The Institute of Chartered Accountants in England and Wales

ACCOUNTING

For exams from 1 August 2016 to 31 December 2017

Study Manual

www.icaew.com
Welcome to ICAEW

I am delighted that you have chosen ICAEW to progress your journey towards joining the chartered accountancy profession. It is one of the best decisions I also made.

The role of the accountancy profession in the world’s economies has never been more important. People making financial decisions need knowledge and guidance based on the highest technical and ethical standards. ICAEW Chartered Accountants provide this better than anyone. They challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity all over the world.

As a world leader of the accountancy and finance profession, we are proud to promote, develop and support over 145,000 Chartered Accountants worldwide. Our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. They are part of something special, and now, so are you. It’s with our support and dedication that our members and hopefully yourself, will realise career ambitions, maintain a professional edge and contribute to the profession.

You are now on your journey towards joining the accountancy profession, and a highly rewarding career with endless opportunities. So, if you are studying for our Certificate in Finance, Accounting and Business (ICAEW CFAB) or our world-leading chartered accountancy qualification, the ACA, you too have made the first of many great decisions in your career.

You are in good company, with a network of over 28,000 students around the world made up of like-minded people. You are all supported by ICAEW as you progress through your studies and career; we will be with you every step of the way. Visit page viii to review the key resources available as you study.

I wish you the best of luck with your studies and look forward to welcoming you to the profession in the future.

Michael Izza
Chief Executive
ICAEW
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Questions within the study manual should be treated as preparation questions, providing you with a firm foundation before you attempt the exam standard questions. The exam standard questions are found in the question bank.
1 Introduction

ACA qualification

The ICAEW chartered accountancy qualification, the ACA, is a world-leading professional qualification in accountancy, finance and business.

The ACA has integrated components that will give you an in-depth understanding across accountancy, finance and business. Combined, they help build the technical knowledge, professional skills and practical experience needed to become an ICAEW Chartered Accountant.

Each component is designed to complement each other, which means that you can put theory into practice and you can understand and apply what you learn to your day-to-day work. Progression through all the elements of the ACA simultaneously will enable you to be more successful in the workplace and exams.

The components are:

- Professional development
- Ethics and professional scepticism
- Three to five years practical work experience
- 15 accountancy, finance and business modules

To find out more on the components of the ACA and what is involved in training, visit your dashboard at icaew.com/dashboard

ICAEW Certificate in Finance, Accounting and Business

The ICAEW Certificate in Finance, Accounting and Business (ICAEW CFAB) teaches essential skills and knowledge in the three key areas of finance, accounting and business.

ICAEW CFAB consists of the same six modules as the first level of our world-leading qualification, the ACA. This means, it can serve as a stand-alone qualification or as a stepping stone on your journey towards chartered accountancy.

You can find out more about the ICAEW CFAB exams and syllabus at icaew.com/cfabstudents

To learn more about the ACA qualification and chartered accountancy, visit icaew.com/careers
2 Accounting

The full syllabus and technical knowledge grids can be found within the module study guide. Visit icaew.com/exams if you’re studying the ACA or icaew.com/cfabstudents if you’re studying ICAEW CFAB.

2.1 Module aim

To ensure that students have a sound understanding of the techniques of double entry accounting and can apply its principles in recording transactions, adjusting financial records and preparing non-complex financial statements.

On completion of this module, candidates will be:

- Proficient in the use of double entry accounting techniques and the maintenance of accounting records
- Able to identify and correct omissions and errors in accounting records and financial statements
- Able to specify the components of financial statements, and prepare and present non-complex accounts for sole traders, partnerships and limited companies

2.2 Specification grid

This grid shows the relative weightings of subjects within this module and should guide the relative study time spent on each. Over time the marks available in the assessment will equate to the weightings below, while slight variations may occur in individual assessments to enable suitably rigorous questions to be set.

<table>
<thead>
<tr>
<th></th>
<th>Weighting (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintaining financial records</td>
<td>30</td>
</tr>
<tr>
<td>Adjustments to accounting records and financial statements</td>
<td>35</td>
</tr>
<tr>
<td>Preparing financial statements</td>
<td>35</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>
3 Key Resources

We provide a wide range of fantastic resources and services to help you in your studies. Here is a taster of what we have to offer.

Student support team

Our student support team are here to help you, providing full support throughout your studies.

T +44 (0)1908 248 250
E studentsupport@icaew.com

Student website

The student area of our website provides the latest information, guidance and exclusive resources to help you as you progress through the ACA. These include exam webinars, interactive sample assessments, errata sheets and guidance for your computer-based assessments. Find everything you need at icaew.com/dashboard.

If you are studying for the ICAEW CFAB qualification, you can access exam resources and support at icaew.com/cfabstudents.

Online student community

The online student community provides support and practical advice – wherever you are, whenever you need it. With regular blogs covering a range of work, life and study topics as well as a forum where you can post your questions and share your own tips. ACA and ICAEW CFAB students can join the conversation at icaew.com/studentcommunity.

Faculties and Special Interest Groups

These groups are designed to support you in specific areas of work and industry sectors of interest.

Our seven faculties provide knowledge, events and essential technical resources. As an ACA or ICAEW CFAB student, you can register to receive a complimentary e-newsletter from a faculty of your choice.

Our 14 special interest groups provide practical support, information and representation within a range of industry sectors. As an ACA student, you can register for provisional membership to one special interest group of your choice.

Find out more about faculties and special interest groups at icaew.com/facultiesandsigs.

Library & Information Service

The Library & Information Service is ICAEW’s world-leading accountancy and business library. The library provides access to thousands of resources online and a document delivery service, you’ll be sure to find a useful eBook, relevant article or topic-based guide to help you. Find out more at icaew.com/library.

Tuition

The ICAEW Partner in Learning scheme recognises tuition providers who comply with our core principles of quality course delivery. If you are receiving structured tuition with an ICAEW Partner in Learning, make sure you know how and when you can contact your tutors for extra help. If you are not receiving structured tuition and are interested in classroom, online or distance learning tuition, take a look at our recognised Partner in Learning tuition providers in your area, on our website icaew.com/dashboard.
CHAPTER 1

Introduction to accounting

Introduction
Examination context

Topic List

1  The purpose of accounting information
2  The regulation of accounting
3  The main financial statements
4  Capital and revenue items
5  Qualitative characteristics of useful accounting information
6  Accounting concepts and conventions
7  Ethical considerations

Summary and Self-test
Technical reference
Answers to Interactive questions
Answers to Self-test
Introduction

Learning objectives

- Specify why an entity maintains financial records and prepares financial statements
- Specify the ethical considerations for preparers of financial statements
- Record and account for transactions in accordance with the laws, regulations and accounting standards applicable to the financial statements
- Specify the key aspects of the accrual basis of accounting, cash accounting and break-up basis of accounting

Specific syllabus learning outcomes are: 1a, b, d, 3b

Syllabus links

The material in this chapter will be developed further in this paper, and later in the Professional level module of Financial Accounting and Reporting.

Examination context

Questions on topics in this chapter will be knowledge-type multiple choice questions. In the exam you may be required to:

- Identify capital as opposed to revenue expenditure
- Specify the distinctions between the different qualitative characteristics
- Identify the principles that relate to each qualitative characteristic
- Identify the different interests of stakeholders
- Identify the differences between IFRS and UK GAAP
1 The purpose of accounting information

Section overview

- Accounting is a way of recording, analysing and summarising the transactions of an entity.
- The three main types of business entity are sole traders, partnerships and companies.
- Users who need financial information include: managers, owners, customers, suppliers, lenders, employees, trade unions, HM Revenue and Customs, financial analysts and advisers, government agencies and the public.
- Managers and (present and potential) owners are the prime users of published financial statements.
- People need financial information on a company to make economic decisions, to assess managers’ stewardship of the company’s resources, and to assess the level, timing and certainty of its future cash flows.

1.1 What is accounting?

Accounting is a way of recording, analysing and summarising transactions of an entity (a term we shall use to describe any business organisation).

