UNIT 1
Theoretical Framework

(4 Hours) — Financial Accounting (CACS152)

1. Meaning and Scope of Accounting

1.1 Meaning of Accounting

Accounting is the systematic process of identifying, recording, classifying, summarizing, analyzing and interpreting the financial transactions of a business, and communicating the results to interested parties. It is often described as the "language of business" because it conveys financial information about an organization to owners, managers, investors, and regulators in a standardized form.

The American Institute of Certified Public Accountants (AICPA) defines accounting as the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.

1.2 Procedural Aspects of Accounting

Accounting follows a definite sequence of procedural steps, together known as the accounting cycle. Each step feeds into the next until financial statements are produced and communicated to users.

- Identifying — recognizing transactions and events of a financial nature.
- Recording — entering transactions in the Journal in chronological order.
- Classifying — posting journal entries into the Ledger, grouped by account.
- Summarizing — preparing the Trial Balance and Final Accounts (Trading, Profit & Loss Account, and Balance Sheet).
- Analyzing and Interpreting — examining the summarized data to draw meaningful conclusions about performance and position.
- Communicating — reporting the results to owners, management, and other stakeholders through financial statements and reports.

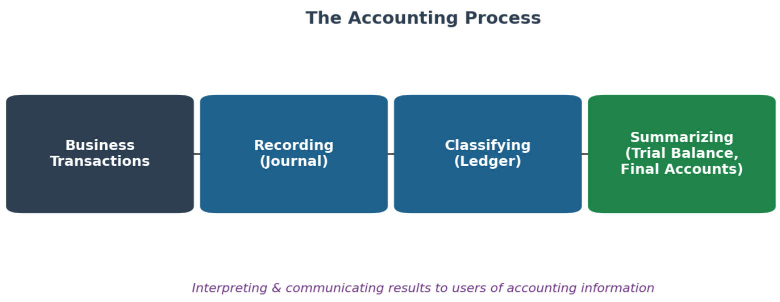

Fig 1.1 — The Accounting Process, from raw transactions to final communication of results.

1.3 Evolution of Accounting as a Social Science

Accounting has evolved from a simple record-keeping practice of ancient traders into a structured social science shaped by economic, legal, and institutional developments. Double-entry bookkeeping, first documented by Luca Pacioli in 1494, marked a turning point by introducing the dual aspect of every transaction. With the growth of joint-stock companies, capital markets, taxation systems, and government regulation, accounting expanded from a private record-keeping tool into a discipline that serves the broader interests of society — shareholders, creditors, employees, the government, and the public at large.

Note: Because accounting now affects the decisions of many groups in society, not just the business owner, it is regarded today as a social science rather than a purely mechanical or clerical exercise.

1.4 Objectives of Accounting

- To maintain systematic records of all financial transactions.
- To ascertain the profit or loss of the business for an accounting period.
- To ascertain the financial position of the business at a given date.
- To provide financial information to owners, management, and other users for rational decision-making.
- To assist management in planning, controlling, and evaluating operations.
- To provide information required for meeting legal and tax obligations.
- To protect the assets of the business against fraud and misuse.

1.5 Functions of Accounting

- Recording function — the basic and primary function of maintaining a systematic record of transactions.
- Reporting function — communicating financial results through periodic statements.

• Controlling function — helping management control resources through budgets, standard costs, and internal checks.

• Forecasting function — using historical data as a basis for future planning and budgeting.

• Decision-making function — providing quantitative financial information that supports economic decisions.

1.6 Sub-fields of Accounting

Sub-field	Focus / Purpose
Financial Accounting	Recording transactions and preparing statements for external users (owners, creditors, tax authorities).
Cost Accounting	Ascertaining and controlling the cost of products, processes, or services.
Management Accounting	Providing financial and non-financial information to management for planning and control.
Tax Accounting	Preparing accounts in accordance with tax laws and computing tax liability.
Auditing	Independent examination of financial statements to express an opinion on their fairness.
Social Responsibility Accounting	Reporting the social costs and benefits of business activities to society.

