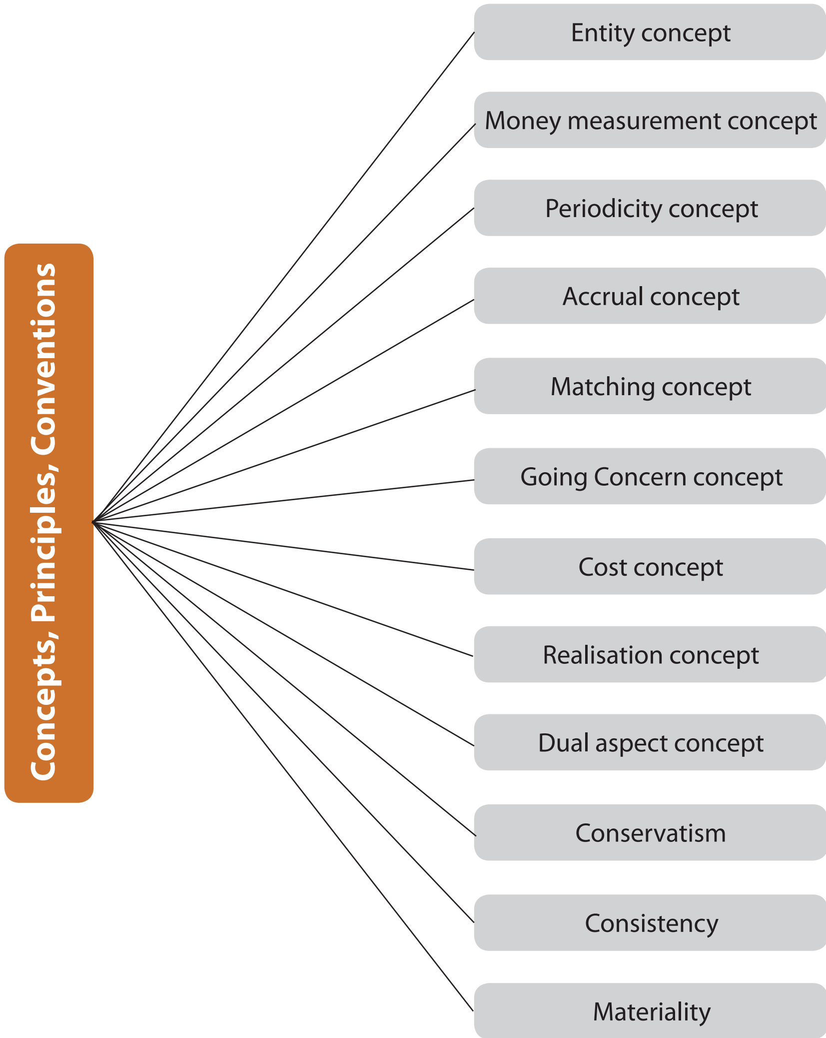
UNIT 2 : ACCOUNTING CONCEPTS, PRINCIPLES AND CONVENTIONS

LEARNING OUTCOMES

After studying this unit, you will be able to :

- Grasp the basic accounting concepts, principles and conventions and observe their implications while recording transactions and events.
- Identify the three fundamental accounting assumptions:
  - Going Concern
  - Consistency
  - Accrual
- Understand the qualitative characteristics that will help to develop the skill in course of time to prepare financial statements.

UNIT OVERVIEW



2.1 INTRODUCTION

Let us imagine a situation where you are a proprietor and you take copies of your books of account to five different accountants. You ask them to prepare the financial statements on the basis of the above records and to calculate the profits of the business for the year. After few days, they are ready with the financial statements and all the five accountants have calculated five different amounts of profits and that too with very wide variations among them. Guess in such a situation what impact would it leave on you about accounting profession. To avoid this, a generally accepted set of rules have been developed. This generally accepted set of rules provides unity of understanding and unity of approach in the practice of accounting and also in better preparation and presentation of the financial statements.

Accounting is a language of the business. Financial statements prepared by the accountant communicate financial information to the various stakeholders for decision-making purpose. Therefore, it is important that financial statements prepared by different organizations should be prepared on uniform basis. Also there should be consistency over a period of time in the preparation of these financial statements. If every accountant starts following his own norms and notions for accounting of different items then there will be an utter confusion.

To avoid confusion and to achieve uniformity, accounting process is applied within the conceptual framework of 'Generally Accepted Accounting Principles' (GAAPs). The term GAAPs is used to describe rules developed for the preparation of the financial statements and are called concepts, conventions, postulates, principles etc. These GAAPs are the backbone of the accounting information system, without which the whole system cannot even stand erectly. These principles are the ground rules, which define the parameters and constraints within which accounting reports are generated. Accounting principles are basic norms and assumptions on which the whole accounting system has been developed and established. Accountant also adheres to various accounting standards issued by the regulatory authority for the standardization of accounting policies to be followed under specific circumstances. These conceptual frameworks, GAAPs and accounting standards are considered as the theory base of accounting.

2.2 ACCOUNTING CONCEPTS

Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared. Certain concepts are perceived, assumed and accepted in accounting to provide a unifying structure and internal logic to accounting process. The word concept means idea or notion, which has universal application. Financial transactions are interpreted in the light of the concepts, which govern accounting methods. Concepts are those basic assumptions and conditions, which form the basis upon which the accountancy has been laid. Unlike physical science, accounting concepts are only result of broad consensus. These accounting concepts lay the foundation on the basis of which the accounting principles are formulated.

2.3 ACCOUNTING PRINCIPLES

"Accounting principles are a body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist."

Accounting principles must satisfy the following conditions:

1. They should be based on real assumptions;
2. They must be simple, understandable and explanatory;
3. They must be followed consistently;
4. They should be able to reflect future predictions;
5. They should be informational for the users.

2.4 ACCOUNTING CONVENTIONS

Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. These conventions are derived by usage and practice. The accountancy bodies of the world may change any of the convention to improve the quality of accounting information. Accounting conventions need not have universal application.

In the study material, the terms 'accounting concepts', 'accounting principles' and 'accounting conventions' have been used interchangeably to mean those basic points of agreement on which financial accounting theory and practice are founded.

2.5 CONCEPTS, PRINCIPLES AND CONVENTIONS - AN OVERVIEW

Now we shall study in detail the various accounting concepts on which accounting is based. The following are the widely accepted accounting concepts:

(a) Entity concept: Entity concept states that business enterprise is a separate identity apart from its owner. Accountants should treat a business as distinct from its owner. Business transactions are recorded in the business books of accounts and owner's transactions in his personal books of accounts. The practice of distinguishing the affairs of the business from the personal affairs of the owners originated only in the early days of the double-entry book-keeping. This concept helps in keeping business affairs free from the influence of the personal affairs of the owner. This basic concept is applied to all the organizations whether sole proprietorship or partnership or corporate entities.

Entity concept means that the enterprise is liable to the owner for capital investment made by the owner. Since the owner invested capital, which is also called risk capital, he has claim on the profit of the enterprise. A portion of profit which is apportioned to the owner and is immediately payable becomes current liability in the case of corporate entities.

Example: Mr. X started business investing ₹ 7,00,000 with which he purchased machinery for ₹ 5,00,000 and maintained the balance in hand. The financial position of the will be as follows:

	₹
Capital	7,00,000
Machinery	5,00,000
Cash	2,00,000

This means that the enterprise owes to Mr. X ₹ 7,00,000. Now if Mr. X spends ₹ 5,000 to meet his family expenses from the business fund, then it should not be taken as business expenses and would be charged to his capital account (i.e., his investment would be reduced by ₹ 5,000). Following the entity concept the revised financial position would be

Liability	₹	₹
Capital	7,00,000	
Less : Drawings	(5,000)	6,95,000
Machinery		5,00,000
Cash		1,95,000

(b) Money measurement concept: As per this concept, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions, even if, they affect the results of the business materially, are not recorded if they are not convertible in monetary terms. Transactions and events that cannot be expressed in terms of money are not recorded in the business books. For example; employees of the organization are, no doubt, the assets of the organizations but their measurement in monetary terms is not possible therefore, not included in the books of account of the organization. Measuring unit for money is taken as the currency of the ruling country i.e., the ruling currency of a country provides a common denomination for the value of material objects.

It may be mentioned that when transactions occur across the boundary of a country, one may see many currencies. Suppose a businessman sells goods worth ₹ 50 lakhs at home and he also sells goods worth of 1 lakh Euro in the United States. What is his total sales? ₹ 50 lakhs plus 1 lakh Euro.

These are not amenable to even arithmetic treatment. So transactions are to be recorded at uniform monetary unit i.e. in one currency. Suppose EURO 1 = ₹ 71.

Total Sales = ₹ 50 lakhs plus 71 lakhs = ₹ 121 lakhs. Money Measurement Concept imparts the essential flexibility for measurement and interpretation of accounting data.

This concept ignores that money is an inelastic yardstick for measurement as it is based on the implicit assumption that purchasing power of the money is not of sufficient importance as to require adjustment. Also, many material transactions and events are not recorded in the books of accounts just because theycannot be measured in monetary terms. Therefore it is recognized by all the accountants that this concept has its own limitations and inadequacies. Yet it is used for accounting purposes because it is not possible to adopt a better measurement scale.

Entity and money measurement are viewed as the basic concepts on which other procedural concepts hinge.

(c) Periodicity concept: This is also called the concept of definite accounting period. As per 'going concern' concept an indefinite life of the entity is assumed. For a business entity it causes inconvenience to measure performance achieved by the entity in the ordinary course of business.

If a textile mill lasts for 100 years, it is not desirable to measure its performance as well as financial position only at the end of its life.

So a small but workable fraction of time is chosen out of infinite life cycle of the business entity for measuring performance and looking at the financial position. Generally one year period is taken up for performance measurement and appraisal of financial position. However, it may also be 6 months or 9 months or 15 months.

According to this concept accounts should be prepared after every period & not at the end of the life of the entity. Usually this period is one calendar year. We generally follow from 1st April of a year to 31st March of the immediately following year.

Thus, for performance appraisal it is not necessary to look into the revenue and expenses of an unduly long time-frame. This concept makes the accounting system workable and the term 'accrual' meaningful. If one thinks of indefinite time-frame, nothing will accrue. There cannot be unpaid expenses and non-receipt of revenue. Accrued expenses or accrued revenue is only with reference to a finite time-frame which is called accounting period.

Thus, the periodicity concept facilitates in:

(i) Comparing of financial statements of different periods

(ii) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business

(iii) Matching periodic revenues with expenses for getting correct results of the business operations

(d) Accrual concept: Under accrual concept, the effects of transactions and other events are recognised on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future.

To understand accrual assumption knowledge of revenues and expenses is required. Revenue is the gross inflow of cash, receivables and other consideration arising in the course of the ordinary activities of an enterprise from sale of goods, from rendering services and from the use by others of enterprise's resources yielding interest, royalties and dividends. For example, (1) Mr. X started a cloth merchandising. He invested ₹ 50,000, bought merchandise worth ₹ 50,000. He sold such merchandise for ₹ 60,000. Customers paid him ₹ 50,000 cash and assure him to pay ₹ 10,000 shortly. His revenue is ₹ 60,000. It arose in the ordinary course of cloth business; Mr. X received ₹ 50,000 in cash and ₹ 10,000 by way of receivables.

Take another example; (2) an electricity supply undertaking supplies electricity spending ₹ 16,00,000 for fuel and wages and collects electricity bill in one month ₹ 20,00,000 by way of electricity charges. This is also revenue which arose from rendering services.

Lastly, (3) Mr. A invested ₹ 1,00,000 in a business. He purchased a machine paying ₹ 1,00,000. He rented it for ₹ 20,000 annually to Mr. B. ₹ 20,000 is the revenue of Mr. A; it arose from the use of the enterprise's resources.

Expense is a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period.

In the first example, Mr. X spent ₹ 50,000 to buy the merchandise; it is the expense of generating revenue of ₹ 60,000. In the second instance ₹ 16,00,000 are the expenses. Also whenever any asset is used it has a finite life to generate benefit. Suppose, the machine purchased by Mr. A in the third example will last for 10 years only. Then ₹ 10,000 is the expense every year relating to the cost of machinery.

Accrual means recognition of revenue and costs as they are earned or incurred and not as money is received or paid. The accrual concept relates to measurement of income, identifying assets and liabilities.

Example: Mr. J D buys clothing of ₹ 50,000 paying cash ₹ 20,000 and sells at ₹ 60,000 of which customers paid only ₹ 50,000.

His revenue is ₹ 60,000, not ₹ 50,000 cash received. Expense (i.e., cost incurred for the revenue) is ₹ 50,000, not ₹ 20,000 cash paid. So the accrual concept based profit is ₹ 10,000 (Revenue – Expenses).

As per Accrual Concept : Revenue – Expenses = Profit

Accrual Concept provides the foundation on which the structure of present day accounting has been developed.

Alternative as per Cash basis

Cash received in ordinary course of business – Cash paid in ordinary course of business = profit.

Timing of revenue and expense booking could be different from cash receipt or paid.

i) when cash received before revenue is booked	- a liability is created when cash is received in advance
ii) when cash received after revenue is booked	- an asset called Trade receivables is created
iii) when cash paid before expense is booked	- creates an asset called Trade Advance when cash is paid in advance
iv)when cash paid after expense is booked	- creates a liability called payables or Trade payables or outstanding liabilities

(e) Matching concept: In this concept, all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

This concept is based on accrual concept as it considers the occurrence of expenses and income and do not concentrate on actual inflow or outflow of cash. This leads to adjustment of certain items like prepaid and outstanding expenses, unearned or accrued incomes.

It is not necessary that every expense identify every income. Some expenses are directly related to the revenue and some are time bound. For example:- selling expenses are directly related to sales but rent, salaries etc are recorded on accrual basis for a particular accounting period. In other words periodicity concept has also been followed while applying matching concept.

Mr. P K started cloth business. He purchased 10,000 pcs. garments @ ₹ 100 per piece and sold 8,000 pcs. @ ₹ 150 per piece during the accounting period of 12 months 1st January to 31st December, 2019. He paid shop rent @ ₹ 3,000 per month for 11 months and paid ₹ 8,00,000 to the suppliers of garments and received ₹ 10,00,000 from the customers.

Let us see how the accrual and periodicity concepts operate.

Periodicity Concept fixes up the time-frame for which the performance is to be measured and financial position is to be appraised. Here, it is January 2019 - December, 2019. So revenues and expenses are to be measured for the year 2019 and assets and liabilities are to be ascertained as on 31st December, 2019.

Accrual Concept operates to measure revenue of ₹ 12,00,000 (arising out of sale of garments 8,000 Pcs × ₹ 150) which accrued during 2019, not the cash received ₹ 10,00,000 and also the expenses correctly. Shop rent for 12 months is an expense item amounting to ₹ 36,000, not ₹ 33,000 the cash paid.

Should the accountant treat ₹ 10,00,000 as expenses for purchase of merchandise ? And should he treat ₹ 1,64,000 as profit? (Revenue ₹ 12,00,000-Merchandise ₹ 10,00,000. Shop Rent ₹ 36,000). Obviously the answer is No. Matching links revenue with expenses.

Revenue – Expenses = Profit

But this unqualified equation may create misconception. It should be defined as :

Periodic Profit = Periodic Revenue – Matched Expenses

From the revenue of an accounting period such expenses are deducted which are expended to generate the revenue to determine profit of that period.

In the given example revenue relates to only sale of 8,000 pcs. of garments. So the cost of 8,000 pcs of garments should be treated as expenses.

Thus, Profit =	Revenue		₹ 12,00,000
Less:	Expenses:		
	Merchandise	₹ 8,00,000	
	Shop Rent	₹ 36,000	(₹ 8,36,000)
			₹ 3,64,000
Assets:			
	Inventory (2,000 pcs × ₹ 100)		₹ 2,00,000
	Trade receivables		₹ 2,00,000

Cash (Cash Receipts ₹ 10,00,000 – cash payments ₹ 8,33,000)		₹ 1,67,000
		₹ 5,67,000
Liabilities:		
Trade Payables		₹ 2,00,000
Expense Payables		₹ 3,000
Capital (for Profit)		₹ 3,64,000
		₹ 5,67,000

Thus, accrual, matching and periodicity concepts work together for income measurement and recognition of assets and liabilities.

(f) Going Concern concept: The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used needs to be disclosed.

The valuation of assets of a business entity is dependent on this assumption. Traditionally, accountants follow historical cost in majority of the cases.