- The transactions are recorded in ‘books of original entry’ (see Chapter 3).
- The transactions are then analysed and posted to the ledgers (see Chapter 4).
- Finally the transactions are summarised in the financial statements (see Chapter 5).

One of the roles of an accountant is to measure the revenue and expenditure of an entity and, if it is a business, its profit. This is not as straightforward as it may seem and in later chapters we will look at some theoretical and practical difficulties.

1.2 Types of business entity

There are three main types of profit-making business entity.

- Sole traders
- Partnerships
- Limited liability companies

Sole traders are people who work for themselves. Examples include a local shopkeeper, plumber or hairdresser. The term sole trader refers to the ownership of the business; sole traders can have employees.

Partnerships occur when two or more people decide to share the risks and rewards of a business together. Examples include an accountancy, medical or legal practice. A partnership can take one of two forms: a general partnership (like two or more sole traders) and a Limited Liability Partnership LLP (more like a company).

Limited liability companies are incorporated to take advantage of ‘limited liability’ for their owners (shareholders). This means that, while sole traders (always) and partners (usually) are personally responsible for the amounts owed by their businesses, the owners (shareholders) of a limited liability company are only responsible for the amount to be paid for their shares.

1.3 The objective of financial statements

Why do businesses need to produce accounting information in the form of financial statements? If a business is being run efficiently, why should it have to go through all the bother of accounting procedures in order to produce financial information?

A business should produce information about its activities because there are user groups who want or need to know that information in order to make economic decisions.
When making economic decisions, users need to assess:

- The ability of the business to generate cash
- The timing and certainty of cash flows

Whether the business can generate cash of the right amount determines whether it can:

- Pay its employees and suppliers
- Meet interest payments
- Repay loans
- Pay something to its owners

Large businesses are of interest to a greater variety of people and so we will consider the case of a large public company, whose shares can be purchased and sold on a stock exchange.

1.4 Who needs financial information?

The following people are likely to be interested in financial information about a large company with listed shares.

- **Managers/directors** appointed by the company's owners to supervise the day to day activities of the company. They need information about the company's present and future financial situation. This enables them to manage the business efficiently (exercising the stewardship function) and to make effective decisions about matters such as pricing, output, employment and financing.

- **Owners of the company** (shareholders) want to assess management performance. They want to know how profitable the company's operations are and how much profit is available for distribution to the shareholders through a dividend. In addition, the value of their investment in the company is affected by the company's profitability.

- **Trade contacts** include suppliers who provide goods on credit and customers who purchase goods or services. **Suppliers** want to know about the company's ability to pay its debts; **customers** need to know that the company is a secure source of supply, so that repeat purchases and after-sales care will be available.

- **Finance providers** include banks which allow the company to operate an overdraft, or provide longer term loan finance secured on the company's assets. A bank wants to ensure that the company is able to keep up loan payments.

- **HM Revenue and Customs (HMRC)** want to know about business profits in order to assess the company's tax liabilities.

- **Employees** have an interest in the company's financial situation, because their careers and remuneration depend on it.

- **Financial analysts and advisers** need information for their clients or audience. For example, stockbrokers need information to advise investors; credit agencies want information to advise potential suppliers of goods to the company; and journalists need information for their reading public.

- **Government agencies** are interested in the efficient allocation of resources and therefore in the activities of enterprises. They also require information in order to provide a basis for national statistics.

- **The public.** Business entities affect members of the public in a variety of ways. For example, they may make a substantial contribution to a local economy by providing employment and using local suppliers. Another important factor is the effect of an entity on the natural environment, for example as regards pollution.

- **Bodies** such as the Financial Conduct Authority (FCA) who regulate the financial services industry, require information to ensure compliance with regulations and the law.

Accounting information is summarised in financial statements to satisfy the information needs of these different groups. However, some of these individual users of financial information may have conflicting needs, therefore, the information provided should meet the needs of the maximum number of primary users.
Managers of a business need the most information, to help them make planning and control decisions. They have greater access to business information, because they are able to review internally produced statements. Managers can obtain extra information through the cost and management accounting system.

Interactive question 1: Accounting information

It is easy to see how 'internal' people get hold of accounting information. A manager, for example, can just go along to the accounts department and ask the staff there to prepare whatever accounting statements she needs. But external users of accounts cannot do this. How, in practice, can a business contact or a financial analyst access accounting information about a company?

See Answer at the end of this chapter.

In addition to management information, additional financial statements are prepared for the benefit of other user groups, who may demand particular information.

- HMRC will receive information to make tax assessments.
- A bank might demand a cash flow forecast as a pre condition of granting an overdraft.

1.4.1 Not-for-profit entities

It is not only businesses that need to prepare financial statements. Charities and clubs, for example, prepare financial statements every year. Financial statements also need to be prepared for government (public sector) organisations.

1.5 Users and their information needs

Below we consider potential users of financial statements, and the aspects of financial statements they are likely to be interested in.

- Investors (current and potential owners) are the providers of risk capital for the company, so they are interested in the risk to their capital presented by the investment, and the return they will get for taking that risk. They need information to help them determine whether they should buy, hold or sell shares. Owners are also interested in information which enables them to assess the ability of the entity to pay dividends.
- Employees and their representative groups need information about the stability and profitability of their employers, so they can assess the entity’s ability to provide remuneration, retirement benefits and employment opportunities.
- Lenders need information that enables them to determine whether their loans, and the interest attached to them, will be paid when due.
- Suppliers and other creditors need information that enables them to determine whether amounts owing to them will be paid. Trade creditors are likely to be interested in an entity over a shorter period than lenders, unless they are dependent upon the continuation of the entity as a major customer.
- Customers need information about the entity’s continuance, especially when they have a long-term involvement with, or are dependent on, the entity.
- Governments and their agencies have the needs listed in section 1.4. They also require information in order to regulate the activities of entities, and determine taxation policies.
- Public. Members of the public have the needs listed in section 1.4, that is they wish to see how the company will be able to continue employing local people and using local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.

The management of a reporting entity will be interested in financial information about the entity but does not need to rely on general purpose financial reports because it is able to obtain the financial information it needs internally.
Therefore instead of being thought of as users of the financial statements, management are primarily responsible for the preparation and presentation of the financial statements.

1.5.1 Ethical considerations

Ethical considerations should underpin the work of all professional accountants, including those in business who prepare financial statements and those who set the rules and regulations of financial reporting.

In order for the work of accountants to continue to be valuable, the financial information that they provide must be perceived as being trustworthy. If this reliability becomes compromised then users will no longer depend on the information and the value of the profession will be damaged.

By adhering to a code of conduct and ethical behaviour, accountants can maintain public confidence in the profession and thus maintain the value of accounting. Ethical considerations are discussed further in section 7 of this chapter.

2 The regulation of accounting

Section overview
- In the UK all companies must comply with the provisions of the Companies Act.
- In the UK financial statements must be prepared in accordance with either the UK GAAP or IFRS. They must also give a true and fair view.

A number of factors have shaped the development of accounting.

The regulatory framework of accounting, and the technical aspects of the changes made, will be covered later in this Study Manual and in your professional studies. The purpose of this section is to give a general picture of some of the factors which have shaped accounting. We will concentrate on the financial statements of limited liability companies, as these are the ones most closely regulated by statute or otherwise.

The following factors can be identified.
- Legislation
- Accounting concepts and individual judgement
- Accounting standards
- Generally accepted accounting practice (GAAP)
- True and fair view/fair presentation

UK GAAP alert!
The Conceptual Framework that underlies IFRS is very similar to that used to develop GAAP. However the elements identified and their definitions under IFRS are different. The UK GAAP alert! will give some insight into these differences throughout this Study Manual.

2.1 Generally Accepted Accounting Practice (GAAP)

GAAP is a term used to cover all the rules, from whatever source, which govern accounting in various jurisdictions. The requirement that financial information is relevant, reliable, comparable and understandable is common to both IFRS and GAAP.

