FINANCIAL ACCOUNTING

WEEK 3 (LECTURE THREE)

CONCEPTUAL FRAMEWORK

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Learning Objectives:

Upon completion of this chapter, you will be able to:

Explain Conceptual Framework:

-Explain accounting (concepts) Principles

-Explain Accounting Conventions and

-Appreciate qualitative characteristics of Financial Statements

Conceptual Framework of accounting

Conceptual framework is an integrated system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature of accounting. It permits:

a) Better understanding and appreciation of financial reports and its reporting
b) Development of accounting standards
c) Appreciation and articulation of emerging issues in the field of finance and accounting
d) Comparability among companies in a given sector and industry. There are many ways

to explain a conceptual framework. It can be any or all of the following:

1. A set of coherent ideas or concepts organized in a manner that makes them easy to communicate to others.
2. A set of assumptions, values and definitions under which we all work together.

The framework sets out the concepts that underlie the preparation of financial statements for external users.

The document covers the following:-

1. The objective(s) of financial statements, including details of the relevant user groups, their information needs and the financial statements (and their underlying assumptions) required to meet those needs.
2. The qualitative characteristics that make financial statements of value to users, e.g. relevance, reliability etc.
3. The elements of financial statements and how these elements interact to form a basis on which financial statements could present information in a structured manner, this includes definitions for assets, liabilities and equity interest.
4. The criteria that an item should attain if it is to be recognized and therefore incorporated, in financial statements.

Accounting Concepts and Conventions

In the modern times, accounting is used to meet a variety of needs of the users of accounting information. The accounting information can be useful or be of great acceptance if there are some generally accepted concepts which guide the manner in which assets, liabilities, revenues and expenses alongside capital are measured. Lack of such common agreement among the practitioners or users can make the practice useless or chaotic without a standardized way of preparation of the various financial reports and statements. Accounting concepts are broad, basic assumptions that underlie the periodic financial accounts of business enterprises.

Accounting principles can be sub-divided into two categories:

- The Accounting Concepts and
- The Accounting Conventions

The term **'concept'** is used to connote what accounting postulates, that is necessary assumptions and conditions upon which accounting is based. There are a series of generally accepted principles which accountants must follow in their practice of accounting. However, there are a number of ways of which something can be done and the accountant can choose from a pool of these but must be within confines.

Features of Accounting Principles

- An accounting principle should be relevant
- An accounting principle should be objective and

- An accounting principle should be feasible i.e. it can be changed from time to time to match changing business practices

The Accounting Concepts include:

The Business entity concept:

The concept is that accountants regard a business as a separate entity, distinct from its owners or managers. The concept applies whether the business is a limited company (and so recognized in law as a separate entity) or a sole proprietorship or partnership (in which case the business is not separately recognized by the law). According to this concept, the owner or proprietor of a business is considered to be separate and distinct from the business he or she owns. This concept applies to all forms of business organizations.

The going concern concept:

Going concern concept implies that the business will continue in operational existence for the foreseeable future, and that there is no intention to put the company into liquidation or to make drastic cutbacks to the scale of operations. Financial statements should be prepared under the going concern basis unless the entity is being (or is going to be) liquidated or if it has ceased (or is about to cease) trading. This concept makes a business to be viewed as an economic or financial system for adding value to the resources it utilizes.

The accruals concept (or matching concept):

It states that revenue and costs must be recognized as they are earned or incurred, not as money is received or paid. They must be matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate.

Assume that a firm makes a profit of $200 by matching the revenue ($400) earned from the sale of 40 units against the cost ($200) of acquiring them. If, however, the firm had only sold eighteen units, it would have been incorrect to charge the profit and loss account with the cost of

twenty units; there is still two units in stock. If the firm intends to sell them later, it is likely to make a profit on the sale. Therefore, only the purchase cost of eighteen units ($180) should be matched with the sales revenue, leaving a profit of $180.

Verifiable objective evidence concept:

According to this concept, all the entries recorded in the books of account should be supported by business documents known as vouchers.

The Prudence Concept:

The prudence concept states that where alternative procedures, or alternative valuations, are possible, the one selected should be the one that gives the most cautious presentation of the business's financial position or results.

Therefore, revenue and profits are not anticipated but are recognized by inclusion in the profit and loss account only when realized in the form of either cash or of other assets, the ultimate cash realization of which can be assessed with reasonable certainty: provision is made for all liabilities (expenses and losses) whether the amount of these is known with certainty or is best estimated in light of the information available. Assets and profits should not be overstated, but a balance must be achieved to prevent the material overstatement of liabilities or losses.

