

Principles & Practice of Accounting

Theoretical Framework



CHAPTER-1

THEORETICAL FRAMEWORK

UNIT : 1

MEANING AND SCOPE OF ACCOUNTING

INTRODUCTION

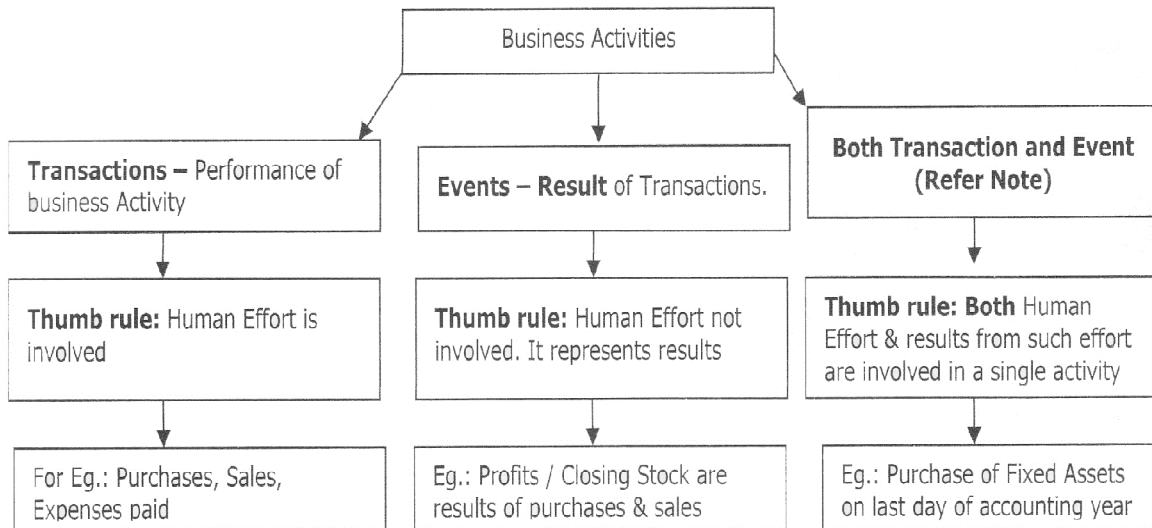
Every individual performs some kind of economic activity. A salaried person gets salary and spends to buy provisions and clothing, for children's education, construction of house, etc. A sports club formed by a group of individuals, a business run by an individual or a group of individuals, a local authority like Calcutta Municipal Corporation, Delhi Development Authority, Governments, either Central or State, all are carrying some kind of economic activities. Not necessarily all the economic activities are run for any individual benefit; such economic activities may create social benefit i.e. benefit for the public, at large. Anyway such economic activities are performed through '**transactions and events**'. **Transaction** is used to mean 'a business, performance of an act, an agreement' while event is used to mean 'a happening, as a consequence of transaction(s), a result'.

1. Definition of Accounting

1. **As per the American Institute of Certified Public Accountants (AICPA)** - Accounting is an **art** of recording, classifying and summarizing **transactions and events** which are in part atleast of **financial character**, in a **significant manner** and in terms of **money**, and **interpreting** the results thereof.
2. Accounting also involves **analyzing** and interpreting the **financial transactions** and **communicating** the results to the persons interested in such information.
3. Accounting is considered as an "**Information System**", as the function of Accounting is to provide **quantitative information**, primarily financial in nature about the business organisation.

2. Transactions Vs Events, Financial Vs Non-Financial

Transactions and Events: In a business or economic scenario.



Note Both Transaction and Event: Purchase of Fixed Assets on the last day of the financial year is a transaction, since it is a business activity. It is also an event as a fixed asset exists as a result of such purchase.

Example: Vignesh Traders buys and sells books. During January, the Firm purchased goods for ₹ 1,00,000 and sold the entire stock for ₹ 1,40,000. During the month, it paid salary to its Shop Manager ₹ 10,000 and Rent ₹ 6,000.

Particulars		
Sales		
Less: Cost of Goods purchased and sold	1,00,000	1,40,000
Expenses paid (Salary ₹ 10,000 + Rent ₹ 6,000)	<u>16,000</u>	<u>(1,16,000)</u>
Surplus - Profit		24,000

➤ Purchase and Sale of goods, and Payment of Salary and Rent Expenses are **“Transactions”**.

➤ Earning Surplus / Profit is an **“Event”**.

2. Types of Transactions - 2 Types:

Financial Transaction

When a business transaction involves a transfer of **money or moneys' worth**, then the transaction is called **“Financial Transaction”**.

Ex. When a business transaction does not involve money or money's worth

1. Cash and Credit Transaction (Refer Point 4)

Non-Financial Transaction

Purchase and Sale of goods, Payment of Expenses, Purchase of Assets, Goods lost by fire etc.

Ex. Quarrel between 2 Managers, Death of an employee etc.

1. No such classification

3. Financial Transactions - Meaning of Money or Money's worth:

Money : Cash - Rupee Notes / Coins;

Money's Worth : Cheque/ **Obligation to pay**, but actual payment to be made later (credit transactions)/ Bill of Exchange / Promissory Note / Setting off one liability against another receivable / Exchange of assets / Debit Note / Credit Note

Notes: Hence, a transaction can be regarded as financial transaction even if money is not involved. It is sufficient that it involves money's worth. Further note that Accounting is concerned with only financial transactions. Non-Financial transactions are not considered.

Barter - It refers to exchange of goods among persons. For eg. A sells pen to B. B sells pencil to A.

4. Cash & Credit Transaction: Financial Transaction can be classified into two types -

Cash Transaction : If the Financial transaction involves Cash / Cheque / Other modes of immediate settlement.

Ex. Cash received from debtors / Cash Sales

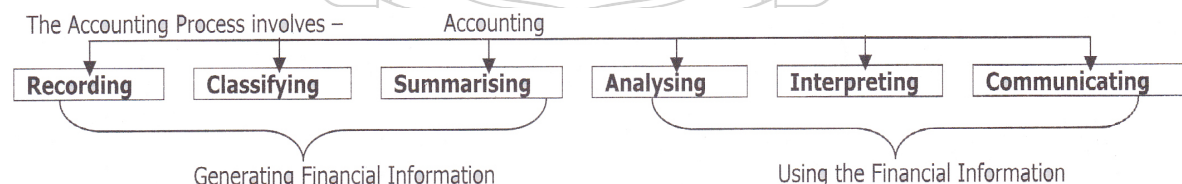
Credit Transaction

If the Financial Transaction does not involve immediate settlement, but there is an **obligation to pay in future**, it is called as credit transaction. The actual settlement in cash will be made later.

Ex. Sales made to Mr.A on condition that -will pay after 60 days, Debit Note -**Credit Sales**.

Students' Notes:

1. It is to be noted that if the financial transaction involves Money / Money's worth (**other than Obligation to pay**), then it is considered as Cash Transaction.
2. **Cash transaction does not mean that cash must be involved.**
3. Hence, if the transaction involves settlement by a Bill of Exchange / Promissory Note / Setting off one liability against another receivable / Exchange of assets, it shall be considered as Cash Transaction only.



3. Processes or Generating Financial information

1. Recording:

Meaning : All **business transactions** which are of **financial nature** (i.e. expressed in terms of money) are recorded in the books of accounts.

Purpose : A businessman cannot keep in his memory all the business activities carried out by him. Hence, there is a need for keeping track of such activities in a separate record.

Basis of Recording : All transactions must be evidenced by supporting documents like Sales Invoice, Purchase Bill, Receipts, Pay Slip, etc. **(These are called Vouchers).**

Relevant A/cs Book : The Books in which primary entry is made is called "**Journal**", which is further sub-divided into several **Subsidiary Books** for Sales, Purchases, Cash & Bank, etc. according to the nature and size of the business.

Checkpoint : It is to be noted that Accounts is concerned with only **FINANCIAL TRANSACTION**. Accounting will not record non-financial transactions in its books.

Example

- ➡ **Salary paid to Manager** will be recorded in the books of accounts.
- ➡ But, good health of the Manager, even if it is of great use to the business, has no financial character and no economic value, and therefore, will not be considered in Accounting.

2 Classifying:

Meaning : Classifying involves grouping transactions of a similar nature at one place, such that information will be compressed and presented in useable form.

Purpose : While the process of recording ensures that all financial transactions are recorded, one cannot make any observations unless all the transactions are grouped together under different categories.

Basis : Classification is based on the transactions recorded in the Journal / Subsidiary Books.

Relevant A/cs Book : The book containing the classified information of transactions is called "**Ledger**". Each page in the Ledger is called as "**Folio**". In each folio (Page No.), an individual Account Head and all transactions relating to that Account Head is recorded / posted.

Checkpoint : Ledger can be prepared only after the preparation of Journal / Subsidiary Books.

Example

- ➡ At recording stage, all transactions are normally recorded chronologically (i.e. date-wise).
- ➡ Assuming a businessman made 10 sale transactions (out of which 6 are on credit), paid telephone charges, rent etc., received payments from 3 debtors in a week, it is not possible to ascertain the exact position of each item unless they are grouped as "Sales A/c, Telephone Charges A/c, Rent A/c, Debtors A/c etc."
- ➡ This will help in finding out Total Sales (Cash and Credit sales) / Expenditure / Amounts due from debtors etc.

3 Summarizing:

Meaning : This involves presentation and preparation of the classified information in a manner useful to the internal and external users of Financial Statements.