2.2 Legislation

A listed company is one whose shares can be traded on a stock exchange, for example the London Stock exchange. Unlisted companies tend to be smaller than listed companies and their shares cannot be traded on a stock exchange. Limited liability companies are required by the Companies Act 2006 to
prepare and publish financial statements annually. Their form and content are regulated by legislation but must comply with **accepted accounting and financial reporting standards**. For listed groups this means compliance with IAS and IFRS. Non-listed companies generally follow UK accounting standards which are substantially converged with international ones. The nature of a limited company and the issue of shares are dealt with in more detail in chapter 11.

### 2.2.1 Accounting standards

While ethical principles underpin financial accounting, different people could still interpret situations differently. In order to deal with some of this subjectivity, and to achieve comparability between different organisations, **accounting standards** were developed. These were developed at an international level, by the IASB and at a UK level by the Accounting Standards Board (ASB), an operating body of the Financial Reporting Council (FRC). The FRC changed its structure recently and the responsibility for accounting standards is now with the Accounting Council of the FRC.

### 2.3 International Financial Reporting Standards (IFRS)

The IASB (International Accounting Standards Board) is responsible for setting international financial reporting standards (IFRS).

The standards and interpretations that are issued by the IASB comprise:

- International Financial Reporting Standards (IFRS)
- International Accounting Standards (IAS)
- IFRS Interpretations committee
- SIC Interpretations

The **Conceptual Framework** sets out concepts that underlie the preparation and presentation of financial statements for a wide range of users, many of whom have to rely on financial statements as their major source of financial information on an entity.

All standards (IASs and IFRSs) stem from the concepts set out in the Conceptual Framework. The Conceptual Framework states that:

‘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 about providing resources to the entity.’

**UK GAAP alert!**

The examinable standards for Certificate Level Accounting are the IFRSs, however, as you continue your studies to FAR level you may choose to study UK GAAP as an alternative. It is important, therefore, to be familiar with UK GAAP.

### 2.4 UK GAAP

Companies in the UK can choose IFRS or UK financial reporting standards (FRS). References to UK GAAP in this Study Manual refer to the use of UK Companies Act 2006 and UK FRS. Whilst IFRS have different standards for different issues, there is one main accounting standard in the UK – FRS 102 – covering all issues. FRS 102 also contains the underpinning concepts and principles, which are similar to those which guide IFRSs.

So, UK GAAP rules derive from:

- The Companies Act 2006
- UK and international accounting and financial reporting standards
UK GAAP uses different terminology in many important respects regarding financial statements. FRS 102 actually uses international terminology, while the Companies Act 2006 uses terminology that is UK specific. In their published financial statements, UK non-listed companies tend to follow Companies Act 2006 and use the UK specific terminology which is as follows:

<table>
<thead>
<tr>
<th>International term</th>
<th>UK GAAP term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of profit or loss</td>
<td>Profit and loss account</td>
</tr>
<tr>
<td>Statement of financial position</td>
<td>Balance sheet</td>
</tr>
<tr>
<td>Non-current asset</td>
<td>Fixed asset</td>
</tr>
<tr>
<td>Carrying amount</td>
<td>Net book value</td>
</tr>
<tr>
<td>Inventories</td>
<td>Stock</td>
</tr>
<tr>
<td>Receivables</td>
<td>Debtors</td>
</tr>
<tr>
<td>Irrecoverable debt</td>
<td>Bad debt</td>
</tr>
<tr>
<td>Irrecoverable debt expense</td>
<td>Bad and doubtful debts expense</td>
</tr>
<tr>
<td>Allowance for irrecoverable debts</td>
<td>Allowance for doubtful debts</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>Retained profits (reserve)</td>
</tr>
<tr>
<td>Payables</td>
<td>Creditors</td>
</tr>
<tr>
<td>Non-current liabilities</td>
<td>Creditors: amounts falling due after more than one year</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>Creditors: amounts falling due in less than one year</td>
</tr>
<tr>
<td>Revenue</td>
<td>Turnover</td>
</tr>
<tr>
<td>Finance costs</td>
<td>Interest payable</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>Tangible fixed assets</td>
</tr>
</tbody>
</table>

2.5 True and fair view/faithful representation

Financial statements are required to give a true and fair view. True and fair view or present fairly in all material respects the financial results of the entity. These terms are not defined and tend to be decided in courts of law on the facts.

- The Conceptual Framework: Conceptual Framework states that if financial information is to be useful, it must be relevant and faithfully represent what it purports to represent.
- The Companies Act: Companies Act 2006 requires that the financial statements should give a true and fair view of the financial position of the entity at a particular point in time.
- In terms of IAS 1, financial statements should present fairly the financial position and performance, and the cash flows, of the entity. This requires faithful representation of the effects of transactions.

2.6 How to use this Study Manual

The study manual will use IFRS throughout this study manual as these are the examinable standards. However, you should be aware that chapters 2 to 10 contain the building blocks for creating financial statements. The aim of the UK GAAP alert! is to highlight the differences or in most cases, the similarities between IFRS and FRS (UK GAAP). Therefore, whether you go on to study UK GAAP or IFRS the skills you learn in these building block chapters will equip you to prepare both sets of accounts. Remember that the UK GAAP alert! is designed to assist you in your studies beyond this course, and that the only examinable standards are the IFRSs.
3 The main financial statements

Section overview
- Financial statements prepared under IASs collectively comprise a statement of financial position, a statement of comprehensive income including a statement of profit or loss (previously referred to as an income statement), a statement of changes in equity, a statement of cash flows, notes and (in certain circumstances) a revised statement of financial position from an earlier period.
- IAS 1 *Presentation of Financial Statements* sets out the form and content of the financial statements.

IAS 1 *Presentation of Financial Statements* identifies a complete set of financial statements for a reporting period (typically a year) as comprising:
- A statement of financial position as at the end of the reporting period (as we shall see in Chapter 14, under UK GAAP this is called a *balance sheet*),
- A statement of comprehensive income for the reporting period, which can be in a two-part format including a separate statement of profit or loss (as we shall see in Chapter 14, under UK GAAP this is called a *profit and loss account*),
- A statement of changes in equity for the reporting period,
- A statement of cash flows for the reporting period,
- Notes comprising a summary of significant accounting policies and other explanatory information, and
- A statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively, makes a restatement of items in its financial statements, or reclassifies items.

In this Study Manual we are only concerned with the statement of financial position, the statement of profit or loss part of the statement of comprehensive income, the statement of cash flows and the summary of accounting policies note.

IAS 1 makes it clear that an entity may use titles for the statements other than those used in the Standard. Many entities will no doubt continue to use the term 'balance sheet' instead of 'statement of financial position', 'statement of profit or loss' instead of 'statement of comprehensive income' and 'cash flow statement' instead of 'statement of cash flows'. However in this Study Manual we shall use the IAS 1 terminology until Chapter 14, when we shall use the terminology of financial statements prepared under UK GAAP ('balance sheet' and 'profit and loss account').

3.1 Statement of financial position

Definitions

**Statement of financial position:** A list of all the assets controlled and all the liabilities owed by a business as at a particular date: it is a snapshot of the financial position of the business at a particular moment. Monetary amounts are attributed to assets and liabilities. It also quantifies the amount of the owners' interest in the company: **equity**.

**Equity:** The amount invested in a business by the owners (IAS 1 refers to 'owners' rather than 'equity holders' or 'shareholders').

Assets and liabilities are explained in more detail in Chapter 2. However, the sum of the assets will always be equal to the sum of the liabilities plus equity/capital.

There are a number of factors affecting a company's financial position at any one time which include:

(a) The **economic resources** it controls (cash, labour, materials, machinery, skills)
(b) Its **financial structure** (whether it is funded by owners, lenders, suppliers, or by all three)
(c) Its **liquidity** (short-term availability of cash) and **solvency** (long-term access to funds)
(d) Its **adaptability** to changes in its operating environment

The Conceptual Framework focuses on how information about the nature and amounts of an entity’s **economic resources** and **claims** (liabilities) can help users to identify the reporting entity’s financial strengths and weaknesses.