Suppose Mr. X purchased a machine for his business paying ₹ 5,00,000 out of ₹ 7,00,000 invested by him. He also paid transportation expenses and installation charges amounting to ₹ 70,000. If he is still willing to continue the business, his financial position will be as follows:

Balance Sheet

Liability	₹	**Assets**	₹
Capital	7,00,000	Machinery	5,70,000
		Cash	1,30,000
	7,00,000		7,00,000

Now if he decides to back out and desires to sell the machine, it may fetch more than or less than ₹ 5,70,000. So his financial position should be different. If going concern concept is taken, increase/ decrease in the value of assets in the short-run is ignored. The concept indicates that assets are kept for generating benefit in future, not for immediate sale; current change in the asset value is not realisable and so it should not be counted.

(g) Cost concept: By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. Although there are various measurement bases, accountants traditionally prefer this concept in the interests of objectivity. When a machine is acquired by paying ₹ 5,00,000, following cost concept the value of the machine is taken as ₹ 5,00,000. It is highly objective and free from all bias. Other measurement bases are not so objective. Current cost of an asset is not easily determinable. If the asset is purchased on 1.1.1995 and such model is not available in the market, it becomes difficult to determine which model is the appropriate equivalent to the existing one. Similarly, unless the machine is actually sold, realisable value will give only a hypothetical figure. Lastly, present value base is highly subjective because to know the value of the asset one has to chase the uncertain future.

However, the cost concept creates a lot of distortion too as outlined below :

(a) In an inflationary situation when prices of all commodities go up on an average, acquisition cost loses its relevance. For example, a piece of land purchased on 1.1.1995 for ₹ 2,000 may cost ₹ 1,00,000 as on 1.1.2020. So if the accountant makes valuation of asset at historical cost, the accounts will not reflect the true position.

(b) Historical cost-based accounts may lose comparability. Mr. X invested ₹ 1,00,000 in a machine on 1.1.1995 which produces ₹ 50,000 cash inflow during the year 2020, while Mr. Y invested ₹ 5,00,000 in a machine on 1.1.2005 which produced ₹ 50,000 cash inflows during the year. Mr. X earned at the rate 50% while Mr. Y earned at the rate 10%. Who is more efficient? Since the assets are recorded at the historical cost, the results are not comparable. Obviously it is a corollary to (a).

(c) Many assets do not have acquisition costs. Human assets of an enterprise are an example. The cost concept fails to recognise such asset although it is a very important asset of any organization.

Many other controversial issues have arisen in financial accounting that revolves around the cost concept which will be discussed at the advanced stage. However, later on we shall see that in many circumstances, the cost convention is not followed. See conservatism concept for an example, which will be discussed later on in this unit.

(h) Realisation concept: It closely follows the cost concept. Any change in value of an asset is to be recorded only when the business realises it. When an asset is recorded at its historical cost of ₹ 5,00,000 and even if its current cost is ₹ 15,00,000 such change is not counted unless there is certainty that such change will materialize.

However, accountants follow a more conservative path. They try to cover all probable losses but do not count any probable gain. That is to say, if accountants anticipate decrease in value they count it, but if there is increase in value they ignore it until it is realised. Economists are highly critical about the realisation concept. According to them, this concept creates value distortion and makes accounting meaningless.

Example: Mr. X purchased a piece of land on 1.1.1995 paying ₹2,000. Its current market value is ₹ 1,02,000 on 31.12.2020. Should the accountant show the land at ₹2,000 following cost concept and ignoring ₹1,00,000 value increase since it is not realised? If he does so, the financial position would be:

Balance Sheet

Liability	₹	Asset	₹
Capital	2,000	Land	2,000
	2,000		2,000

Is it not proper to show it in the following manner?

Balance Sheet

Liabilities	₹	Asset	₹
Capital	2,000	Land	1,02,000
Unrealised Gain	1,00,000		
	1,02,000		1,02,000

Now-a-days the revaluation of assets has become a widely accepted practice when the change in value is of permanent nature. Accountants adjust such value change through creation of revaluation (capital) reserve.

Thus the going concern, cost concept and realization concept gives the valuation criteria.

(i) Dual aspect concept: This concept is the core of double entry book-keeping. Every transaction or event has two aspects:

(1) It increases one Asset and decreases other Asset;

(2) It increases an Asset and simultaneously increases Liability;

(3) It decreases one Asset, increases another Asset;

(4) It decreases one Asset, decreases a Liability.

Alternatively:

(5) It increases one Liability, decreases other Liability;

(6) It increases a Liability, increases an Asset;

(7) It decreases Liability, increases other Liability;

(8) It decreases Liability, decreases an Asset.

Example:

Balance Sheet

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	75,000	Cash	1,00,000
Other Loan	75,000		
	3,00,000		3,00,000

Transactions:

(a) A new machine is purchased paying ₹ 50,000 in cash.

(b) A new machine is purchased for ₹ 50,000 on credit, cash is to be paid later on.

(c) Cash paid to repay bank loan to the extent of ₹ 50,000.

(d) Raised bank loan of ₹ 50,000 to pay off other loan.

Effect of the Transactions:

(a) Increase in machine value and decrease in cash balance by ₹ 50,000.

Balance Sheet (1 & 3)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Bank Loan	75,000	Cash	50,000
Other Loan	75,000		
	3,00,000		3,00,000

(b) Increase in machine value and increase in Creditors by ₹ 50,000.

Balance Sheet (2 & 6)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Creditors for machinery	50,000	Cash	1,00,000
Bank Loan	75,000		
Other Loan	75,000		
	3,50,000		3,50,000

(c) Decrease in bank loan and decrease in cash by ₹ 50,000.

Balance Sheet (4 & 8)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	25,000	Cash	50,000
Other Loan	75,000		
	2,50,000		2,50,000

(d) Increase in bank loan and decrease in other loan by ₹ 50,000.

Balance Sheet (5 & 7)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	1,25,000	Cash	1,00,000
Other Loan	25,000		
	3,00,000		3,00,000

So every transaction and event has two aspects.

This gives basic accounting equation :

Equity (E) + Liabilities (L) = Assets (A)

or

Equity (E)= Assets (A) – Liabilities(L)

Or, Equity + Long Term Liabilities + Current Liabilities = Fixed Assets + Current Assets

Or, Equity + Long Term Liabilities = Fixed Assets + (Current Assets – Current Liabilities)

Or, Equity = Fixed Assets + Working Capital – Long Term Liabilities

ILLUSTRATION

Develop the accounting equation from the following information: -

Particulars	***March 31, 2019*** *(₹)*	***March 31, 2020*** *(₹)*
Capital	*1,00,000*	*?*
12% Bank Loan	*1,00,000*	*1,00,000*
Trade Payables	*75,000*	*70,000*
Fixed Assets	*1,25,000*	*1,10,000*
Trade Receivables	*75,000*	*80,000*
Inventory	*70,000*	*80,000*
Cash & Bank	*5,000*	*6,000*

Required

Find the profit for the year & the Balance sheet as on 31/3/2020.

SOLUTION

For the year ended March 31, 2019:

Equity = Capital ₹ 1,00,000

Liabilities = Bank Loan + Trade Payables

₹ 1,00,000 + ₹ 75,000 = ₹ 1,75,000

Assets = Fixed Assets + Trade Receivables + Inventory + Cash & Bank

₹ 1,25,000 + ₹ 75,000 + ₹ 70,000 + ₹ 5,000 = ₹ 2,75,000

Equity + Liabilities = Assets

₹ 1,00,000 + ₹ 1,75,000 = 2,75,000

For the year ended March 31, 2020:

Assets = ₹ 1,10,000 + ₹ 80,000 + ₹ 80,000 + ₹ 6,000 = ₹ 2,76,000

Liabilities = ₹ 1,00,000 + ₹ 70,000 = ₹ 1,70,000

Equity = Assets – Liabilities = ₹ 2,76,000 – ₹ 1,70,000 = ₹ 1,06,000

Profits = New Equity – Old Equity = ₹ 1,06,000 – ₹1,00,000 = ₹ 6,000

(j) Conservatism: Conservatism states that the accountant should not anticipate any future income however they should provide for all possible losses. When there are many alternative values of an asset, an accountant should choose the method which leads to the lesser value. Later on we shall see that the golden rule of current assets valuation - 'cost or market price whichever is lower' originated from this concept.

The Realisation Concept also states that no change should be counted unless it has materialised. The Conservatism Concept puts a further brake on it. It is not prudent to count unrealised gain but it is desirable to guard against all possible losses.

For this concept there should be at least three qualitative characteristics of financial statements, namely,

(i) *Prudence,* i.e., judgement about the possible future losses which are to be guarded, as well as gains which are uncertain.

(ii) *Neutrality,* i.e., unbiased outlook is required to identify and record such possible losses, as well as to exclude uncertain gains,

(iii) *Faithful representation of alternative values.*

Many accounting authors, however, are of the view that conservatism essentially leads to understatement of income and wealth and it should not be the basis for the preparation of financial statements.

(k) Consistency: In order to achieve comparability of the financial statements of an enterprise through time, the accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

The concept of consistency is applied particularly when alternative methods of accounting are equally acceptable. For example a company may adopt any of several methods of depreciation such as written-down-value method, straight-line method, etc. Likewise there are many methods for valuation of inventories. But following the principle of consistency it is advisable that the company should follow consistently over years the same method of depreciation or the same method of valuation of Inventories which is chosen. However in some cases though there is no inconsistency, they may seem to be inconsistent apparently. In case of valuation of Inventories if the company applies the principle 'at cost or market price whichever is lower' and if this principle accordingly results in the valuation of Inventories in one year at cost price and the market price in the other year, there is no inconsistency here. It is only an application of the principle.

But the concept of consistency does not imply non-flexibility as not to allow the introduction of improved method of accounting.

An enterprise should change its accounting policy in any of the following circumstances only:

a. To bring the books of accounts in accordance with the issued Accounting Standards.

b. To comply with the provision of law.

c. When under changed circumstances it is felt that new method will reflect more true and fair picture in the financial statement.

(l) Materiality: Materiality principle permits other concepts to be ignored, if the effect is not considered material. This principle is an exception to full disclosure principle. According to materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements and any insignificant item which will only increase the work of the accountant but will not be relevant to the users' need should not be disclosed in the financial statements.

The term materiality is the subjective term. It is on the judgement, common sense and discretion of the accountant that which item is material and which is not. For example stationary purchased by the organization though not used fully in the accounting year purchased still shown as an expense of that year because of the materiality concept. Similarly depreciation on small items like books, calculators etc. is taken as 100% in the year of purchase though used by the entity for more than a year. This is because the amount of books or calculator is very small to be shown in the balance sheet though it is the asset of the company.

The materiality depends not only upon the amount of the item but also upon the size of the business, nature and level of information, level of the person making the decision etc. Moreover an item material to one person may be immaterial to another person. What is important is that omission of any information should not impair the decision-making of various users.

2.6 FUNDAMENTAL ACCOUNTING ASSUMPTIONS

There are three fundamental accounting assumptions :

(i) Going Concern

(ii) Consistency

(iii) Accrual

All the above three fundamental accounting assumptions have already been explained in para 2.5.

If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been followed in their preparation of financial statements. However, if any of the above mentioned fundamental accounting assumption is not followed then this fact should be specifically disclosed.

2.7 FINANCIAL STATEMENTS

The aim of accounting is to keep systematic records to ascertain financial performance and financial position of an entity and to communicate the relevant financial information to the interested user groups. The financial statements are basic means through which the management of an entity makes public communication of the financial information along with selected quantitative details. They are structured financial representations of the financial position and the performance of an enterprise. To have a record of all business transactions and also to determine whether all these transactions resulted in either 'profit or loss' for the period, all the entities will prepare financial statements viz., balance sheet, profit and loss account, cash flow statement etc. by following various accounting concepts, principles, and conventions which have been already discussed in detail.

2.7.1 Qualitative Characteristics of Financial Statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The following are the important qualitative characteristics of the financial statements:

1. **Understandability:** An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business, economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

2. **Relevance:** To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

   The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

   Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statement of profit and loss is enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

3. **Reliability:** To be useful, information must also be reliable, Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

   Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognise the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

4. **Comparability:** Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

   An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those polices and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s).

The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

5. **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. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

4. **Faithful Representation:** To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

   Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

7. **Substance Over Form:** If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentations and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

8. **Neutrality:** To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

9. **Prudence:** The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognised

by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality of reliability.

10. **Full, fair and adequate disclosure:** The financial statement must disclose all the reliable and relevant information about the business enterprise to the management and also to their external users for which they are meant, which in turn will help them to take a reasonable and rational decision. For it, it is necessary that financial statements are prepared in conformity with generally accepted accounting principles i.e the information is accounted for and presented in accordance with its substance and economic reality and not merely with its legal form. The disclosure should be full and final so that users can correctly assess the financial position of the enterprise.

    The principle of full disclosure implies that nothing should be omitted while principle of fair disclosure implies that all the transactions recorded should be accounted in a manner that financial statement purports true and fair view of the results of the business of the enterprise and adequate disclosure implies that the information influencing the decision of the users should be disclosed in detail and should make sense.

    This principle is widely used in corporate organizations because of separation in management and ownership. The Companies Act in pursuant of this principle has came out with the format of balance sheet and profit and loss account. The disclosures of all the major accounting policies and other information are to be provided in the form of footnotes, annexures etc. The practice of appending notes to the financial statements is the outcome of this principle.

11. **Completeness:** To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

    Thus, if accounting information is to present faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality, not by their legal form. For example, if a business enterprise sells its assets to others but still uses the assets as usual for the purpose of the business by making some arrangement with the seller, it simply becomes a legal transaction. The economic reality is that the business is using the assets as usual for deriving the benefit. Financial statement information should contain the substance of this transaction and should not only record going by legality. In order to be reliable the financial statements information should be neutral i.e., free from bias. The prepares of financial statements however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that many occur. Such uncertainties are recognised by the disclosure of their nature and extent and by exercise of prudence in the preparation of financial statements. Prudence is the inclusion of a degree of caution in the exercise of judgement needed in making the estimates required under condition of uncertainty such that assets and income are not overstated and loss and liability are not understated.

SUMMARY

- Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared.

  The following are the widely accepted accounting concepts:

  (a) Entity concept (b) Money measurement concept
  (c) Periodicity concept (d) Accrual concept
  (e) Matching concept (f) Going Concern concept
  (g) Cost concept (h) Realisation concept
  (i) Dual aspect concept (j) Conservatism
  (k) Materiality

- Accounting principles are a body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist."
- Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time.
- There are three fundamental accounting assumptions:

  (i) Going Concern (ii) Consistency (iii) Accrual

- Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. Understandability, Relevance, Reliability, Comparability, Materiality, Faithful Representation, Substance over Form, Neutrality, Prudence, Full, fair and adequate disclosure and Completeness are the important qualitative characteristics of the financial statements.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. (i) All the following items are classified as fundamental accounting assumptions except

   (a) Consistency. (b) Business entity.
   (c) Going concern.

   (ii) Two primary qualitative characteristics of financial statements are

   (a) Understandability and materiality. (b) Relevance and reliability.
   (c) Neutrality and understandability.

   (iii) Kanika Enterprises follows the written down value method of depreciating machinery year after year due to

   (a) Comparability. (b) Convenience.
   (c) Consistency.

(iv) A purchased a car for ₹ 5,00,000, making a down payment of ₹ 1,00,000 and signing a ₹ 4,00,000 bill payable due in 60 days. As a result of this transaction

(a) Total assets increased by ₹ 5,00,000.

(b) Total liabilities increased by ₹ 4,00,000.

(c) Total assets increased by ₹ 4,00,000 with corresponding increase in liabilities by ₹ 4,00,000.

(v) Mohan purchased goods for ₹15,00,000 and sold 4/5th of the goods amounting ₹18,00,000 and met expenses amounting ₹ 2,50,000 during the year, 2020. He counted net profit as ₹ 3,50,000. Which of the accounting concept was followed by him?

(a) Entity. (b) Periodicity.

(c) Matching.

(vi) A businessman purchased goods for ₹ 25,00,000 and sold 80% of such goods during the accounting year ended 31st March, 2020. The market value of the remaining goods was ₹ 4,00,000. He valued the closing Inventory at cost. He violated the concept of

(a) Money measurement. (b) Conservatism.

(c) Cost.

(vii) Capital brought in by the proprietor is an example of

(a) Increase in asset and increase in liability.

(b) Increase in liability and decrease in asset.

(c) Increase in asset and decrease in liability.

2. (i) Assets are held in the business for the purpose of

(a) Resale. (b) Conversion into cash.

(c) Earning revenue.

(ii) Revenue from sale of products, is generally, realized in the period in which

(a) Cash is collected. (b) Sale is made.

(c) Products are manufactured.

(iii) The concept of conservatism when applied to the balance sheet results in

(a) Understatement of assets. (b) Overstatement of assets.

(c) Overstatement of capital.

(iv) Decrease in the amount of trade payables results in

(a) Increase in cash. (b) Decrease in bank over draft account.

(c) Decrease in assets.

(v) The determination of expenses for an accounting period is based on the principle of

(a) Objectivity. (b) Materiality.

(c) Matching.

