

## Limited Company Accounts Tutorial - changes for 2011 reprint

### 'Conceptual Framework for Financial Reporting' – Assessable from September 2011

The *Framework for the Preparation and Presentation of Financial Statements* has been replaced by the *Conceptual Framework for Financial Reporting*. This new document, which incorporates aspects of its predecessor, is assessable in the AAT Level 4 Learning Area 'Financial Statements' from 1 September 2011.

The text set out below updates the Osborne Books Limited Company Accounts Tutorial book (Chapter 1).

## CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

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The *Conceptual Framework for Financial Reporting* sets out the concepts which underlie the preparation and presentation of financial statements for external users. Whilst not itself an accounting standard, it helps the development of future international accounting standards and the review of existing standards.

It deals with the objective of financial reporting, the qualitative characteristics of useful financial information and the definition, recognition and measurement of the elements of financial statements.

### users of financial information

The *Conceptual Framework for Financial Reporting* identifies the primary users of financial information as:

- investors, both existing and potential
- lenders
- other creditors

These users will make use of the financial reports of an entity in order to help in making decisions, eg to buy or sell a company's shares, to make a loan to the company, and to provide other forms of credit.

Other users of financial reports include:

- the management of the reporting entity
- regulators
- members of the public (other than investors, lenders and other creditors)

### the objective of financial reporting

The *Conceptual Framework for Financial Reporting* states that the objective of financial reporting is '*to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity*'.

Financial reports provide information about the reporting entity's *financial position* through a statement of financial position. Financial reports also show the *performance* of the entity, usually presented in a statement of comprehensive income, and the *changes in financial position*, shown by a statement of cash flows.

Financial statements do not provide all the information users may need since they only show the financial effects of what has happened in the past and exclude a lot of non-financial information. Users work with financial statements to assess the stewardship of management and to make decisions.

### underlying assumptions

When preparing financial statements, it is assumed they are prepared on the basis that the entity is a going concern.

*Going concern* means that financial statements are prepared on the assumption that the entity will continue in business for the foreseeable future. Thus there is no intention to liquidate or reduce the size of the business – if this was the case, the financial statements would have to be prepared on a different basis.

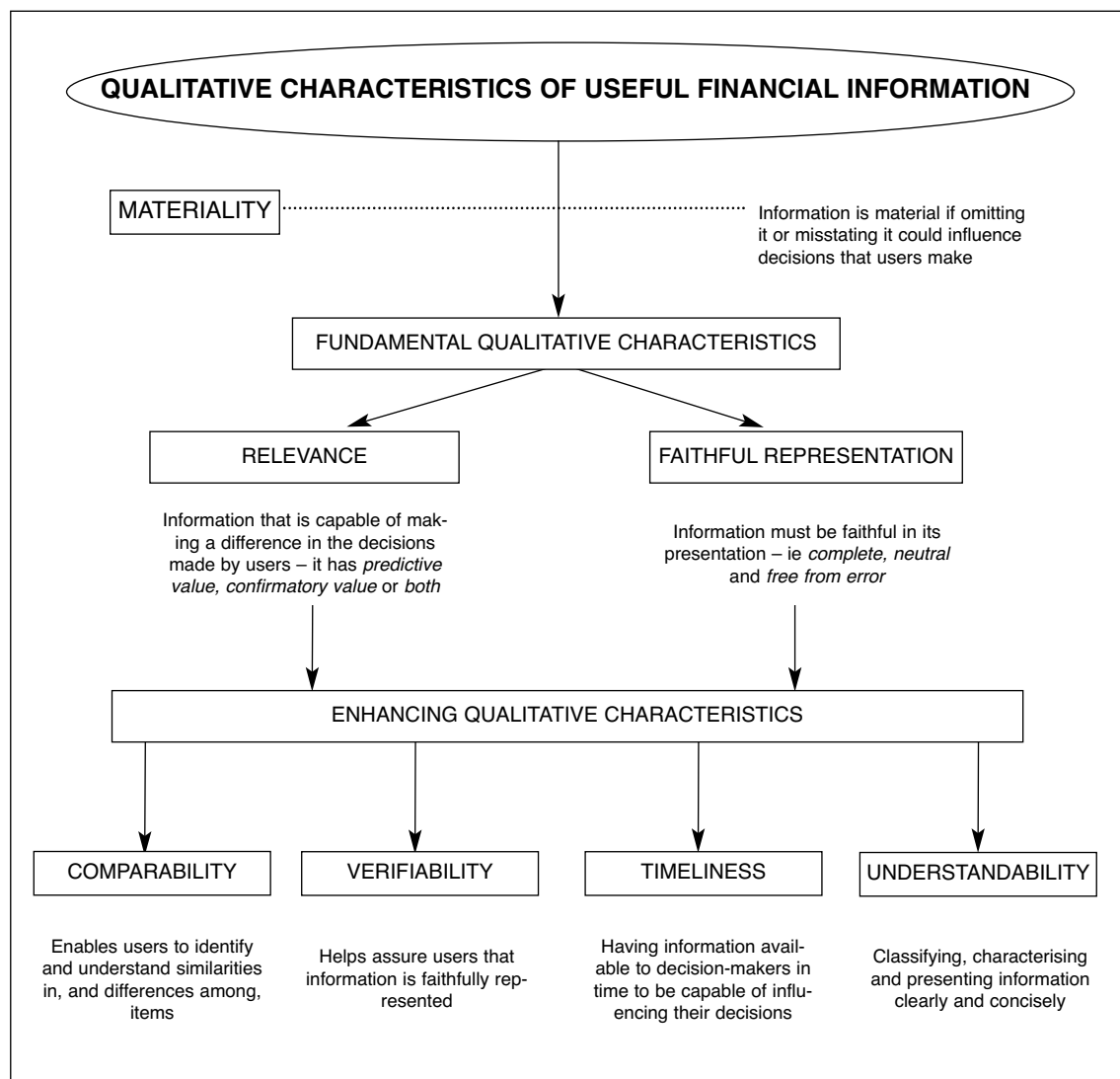
At the same time, it is important that financial performance reflects the principles of *accrual accounting*. Using the accrual basis means that the effects of transactions are recognised when they occur (and not when cash is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