In particular it points out that information about the nature and amounts of an entity’s economic resources and claims can help users to assess:

- The entity’s liquidity and solvency
- The entity’s need for additional financing
- How successful the entity is likely to be in obtaining that financing

Additionally by gaining knowledge of the economic resources a business controls, users will be in a better position to predict the entity’s **ability to generate cash in the future**.

Information about an entity’s financial structure and liquidity/solvency can also help financial statement users.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Information on this helps users</th>
</tr>
</thead>
</table>
| **Financial structure** | • To predict future borrowing needs  
                            • To predict how future profits and cash flows will be distributed among owners and lenders  
                            • To predict how successfully it will be able to raise future finance |
| **Liquidity/solvency** | • To predict its ability to meet financial commitments as they fall due |

### 3.2 Statement of profit or loss

**Definition**

**Statement of profit or loss**: A statement displaying items of **income** and **expense** in a **reporting period** as components of **profit or loss for the period**. The statement shows whether the business has had more income than expense (a profit for the period) or vice versa (a loss for the period).

The reporting period chosen will depend on the purpose for which the statement is produced. The statement of profit or loss which forms part of the published annual financial statements of a **limited liability company** will usually be for the period of a **year**, commencing from the date of the previous year’s financial statements. On the other hand, **management** might want to keep a closer eye on a company’s profitability by making up **quarterly, monthly, weekly or even daily** statements.

The Conceptual Framework sets out how information about the business’s financial performance, ie its profits or losses, is needed by users.

- To **understand the return** that the entity has produced on its economic resources
- To assess how well management has discharged its responsibilities to make efficient and effective use of the reporting entity’s resources
- To help predict the business’s **future returns** on its economic resources

The link between the statement of financial position and the statement of comprehensive income is provided by the **statement of cash flows** and the **statement of changes in equity**. These are covered in detail later in your professional studies. However, you will find an introduction to the statement of cash flows in Chapter 13. The statement of cash flows shows the actual cash flowing into and paid out of the business.
Companies reporting under UK GAAP will present their financial statements in accordance with:
- Companies Act 2006
- FRS 102

Details of the different terminology used is outlined in the table above. Generally the profit and loss account formats require less detail than IAS 1. The Companies Act balance sheet formats are less flexible than the IAS 1 formats. The Companies Act formats are enshrined in law.

3.3 Presentation of financial statements

Both the statement of financial position and the statement of profit or loss are summaries of accumulated data. For example, the statement of profit or loss shows a figure for revenue earned from selling goods and services to customers. This is the total revenue earned from all sales made during the period. An accountant devises methods of recording such transactions, so as to produce summarised financial statements from them.

The statement of financial position and the statement of profit or loss form the basis of financial statements for most businesses. For limited liability companies, other information by way of statements (such as the statement of cash flows and the statement of changes in equity) and notes is required by statute and accounting standards.

4 Capital and revenue items

Section overview
- Capital and revenue income and expenditure must be distinguished from each other.

4.1 Capital and revenue expenditure

Definition
Capital expenditure: Expenditure which results in the acquisition of long-term assets, or an improvement or enhancement of their earning capacity.

Long-term assets are those which will be kept in the entity for more than one year.
- Capital expenditure is not charged as an expense in the statement of profit or loss (although a ‘depreciation’ charge will usually be made to write off the capital expenditure gradually over time; depreciation expense is shown in the statement of profit or loss).
- Capital expenditure on long-term assets appears in the statement of financial position.

Definition
Revenue expenditure: Expenditure which is incurred either:
- For trade purposes. This includes purchases of raw materials or items for resale, expenditure on wages and salaries, selling and distribution expenses, administrative expenses and finance costs, or
- To maintain the existing earning capacity of long-term assets.

Revenue expenditure is charged to the statement of profit or loss of a period, provided that it relates to the trading activity and sales of that particular period.
Worked example: Revenue expenditure
If a business buys ten steel bars for £200 (£20 each) and sells eight of them during a reporting period, it will have two steel bars left at the end of the period. The full £200 is revenue expenditure but only £160 is the cost of the goods sold during the period. The remaining £40 (cost of two units) will be included in the statement of financial position as ‘inventory’ valued at £40.

Worked example: Capital expenditure
A business purchases a building for £300,000. It then adds an extension to the building at a cost of £100,000. After a few months the building needs to have a few broken windows mended, its floors polished and some missing roof tiles replaced. These cleaning and maintenance jobs cost £900.

In this example, the original purchase (£300,000) and the cost of the extension (£100,000) are capital expenditure, because they are incurred to acquire and then improve a long-term asset. The other costs of £900 are revenue expenditure, because these merely maintain the building and thus its ‘earning capacity’.

Capital expenditure can include costs incurred in bringing a long-term asset to its final condition and location, such as legal fees, duties and carriage costs borne by the asset’s purchaser, plus installation costs. Repair, maintenance and staff costs in relation to long-term assets are revenue expenditure.

4.2 Capital income and revenue income

Definition
Capital income: Proceeds from the sale of non-current assets.

The profits (or losses) from the sale of long-term assets are included in the statement of profit or loss for the reporting period in which the sale takes place. For instance, the business may sell machinery or property which it no longer needs.

Revenue income: Income derived from:
- The sale of trading assets, such as goods held in inventory
- The provision of services
- Interest and dividends received from business investments

4.3 Capital transactions
The categorisation of capital and revenue items given above does not mention raising additional funds from the owner(s) of the business, or raising and repaying loans.
- These transactions add to the cash assets of the business and create corresponding capital or liabilities (loans).
- When a loan is repaid, it reduces the liabilities (loan) and the assets (cash).

None of these transactions would be reported through the statement of profit or loss.

4.4 Why is the distinction between capital and revenue items important?
Calculating profit for any reporting period depends on the correct and consistent classification of revenue or capital items. You must get used to the terminology here as these words appear in the accounting and financial reporting standards themselves.
Interactive question 2: Capital or revenue?

State whether each of the following items should be classified as 'capital' or 'revenue' expenditure or income.

(a) The purchase of a property (eg an office building)
(b) Property depreciation
(c) Solicitors’ fees in connection with the purchase of property
(d) The costs of adding extra memory to a computer
(e) Computer repairs and maintenance costs
(f) Profit on the sale of an office building
(g) Revenue from sales paid for by credit card
(h) The cost of new machinery
(i) Customs duty charged on machinery when imported into the country
(j) The ‘carriage’ costs of transporting the new machinery from the supplier’s factory to the premises of the business purchasing it
(k) The cost of installing the new machinery in the premises of the business
(l) The wages of the machine operators

See Answer at the end of this chapter.

5 Qualitative characteristics of useful accounting information

Section overview

- Financial information should be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

What type of information then should financial statements contain? What should its main qualities be from the user’s point of view?

5.1 The fundamental qualitative characteristics

The Conceptual Framework identifies the fundamental qualitative characteristics to be relevance and faithful representation. Information must be both relevant and faithfully represented to be useful.

- Relevance. Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources.

Financial information can make a difference to decisions if it has:

- Predictive value. It can be used to predict future outcomes.
- Confirmatory value. It provides feedback about previous evaluations (it confirms whether past predictions were reasonable).

Information’s relevance is affected by its nature and materiality. (We shall come back to materiality; for now you can think of it as ‘important’). You should note that information may become less relevant if there is undue delay in its reporting.
• **Faithful representation.** If information is to be useful, it must represent faithfully the transactions and other events it purports to represent. A faithful representation will be:
  
  – **Complete.** All information necessary for a user to understand the transactions or events being depicted is included.
  
  – **Neutral** (unbiased)
  
  – **Free from error.** Free from error in the context of faithful representation does not mean the information is perfectly accurate in all respects. Instead it means there are no errors or omissions in the description of it and the process used to produce the reported information has been selected and applied with no errors in the process.