The other aspect of the prudence concept is that where a loss is foreseen, it should be anticipated and considered immediately. If a business purchases stock for $2,400 but because of a sudden slump in the market only $1,800 is likely to be realized when the stock is sold, the prudence concept dictates that the stock should be valued at $1,800. It is not enough to wait until the stock is sold, and then recognize the $600 loss; it must be recognized as soon as it is foreseen.

A company begins trading on 1 January 2020 and sells goods worth $100,000 during the year to 31 December. At 31 December, there are debts outstanding of $15,000. Of these, the company is now doubtful whether $6,000 will ever be paid. The company should make a provision for doubtful debts of $6,000. Sales for 2022 will be shown in the profit and loss account at their full value of $100,000, but the provision for doubtful debts would be a charge of $6,000. Because there is some uncertainty that the sales will be realized in the form of cash, the prudence concept dictates that the $6,000 should not be included in the profit for the year.

The consistency concept:

The consistency concept states that in preparing accounts, consistency should be observed in two respects.

(a) Similar items within a single set of accounts should be given similar accounting treatment.

(b) The same treatment should be applied from one period to another in accounting for similar items. This enables valid comparisons to be made from one period to the next.

The money measurement concept:

The money measurement concept states that accounts will only deal with those items to which a monetary value can be attributed. For example, in the balance sheet of a business, monetary values can be attributed to such assets as machinery (e.g. the original cost of the machinery; or the amount it would cost to replace the machinery) and stocks of goods (e.g. the original cost of goods, or, theoretically, the price at which the goods are likely to be sold).

The monetary measurement concept introduces limitations to the subject matter of accounts. A business may have intangible assets such as the flair of a good manager or the loyalty of its workforce. These may be important enough to give it a clear superiority over an otherwise identical business, but because they cannot be evaluated in monetary terms they do not appear anywhere in the accounts.

The separate valuation principle: The separate valuation principle states that, in determining the amount to be attributed to an asset or liability in the balance sheet, each component item of the asset or liability must be determined separately. These separate valuations must then be aggregated to arrive at the balance sheet figure. For example, if a company's stock comprises 50 separate items, a valuation must (in theory) be arrived at for each item separately; the 50 figures must then be aggregated and the total is the stock figure which should appear in the balance sheet.

The materiality concept: An item is considered material if it's omission or misstatement will affect the decision-making process of the users. Materiality depends on the nature and size of the item. Only items material in amount or in their nature will affect the true and fair view given by a set of accounts. An error that is too trivial to affect anyone's understanding of the accounts is

referred to as immaterial. In preparing accounts it is important to assess what is material and what is not, so that time and money are not wasted in the pursuit of excessive detail.

Example:

(a) If a balance sheet shows fixed assets of $2 million and stocks of $30,000, an error of $20,000 in the depreciation calculations might not be regarded as material, whereas an error of $20,000 in the stock valuation probably would be. In other words, the total of which the erroneous item forms part of the whole must be considered.

a) If a business has bank loan of $50,000 balance and a $55,000 balance on bank deposit account, it might well be regarded as a material misstatement if these two amounts were displayed on the balance sheet as ‘cash at bank $5,000’. In other words, incorrect presentation may amount to material misstatement even if there is no monetary error.

The historical cost concept:

A basic principle of accounting is that resources are normally stated in accounts at historical cost, i.e. at the amount that the business paid to acquire them. An important advantage of this procedure is that the objectivity of accounts is maximized: there is usually objective, documentary evidence to prove the amount paid to purchase an asset or pay an expense. Historical cost means transactions are recorded at the cost when they occurred.

Objectivity (neutrality):

An accountant must show objectivity in his work. This means he should try to strip his answers of any personal opinion or prejudice and should be as precise and as detailed as the situation warrants. The result of this should be that any number of accountants will give the same answer independently of each other. Objectivity means that accountants must be free from bias. They must adopt a neutral stance when analyzing accounting data.

The realization concept:

Revenue and profits are recognized when realized. The concept states that revenue and profits are not anticipated but are recognized by inclusion in the income statement only when realized in the form of either cash or of other assets, the ultimate cash realization of which can be assessed with reasonable certainty.