1.7 Users of Accounting Information

User Group	Nature of Interest
Owners / Shareholders	Return on investment and safety of capital invested.
Management	Day-to-day planning, control, and decision-making.
Investors / Prospective investors	Profitability and future prospects of the business.
Creditors and Lenders	Ability of the business to repay debts on time.
Employees	Job security, wages, bonuses, and continuity of employment.
Government	Assessment of tax liability and formulation of economic policy.
Customers	Continuity of the business and reliability of products/services.
General Public	Contribution of the business to the local economy and employment.

1.8 Relationship of Accounting with Other Disciplines

Accounting does not function in isolation; it draws upon, and contributes to, several other fields of knowledge.

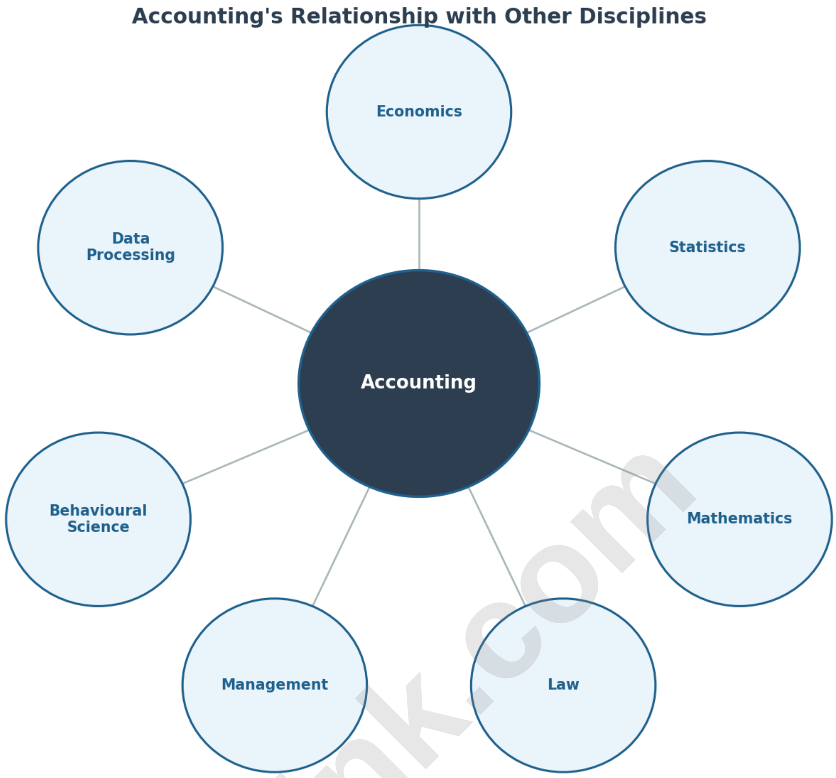

Fig 1.2 — Accounting draws upon economics, statistics, mathematics, law, management, behavioural science, and data processing.

- Economics — accounting concepts such as income and value are rooted in economic theory.
- Statistics — statistical tools are used in analyzing financial data and forecasting trends.
- Mathematics — arithmetic and algebraic techniques underlie bookkeeping and financial calculations.
- Law — company law, tax law, and contract law shape accounting practice and disclosure requirements.
- Management — accounting information is a key input to managerial planning and control.
- Behavioural Science — studies how accounting information influences the behaviour of individuals and organizations.
- Data Processing — modern accounting relies heavily on computerized information systems.

1.9 Limitations of Accounting

- Accounting records only transactions that can be expressed in monetary terms; non-monetary factors (employee morale, brand reputation) are excluded.
- It is based on historical cost, which may not reflect current market value.
- The use of estimates (e.g., depreciation, provisions) introduces an element of personal judgment and possible bias.
- Accounting information is essentially historical and may not fully represent the future prospects of the business.
- Price-level changes (inflation) are usually ignored under the historical cost convention.