Accounts Books : It involves preparation of Trial Balance, and Financial Statements therefrom, viz. (i) Profit and Loss Account (used to find out profits / losses for the business), (ii) Balance Sheet (used to ascertain the financial position), and (iii) Cash Flow Statement (used to determine the factors for increase or decrease in cash & bank balances)

Basis : Summarizing is based on the classified transactions presented in Ledger

4. Analysing:

Meaning : Analysis involves **methodical classification** of the data given in the **Financial Statements**.

Nature of process : Analysis is concerned with the determining the relationship between the items in the Profit and Loss Account and Balance Sheet (i.e. Ratio Analysis). Thus, it **provides the basis for interpretation**. Further, analysis involves comparing current year figures with the previous year figures

Basis : Financial Statements generated above in summarizing

Example : Net Profit Ratio - The Sales and Net Profit is compared to find out the % of Net Profit earned on Sales. This helps to ascertain how much sales have to be achieved, to make specified net profits.

For Eg. If NP Ratio is 20% on sales and a businessman wants to achieve net profits of ₹ 20 Lakhs in a year, then he must make a sale of ₹ 100 Lakhs (20 Lakhs / 20%) during that year.

5. Interpreting:

Meaning : Drawing observations from the items in the financial statements and also from relationships determined in analyzing process

Purpose : The recorded financial data is analysed and interpreted in the manner that will enable the data users to make a meaningful judgment about the financial condition and profitability of the business operation.

Nature of process : Financial Statements are interpreted to explain **what had** happened, **why** it had happened and **what is likely** to happen under specified conditions.

Based on analysed information, interpretation shall be done.

Basis : Financial Statements generated in summarizing process and relationships determined in Analyzing process.

Example : Assuming the NP ratio for 2011 is 20% on sales, whereas it was 15% in 2010. Similarly the expenses ratio for 2011 is 80% on sales, whereas it was 85% in 2010.

This means the profit has increased mainly due to decrease in expenses, (so the increase is not due to increase in sales)

6. Communicating:

Meaning : It is concerned with the transmission of summarised analysed and interpreted information to the end user to enable them to make rational decisions.

Modes : This is done through preparation and distribution of Accounting Reports, which includes Profit and Loss Account and Balance Sheet, additional information in the form of Accounting Ratios, Graphs, Diagrams, Funds Flow Statement, etc.

4. Objectives and Functions of Accounting

The objectives of Accounting are -

1. To have a **systematic record all business transactions** which are of financial nature.
2. To know the **result of business operations** for a particular period of time. If Revenue / Income exceeds the Expenses, then it is said that the business is running profitably, but if the Expenses exceed the Revenue, then the business is operating at a loss.
3. To know the **financial position** of the business. This will help answer questions like how much Assets and Liabilities that the business has on any date, whether the business is solvent, i.e. ability to meet its liabilities in the short run and also in the long run as and when they fall due.
4. To provide **information to Users for decision making**. Accounting, as the language of business, communicates the financial result of enterprises, to various Users. Accounting aims to meet the information needs of the decision maker **and help them in rational decision making**.

Objectives of Accounting

Systematic record of all business transactions : Book-keeping, i.e. Journal, Ledger and Trial Balance

Ascertainment of results of business operation : Trading and Profit & Loss Account

Ascertainment of financial position : Balance Sheet

Providing information to Users : Financial Statements and Reports

5. Functions of Accounting

The **American Principles Board** of the **AICPA** enumerated the following functions of accounting:

1. **Measurement:** Accounting measures the performance of the business entity and depicts its current financial position.
2. **Forecasting:** Accounting helps in forecasting future performance and financial position of enterprise using past data.
3. **Decision-making:** Accounting provides relevant information to the Users of accounts to aid rational decision-making.
4. **Comparison & Evaluation:** Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and Contingent Liabilities, which play an important role in predicting, comparing and evaluating the financial results.
5. **Control:** Accounting identifies weaknesses in the operational system and provides feedback regarding effectiveness of measures to rectify such weaknesses.
6. **Government Regulation:** Accounting provides necessary information to the Government, to exercise control on the entity as well as in collection of direct and indirect tax revenues.

6. Book-Keeping - Meaning and Features

Meaning : It is an activity of **recording and classifying** the financial data relating to business operations in a significant and orderly manner.

Objective :

- Complete recording of transactions.
- Ascertainment of financial effect on the business.

Features :

- It is an art of scientifically **recording** the transactions.
- The recording is done only in **monetary terms**.
- Recording of transaction is restricted only to that of a **particular enterprise**.
- The recordings are made in a given set of **books**.

Advantages :

- From the Financial Statements, financial information is **readily available** to the Users.
- **Qualitative financial decisions** can be taken, since the financial information is reliable.
- Valuable **conclusions** can be drawn on comparing the books of different years of the same, enterprise, or comparing books of the same period for different enterprise.
- Financial accounts of an enterprise are treated as **evidence** in a Court of Law.
- Maintaining records of various assets helps **control**, i.e. to ensure there is no unauthorized use or disposal of any asset or property of the business.

7. Book-Keeping Vs Accounting

	Basis	Book-keeping	Accounting
1	Scope	Book-keeping involves - (a) Identifying the transactions, (b) Measuring the identified transactions, (c) Recording the measured transactions, (d) Classifying the recorded transactions.	In addition to book-keeping, Accounting involves- (a) Summarizing the classified transactions, (b) Analyzing the summarized results, (c) Interpreting the analysed results, and (d) Communicating the information to interested parties.
2	Stage	Book-keeping is the primary stage, (i.e. record-keeping phase)	Accounting is the secondary (summarizing) stage. It starts where book-keeping ends.
3	Basic Objective	To maintain systematic records of financial transactions.	To ascertain net results of operations and financial position and to communicate information to the interested parties.
4	Person	Book-keeping is done by Junior Staff.	Accounting work is performed by Senior Staff.
5	Knowledge level	Book-Keeper is not required to have higher level of knowledge than an accountant.	Accountant is required to have higher level of knowledge than that of Book-Keeper.
6	Analytical skills	Book-Keeper may or may not possess analytical skills.	Accountant is required to possess analytical skills.
7	Nature of job	The job of a Book-Keeper is often routine and clerical in nature.	The job of an Accountant is analytical in nature.
8	Designing of System	It does not cover designing of accounts system.	It covers designing of accounting system.
9	Supervision	The Book-Keeper does not supervise and check the work of an Accountant.	An Accountant supervises and checks the work of a Book-Keeper.
10	Financial	Financial position of the business cannot be ascertained through book keeping	Financial position of the business is ascertained based on the accounting reports.
11	Financial Statements	Financial Statements do not form a part of the book-keeping process.	Financial Statements are part of the accounting process. These Statements are prepared based on book-keeping records.
12	Managerial decision	Managerial decision cannot be taken with the help of book-keeping records alone.	Management can take decision on the basis of accounting records and statements.
13	Sub-fields	There are no sub-fields for Book-Keeping.	It has several sub-fields such as Financial Accounting, Management Accounting, etc.

Notes In terms of scope, Book-Keeping < Accounting < Accountancy.

CLASS WORK**MULTIPLE CHOICE QUESTIONS**

1. Which of the following is not a subfield of accounting?
(a) Management accounting. (b) Cost accounting.
(c) Book-keeping
2. Purposes of an accounting system include all the following except
(a) Interpret and record the effects of business transaction.
(b) Classify the effects of transactions to facilitate the preparation of reports.
(c) Dictate the specific types of business enterprise transactions that the enterprises may engage in.
3. Bookkeeping is mainly concerned with
(a) Recording of financial data.
(b) Designing the systems in recording, classifying and summarising the recorded data.
(c) Interpreting the data for internal and external users.
4. All of the following are functions of Accounting except
(a) Decision making. (b) Ledger posting.
(c) Forecasting.
5. Financial statements are part of
(a) Accounting. (b) Bookkeeping.
(c) Management Accounting.
6. Financial position of the business is ascertained on the basis of
(a) Records prepared under bookkeeping process.
(b) Trial balance.
(c) Balance Sheet.
7. Users of accounting information include
(a) Creditors/Suppliers (b) Lenders/ Customers
(c) Both (a) and (b)
8. Financial statements do not consider
(a) Assets expressed in monetary terms.
(b) Liabilities expressed in monetary terms.
(c) Assets and liabilities expressed in non-monetary terms
9. On January 1, Sohan paid rent of ₹ 5,000. This can be classified as
(a) An event. (b) A transaction.
(c) A transaction as well as an event.
10. On March 31, 2015 after sale of goods worth ₹ 2,000, he is left with the closing inventory of ₹ 10,000. This is
(a) An event. (b) A transaction.
(c) A transaction as well as an event.

HOME WORK

THEORY QUESTIONS

1. Define accounting. What are the sub-fields of accounting?
2. Who are the users of accounts?
3. Discuss briefly the relationship of accounting with
(i) Economics (ii) Statistics (iii) Law
4. Discuss the limitations which must be kept in mind while evaluating the Financial Statements.
5. What services can a Chartered Accountant provide to the society?



UNIT : 2**ACCOUNTING CONCEPTS, PRINCIPLES AND CONVENTIONS****INTRODUCTION**

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.

