MODULE-2

THE CONCEPTUAL FRAMEWORK
OF ACCOUNTING

IASB FRAMEWORK

A conceptual framework can be defined as a system of ideas and objectives that lead to the creation of a consistent set of rules and standards set the nature, function and limits of financial accounting and financial statements.

IASB FRAMEWORK

1. Objectives of financial reporting by business enterprises.
2. Qualitative characteristics of accounting information.
3. Recognition and measurement in financial statements of business enterprises.
4. Elements of financial statements.
5. Concepts of capital and capital maintenance.

IASB FRAMEWORK DEALS WITH

Objective of financial statements	Underlying assumptions	Qualitative characteristics	Elements of financial statements	Concepts of capital and maintenance
Inform. on financial position	Accrual system	Understand ability	Assets	
Inform. On performance	Going concern	relevance	Liabilities	
Inform. On changes in financial position		reliability	Equity	
		comparability	Income	
			Expenses	

Framework is comprised in 3 levels

1-Basic objectives

2-Qualitative characteristics and basic elements

3-Recognition and measurement concepts.

ASSUMPTIONS:

1. Economic entity
2. Going concern
3. Monetary unit
4. Periodicity

PRICIPLES:

1. Historical cost
2. Revenue recognition
3. Matching
4. Full disclosure

CONSTRAINTS:

1. Cost benefit
2. Materiality
3. Industry practice
4. Conservatism

Qualitative characteristics:

Relevance
Reliability
Comparability
consistency

Elements:

Assets, liabilities & equity
Investment by owner
Distribution to owner
Revenues &expenses
Gains &losses

Objectives:

1. Usefull in investment and credit decision
2. Usefull in assessing the future cash flows
3. About enterprise resources, claims to resources and changes in them.

1. Basic objectives

- Financial reporting should provide the information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decision.
- To help investors and creditors and other users in assessing the amounts timing and uncertainty of prospective cash receipt.
- To portrays the economic resources of an enterprise, the claims to those resources, and the effect of transactions, events and circumstances that change its resources and claims to those resources.

2:qualitative characteristics and elements

The FASB identified the qualitative characteristics of accounting information that distinguish better information from inferior information for decision making purposes.

3: Fundamental concepts

Decision usefulness: by determining which alternative provides the most useful information for decision making purposes.

Purpose of financial statement

- General : statements are prepared and presented at least annually and are directed towards the common information needs of a wide range of users.
- Special: framework prospectuses and computations prepared for taxation purposes, are outside the scope of this framework.
- Financial statements are part of the process of financial reporting.

Users of financial statement

1.Investors:
2.Employees:
3.Lenders:
4.Suppliers and other trade creditors:
5.customers:
6.Governaments and their agencies:
7.Public

Objective of financial statements

- They largely portray the financial effects of past events, & do not necessarily provide non financial information.
- It also show the results of the stewardship of management or the accountability of management for the resources entrusted to it action.

Importance of financial statement:

- The economic decisions that are taken by users of financial statements require an evolution of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation.
- The financial position of an enterprise is affected by the economic resources .
- Information about financial structure is useful in predicting future barrowing needs and how future profits and cash flows will be distributed.

- Information about the performance of an enterprise , in particular its profitability, is required in order to assess potential changes in economic resources that it is likely to control in the future.
- Information concerning cash flows of an enterprise is useful in order to evaluate its investing , financing and operating activities during the reporting period.

Underlying assumptions:

- Accrual basis:
- Going concern:
- Consistency:

Qualitative characteristics of financial statement:

- Understandability:
- Decision usefulness:

Relevance:

Predictive value: helps to predict future consequences based on past transaction and event.

Feedback value : helps to confirm or change a decision maker's beliefs based on whether the information matches what was expected.

Timeliness: quality of information that it provided on a timely basis

Reliability : free from error and represents what it claims to represent.

1. Verifiability : reported information should be based on objectively determined facts that can be verified by other accountants using the same measurement method.
2. Representational faithfulness: the amounts and description reported in a financial statement should reflect the actual result of economic transactions and events.
3. Neutrality: the information should be presented in an unbiased manner ; fairness.

- Comparability : Requires similar events be accounted for in the same manner on the financial statements of 1) different companies and 2) for a particular company for different periods(consistency).
- Substance over form : It is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.
- Materiality: The relevance of information is affected by its materiality, information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. It is depend on the size and nature of the item or error.

Constraints on financial statement:

1.Timeliness:

If there is undue delay in the reporting of information it may lose its relevance.