(vi) Economic life of an enterprise is split into the periodic interval to measure its performance is as per

(a) Entity. (b) Matching.

(c) Periodicity.

3. (i) If an individual asset is increased, there will be a corresponding

(a) Increase of another asset or increase of capital.

(b) Decrease of another asset or increase of liability.

(c) Decrease of specific liability or decrease of capital.

(ii) Purchase of machinery for cash

(a) Decreases total assets. (b) Increases total assets.

(c) Retains total assets unchanged.

(iii) Consider the following data pertaining to Alpha Ltd.:

Particulars	₹
Cost of machinery purchased on 1st April, 2019	10,00,000
Installation charges	1,00,000
Market value as on 31st March, 2020	12,00,000

While finalizing the annual accounts, if the company values the machinery at ₹ 12,00,000. Which of the following concepts is violated by the Alpha Ltd.?

(a) Cost. (b) Matching.

(c) Accrual.

Theoretical Questions

1. Write short notes on:

(i) Fundamental accounting assumptions.

(ii) Periodicity concept.

(iii) Accounting conventions.

2. Distinguish between:

(i) Money measurement concept and matching concept

(ii) Going concern and cost concept

3. Briefly explain the qualitative characteristics of the financial statements:

ANSWERS / HINTS

Multiple Choice Questions

1.(i)	(b)	(ii)	(b)	(iii)	(c)	(iv)	(c)	(v)	(c)	(vi)	(b)
(vii)	(a)	2.(i)	(c)	(ii)	(b)	(iii)	(a)	(iv)	(c)	(v)	(c)
(vi)	(c)	3.(i)	(b)	(ii)	(c)	(iii)	(a)				

Theoretical Questions

1. (i) **Fundamental accounting assumptions:** There are three fundamental accounting assumptions: Going Concern; Consistency and Accrual. If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been followed in their preparation of financial statements.

   (ii) **Periodicity concept:** According to this concept accounts should be prepared after every period & not at the end of the life of the entity. For details, refer para 2.5.

   (iii) **Accounting conventions:** Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. For details, refer para 2.4.

2. (i) Distinction between Money measurement concept and matching concept

As per **Money Measurement concept**, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions and events that cannot be expressed in terms of money are not recorded in the business books.

In **Matching concept**, all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

(ii) Distinction between Going concern and cost concept

Going Concern Concept

The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future.

Cost Concept

By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. For details refer para 2.5.

3. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. For details, refer para 2.7.

UNIT 3 : ACCOUNTING TERMINOLOGY - GLOSSARY

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Define basic accounting terms; and
- Understand the application of these accounting terms while recording transactions and events.

ACCOUNTING TERMINOLOGY - GLOSSARY

Acceptance

The drawee's signed assent on bill of exchange, to the order of the drawer. This term is also used to describe a bill of exchange that has been accepted.

Accounting policies

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Accrual

Recognition of revenues and costs as they are earned or incurred (and not as money is received or paid). It includes recognition of transactions relating to assets and liabilities as they occur irrespective of the actual receipts or payments.

Accrual/Mercantile Basis of Accounting

The method of recording transactions by which *revenues, costs, assets* and *liabilities* are reflected in the accounts in the period in which they accrue. The 'accrual basis of accounting' includes considerations relating to *deferrals, allocations, depreciation* and *amortisation*. This basis is also referred to as *mercantile basis of accounting*.

Accrued Asset

A developing but not yet enforceable claim against another person which accumulates with the passage of time or the rendering of service or otherwise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

Accrued Expense

An expense which has been incurred in an accounting period but for which no enforceable claim has become due in that period against the enterprise. It may arise from the purchase of services (including the use of money) which at the date of accounting have been only partly performed, and are not yet billable.

Accrued Liability

A developing but not yet enforceable claim by another person which accumulates with the passage of time or the receipt of service or otherwise. It may arise from the purchase of services (including the use of money) which at the date of accounting have

Accrued Revenue

Revenue which has been earned in an accounting period but in respect of which no enforceable claim has become due in that period by the enterprise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

Accumulated Depletion

The total to date of the periodic depletion charges on wasting assets.

Accumulated Depreciation

The total to date of the periodic depreciation charges on depreciable assets.

Advance

Payment made on account of, but before completion of, a contract, or before acquisition of goods or receipt of services.

Amortised Value

The *amortizable* amount less any portion already provided by way of *amortization*.

Annual Report

The information provided annually by the management of an enterprise to the owners and other interested persons concerning its operations and financial position. It includes the information statutorily required, e.g., in the case of a company, the *balance sheet, profit and loss statement* and notes on accounts, the *auditor's report* thereon, and the report of the Board of Directors. It also includes other information voluntarily provided e.g., *value added statement*, graphs, charts, etc.

Appropriation Account

An account sometimes included as a separate section of the *profit and loss statement* showing application of *profits* towards *dividends, reserves*, etc.

Assets

Tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.

Authorised Share Capital

The number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as **nominal share capital**.

Average Cost

The cost of an item at a point of time as determined by applying an average of the cost of all items of the same nature over a period. When weightages are also applied in the computation, it is termed as **weighted average cost**.

Bad Debts

Debts owed to an enterprise which are considered to be irrecoverable.

Balance Sheet

A statement of the financial position of an enterprise as at a given date, which exhibits its *assets, liabilities, capital, reserves* and other account balances at their respective *book values*.

Bill of Exchange

An instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only, to or to the order of a certain person or to the bearer of the instrument.

Bonus Shares

Shares allotted by capitalization of the reserves or surplus of a corporate enterprise.

Book Value

The amount at which an item appears in the books of account or financial statements. It does not refer to any particular basis on which the amount is determined e.g., cost, replacement value, etc.

Borrowing costs

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

Bond/Debenture

A formal document constituting acknowledgment of a debt by an enterprise usually given under its common seal and normally containing provisions regarding payment of interest, repayment of principal and security, if any. It is transferable in the appropriate manner.

Call

A demand pursuant to terms of issue to pay a part or whole of the balance remaining payable on shares or *debentures* after allotment.

Called-up Share Capital

That part of the subscribed share capital which shareholders have been required to pay.

Capital

Generally refers to the amount invested in an enterprise by its owners e.g. *paid-up share capital* in a corporate enterprise. It is also used to refer to the interest of owners in the assets of an enterprise.

Capital Assets

Assets, including *investments* not held for sale, conversion or consumption in the ordinary course of business.

Capital Commitment

Future *liability* for capital expenditure in respect of which contracts have been made.

Capital Employed

The finances deployed by an enterprise in its *net fixed assets*, *investments* and *working capital*. Capital employed in an operation may, however, exclude *investments* made outside that operation.

Capital Profit/Capital Loss

Excess of the proceeds realised from the sale, transfer, or exchange of the whole or a part of a capital asset over its cost. When the result of this computation is negative, it is referred to as **capital loss**.

Capital Reserve

A *reserve* of a corporate enterprise which is not available for distribution as *dividend*.

Capital Work-in-progress

Expenditure on *capital assets* which are in the process of construction or completion.

Cash

Cash comprises cash on hand and demand deposits with banks

Cash equivalents

Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash Basis of Accounting

The method of recording transactions by which *revenues* and *costs* and *assets* and *liabilities* are reflected in the accounts in the period in which actual receipts or actual payments are made.

Cash Discount

A reduction granted by a supplier from the invoiced price in consideration of immediate payment or payment within a stipulated period.

Cash Profit

The *net profit* as increased by non-cash costs, such as *depreciation, amortization*, etc. When the result of the computation is negative, it is termed as **cash loss**.

Carrying amount

Carrying amount is the amount at which an asset is recognized in the balance sheet, net of any accumulated amortization and accumulated impairment losses thereon.

Charge

An encumbrance on an asset to secure an indebtedness or other obligations. It may be fixed or floating.

Cheque

A *bill* of exchange drawn upon a specified banker and not expressed to be payable otherwise than on demand.

Collateral Security

Security which is given in addition to the principal security against the same *liability* or obligation.

Costs of disposal

Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

Contingency

A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

Contingent Asset

An *asset* the existence, ownership or value of which may be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

Contingent Liability

An obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

Contra Account

One or two or more accounts which partially or wholly off-set another or other accounts.

Cost

The amount of *expenditure* incurred on or attributable to a specified article, product or activity.

Cost of Purchase

The purchase price including duties and taxes, freight inwards and other *expenditure* directly attributable to acquisition, less *trade discounts*, rebates, duty drawbacks, and subsidies in respect of such purchase.

Cost of Goods Sold

The cost of goods sold during an accounting period. In manufacturing operations, it includes (i) cost of materials; (ii) labour and factory overheads; selling and administrative expenses are normally excluded.

Conversion Cost

Cost incurred to convert raw materials or components into finished or semi-finished products. This normally includes costs which are specifically attributable to units of production, i.e., direct labour, direct expenses and subcontracted work, and production overheads as applicable in accordance with either the *direct cost* or *absorption costing method*. Production overheads exclude expenses which relate to general administration, finance, selling and distribution.

Convertible Debenture

A *debenture* which gives the holder a right to its conversion, wholly or partly, in shares in accordance with the terms of issue.

Cumulative Dividend

A *dividend* payable on *cumulative preference shares* which, if unpaid, accumulates as a claim against the earnings of a corporate enterprise, before any distribution is made to the other shareholders.

Cumulative Preference Shares

A class of preference shares entitled to payment of *cumulative dividends*. Preference shares are always deemed to be cumulative, unless they are expressly made non-cumulative.

Current Assets

Cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business.

Current Liability

Liability including loans, deposits and bank overdraft which falls due for payment in a relatively short period, normally not more than twelve months.

Deferral

Postponement of recognition of a revenue or expense after its related receipt or payment (or incurrence of a *liability*) to a subsequent period to which it applies. Common examples of deferrals include prepaid rent and taxes, unearned subscriptions received in advance by newspapers and magazine selling companies, etc.

Deficiency

The excess of *liabilities* over *assets* of an enterprise at a given date. The debit balance in the *profit and loss statement*.

Deficit

The debit balance in the profit and loss statement.

Depletion

A measure of exhaustion of a wasting asset represented by periodic write off of cost or other substituted value.

Depreciation

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

Depreciable amount

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

Depreciable assets

Depreciable assets are assets which

(i) are expected to be used during more than one accounting period; and

(ii) have a limited useful life; and

(iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

Depreciation Method

Any method of calculating depreciation for an accounting period.

Depreciation Rate

A percentage applied to the historical cost or the substituted amount of a *depreciable asset* (or in case of *diminishing balance method*, the historical cost or the substituted amount less *accumulated depreciation*).

Diminishing Balance Method

A method under which the periodic charge for *depreciation* of an *asset* is computed by applying a fixed percentage to its historical cost or substituted amount less *accumulated depreciation* (net book value). This is also referred to as **written down value method**.

Discount

A reduction from a list price, quoted price or invoiced price. It also refers to the price for obtaining payment on a bill before its maturity.

Dividend

A distribution to shareholders out of profits or reserves available for this purpose.

Entity Concept

The view of the relationship between the accounting entity and its owners which regards the entity as a separate person, distinct and apart from its owners.

Equity Share

A share which is not a preference share. Also sometimes called **ordinary share**.

Exchange difference

Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

Expenditure

Incurring a *liability*, disbursement of cash or transfer of property for the purpose of obtaining *assets*, goods or services.

Expense

A cost relating to the operations of an accounting period or to the *revenue* earned during the period or the benefits of which do not extend beyond that period.

Expired Cost

That portion of an *expenditure* from which no further benefit is expected. Also termed as **expense**.

Extraordinary items

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Fair value

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

Fair Market Value

The price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

First Charge

A *charge* having priority over other charges.

First In, First Out (FIFO)

Computation of the cost of items sold or consumed during a period as though they were sold or consumed in order of their acquisition.

Fixed asset

Asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

Fixed Cost

That cost of production which by its very nature remains relatively unaffected in a defined period of time by variations in the volume of production.

Fixed Deposit

Deposit for a specified period and at specified rate of interest.

Fixed or Specific Charge

A *charge* which attaches to a particular *asset* which is identified when the charge is created, and the identity of the *asset* does not change during the subsistence of the *charge*.

Floating Charge

A general *charge* on some or all *assets* of an enterprise which are not attached to specific *assets* and are given as security against a debt.

Financial Instrument

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

Foreign currency

Foreign currency is a currency other than the reporting currency of an enterprise.

Forfeited Share

A share to which title is lost by a member for non-payment of call money or default in fulfilling any engagement between members or expulsion of members where the articles specifically provide therefor.

Free Reserve

A *reserve* the utilization of which is not restricted in any manner.

Functional Classification

A system of classification of *expenses* and *revenues* and the corresponding *assets* and *liabilities* to each function or activity, rather than by reference to their nature.

Fund

An account usually of the nature of a *reserve* or a *provision* which is represented by specifically earmarked *assets*.

Fundamental Accounting Assumptions

Basic accounting assumptions which underlie the preparation and presentation of financial statements. They are *going concern*, consistency and *accrual*. Usually, they are not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

Gain

A monetary benefit, *profit* or advantage resulting from a transaction or group of transactions.

General Reserve

A *revenue reserve* which is not earmarked for a specific purpose.

Going Concern Assumption

An accounting assumption according to which an enterprise is viewed as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

Goodwill

An *intangible asset* arising from business connections or trade name or reputation of an enterprise.

Gross Margin or Gross Profit

The excess of the proceeds of goods sold and services rendered during a period over their *cost*, before taking into account administration, selling, distribution and financing expenses. When the result of this computation is negative it is referred to as **gross loss**.

Government

Government refers to government, government agencies and similar bodies whether local, national or international.

Government grants

Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Gross book value

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

Income and Expenditure Statement

A financial statement, often prepared by non-profit making enterprises like clubs, associations etc. to present their *revenues* and *expenses* for an accounting period and to show the excess of *revenues* over *expenses* (or vice versa) for that period. It is similar to profit and loss statement and is also called **revenue and expense statement**.

Intangible Asset

Asset which does not have a physical identity e.g. *goodwill*, patents, copyright etc.

Inventories are assets**:**

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Investment

Expenditure on *assets* held to earn interest, *income, profit* or other benefits.

Investments

Assets held not for operational purposes or for rendering services i.e. assets other than *fixed assets* or *current assets* (e.g. securities, shares, *debentures*, immovable properties).

Issued Share Capital

That portion of the *authorized share capital* which has actually been offered for subscription. This includes any *bonus shares* allotted by the corporate enterprise.

Joint venture

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

Last In, First Out (LIFO)

Computation of the cost of items sold or consumed during a period on the basis that the items last acquired were sold or consumed first.

Liability

The financial obligation of an enterprise other than owners' funds.

Lien

Right of one person to satisfy a claim against another by holding or retaining possession of that other's *assets*/property.

Long-term Liability

Liability which does not fall due for payment in a relatively short period, i.e., normally a period not more than twelve months.

Lease

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Materiality

An accounting concept according to which all relatively important and relevant items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements are disclosed in the financial statements.

Mortgage

A transfer of interest in specific immovable property for the purpose of securing a loan advanced, or to be advanced, an existing or future debt or the performance of an engagement which may give rise to a pecuniary *liability*. The security is redeemed when the loan is repaid or the debt discharged or the obligations performed.

Net Assets/Shareholders' funds/Net Worth

The excess of the *book value* of *assets* (other than *fictitious assets*) of an enterprise over its *liabilities*. This is also referred to as **net worth** or **shareholders' funds**.

Net Fixed Assets

Fixed assets less accumulated depreciation thereon up-to-date.

Net Profit/Net loss

The excess of *revenue* over *expenses* during a particular accounting period. When the result of this computation is negative, it is referred to as **net loss**. The net profit may be shown before or after tax.

Net realizable value

Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Obsolescence

Diminution in the value of an asset by reason of its becoming out-of date or less useful due to technological changes, improvement in production methods, change in market demand for the product or service output of the asset, or legal or other restrictions.

Operating Profit

The *net profit* arising from the normal operations and activities of an enterprise without taking account of extraneous transactions and expenses of a purely financial nature.

Paid-up Share Capital

That part of the *subscribed share capital* for which consideration in cash or otherwise has been received. This includes *bonus shares* allotted by the corporate enterprise.

Preference Share Capital

That part of the *share capital* of a corporate enterprise which enjoys preferential rights in respect of payments of fixed *dividend* and repayment of *capital*. Preference shares may also have full or partial participating rights in surplus profits or surplus capital.

Preliminary Expenses

Expenses relating to the formation of an enterprise. These include legal, accounting and share issue expenses incurred for formation of the enterprise.

Prepaid Expense

Payment for expense in an accounting period, the benefit for which will accrue in the subsequent accounting period(s).

Prime Cost

The total *cost* of direct materials, direct wages and other direct production expenses.

Prior Period Item

Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Profit/Loss

A general term for the excess of *revenue* over related *cost*. When the result of this computation is negative it is referred to as **loss**.