1. Fundamental Accounting Assumptions**1. Going Concern:**

- (a) The enterprise is normally viewed as Going Concern, i.e. **continuing** in operation for the foreseeable future (endlessly)..
- (b) It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of reducing substantially its level of operations.
- (c) **For Example** - When we invest in shares of Reliance Company, we normally assume that the company's operations will be continued. We do not expect the company to be closed.
- (d) **Exception to Going Concern Assumption** - Joint Venture (Which is created for specific purpose / period)
- (e) *Going Concern is also considered as one of the accounting concepts.*
- (f) **Significance:**
 - The Going Concern Convention is important for valuation of assets and liabilities.
 - It indicates the need to value the assets based on the future returns that can be earned from such assets.
 - Based on Going Concern Assumption, Historical Cost is used for measuring / valuing Fixed Assets. If the Going Concern assumption becomes inappropriate (i.e. if the enterprise cannot be taken as a going concern) then assets should be valued at their Net Realisable Value, i.e. if the business is to be closed, then the assets must be valued at Market Values and not at cost.

2. Consistency:

- (a) **Meaning:** The accounting principles followed by the entity shall be consistent i.e. the same, over a period of time. Frequent changes in accounting policies will distort comparison.
- (b) **Example:** If one year, a particular payment is treated as expense, then the assumption is that the subsequent years also it shall be treated only as an expense,
- (c) Consistency is also considered as one of the Accounting Concepts.
- (d) **Exception:** As per Consistency Concept, a change in an accounting policy should be made only -
 - If the adoption of a different accounting policy is required by Statute, or
 - For compliance with an Accounting Standard, or

- If it is considered that the change would result in a more appropriate presentation of the Financial Statements of the enterprise.

3. **Accrual:**

- Revenue and Costs are **"accrued"**, i.e. recognized as they are earned or incurred and recorded in the Financial Statements of the period to which they **relate**, and not when money is received or paid.
- For Eg. If a sale for ₹ 10,000 is made on credit to a person in 2011, but the settlement is received in 2012. In this case, ₹ 10,000 shall be treated as income in 2011 (in the year of accrual) and not in 2012. (year of receipt)
- Accrual is also treated as **one of the Accounting Concepts**.*

Disclosure Requirements

If the above assumptions are **followed in** preparing accounts

Separate disclosure is **not required**, since their acceptance and use **are assumed**.

If the above assumptions are **not followed**

Disclosure is **necessary**, specifying that the general accounting assumptions are not followed

Students' Note: Accrual Vs Receipt

- "Accrual" means "right to **receive/obligation to pay** money". "Receipt" means **"Actual Receipt/Payment of money"**
- "Accrual Basis" is otherwise called as "Mercantile Basis"
- Example:** B Sold to A for ₹ 10,000 on 01.01.2011 on credit for 60 days. In this case, B has a right to receive money from A but he can actually receive money only on 02.03.2011 (after 60 days). Hence, ₹ 10,000 has accrued on 01.01.2011, but it is received on 02.03.2011. Sales will be recorded on 01.01.2011 and not on 02.03.2011.

2. Accounting Concepts

Business Entity

- Meaning:** The business enterprise is a **separate identity and distinct** from that of its Owners or Managers. The Owner of the business and the business as such is treated as two different persons.
- Impact of above concept:** All transactions are classified into - (a) Business Transactions, and (b) Personal Transactions. Business Transactions are recorded in the books of accounts of the business. Owner's Personal transactions are recorded in his personal book of account and not in the books of the business.
- Example:**
 - Mr.A is a owner of a CA firm "M/s A & Co." The profits arising from M/s A & Co. belong to Mr.A only. However, for accounting purposes, Mr.A is a different person and M/s A & Co. is a different person.
 - Accounting will be done only for the transactions in which M/s A & Co is involved and not for A's personal transactions
- Accounting Entity:** The entity for which the accounting is to be made may be Business Undertakings : (a) Business Unit itself (i.e. Sole Proprietorship Firm, Partnership Firm, Company or Government Undertaking), or (b) a defined part of a business (i.e. a department), or (c) a combination of related businesses (i.e. Holding and Subsidiary Company) depending on the User's needs.

Non-Business Undertakings : Trusts, Club, Religious Bodies or Government

5. **Impact on Accounting:** The entity concept has the following impact for accounting -
- Business Viewpoint:** All transactions are recorded from the viewpoint of the entity itself and not from the viewpoint of other parties such as Owners, Managers or Customers.
 - Owner-Business transactions:** This concept leads to Lender - Borrower relationship between the business and the owner of the business.

Event	From Business' View	Treatment
Owner invests money in business	It is money borrowed by business from the owner and hence is a liability	Capital (Note)
Owner withdraws money from business	It is repayment of loan by the business to the owner	Drawings (Note)
Profits of the Business	Whatever profits earned by the business belong to the owner. Hence, profits are also considered as liability of the business to the owner.	Added to Capital
Losses of the Business	Similar to profits, losses also belong to the owner. But, losses will reduce the amount due to the owner	Reduced from Capital

Note: The above terms are used to distinguish the owners loans /repayments from other persons'loans / repayment.

- Owner Vs Business Transactions:**
 - The Owner's Personal transactions are not recorded in the Books of Accounts of the Business.
 - For eg. If the owner purchases Television for his home, it shall not be recorded in the books of the business (**Reason:** This is to find out the true profits and true financial position of the business. If the owner's personal-a transactions are combined with business transactions, then the every purpose of accounts will be lost)
- Payments to Owners Vs Payments to Others:**
 - Payments to outsiders represent the expenses for operating the business. For eg. Rent, Interest on Loans etc
 - Payments of profits to the owners like dividend etc. are not treated as expenses
- The Entity Concept gives meaning to the basic accounting equation - $\text{Equity} + \text{Liabilities} = \text{Assets}$.

Money Measurement

- Meaning:** Accounting data must be quantified so that data can be aggregated and hence summarized. Hence transactions and events should be measured in terms of money. Transactions are recorded in books of account, in the **ruling currency of the country where the books of accounts are prepared.**
- Common Unit:** A common measuring unit in terms of money helps to - (a) quantify data, and (b) enable determination of profit / loss and financial position. For example, the **Rupee** is the common unit of measurement for economic events and transactions in India. It is the legal tender used as the medium of exchange in market transactions.

3. Justification of Money Measurement:

- (a) All transactions should be measured in terms of money.
- (b) Managerial planning and control must take shape in monetary terms. The profit objective should be stated in monetary denominations in order to make performance evaluation meaningful.
- (c) It is used for providing financial information to Shareholders, employees and a variety of other users who need such information for decision-making.

4. Criticism of Money Measurement:

- (a) **Value of money erodes** over a period of time. Future Cash Flows have a lower value than the Present Cash Flows. Hence, money by itself is not a meaningful measurement base.

Example: One kg of Onion in 2010 was ₹ 40; But the same one kg of onion in 2011 is ₹ 80. This implies that the **real value of money has gone down**. However, this is not reflected in money measurement concept.

- (b) **Exchange value of a currency** (e.g. Rupee) in relation to other currency **is not constant** over a time period. Hence, money does not provide a stable measurement yardstick.
- (c) **Many material transactions and events are not recorded** in the books of accounts just because they **cannot be measured** in terms of **money**. For eg. Appointment of new Chairman for the Company.

5. Impact on Accounting:

- (a) As per Money Measurement Concept, only those transaction, which are capable of being measured in terms of money are recorded in the books of accounts, that too in the ruling currency of the country, e.g. in Rupees in India, in Dollars in USA, in Pounds in UK.
- (b) Transactions which are not in monetary terms, even if they affect the results of the business materially, are not recorded in the book of accounts.

Note: Entity and Money Measurement Concepts are the **basic concepts** on which the other procedural concepts depend.

Periodicity or Accounting Period

- 1. **Need:** As per the Going Concern Assumption, the enterprise has an indefinite life. However, it is necessary to **sub-divide such indefinite period** into a **smaller time units** for (a) measurement of performance; (b) understanding the financial position of the enterprise and (c) control over operations. Such smaller and usable time-frame for reporting purposes is called **Accounting Period**.

2. **Meaning:**

- (a) Hence, during the life-time of an entity, Financial Statements can be prepared in periodic intervals of time. The economic life of an enterprise is split into the periodic interval (being a financial year).
- (b) As per Periodicity Concept, the Financial Statements should be prepared after **every accounting / financial period, and not at the end of the life of the entity**.
- (c) Generally, a period of 12 months (i.e. one year) is considered as the accounting period, by most enterprises. In the corporate sector, Interim Financial Reporting is also prevalent. The length of the accounting period is also determined by the statute in certain cases.

Note: Normally the term "Financial Year" refers to the period for which the accounts are prepared. It is usually taken as the period from 1st April to 31st March of the next year.

3. **Periodicity Concept facilitates in -**
 - (a) Comparison of Financial Statements of different periods,
 - (b) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business,
 - (c) Matching periodic revenues with expenses for getting correct result of the business operations.
4. **Expense Classification:** Based on the Periodicity Concept, expenses are classified into
 - (a) **Capital :** They create an enduring benefit, (say, for 7 to 10 years) **Example:** Factory Building, Machinery, Motor Car, Land etc. **They are otherwise called as "Fixed Assets".**
They are **deducted** from Income **over their useful in a specified proportion. This deduction is otherwise called as "Depreciation".**
 - (b) **Revenue :** They result in benefit which is fully used within **one** financial period
Example: Rent, Repairs, Insurance, Salary etc. They are otherwise called as **"Expenses"**
They are **deducted** from Income **in FULL** in the **period in which they are incurred.**
 - (c) **Deferred Revenue :** They take the nature of both revenue and capital expenditure. They are **revenue expenditure which provide benefits for 3 to 5 years.**
Example: Advertisement. It is strictly a revenue expenditure, but as the benefits from advertisement may arise for 3 to 5 years, it is *deferred and treated as revenue in 3 to 5 years*

They are **deducted** from Income over the periods in which the benefits arise.