1.10 Role of the Accountant in Society

An accountant serves as a trusted intermediary between a business and the many groups that rely on its financial information. Beyond preparing records and statements, the accountant is expected to ensure the accuracy, reliability, and fairness of financial reporting, to advise management on financial matters, to assist in tax compliance, and — particularly in the case of auditors — to safeguard the interests of shareholders and the public by verifying that financial statements give a true and fair view of the affairs of the business.

2. Accounting Concepts, Principles and Conventions

2.1 Accounting Concepts, Principles and Conventions — An Overview

To ensure that financial statements are prepared on a consistent and comparable basis, accountants follow a body of broadly accepted rules known as Generally Accepted Accounting Principles (GAAP). These rules are commonly grouped into concepts (basic assumptions underlying accounting), principles (general rules that guide the preparation of accounts), and conventions (customary practices followed for the sake of uniformity, such as conservatism and materiality).

Concept / Principle	Meaning
Business Entity	The business is treated as an entity separate and distinct from its owner(s).
Money Measurement	Only transactions expressible in monetary terms are recorded.
Going Concern	The business is assumed to continue operating for the foreseeable future.
Accounting Period	The life of the business is divided into periodic intervals (usually one year) for reporting purposes.
Cost Concept	Assets are recorded at their original (historical) purchase cost.
Dual Aspect	Every transaction has two aspects — a debit and a corresponding credit.

Concept / Principle	Meaning
Matching Principle	Expenses are matched against the revenues they help generate within the same period.
Realization Principle	Revenue is recognized only when it is earned, not merely when cash is received.
Consistency	The same accounting methods should be applied period after period to enable comparison.
Conservatism (Prudence)	Anticipate no profit but provide for all possible losses.
Materiality	Only items significant enough to influence a user's decision need be disclosed in detail.
Full Disclosure	All material and relevant information should be disclosed in the financial statements.

2.2 Qualitative Characteristics of Financial Statements

Qualitative characteristics are the attributes that make financial information useful to its users. The IASB Conceptual Framework identifies the following as the principal qualitative characteristics.

- Relevance — information must be capable of influencing the economic decisions of users.
- Faithful Representation — information must be complete, neutral, and free from material error.
- Comparability — information should allow users to identify similarities and differences across periods and entities.
- Verifiability — different knowledgeable observers should be able to reach a consensus that the information is faithfully represented.
- Timeliness — information must be available to decision-makers before it loses its capacity to influence decisions.
- Understandability — information should be presented clearly so that users with reasonable business knowledge can comprehend it.

2.3 Fundamental Accounting Assumptions

Certain assumptions are so fundamental to the preparation of financial statements that they need not be separately disclosed if they are followed; if any of these is not followed, that fact must be disclosed.

Example 2.1 — Applying the Going Concern Assumption
A company purchases machinery for Rs. 10,00,000 with a useful life of 10 years. Under the going concern assumption, the cost is depreciated over its useful life rather than written off immediately, because the business is expected to continue operating and using the asset.

Explanation
If the going concern assumption did not hold (e.g., the business were about to be liquidated), the machinery would instead be shown at its expected net realizable (liquidation) value rather than at depreciated historical cost.

- Going Concern — the enterprise will continue in operation for the foreseeable future.
- Consistency — accounting policies are applied consistently from one period to another.
- Accrual — revenues and costs are recognized as they are earned or incurred, not merely when cash is received or paid, and are recorded in the period to which they relate.

3. Accounting Standards

3.1 Concepts, Objectives and Benefits of Accounting Standards

Accounting Standards are authoritative statements of accounting practice issued by a recognized standard-setting body, prescribing the manner in which particular types of transactions and events should be recognized, measured, presented, and disclosed in financial statements. They exist to harmonize accounting practices and to reduce variations arising from differing judgments and choices among preparers.