Profit and Loss Account

A financial statement which presents the *revenues* and *expenses* of an enterprise for an accounting period and shows the excess of *revenues* over *expenses* (or vice versa). It is also known as **profit and loss account**.

Promissory Note

An instrument in writing (not being a bank note or currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

Provision

An amount written off or retained by way of providing for *depreciation* or diminution in value of assets or retained by way of providing for any known *liability* the amount of which cannot be determined with substantial accuracy.

Provision for Doubtful Debts

A *provision* made for debts considered doubtful of recovery.

Prudence

A concept of care and caution used in accounting according to which (in view of the uncertainty attached to future events) *profits* are not anticipated, but recognised only when realised, though not necessarily in cash. Under this concept, *provision* is made for all known *liabilities* and losses, even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Redeemable Preference Share

The preference share that is repayable either after a fixed or determinable period or at any time decided by the management (by giving due notice), under certain conditions prescribed by the instrument of incorporation or the terms of issue.

Redemption

Repayment as per given terms normally used in connection with preference shares and debentures.

Reserve

The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a *provision* for *depreciation* or diminution in the value of assets or for a known *liability*. The reserves are primarily of two types: *capital reserves* and *revenue reserves*.

Revaluation Reserve

A *reserve* created on the revaluation of *assets* or *net assets* of an enterprise represented by the surplus of the estimated replacement cost or estimated market values over the *book values* thereof.

Residual value

Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Revenue/Income

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

Revenue Reserve

Any reserve other than a capital reserve.

Right Share

An allotment of shares on the issue of fresh *capital* by a corporate enterprise to which a shareholder is entitled on payment, by virtue of his holding certain shares in the enterprise in proportion to the number of shares already held by him. (Shares allotted to certain categories of *debenture* holders pursuant to the rights enjoyed by them are sometimes called right shares)

Sales Turnover/Gross Turnover/Gross Sales

The aggregate amount for which sales are effected or services rendered by an enterprise. The terms **gross turnover** and **net turnover** (or **gross sales** and **net sales**) are sometimes used to distinguish the sales aggregate before and after deduction of returns and trade discounts.

Secured Loan

Loan secured wholly or partly against an asset.

Share Capital

Aggregate amount of money paid or credited as paid on the shares and/ or stocks of a corporate enterprise.

Share Discount

The excess of the face value of shares over their issue price.

Shareholders' Equity

The interest of the shareholders in the *net assets* of a corporate enterprise. However, in the case of liquidation it is represented by the residual assets after meeting prior claims.

Share Issue Expenses

Costs incurred in connection with the issue and allotment of shares. These include legal and professional fees, advertising expenses, printing costs, underwriting commission, brokerage, and also expenses in connection with the issue of prospectus and allotment of shares.

Share warrants

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

Securities Premium

The excess of the issue price of shares over their face value.

Sinking Fund

A *fund* created for the repayment of a *liability* or for the replacement of an asset.

Straight Line Method

The method under which the periodic charge for *depreciation* is computed by dividing the *depreciable amount* of a *depreciable asset* by the estimated number of years of its useful life.

Subscribed Share Capital

That portion of the *issued share capital* which has actually been subscribed and allotted. This includes any *bonus shares* allotted by the corporate enterprise.

Substance over Form

An accounting concept according to which the substance and not merely the legal form of transactions and events governs their accounting treatment and presentation in financial statements.

Sundry Creditors / Trade Creditors/Trade payables

Amount owed by an enterprise on account of goods purchased or services received or in respect of contractual obligations. Also termed as **trade creditors** or **account payables** or **Trade payables**.

Sundry Debtors / Trade Debtors/ Trade Receivables

Person from whom amounts are due for goods sold or services rendered or in respect of contractual obligations. Also termed as **debtors, trade debtors, account receivables, trade receivables**.

Surplus

Credit balance in the *profit and loss statement* after providing for proposed appropriations, e.g., *dividend* or *reserves*.

Trade Discount

A reduction granted by a supplier from the list price of goods or services on business considerations other than for prompt payment.

Unexpired Cost

That portion of an *expenditure* whose benefit has not yet been exhausted.

Unissued Share Capital

That portion of the *authorised share capital* for which shares have not been offered for subscription.

Unpaid Dividend

Dividend which has been declared by a corporate enterprise but has not been paid, or the warrant or *cheque* in respect whereof has not been dispatched within the prescribed period.

Useful life

Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise

TEST YOUR KNOWLEDGE

QUESTION

Define following terms:

1. Accrual Basis of Accounting
2. Amortisation
3. Contingent Asset
4. Contingent Liability

ANSWER

1. Accrual Basis of Accounting

The method of recording transactions by which *revenues, costs, assets* and *liabilities* are reflected in the accounts in the period in which they accrue.

2. Amortisation

The gradual and systematic writing off of an asset or an account over an appropriate period.

3. Contingent Asset

An *asset* the existence, ownership or value of which may be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

4. Contingent Liability

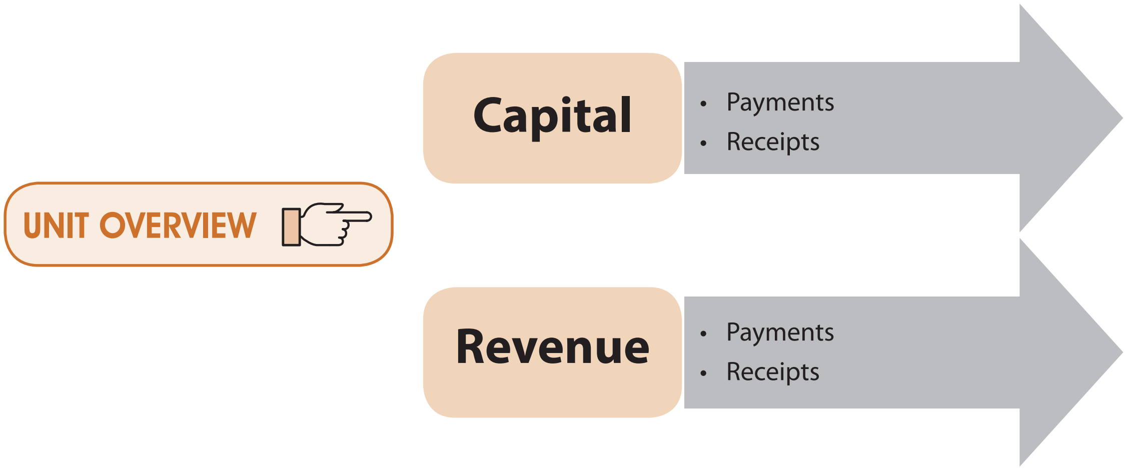
An obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

UNIT 4 : CAPITAL AND REVENUE EXPENDITURES AND RECEIPTS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Learn the criteria for identifying Revenue Expenditure and distinguishing from Capital Expenditure
- Learn the distinction between capital and revenue receipts.
- Understand the linkage of such distinction with the preparation of final accounts.



4.1 INTRODUCTION

Accounting aims in ascertaining and presenting the results of the business for an accounting period. For ascertaining the periodical business results, the nature of transactions should be analyzed whether they are of capital or revenue nature. The Revenue Expense relates to the operations of the business of an accounting period or to the revenue earned during the period or the items of expenditure, benefits of which do not extend beyond that period. Capital Expenditure, on the other hand, generates enduring benefits and helps in revenue generation over more than one accounting period. Revenue Expenses must be associated with a physical activity of the entity. Therefore, whereas production and sales generate revenue in the earning process, use of goods and services in support of those functions causes expenses to occur. Expenses are recognised in the Profit & Loss Account through matching principal which tells us when and how much of the expenses to be charged against revenue. A part of the expenditure can be capitalised only when these can be traced directly to definable streams of future benefits.

The distinction of transaction into revenue and capital is done for the purpose of placing them in Profit and Loss account or in the Balance Sheet. For example: revenue expenditures are shown in the profit and loss account as their benefits are for one accounting period i.e. in which they are incurred while capital expenditures are placed on the asset side of the balance sheet as they will generate benefits for more than one accounting period and will be transferred to profit and loss account of the year on the basis of utilisation of that benefit in particular accounting year. Hence, both capital and revenue expenditures are ultimately transferred to profit and loss account.

Revenue expenditures are transferred to profit and loss account in the year of spending while capital expenditures are transferred to profit and loss account of the year in which their benefits are utilised. Therefore we can conclude that it is the time factor, which is the main determinant for transferring the expenditure to profit and loss account. Also expenses are recognized in profit and loss account through matching concept which tells us when and how much of the expenses to be charged against revenue. However, distinction between capital and revenue creates a considerable difficulty. In many cases borderline between the two is very thin.

4.2 CONSIDERATIONS IN DETERMINING CAPITAL AND REVENUE EXPENDITURES

The basic considerations in distinction between capital and revenue expenditures are:

(a) **Nature of business:** For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is a very important criteria in separating an expenditure between capital and revenue.

(b) **Recurring nature of expenditure:** If the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting year. Monthly salary or rent is the example of revenue expenditure as they are incurred every month while purchase of assets is not the transaction done regularly therefore, classified as capital expenditure unless materiality criteria defines it as revenue expenditure.

(c) **Purpose of expenses:** Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature. However, determination of the cost of maintenance and ordinary repairs which should be expensed, as opposed to a cost which ought to be capitalised, is not always simple.

(d) **Effect on revenue generating capacity of business:** The expenses which help to generate income/ revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On the other hand, if expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure.

    When expenditure on improvements and repair of a fixed asset is done, it has to be charged to Profit and Loss Account if the expected future benefits from fixed assets do not change, and it will be included in book value of fixed asset, where the expected future benefits from assets increase.

(e) **Materiality of the amount involved:** Relative proportion of the amount involved is another important consideration in distinction between revenue and capital.

4.3 CAPITAL EXPENDITURES AND REVENUE EXPENDITURES

As we have already discussed, capital expenditure contributes to the revenue earning capacity of a business over more than one accounting period whereas revenue expense is incurred to generate revenue for a particular accounting period. The revenue expenses either occur in direct relation with the revenue or in relation with accounting periods, for example cost of goods sold, salaries, rent, etc. Cost of goods sold is directly related to sales revenue whereas rent is related to the particular accounting period. Capital expenditure may represent acquisition of any tangible or intangible fixed assets for enduring future benefits. Therefore, the benefits arising out of capital expenditure last for more than one accounting period whereas those arising out of revenue expenses expire in the same accounting period.

ILLUSTRATION 1

State with reasons whether the following statements are 'True' or 'False'.

(1) Overhaul expenses of second-hand machinery purchased are Revenue Expenditure.

(2) Money spent to reduce working expenses is Revenue Expenditure.

(3) Legal fees to acquire property is Capital Expenditure.

(4) Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.

(5) Amount spent for replacement of worn out part of machine is Capital Expenditure.

(6) Expense incurred on the repairs and white washing for the first time on purchase of an old building are Revenue Expenses.

(7) Expenses in connection with obtaining a license for running the cinema is Capital Expenditure.

(8) Amount spent for the construction of temporary huts, which were necessary for construction of the Cinema House and were demolished when the cinema house was ready, is Capital Expenditure.

SOLUTION

(1) False: Overhaul expenses are incurred to put second-hand machinery in working condition to derive endurable long-term advantage. So it should be capitalised.

(2) False: It may be reasonably presumed that money spent for reducing revenue expenditure would have generated long-term benefits to the entity. It becomes part of intangible fixed assets if it is in the form of technical know-how and tangible fixed assets if it is in the form of additional replacement of any of the existing tangible fixed assets. So this is capital expenditure.

(3) True: Legal fee paid to acquire any property is part of the cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.

(4) False: Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any endurable benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.

(5) False: Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.

(6) False: Repairing and white washing expenses for the first time of an old building are incurred to put the building in usable condition. These are the part of the cost of building. Accordingly, these are capital expenditure.

(7) True: The Cinema Hall could not be started without license. Expenditure incurred to obtain the license is pre-operative expense which is capitalised. Such expenses are amortised over a period of time.

(8) True: Cost of temporary huts constructed which were necessary for the construction of the cinema house is part of the construction cost of the cinema house. Therefore such costs are to be capitalised.

ILLUSTRATION 2

State with reasons whether the following are Capital or Revenue Expenditure:

(1) Expenses incurred in connection with obtaining a license for starting the factory for ₹ 10,000.

(2) ₹ 1,000 paid for removal of Inventory to a new site.

(3) Rings and Pistons of an engine were changed at a cost of ₹ 5,000 to get fuel efficiency.

(4) Money paid to Mahanagar Telephone Nigam Ltd. (MTNL) ₹ 8,000 for installing telephone in the office.

(5) A factory shed was constructed at a cost of ₹ 1,00,000. A sum of ₹ 5,000 had been incurred in the construction of temporary huts for storing building material.

SOLUTION

(1) Money paid ₹ 10,000 for obtaining license to start a factory is a capital expenditure. This is an item of expenditure incurred to acquire the right to carry on business.

(2) ₹ 1,000 paid for removal of Inventory to a new site is revenue expenditure. This is neither bringing enduring benefit nor enhancing the value of the asset.

(3) ₹ 5,000 spent in changing Rings and Pistons of an engine to get fuel efficiency is capital expenditure. This is an expenditure on improvement of a fixed asset. It results in increasing profit-earning capacity of the business by cost reduction.

(4) Money deposited with MTNL for installation of telephone in office is not expenditure. This is treated as an asset and the same is adjusted over a period of time against actual telephone bills.

(5) Cost of construction of building including cost of temporary huts is capital expenditure. Building is fixed asset which will generate enduring benefit to the business over more than one accounting period. Construction of temporary huts is incidental to the main construction. Such cost is also capitalised with the cost of building.

4.4 CAPITAL RECEIPTS AND REVENUE RECEIPTS

Just as a clear distinction between Capital and Revenue expenditure is necessary, in the same manner capital receipts must be distinguished from revenue receipts.

Receipts which are obtained in course of normal business activities are revenue receipts (e.g. receipts from sale of goods or services, interest income etc.). On the other hand, receipts which are not revenue in nature are capital receipts (e.g. receipts from sale of fixed assets or investments, secured or unsecured loans, owners' contributions etc.). Revenue and capital receipts are recognised on accrual basis as soon as the right of receipt is established. Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.

On the other hand, Capital receipts are not directly credited to Profit and Loss Account. For example, when a fixed asset is sold for ₹ 92,000 (cost ₹ 90,000), the capital receipts ₹ 92,000 is not credited to Profit and Loss Account. only Profit or Loss on sale of fixed assets is calculated and credited to Profit and Loss Account as follows:

Sale Proceeds	₹ 92,000
Cost	(₹ 90,000)
Profit	₹ 2,000

ILLUSTRATION 3

Good Pictures Ltd., constructs a cinema house and incurs the following expenditure during the first year ending 31st March, 2020.

(i) Second-hand furniture worth ₹ 9,000 was purchased; repainting of the furniture costs ₹ 1,000. The furniture was installed by own workmen, wages for this being ₹ 200.

(ii) Expenses in connection with obtaining a license for running the cinema worth ₹ 20,000. During the course of the year the cinema company was fined ₹ 1,000, for contravening rules. Renewal fee ₹ 2,000 for next year also paid.

(iii) Fire insurance, ₹ 1,000 was paid on 1st October, 2019 for one year.

(iv) Temporary huts were constructed costing ₹ 1,200. They were necessary for the construction of the cinema. They were demolished when the cinema was ready.

Point out how you would classify the above items.

SOLUTION

1. The total cost of the furniture should be treated as ₹ 10,200 i.e., all the amounts mentioned should be capitalised since without such expenditure the furniture would not be available for use. If ₹ 1,000 and ₹ 200 have been respectively debited to the Repairs Account and the Wages Account, these accounts will be credited to the Furniture Account.
2. License for running the cinema house is necessary, hence its cost should be capitalised. But the fine of ₹ 1,000 is revenue expenditure. The renewal fee for the next year is also revenue expenditure but pertains to the next year; hence, it is a prepaid expense.
3. Half of the insurance premium pertains to the year beginning on 1st April, 2020. Hence such amount should be treated as prepaid expense. The remaining amount is revenue expense for the current year.
4. Since the temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

ILLUSTRATION 4

State with reasons, how you would classify the following items of expenditure:

1. *Overhauling expenses of ₹ 25,000 for the engine of a motor car to get better fuel efficiency.*
2. *Inauguration expenses of ₹ 25 lacs incurred on the opening of a new manufacturing unit in an existing business.*
3. *Compensation of ₹ 2.5 crores paid to workers, who opted for voluntary retirement.*

SOLUTION

1. Overhauling expenses are incurred for the engine of a motor car to derive better fuel efficiency. These expenses will reduce the running cost in future and thus the benefit is in form of endurable long-term advantage. So this expenditure should be capitalised.