Exception: In Joint Venture Accounting, the above classification of Capital and Revenue Expenditure is not applicable, **as the Venture is only for a specific duration, and not on long-term basis.**

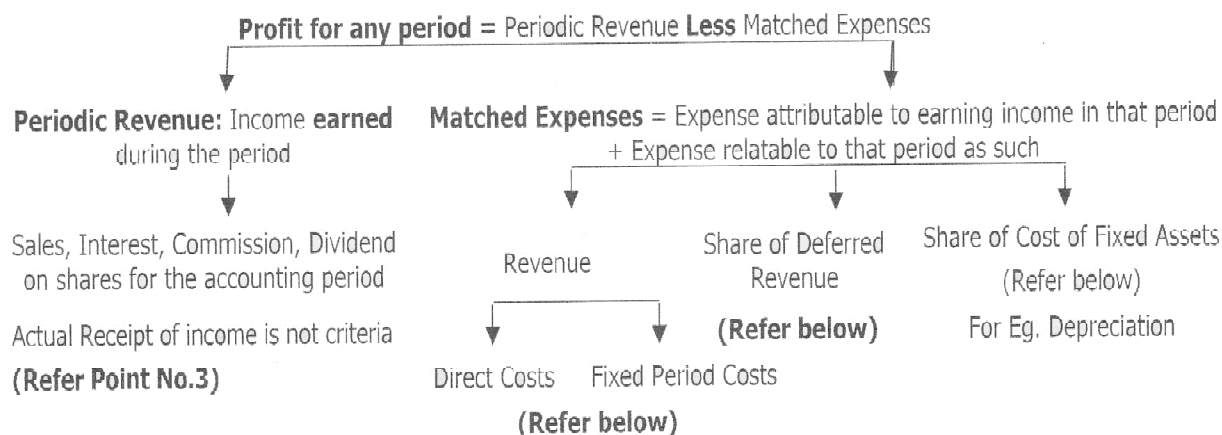
Accrual

1. **Meaning :** "Accrual" means recognition of revenue as they are earned and the cost as they are incurred and not when money is received or paid. This Concept relates to measurement of income, identifying assets and liabilities.
2. **Method :** Under Accrual Concept, all transactions and events are recognized on **mercantile basis**, i.e. as they are earned or incurred, and recorded in the Financial Statements of the period to which they **relate**, and not when cash **is** actually received or paid.
3. As per Accrual Concept, **Profits = Revenue - Expenses**
 - (a) **Revenue** = Gross Inflow of Cash, Receivables and other consideration arising in the course of 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.
 - (b) **Expenses** = 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.

Matching

1. **Meaning:**
 - (a) Performance of a business entity is measured with reference to a specific accounting period.
 - (b) Hence, to determine the profits for a particular period, Revenue **earned** in that period **should be matched** the expenses **incurred** for earning such revenue.

2. Impact of Matching Concept: As per Matching Concept.



Notes:

- Direct Costs** - Expenses directly related to output / sales of an enterprise, e.g. Materials Consumed, Labour etc.
- Fixed Period Costs** - Expenses incurred over the period and not directly related to the goods / services sold/rendered by the enterprise. It may be difficult to relate such expenditure with the revenue earned, e.g. Salaries, Office Rent, Insurance Premium etc.
- Deferred Revenue Expenditure - Refer Periodicity Concept:** e.g. Advertisement, Research & Development etc.
- Fixed Assets** - Expenses spent on fixed assets for the production of goods and services, for a longer time frame. The cost of assets to be charged as depreciation against the revenue of a particular period is a matter of judgment.

3. Nature of Income / Expenses:

Particulars	Income	Expenses
Inclusions	Sale/Service rendered but money not received. Outstanding Income / Accrued Income)	Services received / purchases made but money not paid (Outstanding Expenses / Sundry Creditors)
Exclusions	Advances received before sale / service is not income (Income received in advance)	Advances paid before purchases made / services received (Prepaid Expenses/ Expenses paid in advance)

- Impact:** The Accrual Concept, together with Periodicity and Matching concepts, give rise to the recognition of - (a) Prepaid Expenses (b) Outstanding Expenses (c) Income Receivable and (d) Income Received in Advance.

Cost

- Meaning:** As per Cost Concept, Value of an asset as shown in the Balance Sheet must be its Historical Cost, i.e. Acquisition Cost. This is the conventionally adopted measurement base for valuation of assets.

2. Significance / Merits:

- (a) Historical Cost is **objective** and free from bias.
- (b) Historical Cost is **easier to ascertain** than Current Cost, Present Value, etc.
- (c) Historical Cost represents an **actual figure** / outflow of resources for acquiring the asset, and does not reflect a hypothetical or notional figure.

3. Criticism: Historical Cost is criticized on the following grounds - (a) Historical Cost **does not reflect the true value** of the asset, particularly in an inflationary situation. (b) Financial Statements prepared on the basis of Cost Concept loses comparability. (c) Many assets (like Human Resources) do not have acquisition costs. Cost Concept fails to recognize such assets.

Note: Due to the above criticism, other measurement bases like Current Costs, Net Realisable Value, Present Value, etc. are suggested.

Realisation

- 1. **Meaning:** As per Realisation Concept, An asset is recorded at its Historical Cost and any change in its value should only be recognised when it is realized, i.e. at the time of its actual sale / disposal.
- 2. **Concept:** It emphasises that there is no certainty of income until a sale has been made and hence increases in value of the asset should not be taken into account unless it is actually realised.
- 3. **Criticism:** However, Realisation Concept is criticised by arguing that if the value of an asset has been permanently changed, Profit or Loss arising out of such change should be considered to reflect true and fair financial position of the enterprise. Otherwise, accounting will become distorted and meaningless.
- 4. **Revaluation:** So, Fixed Assets may be revalued periodically. However, selective revaluation of an asset may lead to unrepresentative or misleading amounts being reported in Financial Statements. Hence, revaluation of assets should be done on a systematic basis. For Example, all machineries shall be revalued rather than a single machinery.

Fair Value: Thus the Realisation Concept is slowly being replaced by the recognition of assets at their Fair Market Value (Fair Value Accounting Concept). However Accountants follow a more conservative path. They try to cover all probable losses but do not count probable gains.

Dual Aspect

- 1. **Meaning:** The Dual Aspect Concept is the **core of double entry book-keeping**.
- 2. **Basis:** As per this concept, **every transaction or event has two aspects**, which have to be recorded in the books. The amounts of both the aspects are equal.
- 3. The possible combinations of the effects of each transaction is as under -

1 st Aspect	2 nd Aspect	Example	Effect of Transaction
Increase in one Asset	Decrease in another Asset	Purchase of Machine for ₹ 40,000 by paying cash.	<ul style="list-style-type: none"> Machinery A/c increased by ₹ 40,000 Cash A/c decreased, by ₹ 40,000.
Increases an Asset	Increases a Liability	Purchase of goods for ₹ 90,000 on credit.	<ul style="list-style-type: none"> Stock A/c increased, by 90,000, & Creditors A/c increased by ₹ 90,000.
Decreases an Asset	Decreases a Liability to Creditors	Payment of Cash ₹ 20,000	<ul style="list-style-type: none"> Cash A/c decreased, by ₹ 20,000 & Creditors A/c decrease ₹ 20,000.
Increases one Liability	Decreases another Liability	Creditors paid from Bank Overdraft ₹ 10,000	<ul style="list-style-type: none"> Bank O/D increased by ₹ 10,000 Creditors Decrease by ₹ 10,000

4. **Significance:** This concept gives rise to the accounting equation: "**CAPITAL + LIABILITIES = ASSETS**". This equation can take many forms, and some forms are given below -

$$\begin{aligned}
 \text{Capital + Liabilities} &= \text{Assets} \\
 \text{Equity (i.e. Capital) + External Liabilities} &= \text{Fixed Assets + Current Assets} \\
 \text{Equity + Long Term Liabilities + Current Liabilities} &= \text{Fixed Assets + Current Assets} \\
 \text{Equity + Long Term Liabilities} &= \text{Fixed Assets + (Current Assets - Current Liabilities)} \\
 \text{Equity + Long Term Liabilities} &= \text{Fixed Assets + Net Working Capital} \\
 \text{Equity} &= \text{Fixed Assets + Net Working Capital - Long Term Liabilities} \\
 \text{Capital + Income / Profits + Liabilities} &= \text{Assets + Net Loss + Expenses}
 \end{aligned}$$

Note: Closing Capital = Opening Capital (±) Profits/(Losses) during the year (+) Additional Capital (-) Drawings (+) Interest on Capital (-) Interest on Drawings

Note: Capital is otherwise called as Equity. Both the sides of the equations shall always tally.

Full Disclosure

Meaning: As per this concept, all the events and transactions which are relevant shall be **disclosed** in the Books of Accounts and the Financial Statements. The events may relate to the current or the subsequent Accounting Periods.

Purpose: The users of the Financial Statements must be aware of all relevant events and transactions to understand the real position of the business.

Disclosure: The term "Disclosure" means that a **statement describing the event / transaction** (including the amount involved) should be added to the financial statements **as a note therein**. (*Disclosure is not same as accounting. Accounting means Accounting Entries will be passed, whereas in disclosure, a mere statement is given; Journal Entry not passed.*)

Example: The legal suit filed against a company for violation of copyrights shall be disclosed as part of the financial statements, though it cannot be measured accurately.