- Objective: to bring uniformity in accounting policies and practices across enterprises.
- Objective: to improve the reliability and credibility of financial statements.
- Objective: to facilitate meaningful comparison of financial statements between enterprises and over time.
- Benefit: reduces the scope for manipulation and window-dressing of accounts.
- Benefit: enhances the confidence of investors, creditors, and regulators in published accounts.
- Benefit: assists auditors in forming an opinion on financial statements against an objective benchmark.
- Benefit: facilitates cross-border comparability as national standards converge with international standards.

3.2 An Overview of Nepal Accounting Standards (NAS)

In Nepal, accounting standards are issued by the Accounting Standards Board (ASB) Nepal and are largely aligned with International Financial Reporting Standards (IFRS), adapted for the Nepalese regulatory and business environment. Select examples are illustrated below.

NAS	Subject Matter
NAS 1	Presentation of Financial Statements
NAS 2	Inventories
NAS 7	Statement of Cash Flows
NAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
NAS 16	Property, Plant and Equipment
NAS 18	Revenue
NAS 37	Provisions, Contingent Liabilities and Contingent Assets

Note: The list above is illustrative rather than exhaustive; Nepal Financial Reporting Standards (NFRS), which correspond closely to full IFRS, apply to publicly accountable entities such as listed companies and banks.

4. Accounting Policies

4.1 Meaning of Accounting Policies

Accounting policies are the specific principles, bases, conventions, rules, and practices adopted by an enterprise in preparing and presenting its financial statements. While accounting standards lay down the broad framework, policies represent the concrete choices an enterprise makes within that framework — for example, the choice between the straight-line and reducing-balance methods of depreciation, or between FIFO and weighted-average methods of inventory valuation.

4.2 Selection of Accounting Policies

Management selects and applies accounting policies so that financial statements comply with applicable accounting standards and present a true and fair view. Where a standard does not specifically address a transaction, management uses judgment to develop a policy that results in information that is relevant and reliable.

- The policy chosen should represent a true and fair view of the state of affairs and of the profit or loss for the period.
- The primary consideration in selecting a policy is that it results in financial statements that provide relevant and reliable information to users.

- Prudence should be exercised in framing judgments under conditions of uncertainty.
- The substance of transactions should be reflected, not merely their legal form.
- Policies should be applied consistently to enable comparison of financial statements over time.

4.3 Changes in Accounting Policies

An enterprise should ordinarily use the same accounting policy from one period to the next. A change in accounting policy should be made only if it is required by a statute, or by an accounting standard, or if it is considered that the change would result in a more appropriate presentation of the financial statements.

- Any change in an accounting policy that has a material effect should be disclosed, along with the reasons for the change.
- Where the effect of the change is not ascertainable, wholly or in part, that fact should also be disclosed.
- If a change is made but has no material effect on the financial statements for the current period, but is reasonably expected to have a material effect in future periods, that fact should be disclosed.

Note: A mere change in an accounting estimate (e.g., revising the useful life of an asset) is not the same as a change in accounting policy, and the two should not be confused.

Key Takeaways

✓ Accounting is the systematic process of recording, classifying, summarizing, analyzing, and communicating financial information.

✓ The accounting cycle moves from identifying transactions through recording, classifying, and summarizing, to analysis and communication.

✓ Accounting serves a wide range of users — owners, management, investors, creditors, employees, government, and the public.

✓ Accounting concepts, principles, and conventions (GAAP) provide the foundation for consistent and comparable financial reporting.

✓ Going concern, consistency, and accrual are the fundamental accounting assumptions underlying financial statements.

✓ Accounting Standards (including Nepal Accounting Standards) bring uniformity, reliability, and comparability to financial reporting.

✓ Accounting policies are the specific choices an enterprise makes within the framework of accounting standards, and changes to them must be disclosed if material.

— End of Unit 1 —