2. Inauguration expenses incurred on the opening of a new unit may help to explore more customers This expenditure is in the nature of revenue expenditure, as the expenditure may not generate any enduring benefit to the business over more than one accounting period.

3. The amount paid to workers on voluntary retirement is in the nature of revenue expenditure. Since the magnitude of the amount of expenditure is very significant, it may be better to defer it over future years.

ILLUSTRATION 5

Classify the following expenditures and receipts as capital or revenue:

(i) ₹ 10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets.

(ii) Amount received from Trade receivables during the year.

(iii) Amount spent on demolition of building to construct a bigger building on the same site.

(iv) Insurance claim received on account of a machinery damaged by fire.

SOLUTION

(i) Capital expenditure.

(ii) Revenue receipt.

(iii) Capital expenditure.

(iv) Capital receipt.

ILLUSTRATION 6

Are the following expenditures capital in nature?

(i) M/s ABC & Co. run a restaurant. They renovate some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 10 to 13. The total expenditure was ₹ 20,000.

(ii) M/s New Delhi Financing Co. sold certain goods on installment payment basis. Five customers did not pay installments. To recover such outstanding installments, the firm spent ₹ 10,000 on account of legal expenses.

(iii) M/s Ballav & Co. of Delhi purchased a machinery from M/s Shah & Co. of Ahmedabad. M/s Ballav & Co. spent ₹ 40,000 for transportation of such machinery. The year ending is 31st Dec, 2019.

SOLUTION

(i) Renovation of cabins increased the number of cabins. This has an effect on the future revenue generating capability of the business. Thus the renovation expense is capital expenditure in nature.

(ii) Expense incurred to recover installments due from customer do not increase the revenue generating capability in future. It is a normal recurring expense of the business. Thus the legal expenses incurred in this case is revenue expenditure in nature.

(iii) Expenses incurred on account of transportation of fixed asset is capital expenditure in nature.

SUMMARY

- Revenue expenditures are shown in the profit and loss account while capital expenditures are placed on the asset side of the balance sheet since they generate benefits for more than are accounting period.
- Prepaid expenses are future expenses that have been paid in advance. These are shown in the balance sheet as an asset.
- Receipts obtained should be classified between revenue receipts and capital receipts.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. Money spent ₹ 10,000 as traveling expenses of the directors on trips abroad for purchase of capital assets is
   (a) Capital expenditures (b) Revenue expenditures
   (c) Prepaid revenue expenditures
2. Amount of ₹ 5,000 spent as lawyers' fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is
   (a) Capital expenditures (b) Revenue expenditures
   (c) Prepaid revenue expenditures
3. Entrance fee of ₹ 2,000 received by Ram and Shyam Social Club is
   (a) Capital receipt (b) Revenue receipt
   (c) Capital expenditures
4. Subsidy of ₹ 40,000 received from the government for working capital by a manufacturing concern is
   (a) Capital receipt (b) Revenue receipt
   (c) Capital expenditures
5. Insurance claim received on account of machinery damaged completely by fire is
   (a) Capital receipt (b) Revenue receipt
   (c) Capital expenditures
6. Interest on investments received from UTI is
   (a) Capital receipt (b) Revenue receipt
   (c) Capital expenditures
7. Amount received from IDBI as a medium term loan for augmenting working capital is
   (a) Capital expenditures (b) Revenue expenditures
   (c) Capital receipt

8. Revenue from sale of products, ordinarily, is reported as part of the earning in the period in which

   (a) The sale is made. (b) The cash is collected.

   (c) The products are manufactured.

9. If repair cost is ₹ 25,000, whitewash expenses are ₹ 5,000, (both these expenses relate to presently used building) cost of extension of building is ₹ 2,50,000 and cost of improvement in electrical wiring system is ₹ 19,000; the amount to be expensed is

   (a) ₹ 2,99,000. (b) ₹ 44,000.

   (c) ₹ 30,000.

Theory Questions

1. What are the basic considerations in distinguishing between capital and revenue expenditures?
2. Define revenue receipts and give examples. How are these receipts treated?

ANSWERS/HINTS

MCQs

1: (a), 2 (b), 3 (a), 4(b), 5(a), 6 (b), 7(c), 8 (a), 9 (c)

Theoretical Questions

1. The basic considerations in distinction between capital and revenue expenditures are:

   (a) Nature of business.

   (b) Recurring nature of expenditure.

   (c) Purpose of expenses.

   (d) Effect on revenue generating capacity of business.

   (e) Materiality of the amount involved.

2. Receipts which are obtained in course of normal business activities are revenue receipts (e.g. receipts from sale of goods or services, interest income etc.).

   Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.

UNIT 5 : CONTINGENT ASSETS AND CONTINGENT LIABILITIES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the meaning of the terms 'Contingent Assets' and 'Contingent Liabilities'.
- Distinguish 'Contingent Liabilities' with 'Liabilities' and 'Provisions'

UNIT OVERVIEW

Contingent Asseet

- A possible asset arises from past events and their existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events.

Contingent Liability

- A possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

5.1 CONTINGENT ASSET

A contingent asset may be defined as a possible asset that arises from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. It usually arises from unplanned or unexpected events that give rise to the possibility of an inflow of economic benefits to the business entity. For example, a claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent asset.

As per the concept of prudence as well as the present accounting standards, an enterprise should not recognise a contingent asset. These assets are uncertain and may arise from a claim which an enterprise pursues through a legal proceeding. There is uncertainty in realisation of claim. It is possible that recognition of contingent assets may result in recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset no longer remains as contingent asset.

A contingent asset need not be disclosed in the financial statements. A contingent asset is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise), if an inflow of economic benefits is probable. Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

5.2 CONTINGENT LIABILITIES

The term 'Contingent liability' can be defined as

"(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognised because:

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

  (ii) a reliable estimate of the amount of the obligation cannot be made."

A contingent liability is a possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events [part (a) of the definition]. A contingent liability may also be a present obligation that arises from past events [(part (b) of the definition)].

An enterprise should not recognise a contingent liability in balance sheet, however it is required to be disclosed in the notes to accounts, unless possibility of outflow of a resource embodying economic benefits is remote. These liabilities ar assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow or future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in financial statements of the period in which the change in probability occurs except in the extremely rare circumstances where no reliable estimate can be made.

5.3 DISTINCTION BETWEEN CONTINGENT LIABILITIES AND LIABILITIES

The distinction between a liability and a contingent liability is generally based on the judgement of the management. A liability is defined as the present financial obligation of an enterprise, which arises from past events. The settlement of a liability results in an outflow from the enterprises of resources embodying economic benefits. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability. Examples of contingent liabilities are claims against the enterprise not acknowledged as debts, guarantees given in respect of third parties, liability in respect of bills discounted and statutory liabilities under dispute etc. In addition to present obligations that are recognized as liabilities in the balance sheet, enterprises are required to disclose contingent liability in their balance sheets by way of notes.

5.4 DISTINCTION BETWEEN CONTINGENT LIABILITIES AND PROVISIONS

Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

It is important to know the difference between provisions and contingent liabilities. The distinction between both of them can be explained as follows:

	Provision	Contingent liability
(1)	Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation.	A Contingent liability is a possible obligation that may or may not crystallise depending on the occurrence or non-occurrence of one or more uncertain future events.
(2)	A provision meets the recognition criteria.	A contingent liability fails to meet the same.
(3)	Provision is recognised when (a) an enterprise has a present obligation arising from past events; an outflow of resources embodying economic benefits is probable, and (b) a reliable estimate can be made of the amount of the obligation.	Contingent liability includes present obligations that do not meet the recognition criteria because either it is not probable that settlement of those obligations will require outflow of economic benefits, or the amount cannot be reliably estimated.
(4)	If the management estimates that it is probable that the settlement of an obligation will result in outflow of economic benefits, it recognises a provision in the balance sheet.	If the management estimates, that it is less likely that any economic benefit will outflow the firm to settle the obligation, it discloses the obligation as a contingent liability.

Let us take an example to understand the distinction between provisions and contingent liabilities. The Central Excise Officer imposes a penalty on Alpha Ltd. for violation of a provision in the Central Excise Act. The company goes on an appeal. If the management of the company estimates that it is probable that the company will have to pay the penalty, it recognises a provision for the liability. On the other hand, if the management anticipates that the judgement of the appellate authority will be in its favour and it is less likely that the company will have to pay the penalty, it will disclose the obligation as a contingent liability instead of recognising a provision for the same.

TEST YOUR KNOWLEDGE

Mutiple Choice Questions

1. (i) Contingent asset usually arises from unplanned or unexpected events that give rise to

   (a) The possibility of an inflow of economic benefits to the business entity.

   (b) The possibility of an outflow of economic benefits to the business entity.

   (c) Either (a) or (b).

   (ii) If an inflow of economic benefits is probable then a contingent asset is disclosed

   (a) In the financial statements.

   (b) In the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise).

   (c) In the cash flow statement.

(iii) In the case of ___________, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

(a) Liability (b) Provision

(c) Contingent liabilities

(iv) Present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation is termed as ________.

(a) Provision. (b) Liability.

(c) Contingent liability.

(v) In the financial statements, contingent liability is

(a) Recognised. (b) Not recognised.

(c) Adjusted.

Theoretical Questions

1. Differentiate between:

   (i) Provision and Contingent Liability.

   (ii) Liability and Contingent liability.

ANSWERS/HINTS

Multiple Choice Questions

(i) (a) (ii) (b) (iii) (c) (iv) (a) (v) (b)

Theoretical Questions

1. Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation. On the other hand, a Contingent liability is a possible obligation that may or may not crystallize depending on the occurrence or non-occurrence of one or more uncertain future events.

2. A liability is defined as the present financial obligation of an enterprise, which arises from past events. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

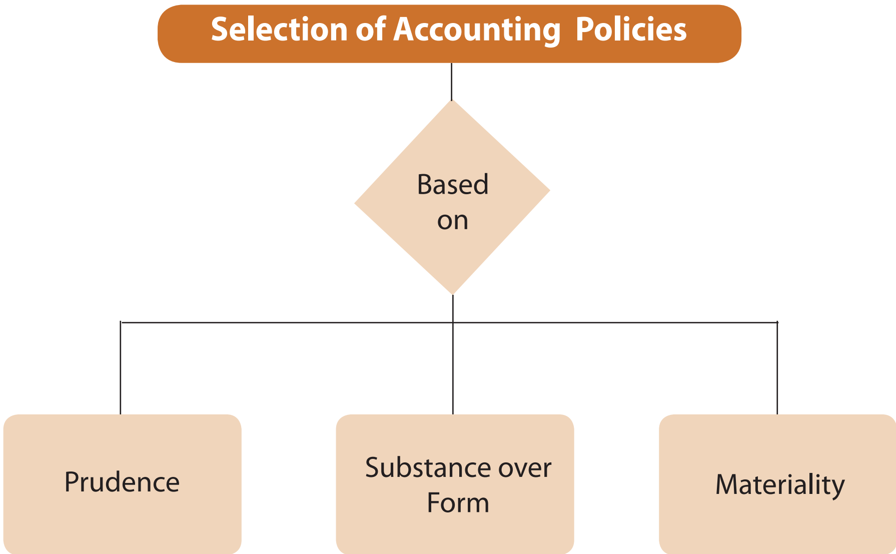
UNIT 6 : ACCOUNTING POLICIES

LEARNING OUTCOMES

After studying this unit, you will be able to :

- Understand the meaning of 'Accounting Policies'.
- Familiarize with the situations under which selection from different accounting policies is required.
- Grasp the conditions where change in accounting policy can be made and the consequences arising from such changes.

UNIT OVERVIEW



6.1 MEANING OF ACCOUNTING POLICIES

Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions that have already been explained in Unit 2 of Chapter 1. There is no single list of accounting policies, which are applicable to all enterprises in all circumstances. Enterprises operate in diverse and complex environmental situations and so they have to adopt various policies. The choice of specific accounting policy appropriate to the specific circumstances in which the enterprise is operating, calls for considerate judgement by the management. ICAI has been trying to reduce the number of acceptable accounting policies through Guidance Notes and Accounting Standards in its combined efforts with the government, other regulatory agencies and progressive managements. Already it has achieved some progress in this respect.

The areas wherein different accounting policies are frequently encountered can be given as follows:

(1) Valuation of inventories;

(2) Valuation of investments.

This list should not be taken as exhaustive but is only illustrative. As the course will progress, students will see the intricacies of the various accounting policies.

Suppose an enterprise holds some investments in the form of shares of a company at the end of an accounting period. For valuation of shares, the enterprise may adopt FIFO, average method etc. The method selected by that enterprise for valuation is called an accounting policy. Different enterprises may adopt different accounting policies. Likewise, different methods of providing depreciation on fixed assets, i.e. Straight line, written down, etc. are available to the business enterprises which will lead to different depreciation amounts.

6.2 SELECTION OF ACCOUNTING POLICIES

Choice of accounting policy is an important policy decision which affects the performance measurement as well as financial position of the business entity. Selection of inappropriate accounting policy may lead to understatement or overstatement of performance and financial position. Thus, accounting policy should be selected with due care after considering its effect on the financial performance of the business enterprise from the angle of various users of accounts.

It is believed that no unified and exhaustive list of accounting policies can be suggested which has universal application. Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz.,Prudence, Substance over form, and Materiality. The financial statements should be prepared on the basis of such accounting policies, which exhibit true and fair view of state of affairs of Balance Sheet and the Profit & Loss Account.

Examples wherein selection from a set of accounting policies is made, can be given as follows:–

1. Inventories are valued at cost except for finished goods and by-products. Finished goods are valued at lower of cost or market value and by-products are valued at net realizable value.

2. Investments (long term) are valued at their acquisition cost. Provision for permanent diminution in value has been made wherever necessary.

Sometimes a wrong or inappropriate treatment is adopted for items in Balance Sheet, or Profit & Loss Account, or other statement. Disclosure of the treatment adopted is necessary in any case, but disclosure cannot rectify a wrong or inappropriate treatment.

6.3 CHANGE IN ACCOUNTING POLICIES

A change in accounting policies should be made in the following conditions:

(a) It is required by some statute or for compliance with an Accounting Standard.

(b) Change would result in more appropriate presentation of financial statement.

Change in accounting policy may have a material effect on the items of financial statements. For example, if depreciation method is changed from straight-line method to written-down value method, or if cost formula used for inventory valuation is changed from weighted average to FIFO, or if interest is capitalized which was earlier not in practice, or if proportionate amount of interest is changed to inventory which was earlier not the practice, all these may increase or decrease the net profit. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts. Therefore, it is necessary to quantify the effect of change on financial statement items like assets, liabilities, profit/loss.

For Example, Omega Enterprises revised its accounting policy relating to valuation of inventories to include applicable production overheads.

SUMMARY

- Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions.
- Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz., Prudence, Substance over form, and Materiality.
- A change in accounting policies should be made in the following conditions:
  - (a) It is required by some statute or for compliance with an Accounting Standard.
  - (b) Change would result in more appropriate presentation of financial statement.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. A change in accounting policy is justified
   - (a) To comply with accounting standard and law.
   - (b) To ensure more appropriate presentation of the financial statement of the enterprise.
   - (c) All of the above.
2. Accounting policy for inventories of Xeta Enterprises states that inventories are valued at the lower of cost determined on weighted average basis or net realizable value. Which accounting principle is followed in adopting the above policy?
   - (a) Materiality. (b) Prudence.
   - (c) Substance over form.
3. The areas wherein different accounting policies can be adopted are
   - (a) Providing depreciation. (b) Valuation of inventories.
   - (c) Both the option.
4. Selection of an inappropriate accounting policy decision may
   - (a) Overstate the performance and financial position of a business entity.
   - (b) Understate/overstate the performance and financial position of a business entity.
   - (c) Overstate the performance of a business entity.

5. Accounting policies refer to specific accounting
   (a) Principles. (b) Methods of applying those principles.
   (c) Both (a) and (b).

Theoretical Questions

1. Define Accounting Policies in brief. Identify few areas wherein different accounting policies are frequently encountered.
2. "Change in accounting policy may have a material effect on the items of financial statements." Explain the statement with the help of an example.

ANSWERS/HINTS

Multiple Choice Questions

(1) (c), (2) (b), (3) (c), (4) (b), (5) (c)

Theoretical Questions

1. Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. For details, refer para 6.1.

2. Change in accounting policy may have a material effect on the items of financial statements. For example, if depreciation method is changed from straight-line method to written-down value method, or if cost formula used for inventory valuation is changed from weighted average to FIFO. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts.