**Conceptual Framework:**

**fundamental qualitative characteristics**

**Relevance**  
**Faithful representation**

**Enhancing qualitative characteristics**

- **Complete**  
- **Free from error**  
- **Unbiased**

5.2 **Enhancing qualitative characteristics**

According to the Conceptual Framework information that is relevant and faithfully represented can be enhanced by the following ‘enhancing’ qualitative characteristics:

• **Comparability.** Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information should be produced so that valid comparisons can be made with information from previous periods and with information produced by other entities (for example, the financial statements of similar companies operating in the same line of business). Comparability should not be confused with **consistency.** Applying consistency (using the same methods for the same items) is a means of achieving comparability (comparability is the goal).

• **Verifiability.** Verifiability helps to assure users that information is a faithful representation of the transactions or events it purports to represent. If information is verifiable it essentially means that it can be proven, for example you may be able to check it is true by examination, inspection or comparison. The Conceptual Framework states that ‘verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation’.

• **Timeliness.** Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. As a general rule older information is less useful than recent information. However, you should note that some information may still be timely for a long time after the end of a reporting period. This is true of information for users of financial information who need to identify and assess trends.

• **Understandability.** Information is understandable if it is classified, characterised and presented clearly and concisely. When considering whether information is understandable you should bear in mind that financial reports are prepared for users who have a **reasonable knowledge of business and economic** activities.
6  Accounting concepts and conventions

Section overview

- The fundamental assumptions behind ledger accounting and the preparation of financial statements are contained in IAS 1 and the Conceptual Framework.
- IAS 1 is concerned with the presentation of financial statements so that they are comparable across time and with other companies.
- The objective of financial statements is to provide useful information to users making economic decisions. To achieve this information must be presented fairly or faithfully, which generally means it should be presented in accordance with IASs.
- Each entity needs to select and apply accounting policies in order to present its financial statements. The result will be information that is relevant and faithfully represents what it purports to represent.

Many accounting procedures are operated automatically by people who have never questioned whether alternative methods exist which have equal validity. In fact the procedures in common use imply the acceptance of certain concepts which are by no means self evident, nor are they the only possible concepts which could be used to build up an accounting framework.

Our next step is to look at some of the more important concepts which are used in preparing financial statements.

We begin by considering the fundamental assumptions which are the subject of IAS 1 Presentation of Financial Statements (and which are also covered in the Conceptual Framework).

6.1  Fair presentation

In this section we look at the general requirements of IAS 1’s assumptions. The rest of IAS 1, on the format and content of financial statements will be covered in Chapter 11 and 12 when we look in detail at the preparation of company financial statements.

6.1.1  Objectives and scope of IAS 1

The main objective of IAS 1 is:

‘to prescribe the basis for presentation of general purpose financial statements, to ensure comparability both with the entity’s financial statements of previous periods and with the financial statements of other entities.’

IAS 1 applies to all general purpose financial statements prepared and presented in accordance with International Financial Reporting Standards (IFRSs – this refers to IASs as well, the collective term that we use in this Study Manual). General purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to meet their particular information needs.

6.1.2  Purpose of financial statements

The objectives of financial statements are:

- To provide information about the financial position, performance and cash flows of an entity that is useful to a wide range of users in making economic decisions
- To show the result of management’s stewardship of the resources entrusted to it
- To assist users in predicting the entity’s future cash flows and, in particular, their timing and certainty
To fulfil these objectives, financial statements must provide information about the entity’s:

- Assets
- Liabilities
- Equity
- Income and expenses (including gains and losses)
- Other changes in equity
- Cash flows

As defined in Chapter 2, these are called the **elements of financial statements**

A complete set of financial statements includes:

- Statement of financial position
- Statement of profit or loss (part of the statement of comprehensive income)
- Accounting policies note
- Statement of cash flows
- Statement of changes in equity
- Explanatory notes

Covered in the **Accounting syllabus**

A further statement of financial position from an earlier period where there has been retrospective application of an accounting policy, a reclassification or a retrospective restatement – issues that we shall come back to in Chapter 11.

Preparation of the financial statements is the responsibility of the **board of directors.** IAS 1 also recognises the value of a **financial review** by management and the production of any other reports and statements which may aid users, but these fall outside the **Accounting syllabus** scope.

6.1.3 **Fair presentation and compliance with IASs**

Most importantly, financial statements should **present fairly** the financial position, financial performance and cash flows of an entity. Applying **IASs** is presumed to result in fair presentation.

**Definition**

**Fair presentation:** The faithful representation of the effects of transactions, other events and conditions in accordance with the **Conceptual Framework.**

The following points made by IAS 1 expand on this principle.

- Compliance with IASs should be explicitly stated in a note to the financial statements.
- All relevant IASs must be followed if compliance with IASs is disclosed.
- Use of an inappropriate accounting treatment cannot be rectified either by disclosure of accounting policies or notes/explanatory material.

IAS 1 states what is required for a fair presentation.

- **Selection and application of accounting policies.**
- **Presentation of information** in a manner which provides relevant, reliable, comparable and understandable information.
- **Additional disclosures** where required to enable users to understand the impact of particular transactions, events and conditions on the entity’s financial position and performance.

6.1.4 **Departures from IASs**

There may be (very rare) circumstances when management decides that compliance with a requirement of an IAS would be so misleading that financial statements would not meet their objectives. **Departure from the IAS** may therefore be required to achieve a fair presentation. The following should be disclosed in such an event.
• Management confirmation that the financial statements fairly present the entity's financial position, performance and cash flows.
• Statement that all IASs have been complied with except in respect of departure from individual IASs, required to achieve a fair presentation.
• Details of the nature of the departure, why the IAS treatment would be misleading, and the treatment adopted.
• Financial effect of the departure.

6.2 Going concern (IAS 1)

Definition

Going concern: The entity is viewed as continuing in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the necessity of liquidation or ceasing to trade.

This concept assumes that, when preparing a normal set of financial statements, the business will continue to operate in approximately the same manner for the foreseeable future (at least, but not limited to, the next 12 months). In particular the entity will not go into liquidation or cease trading, or have no realistic alternative but to liquidate or cease trading.

When an entity is not a going concern, the financial statements must state that they are prepared on a basis other than going concern, and clarify what this basis entails. When presenting financial statements using a break up basis of accounting, an entity's assets are valued at their 'break up' value: the amount they would sell for (their net realisable value) if they were sold off individually in a forced sale and the business were broken up. Since this forced sale is necessary because the business has foreseen problems in the next 12 months, financial statements prepared on a break-up basis will contain neither non-current assets nor non-current liabilities. All assets will be deemed to be for sale and all liabilities will be treated as becoming due within 12 months of the date of the statement of financial position.

Interactive question 3: Going concern

A retailer commences business on 1 January and buys 20 washing machines, each costing £100. During the year he sells 17 machines at £150 each. How should the remaining machines be valued at 31 December in the following circumstances?

(a) He is forced to close down his business at the end of the year and the remaining machines will realise only £60 each in a forced sale.

(b) He intends to continue his business into the next year.

See Answer at the end of this chapter.

If the going concern assumption is not followed, that fact must be disclosed, together with:

• The basis on which the financial statements have been prepared.
• The reasons why the entity is not considered to be a going concern.

When there is uncertainty as to whether the entity is a going concern, this should be disclosed along with the nature of the uncertainty.

6.3 Accrual basis of accounting (IAS 1)

An entity should prepare its financial statements, except for cash flow information, using the accrual basis of accounting.
**Definition**

**Accrual basis of accounting**: Items are recognised as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the *Conceptual Framework*.

Entities should prepare their financial statements on the basis that transactions are recorded in them, not as the cash is paid or received (*cash accounting*), but as the income or expenses are *earned or incurred* in the reporting period to which they relate.

According to the accrual basis, when computing profit *income earned must be matched against the expenses incurred in earning it*.

**Worked example: Accrual basis**

Emma purchases 20 T-shirts in her first month of trading (May) at a cost of £5 each on credit. She sells all of them on credit for £10 each. Emma has therefore made a profit of £100, by matching the income (£200) earned against the cost (£100) of acquiring them.