### qualitative characteristics of useful financial information

The qualitative characteristics identify the types of information that are likely to be most useful to users of financial statements for making decisions. The *Conceptual Framework for Financial Reporting* identifies:

- fundamental qualitative characteristics
  - relevance
  - faithful representation
- enhancing qualitative characteristics
  - comparability
  - verifiability
  - timeliness
  - understandability

The diagram below shows these characteristics.



#### relevance

The diagram shows that, for information to be *relevant*, it must:

- be capable of making a difference in the decisions made by users
- have predictive value, which helps users to predict future outcomes
- have confirmatory value, which helps users to confirm previous evaluations

### faithful representation

For the faithful representation of information it must:

- correspond to the effect of transactions or events
- as far as possible be *complete* (to include all information necessary for a user), *neutral* (without bias), and *free from error* (no errors in the description or process)

### enhancing qualitative characteristics

- *comparability* enables users to identify and understand similarities in, and differences among, items – a comparison relates to at least two items
- *verifiability* helps assure users that information is faithfully represented – can be direct (eg counting cash) or indirect (eg calculating inventory valuations using a method such as first-in, first-out).
- *timeliness* means having information available to decision-makers in time to be capable of influencing their decisions – generally the older the information is the less useful it is
- *understandability* means that information is classified, characterised and presented clearly and concisely – financial reports are prepared on the basis that users and their advisers have a reasonable knowledge of business and economic activities

### materiality

Under the heading of qualitative characteristics, the *Conceptual Framework for Financial Reporting* also refers to *materiality*. Although materiality is rarely defined in law or accounting standards, the preparer of financial statements must make judgements as to whether or not an item is material. As the *Conceptual Framework* says: 'Information is material if omitting it or misstating it could influence the decisions that users make on the basis of financial information about a specific reporting entity.' It goes on to say: 'Materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.' Thus materiality depends very much on the size of the business: a large company may consider that items of less than £1,000 are not material; a small company will use a much lower figure. What is material, and what is not, becomes a matter of judgement, based on the overall relevance of the financial information.

Note that the definitions of the elements of financial statements – assets, liabilities, equity, income and expenses – are currently unchanged in the *Conceptual Framework for Financial Reporting*.