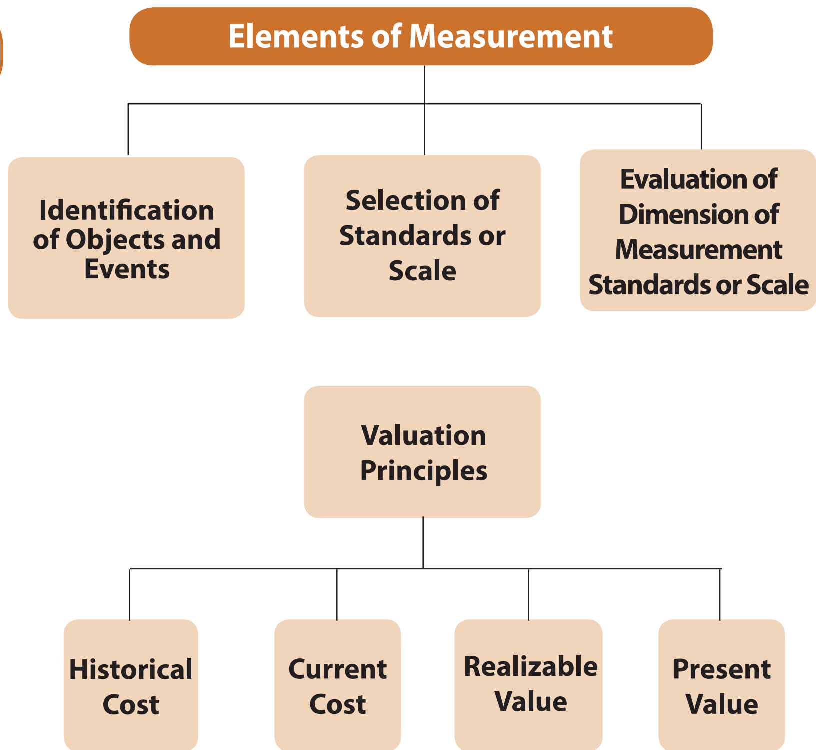
UNIT 7 : ACCOUNTING AS A MEASUREMENT DISCIPLINE – VALUATION PRINCIPLES, ACCOUNTING ESTIMATES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the meaning of measurement and its basic elements.
- Know how far accounting is a measurement discipline if considered from the standpoint of the basic elements of measurement.
- Distinguish measurement from valuation.
- Learn the different measurement bases namely historical cost, realizable value and present value.
- Understand the measurement bases which can give objective valuation to transactions and events.
- Understand that the traditional accounting system mostly uses historical cost as measurement base although in some cases other measurement bases are also used.

UNIT OVERVIEW



7.1 MEANING OF MEASUREMENT

Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Any measurement discipline deals with three basic elements of measurement viz., identification of objects and events to be measured, selection of standard or scale to be used, and evaluation of dimension of measurement standards or scale.

Prof. R. J. Chambers defined 'measurement' as "assignment of numbers to objects and events according to rules specifying the property to be measured, the scale to be used and the dimension of the unit". (R.J. Chambers, Accounting Evaluation and Economic Behaviour, Prentice Hall, Englewood Cliffs, N.J. 1966, P.10).

Kohler defined measurement as the assignment of a system of ordinal or cardinal numbers to the results of a scheme of inquiry or apparatus of observations in accordance with logical or mathematical rules – [A Dictionary of Accountant].

Ordinal numbers, or ordinals, are numbers used to denote the position in an ordered sequence: first, second, third, fourth, etc., whereas a cardinal number says 'how many there are': one, two, three, four, etc.

Chambers' definition has been widely used to judge how far accounting can be treated as a measurement discipline.

According to this definition, the three elements of measurement are:

(1) Identification of objects and events to be measured;

(2) Selection of standard or scale to be used;

(3) Evaluation of dimension of measurement standard or scale.

7.2 OBJECTS OR EVENTS TO BE MEASURED

We have earlier defined Accounting as the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of the information. So accounting essentially includes measurement of 'information'.

Decision makers need past, present and future information. For external users, generally the past information is communicated.

There is no uniform set of events and transactions in accounting which are required for decision making. For example, in cash management, various cash receipts and expenses are the necessary objects and events. Obviously, the decision makers need past cash receipts and expenses data along with projected receipts and expenses. For giving loan to a business one needs information regarding the repayment ability (popularly called debt servicing) of principal and interest. This also includes past information, current state of affairs as well as future projections. It may be mentioned that past and present objects and events can be measured with some degree of accuracy but future events and objects are only predicted, not measured. Prediction is an essential part of accounting information. Decision makers have to take decisions about the unseen future for which they need suitable information.

7.3 STANDARD OR SCALE OF MEASUREMENT

In accounting, money is the scale of measurement (see money measurement concept), although now-a-days quantitative information is also communicated along with monetary information.

Money as a measurement scale has no universal denomination. It takes the shape of currency ruling in a country. For example, in India the scale of measurement is Rupee, in the U.K. Pound-Sterling (£), in Germany Deutschmark (DM), in the United States Dollar ($) and so on. Also there is no constant exchange relationship among the currencies.

If one businessman in India took loan $5,000 from a businessman of the U.S.A., he would enter the transaction in his books in terms of ₹ Suppose at the time of loan agreement exchange rate was US $ = ₹ 50. Then loan amounted to ₹ 2,50,000. Afterwards the exchange rate has been changed to $ 1 = ₹ 55. At the changed exchange rate the loan amount becomes₹ 2,75,000. So money as a unit of measurement lacks universal applicability across the boundary of a country unless a common currency is in vogue. Since the rate of exchange fluctuates between two currencies over the time, money as a measurement scale also becomes volatile.

7.4 DIMENSION OF MEASUREMENT SCALE

An ideal measurement scale should be stable over time. For example, if one buys 1 kg. cabbage today, the quantity he receives will be the same if he will buy 1 kg. cabbage one year later. Similarly the length of 1 metre cloth will not change if it is bought a few days later. That is to say a measurement scale should be stable in dimension. Money as a scale of measurement is not stable. There occurs continuous change in the input output prices. The same quantity of money may not have the ability to buy same quantity of identical goods at different dates. Thus information of one year measured in money terms may not be comparable with that of another year. Suppose production and sales of a company in two different years are as follows:

Year 1		Year 2	
Qty.	**₹**	**Qty.**	**₹**
5,000 pcs	5,00,000	4,500 pcs	5,40,000

Looking at the monetary figures one may be glad for 8% sales growth. In fact there was 10% production and sales decline. The growth envisaged through monetary figures is only due to price change. Let us suppose further that the cost of production for the above mentioned two years is as follows:

Year 1		Year 2	
Qty.	**₹**	**Qty.**	**₹**
5,000 pcs	4,00,000	4,500 pcs	4,50,000

Take Gross profit = Sales – Cost of Production. Then in the first year profit was ₹ 1,00,000 while in the second year the profit was ₹ 90,000. There was 10% decline in gross profit.

So money as a unit of measurement is not stable in the dimension.

Thus Accounting measures information mostly in money terms which is not a stable scale having universal applicability and also not stable in dimension for comparison over the time. So it is not an exact measurement discipline.

7.5 ACCOUNTING AS A MEASUREMENT DISCIPLINE

How do you measure a transaction or an event? Unless the measurement base is settled we cannot progress to the record keeping function of book-keeping. It has been explained that accounting is meant for generating information suitable for users' judgments and decisions. But generation of such information is preceded by recording, classifying and summarising data. By that process it measures performance of the business entity by way of profit or loss and shows its financial position. Thus measurement is an important part of accounting discipline. But a set of theorems governs the whole measurement sub-system. These theorems should be carefully understood to know how the cogs of the 'accounting-wheel' work. Now-a-days accounting profession earmarked three theorems namely going concern, consistency and accrual as fundamental accounting assumptions, i.e. these assumptions are taken for granted. Also while measuring, classifying, summarising and also presenting, various policies are adopted. Recording, classifying summarising and communication of information are also important part of accounting, which do not fall within the purview of measurement discipline. Therefore we cannot simply say that accounting is a measurement discipline.

But in accounting money is the unit of measurement. So, let us take one thing for granted that all transactions and events are to be recorded in terms of money only. Quantitative information is also required in many cases but such information is only supplementary to monetary information.

7.6 VALUATION PRINCIPLES

There are four generally accepted measurement bases or valuation principles. These are:

(i) Historical Cost;

(ii) Current Cost;

(iii) Realizable Value;

(iv) Present Value.

Let us discuss these principles in detail.

(i) *Historical Cost:* It means acquisition price. For example, the businessman paid ₹ 7,00,000 to purchase the machine and spend ₹1,00,000 on its installation, its acquisition price including installation charges is ₹ 8,00,000. The historical cost of machine would be ₹ 8,00,000.

According to this base, assets are recorded at an amount of cash or cash equivalent paid at the time of acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation. In some circumstances a liability is recorded at the amount of cash or cash equivalent expected to be paid to satisfy it in the normal course of business.

When one Mr. X a businessman, takes ₹ 5,00,000 loan from a bank @ 10% interest p.a., it is to be recorded at the amount of proceeds received in exchange for the obligation. Here the obligation is the repayment of loan as well as payment of interest at an agreed rate i.e. 10%. Proceeds received are ₹ 5,00,000 - it is historical cost of the transactions. Take another case regarding payment of income tax liability. You know every individual has to pay income tax on his income if it exceeds certain minimum limit. But the income tax liability is not settled immediately when one earns his income. The income tax authority settles it some time later, which is technically called assessment year. Then how does he record this liability? As per historical cost base it is to be recorded at an amount expected to be paid to discharge the liability.

(ii) *Current Cost:* Take that Mr. X purchased a machine on 1st January, 2011 at ₹ 7,00,000. As per historical cost base he has to record it at ₹ 7,00,000 i.e. the acquisition price. As on 1.1.2020, Mr. X found that it would cost ₹ 25,00,000 to purchase that machine. Take also that Mr. X took loan from a bank as on 1.1.2011 ₹ 5,00,000 @ 18% p.a repayable at the end of 15th year together with interest. As on 1.1.2020 the bank announces 1% prepayment penalty on the loan amount if it is paid within 15 days starting from that day. As per historical cost the liability is recorded at ₹ 5,00,000 at the amount or proceeds received in exchange for obligation and asset is recorded at ₹ 7,00,000.

Current cost gives an alternative measurement base. Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

So as per current cost base, the machine value is ₹ 25,00,000 while the value of bank loan is ₹ 5,05,000.

(iii) *Realisable Value:* Suppose Mr. X found that he can get ₹ 20,00,000 if he would sell the machine purchased, on 1.1.2011 paying ₹ 7,00,000 and which would cost ₹ 25,00,000 in case he would buy it currently. Take also that Mr. X found that he had no money to pay off the bank loan of ₹ 5,00,000 currently.

As per realisable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal. Haphazard disposal may yield something less. Liabilities are carried at their settlement values; i.e. the undiscounted amount of cash or cash equivalents expressed to be paid to satisfy the liabilities in the normal course of business.

So the machine should be recorded at ₹ 20,00,000 the realisable value in an orderly sale while the bank loan should be recorded at ₹ 5,00,000 the settlement value in the normal course of business.

(iv) *Present Value:* Suppose we are talking as on 1.1.2020 - take it as time for reference. Now think the machine purchased by Mr. X can work for another 10 years and is supposed to generate cash @ ₹ 1,00,000 p.a. Also take that bank loan of ₹ 5,00,000 taken by Mr. X is to be repaid as on 31.12.2026. Annual interest is ₹ 90,000.

As per present value, an asset is carried at the present discounted 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 discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The term 'discount', 'cash inflow' and 'cash outflow' need a little elaboration. ₹ 100 in hand as on 1.1.2020 is not equivalent to ₹ 100 in hand as on 31.12.2020. There is a time gap of one year. If Mr. X had ₹ 100 as on 1.1.2020 he could use it at that time. If he received it only on 31.12.2020, he had to sacrifice his use for a year. The value of this sacrifice is called 'time value of money'. Mr. X would sacrifice i.e. he would agree to take money on 31.12.2020 if he had been compensated for the sacrifice. So a rational man will never exchange ₹ 100 as on 1.1.2020 with ₹ 100 to be received on 31.12.2020. Then ₹ 100 of 1.1.2020 is not equivalent to ₹ 100 of 31.12.2020. To make the money receivable at a future date equal with the money of the present date it is to be devalued. Such devaluation is called discounting of future money.

Perhaps you know the compound interest rule: A = P (1+ i)n

A = Amount

P = Principal

i = interest / 100

n = Time

This equation gives the relationship between present money, principal and the future money amount. If A, i and n are given, to find out P, the equation is to be changed slightly.

$$P = \frac{A}{(1+i)^n}$$

Using the equation one can find out the present value if he knows the values of A, i and n.

Suppose i = 20%, now what is the present value of ₹ 1,00,000 to be received as on 31.12.2020 (Take 1.1.2020 as the time of reference).

$$P \quad = {}^{1,00,000}\!\big/_{(1+20)^1} = ₹\ 83,333$$

Similarly,

Time of Receipt	Money Value ₹	Present Value ₹
31.12.2021	1,00,000	69,444
31.12.2022	1,00,000	57,870
31.12.2023	1,00,000	48,225
31.12.2024	1,00,000	40,188
31.12.2025	1,00,000	33,490
31.12.2026	1,00,000	27,908
31.12.2027	1,00,000	23,257
31.12.2028	1,00,000	19,381
31.12.2029	1,00,000	16,150

Total of all these present values is ₹ 4,19,246. Since the machine purchased by Mr. X will produce cash equivalent to ₹ 4,19,246 in terms of present value, it is to be valued at such amount as per present value measurement basis.

Here, Mr. X will receive ₹ 1,00,000 at different points of time-these are cash inflows. In the other example, he has to pay interest and principal of bank loan-these are cash outflows.

Perhaps you also know the annuity rule:

Present value of an Annuity or Re. A for n periods is

A = Annuity

i = interest

t = time 1, 2, 3, ...n.

$$\frac{A}{i}\left[1-\frac{1}{(1+i)^n}\right]$$

Applying this rule one can derive the present value of ₹ 1,00,000 for 10 years @ 20% p.a.

$$\frac{1,00,000}{0.20}\left[1-\frac{1}{(1+0.20)^{10}}\right] = ₹4,19,246$$

Similarly, the present value of bank loan is

$$\frac{90{,}000}{0.20}\left[1-\frac{1}{(1+0.20)^5}\right]+\frac{5{,}00{,}000}{(1+0.20)^5}$$

= ₹ 2,69,155 + ₹ 2,00,939= ₹ 4,70,094

Thus, we get the four measurements as on 1.1.2020:

	Historical cost ₹	Current cost ₹	Realisable value ₹	Present value ₹
Asset: Machine	7,00,000	25,00,000	20,00,000	4,19,246
Liability: Bank Loan	5,00,000	5,05,000	5,00,000	4,70,094

The accounting system which we shall discuss in the remaining chapters is also called historical cost accounting. However, this need not mean that one shall follow only historical cost basis of accounting. In the later stages of the CA course, we shall see that the accounting system uses all types of measurement bases although under the traditional system most of the transactions and events are measured in terms of historical cost.

7.7 MEASUREMENT AND VALUATION

Value relates to the benefits to be derived from objects, abilities or ideas. To the economist, value is the utility (i.e.; satisfaction) of an economic resource to the person contemplating or enjoying its use. In accounting, to mean value of an object, abilities or ideas, a monetary surrogate is used. That is to say, value is measured in terms of money. Suppose, an individual purchased a car paying ₹ 2,50,000. Its value lies in the satisfaction to be derived by that individual using the car in future. Economists often use ordinal scale to indicate the level of satisfaction. But accountants use only cardinal scales. If the value of car is taken as ₹ 2,50,000 it is only one type of value called acquisition cost or historical cost. So value is indicated by measurement. In accounting the value is always measured in terms of money.

7.8 ACCOUNTING ESTIMATES

Earlier in this unit we have learned how to measure a transaction, which had already taken place and for which either some value/money has been paid or some valuation principles are to be adopted for their measurement. But there are certain items, which have not occurred therefore cannot be measured using valuation principles still they are necessary to record in the books of account, for example, provision for doubtful debts. For such items, we need some value. In such a situation reasonable estimates based on the existing situation and past experiences are made.

The measurement of certain assets and liabilities is based on estimates of uncertain future events. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. Therefore, the management makes various estimates and assumptions of assets, liabilities, incomes and expenses as on the date of preparation of financial statements. Such estimates are made in connection with the computation of depreciation, amortisation and impairment losses as well as, accruals, provisions and employee benefit obligations. Also estimates may be required in determining the bad debts, useful life and residual value of an item of plant and machinery and inventory obsolescence. The process of estimation involves judgements based on the latest information available.

An estimate may require revision if changes occur regarding circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. Change in accounting estimate means difference arises between certain parameters estimated earlier and re-estimated during the current period or actual result achieved during the current period.

Few examples of situations wherein accounting estimates are needed can be given as follows:

(1) A company incurs expenditure of ₹ 10,00,000 on development of patent. Now the company has to estimate that for how many years the patent would benefit the company. This estimation should be based on the latest information and logical judgement.

