ACC 201: Financial Accounting

Unit 2: Conceptual Framework of Accounting 3 LH

Reference: Financial Accounting, BBA/BIM/BBM, KEC Publication Book

Unit 2: Conceptual Framework of Accounting

- GAAP and its features;
- Basic accounting concepts: the business entity concept, the monetary concept, the going concern concept, the cost concept, the dual aspect concept, the accounting period concept, the realization concept, the accrual concept and the matching concept;
- Basic accounting conventions: consistency, conservatism, materiality and full disclosure;
- Differences between accrual versus cash basis of accounting;
- Differences between accounting and accountancy.
- Accounting standards: meaning, nature, need, significance and classification of accounting standards;
- Concept of Nepal Accounting Standards (NASs)
- International Accounting Standards (IASs)
- Nepal Financial Reporting Standards (NFRSs)
- International Financial reporting Standards (IFRSs)
- Disclosures required as per NFRS.

Generally Accepted Accounting principles (GAAP):

The financial accounting based on certain standards or principles (concept) that increases the objectivity of information and they are called Generally Accepted Accounting principles (GAAP). These concept are established by the international financial accounting standard board.

Features of GAAP:

i. Relevance: **ii. Reliability:** **iii. Understandability:** **iv. Comparability:**

Accounting concept/Assumption/principles :

i) Business entity concept:

According this concept the business and the owner (proprietor) are two different entities. Business is treated separate from the owner. All business transaction are recorded in the books of firms and not owners book. If business transaction and private transaction are mixed the true financial position of the business will not be available. for example Mr. A established a business organization as Kathmandu Enterprise for doing business . for maintaining books of account of Kathmandu Enterprises it is necessary to separate Mr. A from Kathmandu Enterprise.

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ii) Money measurement concept :

According to this concept, those transaction, which can be expressed in monetary term are recorded in accounting those transaction which cannot be measured in money will not be recorded in accounting books. For example, (i) A threat to strike by labour, loss by Nepal Banda, loss due to conflict between upper level and lower level staffs cannot be measured in terms of money. So, they are not recorded in the books of account. Rent paid, salary paid, goods purchased, cash deposited etc can be measured in terms of money and are recorded in the books of account.

iii) Going concern concept:

This concept relates with the long life of the business. A business is intended to continue for an indefinitely long period. Under this concept the fixed assets are recorded at original cost and depreciation is charge in a proper manner market value of fixed assets are not considered while preparing final account but outstanding expenditure and prepaid expenses are considered on the assumption of business will continue.

iv)Accounting period concept:

Accounting is a continuous process in any business undertaking. Every business man wants to know the result and financial position at the frequent time interval. Accounts choose some shorter period to measure the result. Therefore one year has been generally accepted as the accounting period. In the context of Nepal , accounting period is started from first Shrawan of current year to Ashadh of next year.

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V) Cost concept:

According to this concept, cost of goods and service are recognized when they are incurred and recorded at their cost so it is also called historical cost concept. Fixed assets are always recorded in cost price but in subsequent years recorded at book values (cost price less depreciation) not at their current market value or sales value.

vi) Realization concept:

Revenue is earned either by selling goods or rendering service so revenue should be realize at the time when it is actually earned, it does not matter whether cash has been received or not. So it is also known as Revenue recognition concept. This concept is very important is ascertaining the exact profit earned during a period in a business concern.

vii) Matching concept:

According to this concept the expense incurred in an accounting period should be match with the revenue recognized in that period, so as to calculate the profit earned or loss suffered during the period.

VII. Dual aspect concept:

Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e. it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. For example, goods purchased for cash has two aspects which are (i) Giving of cash (ii) Receiving of goods. These two aspects are to be recorded. Thus, the duality concept is commonly expressed in terms of fundamental accounting equation :

$$\text{Assets} = \text{Liabilities} + \text{Capitals}$$

VIII. Accrual concept:

The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognized when they become receivable. Though cash is received or not received and the expenses are recognized when they become payable though cash is paid or not paid.