Exception: The **Conventions of Materiality and Conservatism** are exceptions to the **Concept of Full Disclosure**, due to following reasons:

- (a) **Materiality Vs Full Disclosure: (Refer Materiality Convention below)**
 - As per Full Disclosure, **all relevant events and transactions** must be disclosed.
 - As per Materiality, Accounting Principles to be applied **only for MATERIAL events & transactions and not for all.**
- (b) **Conservatism Vs Full Disclosure: (Refer Conservatism Convention below)**
 - As per Full Disclosure, **all relevant events and transactions** must be disclosed
 - As per Conservatism, only those events and transactions which lead to **Possible Losses** must be accounted and disclosed. **Unrealised profits shall not be accounted / disclosed.**

Substance over Legal Form

1. **Meaning:** The accounting treatment presentation in Financial Statements, of transactions and events, should be ***governed by their substance and not merely by the legal form.***
2. **For Example,**
 - (a) **Sale of Land & Building without Registration;** If the Firm has sold its Land and Building, received the consideration and handed over the possession to the Buyer, it **should be recorded as Sale** of Land and Building. This recognition **cannot be postponed for mere procedural formality** pending, e.g. registration of Sale Deed.
 - (b) **Hire Purchase - Considered as sale:** In case of an asset required on Hire Purchase, ownership is not transferred till last installment is paid. However, the asset is shown in the books of the Hire Purchaser.
 - (c) **Financing Agreement:** A Ltd enters into an agreement with B Ltd for sale goods at ₹2,50,000. However, the same goods are to be repurchased in the next year for ₹2,75,000. This is **not a trading transaction**, and effectively **reflects a financing transaction**. It should be recorded only as a **financing transaction**.

3. Accounting Conventions

Conservatism Convention

1. **Meaning:** (a) Conservatism or Prudence demands that **unrealised profits and gains should not be recognised** in accounts. However, **provision** should be **made for all actual and possible losses**. (b) The Accountants should not anticipate income, but should provide all possible losses.
2. **Example:** Assume that Mr.Z is dealing in two commodities - Pen and Pencil. The following details are given -

Particulars	Pen	Pencil
Quantity in Stock on 31.03.2011	10,000 Nos.	15,000 Nos.
Cost of purchase of above stocks	₹ 10 / Pen	₹ 5 / Pencil
Market Value of stock on 31.3.2011	₹ 8 / Pen	₹ 8 / Pencil
Relevant amount for valuation	₹ 8 / Pen	₹ 5 / Pencil
Stock Value on 31.03.2011	₹ 80,000	₹ 75,000
Treatment	Expected Loss to be recognised	Unrealized loss not to be recognised
Reasoning	There is a Possible loss of ₹ 2/Pen, totaling upto ₹ 20,000	There is an expected gain of ₹ 3/pen, but that will not be considered as it is not sold

3. Applications of Conservatism Convention:

- (a) **Choice among different methods of Valuation:** If there is a choice between two methods of valuing an asset, the Accountant should choose a method which leads to the lesser value, e.g. Current Assets are valued at Cost or NRV, whichever is lower.
- (b) **Market Value Vs Book Value:** If the market value of the fixed assets is greater than the Book Value of fixed assets, then the difference between Market Value and Book Value shall not be recorded in the books of accounts as it is not realized profits.
- (c) This concept prohibits Window Dressing. **(It means manipulating the financial statements to make them attractive viz. inflating the profits, suppressing expenses, treating revenue expenditure as capital expenditure etc.)**
- (d) **Exceptions:** It is considered as an exception to (a) Full Disclosure Concept (b) Consistency Concept.

4. Advantages: This Concept has led to the following qualitative characteristics of Financial Statements -

- (a) Prudence, (b) Neutrality, and (c) Faithful representation of alternative values.

5. Disadvantages:

- (a) Conservatism is **subjective** as the amount of possible losses may be quantified by different persons in a different manner and hence the loss amount determined by different persons **may not be the same**.
- (b) If the principle of Conservatism is **stretched without reservation**, it may result in - (a) Creation of Secret Reserves, (b) Violation of the Doctrine of Full Disclosure, and (c) Reported Profits being less than Actual Profits.
- (c) Conservatism is an exception to the doctrine of full disclosure **(Refer Exception under Full Disclosure)**

Materiality Convention

1. Meaning: As per Materiality Concept, all items having **significant** economic effect on the business should be disclosed in the Financial Statements.

2. Material items refer to the items in the financial statements the knowledge of which might influence the decisions of the users of Financial Statements.

3. Examples:

- (a) **Stationery** (like Notebooks, Calculator) purchased by the Firm, though not used fully in the accounting year purchased, is still shown as an expense of that year because of the Materiality concept. This is because the amount of such Stationery is very small to be shown as asset though it constitutes Assets of the Firm.
- (b) **Payment of penalties/fines for violation of law** should be disclosed separately, even if the amount is negligible. It should not be clubbed together with "Office Expenses" or "Miscellaneous Expenses".

4. Factors: Materiality depends on the size and nature of the items or errors, judged in the particular circumstances of its misstatement.

5. Advantage: Materiality provides a threshold or cut-off point for classifying the amounts into assets or expenses.

6. Exception: This principle is an exception to the full disclosure principle.

7. Disadvantage: Materiality is more a subjective and a judgmental principle.

Example, ₹ 10,000 spent on advertisement may be material for a small firm with sales of ₹ 1 Lakh; However, the same amount is not material for a company like reliance.

CLASS WORK**MULTIPLE CHOICE QUESTIONS**

1. All the following items are classified as fundamental accounting assumptions except
(a) Consistency. (b) Business entity. (c) Going concern.
2. Two primary qualitative characteristics of financial statements are
(a) Understandability and materiality. (b) Relevance and reliability.
(c) Neutrality and understandability.
3. Kanika Enterprises follows the written down value method of depreciating machinery year after year due to
(a) Comparability. (b) Convenience. (c) Consistency
4. 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.
5. 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, 2015. He counted net profit as ₹ 3,50,000.
Which of the accounting concept was followed by him?
(a) Entity. (b) Periodicity. (c) Matching.
6. A businessman purchased goods for ₹ 25,00,000 and sold 80% of such goods during the accounting year ended 31st March, 2017. 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.
7. 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
8. Assets are held in the business for the purpose of
(a) Resale. (b) Conversion into cash. (c) Earning revenue.
9. 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.
10. The concept of conservatism when applied to the balance sheet results in
(a) Understatement of assets. (b) Overstatement of assets.
(c) Overstatement of capital.

11. Decrease in the amount of trade payables results in
 - (a) Increase in cash.
 - (b) Decrease in bank over draft account.
 - (c) Decrease in assets.
12. The determination of expenses for an accounting period is based on the principle of
 - (a) Objectivity.
 - (b) Materiality.
 - (c) Matching.
13. Economic life of an enterprise is split into the periodic interval to measure its performance is as per
 - (a) Entity.
 - (b) Matching.
 - (c) Periodicity.
14. 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.
15. Purchase of machinery for cash
 - (a) Decreases total assets.
 - (b) Increases total assets.
 - (c) Retains total assets unchanged.
16. Consider the following data pertaining to Alpha Ltd.:

Particulars	
Cost of machinery purchased on 1st April, 2016	10,00,000
Installation charges	1,00,000
Market value as on 31st March, 2017	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

HOME WORK

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.

UNIT : 3**ACCOUNTING TERMINOLOGY - GLOSSARY****GLOSSARY OF SIGNIFICANT TERMS****INTRODUCTION****Business**

- ☞ It represents the **set of activities** which are regularly carried on by a person or an organisation for the **purpose of earning profits** from such activities.
- ☞ **For Example -**
 - (i) A Tea shop owner regularly prepares tea and sells it in glasses to his customers.
 - (ii) Reliance Communications regularly sells mobile phones to the customers.
- ☞ Profit Motive is involved in Business. (**Note:** *The business may actually lead to losses. But motive is to earn profits*)
- ☞ Business may be
 - (i) **Manufacturing** - Purchasing Raw Materials, Converting them into Finished Goods and selling the goods.
 - (ii) **Trading** - Buying Finished Goods and selling them **as such** without any conversion.
 - (iii) **Service** - Rendering services to clients Eg. Doctors, Chartered Accountants etc. (**Note:** No Goods)

Goods

- ☞ Items / Products / Articles which are **regularly** traded by the businessman are called "Goods".
- ☞ Eg. For a Mobile Shop owner, mobile phones are "goods", as he regularly purchases and sells them.
- ☞ However, for the same mobile shop owner, if he purchases one motor bike for carrying the mobile phones, then the motor bike is **not considered** as goods for him.

Cost/ - Historical Cost

- ☞ It represents the **amount actually spent** or the **liability actually incurred**.
- ☞ For eg. Assume that a land is purchased for ₹ 100 Lakhs, but its market value is ₹ 150 Lakhs. In this case, the Historical Cost is ₹ 100 Lakhs only.

Purchases : (From Buyer's angle) It refers to **Buying of Finished Goods / Raw Materials** by one person from another person for consideration. [**Note:** Sale by one party is the purchase for another party.]

Finished Goods : It refers to the **products manufactured** by the manufacturer. For a trader, the goods purchased and sold by him are called finished goods.