(2) A company dealing in long-term construction contracts, uses percentage of completion method for recognizing the revenue at the end of the accounting year. Under this method the company has to make adequate provisions for unseen contingencies, which can take place while executing the remaining portion of the contract. Since provisioning for unseen contingencies requires estimation, there may be excess or short provisioning, which is to be adjusted in the period when it is recognised.

(3) Company has to provide for taxes which is also based on estimation as there can be some interpretational differences on account of which tax authorities may either accept the expenditure or refuse it. This will ultimately lead to different tax liability.

SUMMARY

- Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money.
- There are three elements of measurement:
  - (i) Identification of objects and events to be measured;
  - (ii) Selection of standard or scale to be used;
  - (iii) Evaluation of dimension of measurement standard or scale.
- There are four generally accepted measurement bases or valuation principles. These are:
  - (i) Historical Cost; (ii) Current Cost;
  - (iii) Realizable Value; (iv) Present Value.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. (i) Measurement discipline deals with

   (a) Identification of objects and events. (b) Selection of scale.

   (c) Both (a) and (b)

   (ii) All of the following are valuation principles except

   (a) Historical cost. (b) Present value.

   (c) Future value.

(iii) Book value of machinery on 31st March, 2019 ₹ 10,00,000

Market value as on 31st March, 2019 if sold ₹ 11,00,000

As on 31st March, 2019, if the company values the machinery at ₹ 11,00,000, which of the following valuation principle is being followed?

(a) Historical Cost. (b) Present Value.

(c) Realisable Value.

2. Mohan purchased a machinery amounting ₹ 10,00,000 on 1st April, 2001. On 31st March, 2019, similar machinery could be purchased for ₹ 20,00,000 but the realizable value of the machinery (purchased on 1.4.2001) was estimated at ₹ 15,00,000. The present discounted value of the future net cash inflows that the machinery was expected to generate in the normal course of business, was calculated as ₹ 12,00,000.

(i) The current cost of the machinery is

(a) ₹ 10,00,000. (b) ₹ 20,00,000.

(c) ₹ 15,00,000.

(ii) The present value of machinery is

(a) ₹ 10,00,000. (b) ₹ 20,00,000.

(c) ₹ 12,00,000.

(iii) The historical cost of machinery is

(a) ₹ 10,00,000. (b) ₹ 20,00,000.

(c) ₹ 15,00,000.

(iv) The realizable value of machinery is

(a) ₹ 10,00,000. (b) ₹ 20,00,000.

(c) ₹ 15,00,000.

Theoretical Questions

1. Define Measurement in brief. Explain the significant elements of measurement.

2. Describe in brief, the alternative measurement bases, for determining the value at which an element can be recognized in the balance sheet or statement of profit and loss.

ANSWER/HINTS

Multiple Choice Questions

1.(i)	(c)	(ii)	(c)	(iii)	(c)	2.(i)	(b)	(ii)	(c)	(iii)	(a)
(iv)	(c)										

Theoretical Questions

1. Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Three elements of measurement are: (1) Identification of objects and events to be measured; (2) Selection of standard or scale to be used;(3)Evaluation of dimension of measurement standard or scale.

2. Alternative measurement bases are: (i)Historical Cost; (ii)Current cost (iii) Realizables (Settlement) Value and (iv) Present Value. Refer para 7.6 for details.

UNIT 8 : ACCOUNTING STANDARDS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the significance of issuance of Accounting Standards.
- Grasp the objectives, benefits and limitations of Accounting Standards.
- Learn the process of formulation of Accounting Standards by the Council of the Institute of Chartered Accountants of India.
- Familiarize with the list of applicable Accounting Standards in India.

UNIT OVERVIEW

Accounting Standards deal with the issues of

- Recognition of events and transactions
- Measurement of transactions and events
- Presentation of transactions and events
- Disclosure requirements

Formulation of Accounting Standards

Identification of area

↓

Constitution of study group

↓

Preparation of draft and its circulation

↓

Ascertainment of views of different bodies on draft

↓

Finalisation of exposure draft (E.D.)

↓

Comments received on exposure draft (E.D.)

↓

Modification of the draft

↓

Issue of AS

8.1 INTRODUCTION OF ACCOUNTING STANDARDS

Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. If the financial accounting process is not properly regulated, there is possibility of financial statements being misleading, tendentious and providing a distorted picture of the business, rather than the true. To ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardize the accounting principles and policies. Accounting Standards (ASs) provide framework and standard accounting policies for treatment of transactions and events so that the financial statements of different enterprises become comparable.

Accounting standards are written policy documents issued by the expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance. The accounting standards deal with the issues of -

(i) recognition of events and transactions in the financial statements;

(ii) measurement of these transactions and events;

(iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader; and

(iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

8.2 OBJECTIVES OF ACCOUNTING STANDARDS

The whole idea of accounting standards is centered around harmonisation of accounting policies and practices followed by different business entities so that the diverse accounting practices adopted for various aspects of accounting can be standardised. Accounting Standards standardise diverse accounting policies with a view to:

(i) eliminate the non-comparability of financial statements and thereby improving the reliability of financial statements; and

(ii) provide a set of standard accounting policies, valuation norms and disclosure requirements.

Accounting standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises.

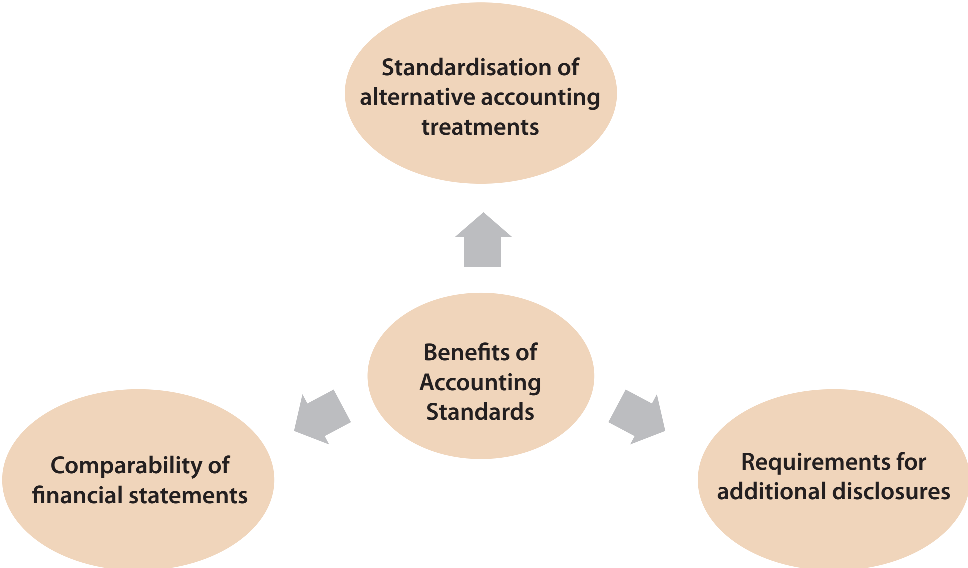
8.3 BENEFITS AND LIMITATIONS OF ACCOUNTING STANDARDS

Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of a pplying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards, the accountant has following benefits:

(i) Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.

(ii) There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.

(iii) The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.



However, there are some limitations of accounting standards:

(i) ***Difficulties in making choice between different treatments:*** Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.

(ii) ***Restricted scope:*** Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

8.4 PROCESS OF FORMULATION OF ACCOUNTING STANDARDS IN INDIA

The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards to ensure that the standard-setting process is fully consultative and transparent. The ASB considers International Financial Reporting Standards (IFRSs) while framing Indian Accounting Standards (ASs) in India and try to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The composition of ASB includes, representatives of industries (namely, ASSOCHAM, CII, FICCI), regulators, academicians, government departments etc. Although ASB is a body constituted by the Council of the ICAI, it (ASB) is independent in the formulation of accounting standards and Council of the ICAI is not empowered to make any modifications in the draft accounting standards formulated by ASB without consulting with the ASB.

The standard-setting procedure of Accounting Standards Board (ASB) can be briefly outlined as follows:

- Identification of broad areas by ASB for formulation of AS.
- Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards. The draft normally includes objective and scope of the standard, definitions of the terms used in the standard, recognition and measurement principles wherever applicable and presentation and disclosure requirements.
- Consideration of the preliminary draft prepared by the study group of ASB and revision, if any, of the draft on the basis of deliberations.
- Circulation of draft of accounting standard (after revision by ASB) to the Council members of the ICAI and specified outside bodies such as Department of Company Affairs (DCA), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc. for comments.
- Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard.
- Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments.
- Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
- Consideration of the final draft of the proposed standard and by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB is done.
- The accounting standard on the relevant subject (for non-corporate entities) is then issued by the ICAI. For corporate entities the accounting standards are issued by The Central Government of India.

8.5 LIST OF ACCOUNTING STANDARDS IN INDIA

The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

Following is the list of applicable Accounting Standards:

List* of Accounting Standards

Sl. No.	Number of the Accounting Standard (AS)	Title of the Accounting Standard
1.	AS 1	Disclosure of Accounting Policies
2.	AS 2 (Revised)	Valuation of Inventories
3.	AS 3 (Revised)	Cash Flow Statements
4.	AS 4 (Revised)	Contingencies and Events Occurring after the Balance Sheet Date
5.	AS 5 (Revised)	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
4.	AS 6 (withdrawn pursuant to issuance of AS 10 on Property, Plant and Equipment 2016)	Depreciation Accounting
7.	AS 7 (Revised)	Accounting for Construction Contracts
8.	AS 8 (withdrawn pursuant to AS 26 becoming mandatory)	Accounting for Research and Development
9.	AS 9	Revenue Recognition
10.	AS 10	Property, Plant and Equipment
11.	AS 11 (Revised)	The Effects of Changes in Foreign Exchange Rates
12.	AS 12	Accounting for Government Grants
13.	AS 13	Accounting for Investments
14.	AS 14	Accounting for Amalgamations
15.	AS 15 (Revised)	Employee Benefits
14.	AS 16	Borrowing Costs
17.	AS 17	Segment Reporting
18.	AS 18	Related Party Disclosures
19.	AS 19	Leases
20.	AS 20	Earnings Per Share
21.	AS 21	Consolidated Financial Statements
22.	AS 22	Accounting for Taxes on Income
23.	AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
24.	AS 24	Discontinuing Operations
25.	AS 25	Interim Financial Reporting
24.	AS 26	Intangible Assets
27.	AS 27	Financial Reporting of Interests in Joint Ventures

Sl. No.	Number of the Accounting Standard (AS)	Title of the Accounting Standard
28.	AS 28	Impairment of Assets
29	AS 29	Provisions, Contingent Liabilities & Contingent Assets

*** Note: The list of accounting standards given above does not form part of syllabus. It has been given here for the knowledge of students only.**

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. Accounting Standards for Non-Corporate entities in India are issued by
   (a) Central Govt. (b) State Govt.
   (c) Institute of Chartered Accountants of India. (d) Reserve Bank of India.

2. Accounting Standards
   (a) Harmonise accounting policies.
   (b) Eliminate the non-comparability of financial statements.
   (c) Improve the reliability of financial statements.
   (d) All the three.

3. It is essential to standardize the accounting principles and policies in order to ensure
   (a) Transparency. (b) Consistency.
   (c) Comparability. (d) All the three.

Theoretical Questions

1. Explain the objective of "Accounting Standards" in brief.
2. State the advantages of setting Accounting Standards.

ANSWERS/HINTS

Multiple Choice Questions

1. (c), 2. (d), 3. (d),

Theoretical Questions

1. Accounting Standards are selected set of accounting policies or broad guidelines regarding the principles and methods to be chosen out of several alternatives. The main objective of Accounting Standards is to establish standards which have to be complied with, to ensure that financial statements are prepared in accordance with generally accepted accounting principles. Accounting Standards seek to suggest rules and criteria of accounting measurements. These standards harmonize the diverse accounting policies and practices at present in use in India.

2. The main advantage of setting accounting standards is that the adoption and application of accounting standards ensure uniformity, comparability and qualitative improvement in the preparation and presentation of financial statements. The other advantages are: Reduction in variations; Disclosures beyond that required by law and Facilitates comparison.

UNIT 9 : INDIAN ACCOUNTING STANDARDS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the significance of issuance of Indian Accounting Standards.
- Learn the need of issuance of Indian Accounting Standards.

UNIT OVERVIEW

Indian Accounting Standards

- Convergence towards Global Standards
- Transparency of financial statements
- Comparability of financial statements
- Enhanced Disclosure requirements

9.1 NEED FOR CONVERGENCE TOWARDS GLOBAL STANDARDS

The last decade has witnessed a sea change in the global economic scenario. The emergence of trans-national corporations in search of money, not only for fueling growth, but to sustain on going activities has necessitated raising of capital from all parts of the world, cutting across frontiers.

Each country has its own set of rules and regulations for accounting and financial reporting. Therefore, when an enterprise decides to raise capital from the markets other than the country in which it is located, the rules and regulations of that other country will apply and this in turn will require that the enterprise is in a position to understand the differences between the rules governing financial reporting in the foreign country as compared to its own country of origin. Therefore translation and re-instatements are of utmost importance in a world that is rapidly globalising in all ways. In themselves also, the accounting standards and principle need to be robust so that the larger society develops degree of confidence in the financial statements, which are put forward by organizations.

International analysts and investors would like to compare financial statements based on similar accounting standards, and this has led to the growing support for an internationally accepted set of accounting standards for cross-border filings. The harmonization of financial reporting around the world will help to raise confidence of investors generally in the information they are using to make their decisions and assess their risks.

Also a strong need was felt by legislation to bring about uniformity, rationalization, comparability, transparency and adaptability in financial statements. Having a multiplicity of accounting standards around the world is against the public interest. If accounting for the same events and information produces different reported numbers, depending on the system of standards that are being used, then it is self-evident that accounting will be increasingly discredited in the eyes of those using the numbers. It creates confusion, encourages error and facilitates fraud. The cure for these ills is to have a single set of global standards, of the highest quality, set in the interest of public. Global Standards facilitate cross border flow of money, global listing in different bourses and comparability of financial statements.

The convergence of financial reporting and accounting standards is a valuable process that contributes to the free flow of global investment and achieves substantial benefits for all capital market stakeholders. It improves the ability of investors to compare investments on a global basis and thus lowers their risk of errors of judgment. It facilitates accounting and reporting for companies with global operations and eliminates some costly requirements say reinstatement of financial statements. It has the potential to create a new standard of accountability and greater transparency, which are values of great significance to all market participants including regulators. It reduces operational challenges for accounting firms and focuses their value and expertise around an increasingly unified set of standards. It creates an unprecedented opportunity for standard setters and other stakeholders to improve the reporting model. For the companies with joint listings in both domestic and foreign country, the convergence is very much significant.

9.2 INTERNATIONAL FINANCIAL REPORTING STANDARDS AS GLOBAL STANDARDS

With a view of achieving convergence towards global reporting, the London based group namely the International Accounting Standards Committee (IASC), responsible for developing International Accounting Standards, was established in June, 1973. It is presently known as International Accounting Standards Board (IASB), The IASC comprises the professional accountancy bodies of over 75 countries (including the Institute of Chartered Accountants of India). Primarily, the IASC was established, in the public interest, to formulate and publish, International Accounting Standards to be followed in the presentation of audited financial statements. International Accounting Standards were issued to promote acceptance and observance of International Accounting Standards worldwide. The members of IASC have undertaken a responsibility to support the standards promulgated by IASC and to propagate those standards in their respective countries.

Between 1973 and 2001, the International Accounting Standards Committee (IASC) released International Accounting Standards. Between 1997 and 1999, the IASC restructured their organisation, which resulted in formation of International Accounting Standards Board (IASB). These changes came into effect on 1st April, 2001. Subsequently, IASB issued statements about current and future standards: IASB publishes its Standards in a series of pronouncements called International Financial Reporting Standards (IFRS). However, IASB has not rejected the standards issued by the ISAC. Those pronouncements continue to be designated as "International Accounting Standards" (IAS).

The term IFRS comprises IFRS issued by IASB; IAS issued by International Accounting Standards Committee (IASC); Interpretations issued by the Standard Interpretations Committee (SIC) and the IFRS Interpretations Committee of the IASB.

International Financial Reporting Standards (IFRSs) are considered a "principles-based" set of standards. In fact, they establish broad rules rather than dictating specific treatments. Every major nation is moving toward adopting them to some extent. Large number of authorities requires public companies to use IFRS for stock-exchange listing purposes, and in addition, banks, insurance companies and stock exchanges may use them for their statutorily required reports. So over the next few years, thousands of companies will adopt the international standards. This requirement will affect about 7,000 enterprises, including their subsidiaries, equity investors and joint venture partners. The increased use of IFRS is not limited to public-company listing requirements or statutory reporting. Many lenders and regulatory and government bodies are looking to IFRS to fulfil local financial reporting obligations related to financing or licensing.