BASIC ACCOUNTING CONVENTION:

Accounting conventions are the ways and procedure which are followed to give a true and equitable view of the financial statement. Accounting conventions are guidelines that help standardize the preparation and presentation of financial statements. They include several key principles:

1. **Consistency:** This convention states that financial statements can be compared only when the accounting policies are followed consistently by the business organization over the period.
2. **Conservatism:** Conservatism is one of the fundamental conventions of accounting, ensuring that financial statements provide a realistic view of a company's financial position. By recognizing potential losses early and deferring revenue recognition until it is certain, this principle helps prevent the overstatement of financial health and ensures that stakeholders have a clear and reliable view of a company’s financial status.
3. **Materiality:** The materiality concept states that only those items to be disclosed in the financial statement which has a significant economic effect.
4. **Full disclosure:** The disclosure principle state that the financial statement of a business should be prepared in such a way that it fairly reveals all the relevant and material information to the users, so as to help them in taking a rational decision making.

Accounting methods (Accrual basis and Cash basis)

Accrual Basis Accounting

Accrual basis accounting is an accounting method that records revenues and expenses before payments are received or issued. In other words, it records revenue when a sales transaction occurs. It records expenses when a transaction for the purchase of goods or services occurs.

The accrual method is the more commonly used method by large companies, especially by publicly-traded companies, as it smooths out earnings over time.

Cash Basis Accounting

Cash basis accounting records revenue and expenses when actual payments are received or payment. It doesn't account for either when the transactions that create them occur.

The cash basis method typically is used by sole proprietors and smaller businesses.

Cash basis and accrual basis refer to two different methods for recording business transactions. While cash-based accounting records income and expenses when the transactions actually received or paid, accrual-based accounting records income and expenses when they are earned or incurred.

ACCOUNTING STANDARDS

CONCEPT ACCOUNTING STANDARDS:

An accounting standard is a common set of principles, standards and procedures that define the basis of financial accounting policies and practices. Accounting standards improve the transparency of financial reporting in all countries.

The main aims of accounting standards are to bring uniformity & reliability in the whole accounting system. Accounting standards standardize the whole accounting procedure of the economy. All companies after adopting these accounting standards follow the same manner of recording transactions.

Nature of Accounting Standards:

1. Mandatory To Follow
2. Guider for accounting
3. Framed According To Law
4. Serves As A Harmonizer
5. Flexible In Nature
6. Avoids Frauds & Data Manipulation

Need / Importance of Accounting Standards:

1. Easy Comparability Of Financial Statements
2. Brings Uniformity in accounting system
3. Assists Auditors
4. Makes Accounting Informative Easy & Simple
5. Avoids Frauds & Manipulations
6. Provides Reliability To Financial Statements.
7. Measures Management Performance

Limitations of Accounting Standards:

1. Difficulty in choosing alternatives
2. Restricted scope:
3. Time-Consuming
4. Involves High Costs

NEPAL ACCOUNTING STANDARDS (NAS)

The Accounting Standards Board (ASB) is an independent statutory body with the responsibility to set and issue accounting standards for preparation and presentation of financial statements in Nepal. The Government of Nepal established ASB in March 2003 with an amendment to the Institute of Chartered Accountants of Nepal Act 1997 incorporating the provision for its establishment and operation. The ASB is primarily responsible for setting accounting and financial reporting standards for business enterprises in line with the International Financial Reporting Standards (IFRSs). Since 2007, ASB has also been entrusted by Nepal Government with the responsibility to develop accounting standards for public sector in line with the International Public Sector Accounting Standards (IPSASs).

INTERNATIONAL ACCOUNTING STANDARDS (IAS)

International Accounting Standards (IAS) were the first international accounting standards that were issued by the International Accounting Standards Committee (IASC), formed in 1973. The goal then, as it remains today, was to make it easier to compare businesses around the world, increase transparency and trust in financial reporting, and encourage global trade and investment.

NEPAL FINANCIAL REPORTING STANDARDS (NFRS)

Nepal Financial Reporting Standards ('NFRS') are designed as a common global language for business affairs so that company accounts are understandable and comparable within Nepal. The rules to be followed by accountants to maintain books of accounts which is comparable, understandable, reliable and relevant as per the users internal or external. NFRS was issued by Nepal Accounting Standard Board in 2013. Earlier it has issued Nepal Accounting Standards. NFRS is prepared in line with on IFRS.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

Businesses are operating all over the world. Certain organizations have worldwide existence. If we take an example of Infosys, which is an Indian IT company, works all over the world. The accounting information of one particular company in so many countries will be as per that country's law and reporting standards. Therefore there will be confusion in considering the accounting information. In order to avoid this confusion, International Accounting Standards Board (IASB) has created one unique accounting language which is called as International Financial Reporting Standards most commonly known as IFRS.