Sales (from the angle of seller)

- ☞ "Sales" refers to "Transfer of **ownership in goods** from one person to another for a consideration"
- ☞ Hence, 3 Conditions for sale are - (a) Transfer of **Ownership** (b) Ownership must be in **goods** (c) Consideration - Some money or money's worth must be given by one person to another.
- ☞ **Transfer of Ownership:** Ownership in goods is transferred when the risks of loss and rewards relating to such goods are transferred.
- ☞ **Example:**
 - (i) Mr.X buys one Mobile phone from Mr.Y. When Mr.X comes out of Y's shop, somebody stole the

mobile phone. In this case, the **loss of mobile phone due to theft is to be borne by Mr.X and NOT by Mr.Y.**

- (ii) However, if the same mobile phone is stolen when it is kept in the display of Mr.Y's shop, then Mr.Y shall bear the loss of mobile phone.
- (iii) Thus in the above case, there is a transfer of **risk of loss** from Mr.Y to Mr.X after the purchase of mobile phone. When there is transfer of risk, it is considered as transfer of ownership and hence safe.

- **Sale of properties other than goods:** If **items other than goods** are sold (For eg. Motor Car), then it is not considered as "Sales" for Accounting purposes. It is referred by the name of the respective item. Hence, if mobile phone dealer sells motor car, it is **NOT referred by the general name of "Sales", but is referred** as "Motor Car Sold".

Raw Materials : (Applicable only for manufacturing business) It refers to the base materials from which finished goods are manufactured. [For Eg - Water Bottles are made from Plastics. In this case, water bottles are finished goods whereas plastics are raw materials.]. For a trader, there is no raw material as he does not produce anything.

Stock

- It refers to the **balance Finished Goods / Raw Materials** existing at the beginning or end of a specified period.
- Closing Stock - Stock at the end of a specified period.
- Opening Stock - Stock at the beginning of the period.
- **Example** - Mr.A purchased 10,000 kgs of sugar in 2011. He sold 8,000 kgs throughout 2011. In this case, the stock on 31.12.2011 is 2,000 kgs of Sugar. This is closing stock on 31.12.2011. On 01.01.2012, the above stock of 2,000 kgs is carried forward from 2011. This is Opening Stock on 01.01.2012.

Assets

- (i) **Technical Definition:** An Asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.
- (ii) **General Definition:** Properties of the business / Amounts receivable from others by the business Eg Stock, Land, Building, Debtors etc. (Detailed Meaning in the next chapter)

Debtors : Persons from whom the business has to receive money, due to **credit sales** made to them.

Liabilities : Amounts payable by the business to outsiders and includes capital. For eg. Bank Loans, Expenses not yet paid.

Creditors : Persons to whom the business has to pay money due to **credit purchases** made from them.

Capital : Amount invested by the owner into the business

Drawings : Cash / Goods **drawn** by the owner for his **personal purposes**. It decreases the capital.

Profits : Incomes - Expenses

Income/ Revenue : Amount receivable due to Sales / any other amount receivable arising out of the regular operations of the business. For Eg. Interest, Commission etc. (**Note:** This excludes loan amounts received/ amounts received from debtors).

Expenses : Amount spent to derive benefit for an accounting period. For Eg. Rent paid for the benefit of occupying a building for 12 Months.

Losses : Amount spent but no benefit is derived / Amount not recoverable from debtors. For eg. Stocks lost due to fire.

Bank Overdraft : It is Bank Account. However, in this account, the *account* holder is *allowed to withdraw over and above the* existing balance. For Eg. Assume that Mr.A has a balance of ₹ 10,000 in his Bank Account. If he draws a cheque for ₹ 15,000, normally it will be rejected by the bank. However, if the account has Overdraft

facility, then the bank will pay ₹ 15,000 on the cheque, despite the insufficient balance.

It is in the nature of Current Liability

Equity : Capital is otherwise called as equity.

Working Capital : Current Assets **Less** Current Liabilities. Also called as "Net Working Capital".

Current Assets : It refers to the assets which are easily convertible into cash or cash equivalents within a single accounting period. For Eg. Bank, Debtors etc.

Current Liabilities : It refers to the liabilities which are payable within the single accounting period. For eg. Creditors, Bank Overdraft etc.

Fixed Assets : Represents Long Term Assets which are expected to be used in the business for a longer period of time. They are meant for usage in the business for production / rendering of services etc. Eg. Machinery, Building.

Disclosure : The term "Disclosure" means that **a statement describing the event / transaction** (included the amount involved) should be added to the financial statements **as a note therein**. (Disclosure is not same as accounting. Accounting means Accounting Entries will be passed, whereas in disclosure, a mere statement is given; Journal Entry not passed.)

Incurred : It refers to the creation / existence of liability for expenses. For rent paid ₹ 12,000 for 12 months is otherwise called as "rent incurred". Mere payment of advances is not considered as "incurred".

Inventory : Technical term for "Stock". It includes Raw Material Stock, Work in Progress and Finished Goods Stock

Depreciation : Gradual Decrease in the value of **Fixed Assets** due to wear and tear, use, passage of time, obsolescence and other related factors.

Hire Purchase : It refers to the transaction wherein the goods are delivered by the seller to the buyer on condition that the settlement has to be made in specified installments. On payment of the last installment, the goods shall be treated as owned by the buyer. Till the last installment, the goods are owned by the seller. In case of default of any installment, the seller can get back the goods delivered.

Liquidity : Ability of the business to meet its Short-Term Liabilities. **Current Assets > Current Liabilities**

Solvency : Ability of the business to meet its Total Liabilities, i.e. **Assets > Liabilities**

Window Dressing : It means manipulating the financial statements to make them attractive viz. inflating the incomes, suppressing the expenses, treating revenue expenditure as capital expenditure etc.

Holding Gains : It refers to the notional gains arising due to increase in prices of stocks held in the business. For Eg. A has 10,000 Kgs of Steel in Stock. They are bought at ₹ 100/Kg. They are not sold for one month. At the end of one month, their market price is ₹ 180/Kg. In this case, if the stocks are sold at the end of one month, then A can earn a profit of ₹ 80/Kg. This is not realized as sale is not actually made and they are just kept in stock.

Notional : It is not realized and may be earned if some event happens. In the above case, if sale happened then ₹ 80 is earned. Till the actual sale, it is only a notional profit.

HOME WORK

THEORY QUESTIONS

1. Define following terms:
 1. Accrual Basis of Accounting
 2. Amortisation
 3. Contingent Asset
 4. Contingent Liability

UNIT : 4**CAPITAL AND REVENUE EXPENDITURE AND RECEIPTS****INTRODUCTION**

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 utilization 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 utilized.

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.

1. Distinguish between Capital Expenditure & Revenue Expenditure

Particulars	Capital Expenditure	Revenue Expenditure
	It is an expenditure incurred for the purpose of-	It is an expenditure, the benefit of which is immediately (normally within one year) exhausted in the process of earning revenue.
1. Meaning	(a) Purchase/Creation/Improvement of Fixed Assets or (b) Expenses necessary for the above purchase/Creation (c) Increasing the earning capacity of the business.	
2. Purpose	(a) Acquiring Fixed Assets, which are held not resale, but for use with a view to earn profits. (b) Making additions to the existing Fixed Assets (c) Increasing earning capacity of the business by improved facilities and equipments (d) Reducing the cost of production. (e) Acquiring benefit of enduring nature of valuable right.	(a) Actual day-to-day running of the business, (b) Maintaining the capital assets in an efficient manner. (c) Cost of Material & Stores (d) Salary and Wages of employees (e) Administrative Exp. Like Stationery, Rent Telephone and Insurance.

3. Treatment in Financial statement	➡ Capital Expenditure is displayed as asset in Balance Sheet. Only depreciation portion is debited to P&L A/c. ➡ It is NOT directly reduced from Incomes.	➡ Expenditure is charged fully in the Profit and Loss Account. ➡ It is fully REDUCED from income
4. Wrong treatment	If wrongly treated as revenue, profits will be understated or reduced .	If wrongly capitalized, profits will be inflated or overstated .
5. Matching	Capital Expenditure is not matched with Capital Receipts	Revenue Expenditure is matched with Revenue Receipts.
6. Time of incurrence	Capital Expenditure may be incurred before or after the commencement of the business.	It is incurred after the commencement of the business.
7. Recurring Nature	Normally Capital Expenditure is generally non-recurring in nature. However, certain Capital Expenditure is required once in 2-5 years. E.g. modernization of Machinery, etc.	Revenue Expenditure is of recurring / repetitive nature. It is incurred every year by the business.
8. Interest on borrowing	If interest on borrowings is payable for the period prior to the commencement of the business / Production	If interest on borrowings is payable for the period on or after commencement of business / production

Note: Amount involved in a transaction is not relevant for Capital vs Revenue distinction. Hence, even a transaction involving a huge amount say ` 5 Crores, maybe considered as Revenue Expenditure.

2. Deferred Revenue Expenditure

1. **Meaning :** It is an expenditure **primarily of revenue nature**, but the benefit whereof extends to periods more than the year of incurrence.
2. **Inclusion :** It also includes expenditure which gives benefits for 2 / 3 years, but does not result in creation or improvement of fixed assets. For Eg. Shifting of business from one location to a convenient location. This results in increase in benefits for many years, but do not result in creation of any fixed asset.
3. **Examples :**
 - (a) Expenditure on an advertisement campaign to introduce a product in the market,
 - (b) Discount allowed on issue of Debentures,
 - (c) Development Expenses in the case of Mines and Plantations.
 - (d) Cost of construction / extension to a leased building (Since the building has to be returned after the lease period is over, its benefits are for only a limited period.)