9.3 BENEFITS OF CONVERGENCE WITH IFRSs

There are many beneficiaries of convergence with IFRSs such as the economy, investors, industry etc.

The Economy: When the markets expand globally the need for convergence increases since the convergence benefits the economy by increasing growth of its international business. It facilitates maintenance of orderly and efficient capital markets and also helps to increase the capital formation and thereby economic growth. It encourages international investing and thereby leads to more foreign capital flows to the country.

Investors: A strong case for convergence can be made from the viewpoint of the investors who wish to invest outside their own country. Investors want the information that is more relevant, reliable, timely and comparable across the jurisdictions. Financial statements prepared using a common set of accounting standards help investors better understand investment opportunities as opposed to financial statements prepared using a different set of national accounting standards. Investors' confidence is strong when accounting standards used are globally accepted. Convergence with IFRS contributes to investors' understanding and confidence in high quality financial statements.

The Industry: A major force in the movement towards convergence has been the interest of the industry. The industry is able to raise capital from foreign markets at lower cost if it can create confidence in the minds of foreign investors that their financial statements comply with globally accepted accounting standards. With the diversity in accounting standards from country to country, enterprises which operate in different countries face a multitude of accounting requirements prevailing in the countries. The burden of financial reporting is lessened with convergence of accounting standards because it simplifies the process of preparing the individual and group financial statements and thereby reduces the costs of preparing the financial statements using different sets of accounting standards.

9.4 DEVELOPMENT IN INDIAN ACCOUNTING STANDARDS (IND AS)

9.4.1 First Step towards IFRSs

The Institute of Chartered Accountants of India (ICAI) being the accounting standards-setting body in India, way back in 2006, initiated the process of moving towards the International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) with a view to enhance acceptability and transparency of the financial information communicated by the Indian corporates through their financial statements. This move towards IFRS was subsequently accepted by the Government of India.

The Government of India in consultation with the ICAI decided to converge and not to adopt IFRSs issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRS requirements and extensive discussion with various stakeholders. Accordingly, while formulating IFRS-converged Indian Accounting Standards (Ind AS), efforts have been made to keep these Standards, as far as possible, in line with the corresponding IFRS and departures have been made where considered absolutely essential. These changes have been made considering various factors, such as, various terminology related changes have been made to make it consistent with the terminology used in law. Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS.

9.4.2 What are Indian Accounting Standards (Ind AS)?

Indian Accounting Standards (Ind-AS) are the International Financial Reporting Standards (IFRS) converged standards issued by the Central Government of India under the supervision and control of Accounting Standards Board (ASB) of ICAI and in consultation with National Advisory Committee on Accounting Standards (NACAS).

National Advisory Committee on Accounting Standards (NACAS) recommend these standards to the Ministry of Corporate Affairs (MCA). MCA has to spell out the accounting standards applicable for companies in India.

The Ind AS are named and numbered in the same way as the corresponding International Financial Reporting Standards (IFRS).

9.4.3 Government of India - Commitment to IFRS Converged Ind AS

Initially Ind AS were expected to be implemented from the year 2011. However, keeping in view the fact that certain issues including tax issues were still to be addressed, the Ministry of Corporate Affairs decided to postpone the date of implementation of Ind AS.

In July 2014, the Finance Minister of India at that time, Shri Arun Jaitely ji, in his Budget Speech, announced an urgency to converge the existing accounting standards with the International Financial Reporting Standards (IFRS) through adoption of the new Indian Accounting Standards (Ind AS) by the Indian companies.

Pursuant to the above announcement, various steps have been taken to facilitate the implementation of IFRS-converged Indian Accounting Standards (Ind AS). Moving in this direction, the Ministry of Corporate Affairs (MCA) has issued the Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 covering the revised roadmap of implementation of Ind AS for companies other than Banking companies, Insurance Companies and NBFCs and Indian Accounting Standards (Ind AS). As per the Notification, Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS) shall be implemented on voluntary basis from 1st April, 2015 and mandatory from 1st April, 2016. Later on, in 2016 MCA notified roadmap for NBFC announcing implementation date for Ind AS. Similarly, Banking and Insurance regulatory authority have issued separate roadmaps for implementation of Ind AS for Banking and Insurance companies respectively.

9.5 LIST OF IND AS

Ind AS	Title of Ind AS
101	First Time Adoption of Indian Accounting Standards
102	Share Based Payment
103	Business Combinations
104	Insurance Contracts
105	Non-current Assets Held for Sale and Discontinued Operations
106	Exploration for and Evaluation of Mineral Resources
107	Financial Instruments: Disclosures
108	Operating Segments
109	Financial Instruments
110	Consolidated Financial Statements
111	Joint Arrangements
112	Disclosure of Interests in Other Entities

Ind AS	Title of Ind AS
113	Fair Value Measurement
114	Regulatory Deferral Accounts
115	Revenue from contract with customers
116	Leases
1	Presentation of Financial Statements
2	Inventories
7	Statement of Cash Flows
8	Accounting Policies, Changes in Accounting Estimates and Errors
10	Events after the Reporting Period
12	Income Taxes
16	Property, Plant and Equipment
19	Employee Benefits
20	Accounting for Government Grants and Disclosure of Government Assistance
21	The Effects of Changes in Foreign Exchange Rates
23	Borrowing Costs
24	Related Party Disclosures
27	Separate Financial Statements
28	Investment in Associates and Joint Ventures
29	Financial Reporting in Hyperinflationary Economies
32	Financial Instruments: Presentation
33	Earnings per Share
34	Interim Financial Reporting
36	Impairment of Assets
37	Provisions, Contingent Liabilities and Contingent Assets
38	Intangible Assets
40	Investment Property
41	Agriculture

Note: The list of Ind AS given above does not form part of syllabus. It has been given here for the knowledge of students only.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. Global Standards facilitate
   (a) Cross border flow of money. (b) Global listing in different bourses.
   (c) Comparability of financial statements. (d) All the three.

2. The Government of India in consultation with the ICAI decided to
   (a) Adapt with IFRS. (b) Converge with IFRS.
   (c) apply IFRS in India. (d) notify IFRS in India.

3. Convergence with IFRSs
   (a) Simplifies the process of preparing the financial statements.
   (b) Reduces the costs of preparing the financial statements.
   (c) Both (a) and (b).
   (d) Facilitates global investors' understanding and confidence in high quality financial statements.

Theoretical Questions

1. Explain the need of convergence rather adoption of IFRS as Global Standards.
2. What is the significance of issue of Indian Accounting Standards? Explain in brief.

ANSWERS/HINTS

Multiple Choice Questions

1. (d); 2. (b); 3. (d)

Theoretical Questions

1. The Government of India in consultation with the ICAI decided to converge and not to adopt IFRSs issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRSs requirements and extensive discussion with various stakeholders. Accordingly, while formulating IFRS-converged Indian Accounting Standards (Ind AS), efforts have been made to keep these Standards, as far as possible, in line with the corresponding IAS/IFRS and departures have been made where considered absolutely essential.

2. Global Standards facilitate cross border flow of money, global listing in different bourses and comparability of financial statements. The convergence of financial reporting and accounting standards is a valuable process that contributes to the free flow of global investment and achieves substantial benefits for all capital market stakeholders. It improves the ability of investors to compare investments on a global basis and thus lowers their risk of errors of judgment. It facilitates accounting and reporting for companies with global operations and eliminates some costly requirements say reinstatement of financial statements.

TEXT YOUR KNOWLEDGE

True and False

State True or False for each of the following, with reason for the same.

Unit -1

1. There is no difference between book keeping and accounting, both are same.
2. Management Accounting covers the preparation and interpretation of financial statements and communication to the users of accounts.
3. Financial accounting is concerned with internal reporting to the managers of a business unit.
4. Customers of business should not be considered as users of accounts prepared by business. They are not interested to know performance of the business
5. Summarising is the basic function of accounting. All business transactions ofa financial characters evidenced by some documents such as sales bill, pass book, salary slip etc. are recorded in the books of account.
6. Balance sheet shows the position of the business on the day of its preparation and not on the future date.
7. Objectives of book-keeping are complete recording of transactions & ascertainment of financial effect on the business.

Unit -2

1. The concept helps in keeping business affairs free from the influence of the personal affairs of the owner is known as the matching concept.
2. Entity concept means that the enterprise is liable to the owner for capital investment made by the owner.
3. Accrual means recognition as money is received or paid and not of revenue and costs as they are earned or incurred.
4. The Conservatism Concept also states that no change should be counted unless it has materialized.
5. The concept of consistency implies non-flexibility as not to allow the introduction of improved method of accounting.
6. The materiality depends only upon the amount of the item and not upon the size of the business, nature and level of information, level of the person making the decision etc.

Unit -3

1. The drawer's signed assent on bill of exchange, to the order of the drawee is called an acceptance:
2. That portion of an expenditure whose benefit has been exhausted is called Unexpired Expenditure.
3. Accrual basis of accounting is the method of recording transactions by which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made.
4. Authorised Share capital is sometimes referred to as nominal share capital.

5. Fixed assets less interest on obligations undertaken to purchase asset less accumulated depreciation thereon up-to-date are called Net Fixed Assets.
6. The credit balance in the profit and loss statement is called a deficit.

Unit -4

1. The nature of business is not an important criteria in separating an expenditure between capital and revenue.
2. Expenditure incurred for major repair of the asset so as to increase its productive capacity is Revenue in nature
3. Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff'sland is Capital Expenditure.
4. Amount spent for replacement of worn out part of machine is Capital Expenditure.
5. Legal fees to acquire property is Capital Expenditure.
6. Amount spent for the construction of temporary huts, which were necessary for construction of the cinema house and were demolished when the cinema house was ready, is Capital Expenditure.

Unit -5

1. A contingent liability need not be disclosed in the financial statements.
2. A Provision fails to meet the recognition criteria.
3. A claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent liability.
4. When it is probable that the firm will need to pay off the obligation, this gives rise to Contingent liability.

Unit -6

1. There is a single list of accounting policies, which are applicable to all enterprises in all circumstances.
2. Selection of accounting policy doesn't impact financial performance and financial position of the business
3. A change in accounting policies should be made as and when business like to show result as per their choice.
4. Choosing FIFO or weighted average method for inventory valuation is an accounting policy choice.
5. Selection of an inappropriate accounting policy decision will overstate the performance and financial position of a business entity every time.

Unit -7

1. There are four generally accepted measurement bases or valuation principles

   (i) Historical Cost; (ii) Current Cost;

   (iii) Realizable Value; (iv) Future Value.
2. Historical Cost means price paid at time acquisition.
3. As per future value, assets are carried at the amount of cash or cash equivalents that could currently be

obtained by selling the assets in an orderly disposal.

4. At Present value, liabilities are carried at the value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.
5. ABC purchased a machinery amounting ₹ 10,00,000 on 1st April, 2001. On 31st March, 2020, similar machinery could be purchased for ₹ 20,00,000. Historical cost of machine is 20,00,000
6. ABC purchased a machinery amounting ₹ 10,00,000 on 1st April, 2001. On 31st March, 2020, similar machinery could be purchased for ₹ 20,00,000. Current cost of machine is 20,00,000

Unit -8

1. Accounting standards are written policy documents issued by the expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements.
2. Accounting standards can override the statute.
3. Difficulties in making choice between different treatments is one of the benefits of accounting standards.
4. Requirements for additional disclosures is limitation of accounting standards.
5. ASB stands for Accounting standardisation benchmarking.
6. There are no limitation to accounting standards.

Unit -9

1. The Government of India in consultation with the ICAI decided to adopt IFRSs issued by the IASB.
2. There are many beneficiaries of convergence with IFRSs such as the economy, investors, industry etc.
3. There was no need to converge to global accounting standards.
4. International Financial Reporting Standards (IFRSs) are considered a "rules-based" set of standards.
5. Govt of India has taken IASB support to develop Ind AS standards.
6. IASC stands for International Accounting Standards Council.

ANSWERS/HINTS

Unit-1

1. False : book-keeping and accounting are differentfrom each other. Accounting is a broad subject. It calls for a greater understanding of records obtained from book-keeping and an ability to analyse and interpret the information provided by book-keeping records.

   Book-keeping is the recording phase while accounting is concerned with the summarising phase of an accounting system.

2. False : Financial accounting covers the preparation and interpretation of financial statements and communication to the users of accounts.
3. False : Management accounting is concerned with internal reporting to the managers of a business unit.
4. False : Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent on the supply of goods
5. False : Recording is the basic function of accounting. Summarising is concerned with the preparation and presentation of the classified data in a manner useful to the internal as well as the external users of financial statements
6. True : Balance Sheet is a statement of the financial position of an enterprise at a given date.
7. True : Book-keeping is concerned with complete recording and combined effect of transactions made during the accounting period.

Unit-2

1. False : Under matching concept all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.
2. True : Since the owner invested capital, he has claim on the profits of the enterprise.
3. False : Under accrual concept, the effects of transactions and other events are recognised on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.
4. False : The Realisation Concept also states that no change should be counted unless it has materialised.
5. False : The concept of consistency does not imply non-flexibility as not to allow the introduction of improved method of accounting.
6. True : As per materiality principle, all the items having significant economic effect on the business of the enterprise should be should be disclosed in the financial statements.

Unit-3

1. False : The drawee's signed assent on bill of exchange, to the order of the drawer. This term is also used to describe a bill of exchange that has been accepted.
2. False : Unexpired Cost - That portion of an expenditure whose benefit has not yet been exhausted.
3. False : Cash Basis of Accounting is the method of recording transactions by which revenues and costs

and assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made.

4. True : Authorised share capital is number and par value of each class of shares that an enterprise may issue in accordance with its instrument of incorporation and is sometimes referred as nominal share capital.
5. False : Net Fixed Assets - Fixed assets less accumulated depreciation thereon up-to-date.
6. False : The debit balance in the profit and loss statement is deficit.

Unit-4

1. False : For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is a very important criteria in separating an expenditure between capital and revenue.
2. False : Expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature
3. False : Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any endurable benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.
4. False : Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.
5. False : Legal fee paid to acquire any property is a part of cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.
6. True : Since temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

Unit-5

1. False : A Contingent liability is required to be disclosed unless possibility of outflow of a resource embodying economic benefits is remote.
2. False : A contingent liability fails to meet the recognition criteria.
3. False : A claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent asset
4. False : When it is probable that the firm will need to pay off the obligation, this gives rise to provision.

Unit-6

1. False : There cannot be single list of accounting policies, which are applicable to all enterprises in all circumstances. There would always be different policies chosen by different industries under different circumstances.
2. False : Accounting policy has big impact on value of items goes under financial statements, hence it impacts financial performance and financial position of the business.

3. False : A change in accounting policies should be made in the following conditions:

   (a) It is required by some statute or for compliance with an Accounting Standard.

   (b) Change would result in more appropriate presentation of financial statement.

4. True : For Inventory valuation, an enterprise may adopt FIFO or weighted average method and the method selected for valuation is called an accounting policy.

5. False : It could understate/overstate the performance and financial position of a business entity.

Unit-7

1. False : There are four generally accepted measurement bases or valuation principles

   (i) Historical Cost; (ii) Current Cost;

   (iii) Realizable Value; (iv) Present Value.

2. True : Historical cost means the acquisition price.

3. False : At Realisable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal.

4. False : Liabilities are carried at the present discounted value of future net cash outflows that are expected to be required to settle theliabilities in the normal course of business.

5. False : Historical cost is 1000000.

6. True : Since similar machine is purchased at 20,00,000, the current cost of machine is 20,00,000

Unit-8

1. True : Accounting standards are documents covering recognition,measurement, presentation and disclosure of accounting transactions and events in the financial statements.

2. False : Accounting standards can never override the statute. The standards are required to be framed within the ambit of prevailing statutes.

3. False : Difficulties in making choice between different treatments is one of the limitation of accounting standard.

4. False : Benefits of accounting standards are:

   - Standardisation of alternative accounting treatments

   - Comparability of financial statements

   - Requirements for additional disclosures

5. False : ASB stands for Accounting standard Board.

6. False : limitations of accounting standards

   - Difficulties in making choice between different treatments

   - Restricted scope

Unit-9

1. False : The Government of India in consultation with the ICAI decided to converge and not to adopt IFRSs issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRS requirements and extensive discussion with various stakeholders.
2. True : Major beneficiaries of convergence with IFRS's are economy,investors and industry.
3. False : Since India is going global, there was huge demand of global standards for better comparison.
4. False : International Financial Reporting Standards (IFRSs) are considered a "principles-based" set of standards.
5. False : Government of India has taken ASB support to develop Ind AS standards.
6. False : IASC stands for International Accounting Standards Committee.