If, however, Emma only sells 18 T-shirts, it is incorrect to charge her statement of profit or loss with the cost of 20 T-shirts, as she still has two T-shirts in hand. If she sells them in June, she is likely to make a profit on the sale. Therefore, only the purchase cost of 18 T-shirts (£90) should be matched with her sales income (£180), leaving her with a profit of £90.

Her statement of financial position will look like this at the end of May.

<table>
<thead>
<tr>
<th></th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Inventory (two T-shirts at cost, ie 2 × £5)</td>
<td>10</td>
</tr>
<tr>
<td>Receivables (18 × £10)</td>
<td>180</td>
</tr>
<tr>
<td><strong>Capital and liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Proprietor's capital (profit for the period)</td>
<td>90</td>
</tr>
<tr>
<td>Payables (20 × £5)</td>
<td>100</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>190</strong></td>
</tr>
</tbody>
</table>

However, if Emma had decided to give up selling T-shirts at the end of May, then the going concern assumption would no longer apply and the two T-shirts in the statement of financial position should be at their break up valuation, not cost. Similarly, if the two unsold T-shirts are unlikely to be sold at more than their cost of £5 each (say, because of damage or a fall in demand) then they should be recorded on the statement of financial position at their *net realisable value* (ie the likely eventual sales price less any expenses incurred to make them saleable) rather than cost.

In this example, the concepts of *going concern and accrual are linked*. Since the business is assumed to be a going concern, it is possible to carry forward the cost of the unsold T-shirts as a charge against profits of the next period.

**Definition**

**Cash accounting basis of accounting**: Under this method, a company records customer receipts in the period that they are received, and expenses in the period in which they are paid. It is easier to use and can be useful for a smaller company, especially for tax purposes where cash flow may be an issue. Under the accruals basis, a company may have to pay tax on profits before the cash is actually received by the business.

Applying the cash accounting basis to the above example, no profit or expenses would be recorded until cash changed hands. Therefore, if Emma bought 20 tshirts on credit for £5 each, and sold them on credit for £10 each in May, no profit or loss would be recorded in May. If, in June Emma received payment for the tshirts she had sold on credit, and in July she paid for the tshirts she had purchased on credit, a profit of £200 would be recorded in June, and a loss of £100 would be recorded in July.
6.4 Consistency of presentation (IAS 1)

To maintain consistency, the presentation and classification of items in the financial statements should stay the same from one period to the next, unless:

- There is a significant change in the nature of the operations, or a review of the financial statements indicates a more appropriate presentation.
- A change in presentation is required by an IAS.

By having consistent presentation the comparability of financial statements is enhanced, both over a period of time, and also between different companies.

6.5 Materiality and aggregation (IAS 1)

**Definition**

**Material:** Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or the nature of an item, or a combination of both, could be the determining factor.

Each material class of similar items shall be presented separately in the financial statements. Items of a dissimilar nature or function shall be presented separately unless they are immaterial.

A specific disclosure requirement in an IAS need not be satisfied if the information is immaterial.

The Conceptual Framework links materiality particularly to the qualitative characteristic of relevance.

Financial statements result from processing large numbers of transactions or other events that are then aggregated into classes according to their nature or function, such as 'revenue', 'purchases', 'trade receivables' and 'trade payables'. The final stage in the process of aggregation and classification is the presentation of condensed and classified items on the face of the statement of financial position or statement of profit or loss. If an item is not individually material it is aggregated with other items on the face of financial statements, though it may be separately classified in the notes.

There is no absolute measure of materiality. In relation to materiality by size it is common to apply a convenient rule of thumb (for example material items are those with a value greater than 5% of net profits). However some items are regarded as particularly sensitive and therefore as being material by nature. Even a very small misstatement of such an item is taken as a material error; an example is the amount of remuneration paid to directors of a company.

6.6 Offsetting (IAS 1)

Assets and liabilities, and income and expenditure must be presented separately in the financial statements. IAS 1 does not allow these items to be offset against each other unless such a treatment is required or permitted by another IFRS.

Income and expenses can be offset only when:

- An IFRS requires or permits it, or
- Gains, losses and related expenses arising from the same/similar transactions are not material (in aggregate).

6.7 The business entity concept

This concept has already been discussed in the context of the separate entity principle: that accountants regard a business as a separate entity, distinct from its owners or managers. The concept applies whether the business is a limited liability company (and so recognised in law as a separate entity), a sole trader or a partnership (in which case the business is not legally recognised as separate from its owners).
6.8 **The historical cost convention**

A basic principle of accounting is that the monetary amount at which **items are normally measured in financial statements is at historical cost**, i.e. at the amount which the business paid to acquire them. An important advantage of this concept is that the objectivity of financial statements is maximised: there is usually a **source document** to prove the amount paid to purchase an asset or pay an expense.

**Definition**

**Historical cost**: Transactions are recorded at their cost when they occurred.

It is easier to deal with costs when measuring items, rather than with 'values', as valuations tend to be subjective and to vary according to what the valuation is for.

**Worked example: Cost or valuation**

A company acquires a machine to manufacture its products. The company expects to use the machine for four years. At the end of two years the company is preparing a statement of financial position and has to decide what monetary amount to give the machine (the Framework refers to this process as 'measurement').

Numerous possibilities can be considered.

- The original cost (historical cost) of the machine
- Half of the historical cost, on the ground that half of its useful life has expired
- The amount the machine might fetch on the secondhand market (**realisable value**)
- The amount needed to replace the machine with an identical machine (**replacement cost**)
- The amount needed to replace the machine with a more modern machine incorporating the technological advances of the previous two years
- The machine's economic value, i.e. the amount of the profits it is expected to generate for the company during its remaining life (**present value**)

All of these valuations have something to commend them, but the great advantage of the first two is that they are based on a figure (the machine's historical cost) which is **objectively verifiable**.

There are many problems associated with the use of historical cost valuations but these are outside the scope of the Accounting syllabus.

**Interactive question 4: Accounting concepts**

(a) Your office equipment will be used, on average, for five years, so you charge 20% of its cost as depreciation each year in your statement of profit or loss. This year your business profitability is down and you think you can squeeze an extra year's life out of your equipment. Is it acceptable not to make any charge this year?

(b) You have recently paid £4.95 for a waste paper bin which should be used for about five years. Should you treat it as a non-current asset?

See **Answer** at the end of this chapter.
7 Ethical considerations

Section overview

- Application of judgement required in applying fundamental accounting concepts.
- The IESBA Code of Ethics for Professional Accountants describes five fundamental principles of professional ethics that accountants must adhere to: integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour.
- ICAEW Code of Ethics is a principles based system.

7.1 Accounting concepts and individual judgement

Many figures in financial statements are derived from the application of judgement in applying fundamental accounting concepts.

Different people exercising their judgement on the same facts could arrive at very different conclusions.

Interactive question 5: Value of reputation

An accountancy training firm has an excellent reputation amongst students and employers. How would you value this and include this asset in the financial statements?

See Answer at the end of this chapter.

Other examples of areas where the judgement of different people may vary are as follows.

- **Valuation of buildings** in times of changing property prices.
- **Research and development** (R&D): is it right to treat this only as an expense? In a sense it is an investment to generate future revenue.
- **Brands** such as 'Snickers' or 'iPod'. Are they assets in the same way that a fork lift truck is an asset?

Working from the same data, different groups of people may produce very different financial statements, but if judgement is completely unregulated, there will be no comparability between the financial statements of different organisations. This will be all the more significant in cases where deliberate manipulation occurs, in order to present financial statements in the most favourable light.

The exercise of judgement in accounting matters should always be underpinned by ethical principles. To this end both the International Ethics Standards Board for Accountants (IESBA) and the ICAEW have produced codes of ethics that state the fundamental ethical principles that all professional accountants should adhere to.