To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known ,thus impairing reliability.

2. Balance between benefit and cost:

It is a pervasive constraints rather than a qualitative characteristic.

The benefits derived from information should exceed the cost providing it.

Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements.

The relative importance of the characteristics in different cases is a matter of professional judgment.

Elements of financial statements

- It is directly related to the measurement of financial position in the balance sheet are assets , liabilities and equity.
- The elements directly related to the measurement of financial performance in the statement of profit and loss are income and expenses.
- The cash flow statement usually reflects elements of statement of profit and loss and changes in balance sheet elements.

Elements of financial position:

- An ASSET:

  It is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

  ex: Used singly or in combination with other assets in the production.

  Goods and services to be sold by the enterprise.

  Exchanged for other assets.

  Used to settle a liability.

  Distributed to the owners of the enterprise.

A liability:

- Present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
- Essential characteristic of a liability is that the enterprise has a present obligation.
- Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement.
- Settlement of a present obligation may occur in a number of ways :

- Payment of cash
- Transfer of other assets
- Provision of services
- Replacement of that obligation with another obligation
- Conversion of the obligation to equity
- Creditor waiving or forfeiting its rights.

EQUITY:

- The residual interest in the assets of the enterprise after deducting all its liabilities .
- The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities.

Elements of financial performance:

- Profit is frequently used as a measure of performance or as the basis for other measures, such as return on the elements directly related to the measurement of profit are income and expenses, investment or earning per share.
- INCOME: is increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decreases of liabilities that result in increases in equity , other than those relating to contributions from equity participants.

- Expenses are decreased in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity , other than those relating to distribution to equity participants.

Income and gains

- The definition of income encompasses both revenue and gains.
- Revenue arises in the course of the ordinary activities of an enterprise - sales, fees, interest, dividends, royalties, rent.
- Gains represent increase in economic benefits and as such are no different in nature from revenue. Hence they are not regarded as a separate element in this framework.
- Gains represent the other items that meet the definition of income and may, or may not arise in the course of the ordinary activities of an enterprise.
- Income includes unrealized gains, gains also include, those arising on the disposal of fixed assets.

Expenses and losses

- Expenses that arise in the course of the ordinary activities of the enterprise include –cost of goods sold, wages and depreciation.
- They take the form of an outflow or depletion of assets or enhancement of liabilities.
- Losses represent other items that meet the definition of expenses and may, or may not arise in the course of ordinary activities of the enterprise.
- Losses represent decrease in economic benefits and as such they are no different in nature from other expenses.
- It include- those resulting from disaster such as fire, flood ,as well as those arising on the disposal of fixed assets.

Recognition of elements

- ASSET : an asset is recognized in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and a asset has a cost and value that can be measured reliably.
- LIABILITY: a liability is recognized in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably

- INCOME : in the statement of profit and loss when an increase in future economic benefits related to an increase in the asset or decrease of a liability has arisen that can be measured reliably.
- EXPENSES: in the statement of profit and loss when an decrease in future economic benefits related to an decrease in the asset or an increase of a liability has arisen that can be measured reliably.

Measurement of elements of FS

- Measurement is the process of determining the monetary amounts at which the elements of financial statement are to be recognized and carried in the balance sheet and statement of profit and loss. This involves the selection of the particular basis of measurement.
- A number of different measurement bases are employed to different degrees and in varying combinations in financial statements.

Historical cost:

- Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition .
- Liabilities are recorded at the amount of proceeds received in exchange for the obligation or in some circumstances(for ex, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Current cost:

- Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently.
- Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realizable value :

- Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal.
- Liabilities are carried at their settlement values, that is the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.

Present value:

- Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business.
- Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Concept of capital and capital maintenance

- Financial concept of capital, such as invested money or invested purchasing power , capital is synonymous with the net assets or equity of the enterprise.
- Physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, ex:-units of output per day.

Financial capital maintainance:

- Under this concept , a profit is earned only if the financial amount (money) of the net assets at the end of the period exceeds the financial amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from owners during the period.
- It can be measured in either nominal monetary units or units of constant purchasing power.

Physical capital maintenance:

- Under this concept, a profit is earned only if the physical productive capacity (operating capability) of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to , and contributions from, owners during the period .

Limitations of financial statements:

- Manipulation or window dressing
- Use of diverse procedures
- Qualitative aspect ignored
- Historical
- Price level changes
- Subjectivity and personal bias
- Lack of regular data/information
- Estimated values