4. **Time Period** : Benefit of such expenditure relates to many years, i.e. relating to the future period.
5. **Treatment** : Written off in parts over the period during which the benefit will accrue. Balance portion is shown as an "Asset" in the Balance Sheet till the period of benefit.

Notes:

- **DRE ≠ Accumulated Losses**: Exceptional losses suffered due to natural calamity, political or other social disturbances, etc. are not Deferred Revenue Expenditures. They constitute "**Accumulated Losses**" since there is no corresponding benefit, either current or future.
- **DRE ≠ Prepaid Expenses**: The benefits available from Prepaid Expenses can be precisely estimated (e.g. Prepaid Insurance), but such precise estimation is not possible in the case of Deferred Revenue Expenditure (e.g. substantial advertisement campaign).

3. Capital Expenditure Vs Deferred Revenue Expenditure**1. Meaning**

Capital Expenditure : It is an expenditure incurred for the purpose of - (a) acquiring, extending or improving assets of a permanent nature for carrying on the business, or (b) increasing the earning capacity of the business.

Deferred Revenue Expenditure : It is an expenditure primarily of revenue nature, but the benefit whereof extends to periods more than the year of incurrence.

2. Treatment

Capital Expenditure : Asset is displayed in the Balance Sheet. Only depreciation portion thereon is debited to P&L A/c.

Deferred Revenue Expenditure : Written off in parts over the period in which benefit will accrue. Balance portion is shown as an "Asset" in the Balance Sheet till the period of benefit.

3. Example

Capital Expenditure : Purchase of Factory Building for use in the business.

Deferred Revenue Expenditure : Advertisement Expenditure

4. Criteria / Considerations for Capital Vs Revenue**1. Nature of Business**

Capital Expenditure if : Expenditure relates to purchase of a Fixed Asset (e.g. Land purchased by a Manufacturing Firm).

Revenue Expenditure if : Expenditure relates to purchase of a Current Asset (e.g. Land purchased by a Construction Company).

2. Recurring Nature

Capital Expenditure if : Expenditure is incurred infrequently, or once in 2-5 years (e.g. purchase of assets.)

Revenue Expenditure if : Expenditure is incurred frequently / regularly, in the normal course of business (e.g. Salary, Rent, etc.)

3. Purpose of Expenses

Capital Expenditure if : Expenditure is for acquiring / creating capital assets or increasing their productive capacity.

Revenue Expenditure if : Expenditure is for maintaining the capital assets in an efficient manner.

4. Period of Benefit

Capital Expenditure if : Expenditure helps to generate revenue over more than one accounting period

Revenue Expenditure if : Expenditure helps to generate income / revenue in the current period only.

5. Materiality

Capital Expenditure if : Expenditure is material / significant.

Revenue Expenditure if : Expenditure is not material, i.e. insignificant.

5. Examples for Capital and Revenue Expenditures**Capital Expenditure**

1. Purchase of Fixed Asset (Land, Building, etc.)
2. Purchase of Second-hand Asset (e.g. Vehicle, Furniture, etc.)
3. Overhaul Expenses to put second-hand machinery in working condition. -
4. Repairing & Painting of Old Building purchased recently by the Firm.
5. Expenditure incurred to reduce working expenses / operating expenses.
6. Legal Fee paid to acquire new property.
7. Licence Fee paid by Cinema Theatre to commence its business.
8. Cost of constructing Temporary Huts which were necessary for Factory Building Construction, which were demolished when the Factory was ready.

Revenue Expenditure

1. Expenditure for replacement of worn-out part of an existing asset.
2. Regular Advertisement Expenses in respect of products and services.
3. Expenditure on removal of stock to new site.
4. Legal Fees incurred to file suit against a Customer from whom money is due.

6. Capital Vs Revenue Receipts**(1) Meaning**

Capital Receipt : Capital Receipts refer to receipts other than Revenue Receipts.

Revenue Receipt : Revenue Receipts are moneys received in the course of normal business activities, and are recurring in nature.

(2) Example

Capital Receipt : Capital contribution by Owner, Issue of Shares / Debentures, Sale Proceeds of Fixed Assets, etc.

Revenue Receipt : Sales, Interest and Other Income Received, Bad Debts Recovered, etc.

(3) Purpose

Capital Receipt : Capital Receipts relate to specific purpose, e.g. Capital Contribution for commencing business or expanding business, Loans taken for acquiring Fixed Assets, etc.

Revenue Receipt : Revenue Receipts relate to general business purpose, and are not specifically identifiable to any purpose as such.

(4) Effect on Profit

Capital Receipt : Capital Receipts do not affect profit.

Revenue Receipt : Revenue Receipts have a direct impact on the profits.

(5) Disclosure

Capital Receipt : They are shown as Liability or Reduction from the Asset in the Balance Sheet.

Revenue Receipt : They are shown on the Credit Side of the Profit and Loss Account.

(6) Matching

Capital Receipt : Capital Receipts are **not** matched with Capital Expenditure, in all cases.

Revenue Receipt : Revenue Receipts is generally matched with Revenue Expenditure.

1. **Revenue Receipts x Cash Receipts.** "Revenue Receipts" refers to Total Income in the period (e.g. Total Sales on & Credit) while "Cash Receipts" refers to Cash Collections (i.e. Cash Sales + Collection from Debtors) in the period.
2. **Deposit of Money with other persons \neq Expenditure:**
 - **Deposit of money** is **not considered as an expenditure** as the money is just kept with another person and it is to be recovered from that person.
 - Expenditure refers to the amount spent to earn benefit. Deposit is **not considered as amount spent**

7. Capital Vs Revenue Profits

(1) Meaning

Capital Profits : Profits arising on issue / repayment of capital, borrowings or sale of fixed assets

Revenue Profits : Profits arising out of the regular operations of the business

(2) Examples

Capital Profits :

- (a) Premium on issue of shares / debentures
- (b) Discount on redemption of shares
- (c) Profits on sale of Fixed Assets (exceeding cost)

Revenue Profits :

- (a) Profits arising out of normal trading operations
- (b) Profits on sale of Fixed Assets (exceeding Book Value but less than cost)

(3) Treatment

Capital Profits : Taken to **Capital Reserve or under any other head** in Balance Sheet (unless realized in cash)

Revenue Profits : Revenue Profits taken to **Profit & Loss Account**

8. Capital Vs Revenue Losses

(1) Meaning

Capital Losses : Loss on issue / repayment of capital, borrowings, Loss of Fixed Assets due to fire / accidents.

Revenue Losses : Losses arising out of the regular operations of the business

(2) Examples

Capital Losses :

- (a) Discount on issue of shares / debentures
- (b) Premium on redemption of shares
- (c) Loss of Fixed Assets

Revenue Losses :

- (a) Losses on normal trading operations
- (b) Bad Debts
- (c) Losses on sale of Fixed Assets (S.V. < B.V.)

(3) Treatment :

Capital Losses : Taken to **Profit and Loss Account**. However, a specific note shall be given that the profits / losses are arrived after considering the capital loss

Revenue Losses : Taken to Profit and Loss Account.

CLASS WORK**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.

HOME WORK**THEORETICAL 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?

UNIT : 5**CONTINGENT ASSETS AND CONTINGENT LIABILITIES****INTRODUCTION**

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 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)].

1. PROVISIONS

- (1) **Meaning :** A Provision is “a Present Obligation, as a result of past events, which leads to probable outflow of resources embodying economic benefits and a reliable estimate of the amount of the obligation can be made”.
- (2) **Features :**
 - (a) Provision is a **present liability** of a certain / uncertain amount.
 - (b) Provision **can** be reasonably measured using a substantial degree of estimation.
- (3) **Treatment :** Provision should be **recognized** in the Books of Accounts and **also disclosed**.
- (4) **Impact on Profits :** Provision should be **recognized** in the Books of Accounts and **also disclosed**.
- (5) **Nature of Account :** Provision is made for liability; Hence, it is in the nature of **Representative Personal Account**, which indirectly represents a person / creditor
- (6) **Journal Entry :**

Debit - Profit and Loss A/c Dr.

Credit - To Provisions for Liabilities A/c
- (7) **Reasoning : Debit Aspect:** Provision is an expense / loss, which reduces the profits of the enterprise. Hence, Profit and Loss A/c is debited. (Debit all expenses and losses)

Credit Aspect: Provision is a liability payable in future. Hence, it is credited (Credit the giver of benefit)
- (8) **Disclosure :** For every Provision, following should be disclosed - (a) Opening and Closing Balance, (b) Addition in the year, (c) Amount used, (d) Unused amount reversed during the period.
- (9) **Balance Sheet :** Provision is **either shown** (a) **on the liabilities** side **(or)** (b) on the **assets side** - **as a deduction from the relevant asset**.
- (10) **Examples**
 - (a) Provision for Guarantees Given, when the original debtor becomes insolvent.
 - (b) Provision for Warranties
 - (c) Provision for Discount on Debtors
 - (d) Provision for Bad and Doubtful Debts
 - (e) Other Similar Provisions
- (11) **Approving Authority :** Persons who approve and authenticate the Financial Statements of an enterprise.

Example: Proprietorship Firm - Proprietor; Partnership Firm - Partner; Company - Board of Directors

2. Illustration for Provisions

1. **Situation:** M/s A and Co. is involved in extraction of coals from coal mines. While operating in a particular *mine*, landslide happened and because of this 10 employees of M/s A and Co. died on 15.03.2011. The Financial Position Assets and Liabilities is ascertained on 31.03.2011.
2. **Analysis:** In this situation, M/s A and Co. has an obligation to compensate the families of the dead employees **as the** deaths happened while working at its site. Though, A & Co. has not actually compensated the families, it has an **obligation to compensate them**.
3. **Explanation:** The question is whether the **obligation to compensate to be treated as liability** on 31.03.2011. The answer is "YES" i.e. it should be treated as liability as it satisfies the definition of the term "Provision", (as given below.)