IESBA Code of Ethics for Professional Accountants – fundamental principles

The International Ethics Standards Board for Accountants (IESBA) develops ethical standards and guidance for use by professional accountants. The IESBA code applies to all professional accountants, whether in public practice, in business, education and the public sector. It serves as the foundation for codes of ethics developed and enforced by member bodies. The IESBA Code of Ethics for Professional Accountants describes five fundamental principles of professional ethics that accountants must adhere to. These are:

- **Integrity.** A professional accountant should be straightforward and honest in all professional and business relationships.
- **Objectivity.** A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgements.
• **Professional competence and due care.** A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.

• **Confidentiality.** A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

• **Professional behaviour.** A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

The structures and processes that support the operations of the IESBA are facilitated by the International Federation of Accountants (IFAC). IFAC is the global organisation for the accounting profession. It aims to ensure that the global accountancy profession is valued in the development of strong and sustainable organisations.

### Interactive question 6: Ethics

Susan works as an auditor for a client called Plasma Screen Ltd. During the audit, the CEO of Plasma Screen Ltd offers Susan their newest model of television, which is about to be released on the market, for free as a thank you for carrying out the audit. If Susan accepts the television, which of IESBA's fundamental principles of professional ethics may be threatened?

See Answer at the end of this chapter.

### ICAEW Code of Ethics

The ICAEW Code states that ‘Chartered Accountants are expected to demonstrate the highest standards of professional conduct and to take into consideration the public interest and to maintain the reputation of the accounting profession’.

It should be noted that the guidance applies to ICAEW members, students, affiliates, employees of member firms and member firms themselves. All of these are ‘expected to follow the guidance contained in the fundamental principles in all of their professional and business activities whether carried out with or without reward and in other circumstances where to fail to do so would bring discredit to the profession.’

Therefore, the Code may apply not only to the paid activities of the professional accountant but also to the life of the professional accountant, particularly if he is involved in matters relevant to his profession, such as being a Trustee of a charity or club.

The Code also states that professional accountants are required to follow the spirit as well as the letter of the guidance. In other words, a specific matter being excluded from the guidance does not mean that the accountant does not have to think about it; rather he must determine if the spirit of the guidance would also apply to that situation.

### Professional competence and due care

The principle of professional competence and due care is of particular relevance to preparers of financial statements.

Professional accountants have a duty to achieve a level of professional knowledge and skill and must ensure that they do not operate beyond their current level of competence.

In order to continue offering services in a particular field the professional accountant must maintain their competence. This can be achieved through a continued awareness of the relevant technical, professional and business developments.
As part of the requirement for diligence the professional accountant should do what is required to deliver the agreed service, should ensure that any staff working under their authority are competent and adequately trained and supervised and where appropriate should ensure that the client or employer understands the limitations of the services that are being provided.

### 7.2 Principles based system

Rather than containing a set of rules, the ethics codes discussed above are principles based. There are a number of advantages to a framework over a system of ethical rules. These are outlined in the table below.

<table>
<thead>
<tr>
<th>Advantages of a principles based over a rules based system of ethics</th>
</tr>
</thead>
<tbody>
<tr>
<td>A principles based system places the <strong>onus on the individual</strong> to actively consider independence for every given situation, rather than just agreeing a checklist of forbidden items. Even if something is not expressly stated in the guidance, professional accountants are required to follow the spirit as well as the letter of the guidance.</td>
</tr>
<tr>
<td>A principles based system <strong>prevents individuals interpreting legalistic requirements narrowly</strong> to get around the ethical requirements. There is an extent to which rules engender deception, whereas principles encourage compliance.</td>
</tr>
<tr>
<td>A principles based system <strong>allows for</strong> the variations that are found in every <strong>individual situation</strong>. Each situation is likely to be different.</td>
</tr>
<tr>
<td>A principles based system can accommodate a <strong>rapidly changing environment</strong>, such as the one that professional accountants regularly face.</td>
</tr>
<tr>
<td>A principles based system <strong>can contain prohibitions</strong> where these are necessary as safeguards are not feasible.</td>
</tr>
</tbody>
</table>

**Interactive question 7: ICAEW Code of Ethics**

Discuss the merits and drawbacks of the ICAEW Code of Ethics being a principles based system.

See **Answer** at the end of this chapter.
Summary and Self-test

Summary

Accounting

Business entity: Sole trader, Partnership, Company

Conceptual Framework:
- Fundamental qualitative characteristics
  - Relevance
  - Faithful representation
  - Comparability
  - Verifiability
  - Timeliness
  - Understandability
- Enhancing qualitative characteristics
  - Materiality
- Make economic decisions
- Assess stewardship
- Estimate cash flows
- Complete
- Free from error
- Unbiased

Financial performance:
- Statement of profit or loss
- Statement of financial position

Accounting information: financial statements

Regulation

Content

Objective

Users
- Managers
- Owners
- Customers
- Suppliers
- Lenders
- Employees
- Government
- Analysts
- Public

Legislation

Conceptual Framework: fundamental qualitative characteristics

UK GAAP (Chapters 14+15)

Accounting standards (Chapter 11)

Accounting concepts

Users
Self-test

Answer the following questions.

1. An entity’s transactions are recorded first in
   A. Books of original entry
   B. Ledger accounts
   C. The statement of profit or loss
   D. The statement of financial position

2. Liability for the debts of the business does **not** fall on
   A. A sole trader
   B. Partners in a general partnership
   C. A limited liability company
   D. Owners of a limited liability company

3. According to IAS 1 which of the following does **not** represent an objective of financial statements?
   A. To provide information to investors in making economic decisions
   B. To provide information to managers in making business decisions
   C. To show the results of management’s stewardship of the resources entrusted to it
   D. To help users predict the entity’s future cash flows

4. Which one of the following issues in an entity’s financial statements is likely to be of most interest to an entity’s lender?
   A. Whether the entity has paid a dividend
   B. Whether the entity will repay a loan when it falls due
   C. Whether the entity will continue to be able to employ people
   D. Whether the entity patronises local suppliers

5. A statement of financial position is best described as:
   A. A snapshot of the entity’s financial position at a particular point in time
   B. A record of an entity’s financial performance over a period of time
   C. A list of all the income and expenses of the entity at a particular point in time
   D. A list of all the assets and liabilities of the entity over a period of time

6. In applying fundamental accounting concepts the preparers of financial information are also using
   A. Legislation
   B. Accounting standards
   C. Judgement
   D. Financial reporting standards

7. Match the fundamental ethical principle to the characteristic.
   A. Integrity
   B. Objectivity
   (i) Members should be straightforward and honest in all professional and business relationships.
   (ii) Members should not allow bias, conflict or interest or undue influence of others to override professional or business judgements.

8. Which of the following would **NOT** be a suitable question to ask yourself when resolving an ethical dilemma?
   A. Would my colleagues think my solution is reasonable?
   B. Have I thought about all the possible consequences of my solution?
   C. Could I defend my solution under public scrutiny?
   D. Does my solution benefit my career?
9 The ICAEW Code only applies to the paid activities of the professional accountant.
   True ☐
   False ☐

10 Which of the following is not a source of the accounting rules embodied in UK GAAP?
   A The Companies Act 2006
   B UK accounting standards
   C Listing requirements of the London Stock Exchange
   D Accounting requirements of an entity’s US parent company

11 Which of the following factors have not influenced financial reporting?
   A National legislation
   B Economic factors
   C Accounting standards
   D GAAP

12 Materiality is an entity-specific aspect of which qualitative characteristic?
   A Relevance
   B Understandability
   C Faithful representation
   D Comparability

13 Which of the following is an item of capital expenditure?
   A Cost of goods sold
   B Purchase of a machine
   C Repairs to a machine
   D Wages cost

Now, go back to the Learning Objectives in the Introduction. If you are satisfied that you have achieved these objectives, please tick them off.
1 The purpose of accounting information

- 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 about providing resources to the entity.
- To provide information about the financial position, performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.
- To show the results of management's stewardship of the resources entrusted to it.
- Assists users of the financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

Conceptual Framework
Para OB2
IAS 1 para 9
IAS 1 para 9
IAS 1 para 9
IAS 1 para 9

2 The regulation of accounting

- A statement of financial position, a statement of comprehensive income, a statement of changes in equity, a statement of cash flows, notes and (in certain circumstances) a revised statement of financial position from an earlier period.
- Fair presentation/faithful representation.

