the business to which the financial statements relate will continue to trade in the foreseeable future</td>
</tr>
<tr>
<td><strong>accruals principle</strong></td>
<td>income and expenses are matched so that they relate to the same goods or services and the same accounting period</td>
</tr>
<tr>
<td><strong>relevance</strong></td>
<td>fundamental qualitative accounting characteristic that requires financial information to be useful to users of financial statements</td>
</tr>
<tr>
<td><strong>faithful representation</strong></td>
<td>fundamental qualitative accounting characteristic that requires financial information to correspond to the effect of transactions or events</td>
</tr>
<tr>
<td><strong>comparability</strong></td>
<td>financial statements can be compared with those from previous years and with similar businesses</td>
</tr>
<tr>
<td><strong>verifiability</strong></td>
<td>users of financial statements are assured that the information given is faithfully represented</td>
</tr>
<tr>
<td><strong>timeliness</strong></td>
<td>users of financial statements receive information in time to enable decisions to be made</td>
</tr>
<tr>
<td><strong>understandability</strong></td>
<td>financial information is presented clearly and concisely so that users can understand the information given</td>
</tr>
<tr>
<td>Term</td>
<td>Description</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>material misstatement</td>
<td>information contained in the financial statements is untrue – whether accidentally or intentionally</td>
</tr>
<tr>
<td>integrity</td>
<td>ethical principle of being straightforward and honest in all professional and business relationships</td>
</tr>
<tr>
<td>objectivity</td>
<td>ethical principle of being aware of conflicts of interest</td>
</tr>
<tr>
<td>professional competence and due care</td>
<td>ethical principle of maintaining professional knowledge and skill at the level required to provide a competent service to an employer or client</td>
</tr>
<tr>
<td>confidentiality</td>
<td>ethical principle that information should not be disclosed to third parties (unless permission is given or there is a legal duty), and should be maintained securely</td>
</tr>
<tr>
<td>professional behaviour</td>
<td>ethical principle of ensuring behaviour complies with relevant laws and regulations and does not bring the accountancy profession into disrepute</td>
</tr>
</tbody>
</table>
### Activities

2.1 For the following three primary users of financial statements, identify how they might use the information contained in the statements:

<table>
<thead>
<tr>
<th>User</th>
<th>Use of Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner</td>
<td></td>
</tr>
<tr>
<td>Lender</td>
<td></td>
</tr>
<tr>
<td>Employee</td>
<td></td>
</tr>
</tbody>
</table>

2.2 (a) State the four important accounting principles (concepts).

(b) Explain how accounting principles help to make financial records and statements useful to users in the following contexts:
   - internal control
   - measuring business performance
   - obtaining credit/financing
   - statutory requirements
2.3 Write in the accounting principle (concept) which relates to each of the statements below.

<table>
<thead>
<tr>
<th>Statement</th>
<th>Accounting Principle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Some items are of such low value that it is not worthwhile recording them separately.</td>
<td></td>
</tr>
<tr>
<td>The financial statements record and report on the activities of one particular business.</td>
<td></td>
</tr>
<tr>
<td>Income and expenses are matched so that they relate to the same goods or services and the same accounting period.</td>
<td></td>
</tr>
<tr>
<td>The presumption is that the business to which the financial statements relate will continue to trade in the foreseeable future.</td>
<td></td>
</tr>
</tbody>
</table>

2.4 (a) State the two fundamental qualitative characteristics that make financial information useful.

1

2

(b) Explain what is meant by each of the two fundamental qualitative characteristics.
2.5 There are four supporting qualitative characteristics that make financial information useful. From the following list, which are the four supporting characteristics?

<table>
<thead>
<tr>
<th>(a)</th>
<th>Verifiability</th>
</tr>
</thead>
<tbody>
<tr>
<td>(b)</td>
<td>Materiality</td>
</tr>
<tr>
<td>(c)</td>
<td>Going concern</td>
</tr>
<tr>
<td>(d)</td>
<td>Timeliness</td>
</tr>
<tr>
<td>(e)</td>
<td>Understandability</td>
</tr>
<tr>
<td>(f)</td>
<td>Faithful representation</td>
</tr>
<tr>
<td>(g)</td>
<td>Comparability</td>
</tr>
<tr>
<td>(h)</td>
<td>Relevance</td>
</tr>
</tbody>
</table>

2.6 (a) Explain what is meant by ‘material misstatement’.
(b) Give one example of the economic consequences to users of financial statements of the following material misstatements:

<table>
<thead>
<tr>
<th>Material misstatement</th>
<th>Economic consequence to users</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit is overstated</td>
<td></td>
</tr>
<tr>
<td>Assets are overvalued</td>
<td></td>
</tr>
<tr>
<td>Sales turnover is overstated</td>
<td></td>
</tr>
</tbody>
</table>
2.7  (a) State the five ethical principles to be followed when preparing financial statements.

(b) Identify the ethical principle involved in the following situations:

<table>
<thead>
<tr>
<th>Situation</th>
<th>Relevant ethical principle</th>
</tr>
</thead>
<tbody>
<tr>
<td>The owner of the business argues that expenses should be increased so as to show a lower profit figure.</td>
<td></td>
</tr>
<tr>
<td>The financial statements show a misleading figure for depreciation so as to show a lower profit figure.</td>
<td></td>
</tr>
<tr>
<td>The accounts trainee, who has only recently started in work, is given the financial statements to complete.</td>
<td></td>
</tr>
<tr>
<td>Your friend, who works for the business whose financial statements you have just prepared, wants to know how much profit was made.</td>
<td></td>
</tr>
<tr>
<td>The accountant preparing the financial statements works in an honest and truthful way.</td>
<td></td>
</tr>
</tbody>
</table>