Duality concept:

Every transaction has a two-fold effect in the accounts and is the basis of double entry bookkeeping. These principles hold that, the amount of assets in a business entity will always be equal to the amount of owner's equity and creditor's claim. This also follows that for every even that is recorded in the accounts affects at least two items or accounts i.e. for every debit transaction made in the books of accounts, there is a corresponding credit entry and vice-versa.

The principle of substance over form:

This principle states that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form e.g. a non-current asset on hire purchase although is not legally owned by the enterprise until it is fully paid for, it is reflected in the accounts as an asset and depreciation provided for in the normal accounting way.

Bases

Bases are the methods that have been developed for expressing or applying fundamental accounting concepts to financial transactions and items. Examples include:

- Depreciation of Non-current Assets (e.g. by straight line or reducing balance method)
- Treatment and amortization of intangible assets (patents and trademarks)
- Stocks and work in progress (FIFO, LIFO and AVCO)

Policies

Accounting policies are the specific accounting bases judged by business enterprises to be the most appropriate to their circumstances and adopted by them for the purpose of preparing their financial accounts.

The Accounting Conventions:

The term '**convention**' is used to signify customs and traditions which have been used as a guide to the presentation of accounting statements. The accounting conventions dignify customs or

traditions relating to accounting. Accounting conventions relate to the practical aspects of accounting while the concepts connote its postulates. The accounting conventions include:

Convention of full disclosure:

According to this convention, disclosure compels the accountant to report the realizable value of stock or marketable securities which calls for the details of each category of capital stock e.g. the par of stated value per share, the preference attached to this issue, the number of shares authorized and the number outstanding and any important information to the shareholders.

The convention of Materiality:

Materiality refers to an information of which non-disclosure would vitiate the true and fair view of financial statements. According to this convention, the less important items or matters are left out from the records and are mentioned by a mere note or footnote in the statements while the important items must be captured accordingly. Giving examples, loss to a business arising from the change of depreciation policy of a company is so material that a profit which could have been was converted into a loss by the fact of changing the depreciation policy of the entity and hence must be documented in the important sections of financial statements as opposed to a debt of $50 being left out in the records from a sum of $150,000 total debts. This is immaterial (0.03%) of the total debts and cannot change a loss to profit or a profit into a loss.

Qualities of good accounting information

These are the attributes that makes the information provided in the financial statements to be useful to the users. There are four principal useful qualitative characteristics i.e.

(a) Understandability
(b) Relevance
(c) Reliability
(d) Comparability

1. Understandability

An essential quality of the information provided in the financial statements is that it should be readily understandable by the users. For this purpose, users are assumed to have a reasonable a reasonable knowledge of business and economic activities and that they have the willingness to study the information with reasonable diligence.

2. Relevance

For information to be useful it must be relevant to the decision-making needs of the users. Information has the quality of relevance if it influences the economic decisions of the users by helping them to evaluate the past, present or future events or in confirming and correcting their past evaluation.

3. Reliability

To be useful, information must be reliable. Information has the quality of reliability when it is free from material error and bias and it can be depended upon by the users to represent faithfully what it either purports to represents or what it could reasonably be expected to represent. The information may be relevant but so unreliable in nature or its representation and its recognition may be potentially misleading. The following are the elements of reliable financial statements.

- **Faithful representation** - To be useful, information must faithfully represent transactions and other events it either purports to represent or could reasonably be expected to represent.
- **Substance over form**- If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and represented in accordance with their substance and economic reality and not merely their legal form e.g. assets acquired on hire purchase transactions
- **Neutrality** - To be reliable, the information contained in the financial statements must be neutral i.e. free from bias. Financial statements are not neutral if by their selection or presentation of the information they influence the decision making or judgments in order to achieve a predetermined result or outcome.
- **Prudence**- For information to be reliable it has to contend with the uncertainties that inevitably surround many events, transactions and circumstances e.g. collectability of doubtful debts, probable useful life of plant and machinery etc. Such uncertainties should be recognized by disclosure of their nature and extents by the exercise of the prudence concept which is the inclusion of a degree of caution in the exercise of judgments needed in making estimates.
- **Completeness** - To be reliable, the financial statements must be complete within the boundaries of materiality and cost. An omission can cause information to be false or misleading and therefore unreliable and deficient in terms of relevance.

4. Comparability

Users must be able to compare the financial statements of an entity over time. This is in order to identify trends in its financial position and performance. They must be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in their financial performance.

References

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