IAS 1 para 10
IAS 1 para 15;
Conceptual Framework
paras QC12 - QC16

3 The main financial statements

- Information about the nature and amounts of an entity's economic resources and claims can help users to assess the entity's liquidity and solvency, its need for additional financing and how successful the entity is likely to be in obtaining that financing.
- Information about a reporting entity's financial performance is needed by users to understand the return that the entity has produced on its economic resources. Information about the return the entity has produced provides an indication of how well management has discharged its responsibilities to make efficient and effective use of the reporting entity's resources. Information about the variability and components of that return is also important, especially in assessing the uncertainty of future cash flows.

Conceptual Framework
Para OB13
Conceptual Framework
para OB16

4 The qualitative characteristics of useful financial information

- Fundamental qualitative characteristics: relevance and faithful representation.
- Enhancing qualitative characteristics: comparability, verifiability, timeliness and understandability.

Conceptual Framework
paras QC6-QC34

5 Objectives and scope of IAS 1

- To prescribe the basis for presentation of general purpose financial statements, to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities.
- To be applied to all general purpose financial statements prepared and presented in accordance with International Financial Reporting Standards (IFRSs).
- General purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to meet their particular information needs.

IAS 1 para 1
IAS 1 para 2
IAS 1 para 7
6 The purpose of financial statements

- To provide information about the financial position, performance and cash flows of an entity that is useful to a wide range of users in making economic decisions
  - To show the results of management’s stewardship of the resources entrusted to it
  - To assist users in predicting the entity’s future cash flows and, in particular, their timing and certainty
  - To provide information about the entity’s assets, liabilities, equity, income and expenses (including gains and losses), other changes in equity and cash flows

7 Components of financial statements

- A statement of financial position at the end of the reporting period, a statement of profit or loss, an accounting policies note, a statement of changes in equity, a statement of cash flows, explanatory notes and a statement of financial position at an earlier date where there has been retrospective application, retrospective restatement or reclassification

8 Fair presentation (IAS 1)

- The faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria in the Framework. The application of IASs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

- Compliance with IASs must be explicit and complete.

- For there to be fair presentation:
  - Accounting policies must be selected and applied.
  - Information must be presented in a manner which provides relevant, reliable, comparable and understandable information.
  - To enable users to understand the impact of particular transactions, events and conditions on the entity’s financial position and performance additional disclosures may be required.

- Use of an inappropriate accounting treatment cannot be rectified either by disclosure of accounting policies or notes/explanatory material

- In some circumstances departure from the IASs may be required to achieve a fair presentation

9 Underlying assumptions

- Financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. Assessment of whether the going concern assumption is appropriate must take into account all available information for at least 12 months from the end of the reporting period. Any uncertainty must be disclosed.

- An entity should prepare its financial statements using the accrual basis of accounting, recognising the elements of financial statements in line with the Framework.

- To maintain consistency, the presentation and classification of items in the financial statements should stay the same from one period to the next, unless there is significant change in the nature of the operations, or a review of the financial statements indicates a more appropriate presentation, or a change in presentation is required by an IAS.
• Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. **Materiality** depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or the nature of an item, or a combination of both, could be the determining factor.

• Each material class of similar items shall be presented separately in the financial statements. Items of a dissimilar nature or function shall be presented separately unless they are immaterial, but a specific disclosure requirement in an IAS need not be satisfied if the information is immaterial.

IAS 1 para 7
IAS 1 paras 29 and 31
Answers to Interactive questions

Answer to Interactive question 1
Limited liability companies (though not other forms of business such as general partnerships) are required to make certain accounting information public. This is done by filing information centrally, as a Companies Act 2006 requirement.

Answer to Interactive question 2
(a) Capital expenditure
(b) Depreciation is revenue expenditure
(c) Legal fees associated with purchasing a property may be added to the purchase price and classified as capital expenditure
(d) Capital expenditure (enhancing an existing long-term asset)
(e) Revenue expenditure (restoring an existing long-term asset)
(f) Capital income (net of the costs of sale)
(g) Revenue income
(h) Capital expenditure
(i) If customs duties are borne by the purchaser of the long-term asset, they should be added to the purchase cost of the machinery and classified as capital expenditure
(j) If carriage costs are paid for by the purchaser of the long-term asset, they should be included in the cost of the long-term asset and classified as capital expenditure
(k) Installation fees of a long-term asset are also added to cost and classified as capital expenditure
(l) Revenue expenditure

Answer to Interactive question 3
(a) If the business is to be closed down, the remaining three machines must be valued at the amount they will realise in a forced sale, ie 3 x £60 = £180.
(b) If the business is regarded as a going concern, the machines unsold at 31 December will be valued as an asset at cost, 3 x £100 = £300.

Answer to Interactive question 4
(a) No, because of the need for consistency. Once the depreciation policy has been established, it should not be changed without good cause.
(b) No, because of the materiality concept. The cost of the bin is very small. Rather than cluttering up the statement of financial position for five years, treat the £4.95 as an expense in this year’s statement of profit or loss.

Answer to Interactive question 5
The firm may have relatively little in the form of things you can touch, perhaps a building, desks and chairs. If you simply drew up a statement of financial position showing the cost of the things owned, then the business would not seem to be worth much, yet its income earning potential might be high. This is true of many service organisations where the people are among the most valuable assets, but justifying their exact value is extremely problematic.
Answer to Interactive question 6

Objectivity. Unless the value of the gift/hospitality is clearly insignificant, a firm or a member of an assurance team should not accept it. It clearly threatens objectivity. In addition there may also be an intimidation threat if there is a suggestion that the receipt of the gift will be made public.

Answer to Interactive question 7

The key merit of the code being principles based is that it is flexible. Professional accountants must consider the spirit of the guidance, even where there is no explicit guidance for a given scenario. This is necessary in the rapidly changing environment in which ICAEW members operate.

Rules based systems tend to give rise to checklists, which are often unsuitable when considering the ethical implications of decisions. Under the principles based system, members cannot simply engage in a box-ticking exercise, and the risk of loopholes arising in ethical guidance is reduced.

Disadvantages

Critics would argue that the principles based system may allow individuals to get away with non-compliance unchallenged, as they apply their own individual interpretation to the guidance.
1. A Books of original entry form the primary record of transactions. These are analysed and posted to the ledger accounts and summarised in the financial statements, including the statement of profit or loss and the statement of financial position.

2. D Sole traders and partners bear full liability for the debts of the business entity, as does a limited liability company itself. The liability of the shareholders or owners for the debts of a company is, however, limited.

3. B IAS 1 identifies A, C and D as an objective. The use of accounting information by managers in making business decisions is not identified as an objective.

4. B A is of interest to investors; C is of interest to employees, D is of interest to suppliers.

5. A A statement of financial position is a list of assets and liabilities which represent the entity’s financial position at a particular point in time. D is wrong because it refers to 'a period of time'; C refers to income and expenses, not assets and liabilities; B defines the statement of profit or loss.

6. C Many figures in financial statements are derived from the application of judgement in putting fundamental accounting concepts into practice.

7. A (i) 
   B (ii) 

8. D The best solution to an ethical dilemma should be taken whether or not it improves your career.

9. False. The Code may apply not only to the paid activities of the professional accountant but also to the life of the professional accountant, particularly if he is involved in matters relevant to his profession, such as being a Trustee of a charity or club.

10. D UK GAAP relates to generally accepted accounting practice; the rules applied as a result of internal requirements can therefore not be part of GAAP.

11. B Economic factors do not influence the development of financial reporting; all the others do (see section 3).

12. A Information is material if omitting or misstating it could influence the decisions of the users. If information is deemed material then it is relevant to the users. The Conceptual Framework states that materiality is an entity-specific aspect of relevance.

13. B This results in the acquisition of a long-term asset. All the others are revenue expenditure.