Conditions from Definition

(a) Present Obligation

- ➡ On 31.03.2011, Sufficient evidence is available that M/s A & Co. will compensate the families of dead employees **in future**.
- ➡ If it does not compensate, then anyway the court will intervene and ask the *concern* to compensate the families

(b) **As a result of Past Events :** The obligation to pay compensation arises because of the death of the employees on 15.03.2011. The event of landslide on 15.03.2011 is a past event on 31.03.2011.

(c) **Probable Outflow of Economic Resources :** Due to above obligation, M/s A and Co. has to pay cash / other considerations to the families.

(d) **Reliable estimate of obligation :** M/s A & Co. can determine the **AMOUNT of liability that should be paid. It will be able to ESTIMATE** the amount to be paid. Accurate calculations are not required

For eg. No. of employees dead x Compensation per dead = 10 x 5 Lakhs = ₹ 50 Lakhs .

Note: If all the four conditions are satisfied, then a provision has to be created. Hence, in the given example, **"Provision for Compensation to employees"** has to be created for ₹ 50 Lakhs.

Journal Entry: Profit and Loss A/c Dr. 50 Lakhs

To Provision for Compensation to Employees A/c 50 Lakhs

3. Contingent Liability

The term 'Contingent liability' can be dened as

Possible Obligation : that arises from past events and the existence of which will be conrmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

Present Obligation : that arises from past events but is not recognised because:

- (i) it is not probable that an out ow of resources embodying economic benets 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 denition]. A contingent liability may also be a present obligation that arises from past events [(part (b) of the denition)].

An enterprise should not recognise a contingent liability. A Contingent liability is required to be disclosed unless possibility of out ow of a resource embodying economic benets is remote. These liabilities are

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.

4. Features of Contingent Liability

- (a) **No Recognition** : An Enterprise **should NOT RECOGNISE** a Contingent Liability.
- (b) **Disclosure** : A Contingent Liability should be **DISCLOSED as a FOOT NOTE to the Balance Sheet**.
- (c) **Periodical Review** : Contingent Liability should be **periodically reviewed**. On such review, if the character of the Contingent Liability is found to be changed and there is a probable outflow resources, then it will be recognized as a Provision and treated accordingly.
- (d) **Impact** : Contingent Liability **will NOT AFFECT the profits** of the concern, as it is not accounted in Books.
- (e) **Examples**
 - (i) Outcome of a law suit
 - (ii) Claims against the business, not acknowledged as debts
 - (iii) Guarantees given, if the principal debtor is solvent
 - (iv) Uncalled Liability on Partly Paid shares
 - (v) Arrears of Fixed Cumulative dividends
 - (vi) Workmen Compensations under Dispute
 - (vii) Unspecified Business Risk
 - (viii) Liability on Bills Discounted

Note: Students may note the difference between Recognition & Disclosure. A Provision should be **recognised** and also disclosed. However, a Contingent Liability should **not be recognized, but only disclosed**.

5. Illustration for Contingent Liability

1. **Situation:** M/s A & Co. produced and sold "MS Windows" software. Microsoft filed a legal suit against A & Co. for violation of copyrights. Microsoft also claimed damages from A & Co. for the producing without its permission. M/s A & Co. **argued in** the court that it has not violated the copyrights. On 31.03.2011, this case is pending at the Court.
2. **Analysis:** The liability for M/s A & Co. may or may not arise based on the decision of the Court. The Court's decision cannot be controlled by A & Co. nor can it be influenced. If the Court decides that A & Co. has not violated any copyrights, then there is no liability for A & Co.
3. **Explanation:** The liability of M/s A & Co. under the above legal suit is a contingent liability and **NOT provision** due to following reason:

Conditions from DEFINITION

- (a) **Possible Obligation** : On 31.03.2011, Sufficient evidence is **NOT** available that A & Co. will pay damages to Microsoft. It is not conclusive whether the Court's decision will be favourable or unfavourable to A & Co. Hence, there is **no probability** of any **future liability**.

- (b) **As a result of Past Events** : The above legal suit is due to the sales of software by the concern in the past.
- (c) **Existence confirmed by occurrence or non-occurrence of uncertain future event** : M/s A & Co. may or may not have the liability due to copyright violation. This is based on the favourable or unfavourable decision of the Court. One cannot predict the decision of the Court and hence it is an uncertain event.
- (d) **Not within the control of the enterprise** : The decision of the Court is not within the control of M/s A & Co. The Court will decide based on the facts of the case, the arguments of the parties and its knowledge.

Note: If all the above 4 conditions are satisfied, then the liability is in the nature of “**Contingent Liability**”. Hence in the example, “**Contingent Liability due to legal suits pending at the Court**” has to be **disclosed** as a **foot note** to the Balance Sheet. There is no Journal Entry. Only a statement describing the liability is given at the end of Balance Sheet.

6. Provisions Vs Contingent Liabilities

1. **Meaning :**

Provision : Provision is a **present Obligation** of a certain / uncertain amount.

Contingent Liabilities : It is a **possible obligation** which arises **from** past event.

2. **Measurement :**

Provision : Provision **can** be reasonably measured using a substantial degree of estimation.

Contingent Liabilities : Contingent Liability **cannot** be reasonably measured.

3. **Recognition :**

Provision : Provision should be **recognized** in the Books of Accounts.

Contingent Liabilities : Contingent Liability should **not** be recognized in the Books of Accounts.

4. **Impact on Profit :**

Provision : A known liability is accounted. Hence, a Provision **reduces** the profit.

Contingent Liabilities : Contingent Liability is **not** accounted. It has no **impact** on profits for the period.

5. **Disclosure :**

Provision : For every Provision, the following **should also be disclosed** - (a) Opening & Closing Balance, (b) Addition during the year, (c) Amount used, (d) Unused amount reversed during the period.

Contingent Liabilities : Contingent Liability is **only disclosed by way of a Footnote to the Balance Sheet** separate Schedule / Annexure thereto.

7. CONTINGENT ASSETS - Meaning and Features

- 1. **Meaning** : A Contingent Asset is a **POSSIBLE ASSET** that **arises from past events**, existence of which **will be confirmed only by occurrence / non-occurrence** of one or more **uncertain future events not wholly within the control** of the enterprise.
- 2. **Treatment** : An enterprise **SHOULD NOT RECOGNISE** a Contingent Asset due to **CONSERVATISM** Convention. Because this may result in recognition of income that may never be realized.
- 3. **Impact** : Contingent Assets will not affect the profits of the enterprise as it is not accounted in the books.
- 4. **Certainty** : If the realisation of income is certain, then it is not a Contingent Asset and the same shall be recognized in the Financial Statements.

5. **Disclosure** : Contingent Assets **should not be disclosed in the Financial Statements** but **may be disclose in the Report of the Approving Authority**.
6. **Examples**
 - (i) Unplanned or unexpected events leading to possibility of inflow of economic benefits.
 - (ii) Expected Gain from a legal suit.
 - (iii) Insurance claims for damage of a property.

8. Illustration for Contingent Assets

1. **Situation: Take the same situation as given under Contingent Liabilities.** Microsoft filed a legal suit against A & Co. for violation of copyrights. Microsoft also claimed damages from A & Co. for the producing without its permission. M/s A & Co. argued in court that it has not violated the copyrights. On 31.03.2011, this case is pending at the Court.
2. **Analysis: FROM THE VIEW OF MICROSOFT**, it may or may not receive compensation from M/s A & Co. based on the decision of the Court. The Compensation is a **possible gain for Microsoft**.
3. **Explanation:** The Compensation from M/s A & Co. is a **Contingent Asset for Microsoft** due to following reasons -

Conditions from Definition Description

Possible Obligation : On 31.03.2011, Sufficient evidence is **NOT** available that Microsoft will receive money from M/s A & Co. Hence it is only a possible asset.

As a result of Past Events : The above gains may arise because M/s A & Co. has violated the copyrights in the past.

Existence confirmed by occurrence or non-occurrence of uncertain future events : Microsoft may or may not receive money from M/s A & Co. This is based on the favourable or unfavourable decision of the Court. One cannot predict the future decision of the Court and hence it is an uncertain event.

Not within the control of the enterprise : The decision of the Court is not within the control of M/s A & Co. The Court will decide based on the facts of the case, the arguments of the parties and its knowledge.

Note: If all the above 4 conditions are satisfied, then the **Gains** are in the nature of **"Contingent Asset"**. Hence, in the example, **"Contingent Asset due to Legal Suit filed for Copyrights Violation"** **MAY** be **disclosed** in the report of the **Board of Directors of Microsoft**. It is not accounted / disclosed in accounts books.

9. Principles behind Provisions, Contingent Liabilities and Assets

1. **Provision** : Matching Concept, Conservatism Convention
2. **Contingent Liability** : Full Disclosure Concept
3. **Contingent Asset** : Conservatism Convention

10. Contingent Assets Vs Contingent Liabilities

- (1) **Nature** :
 - Contingent Asset** : Contingent Asset is a possible asset.
 - Contingent Liability** : Contingent Liability is a possible obligation
- (2) **Recognition** :
 - Contingent Asset** : Should **not** be recognized in the Balance Sheet.
 - Contingent Liability** : Should be recognized in the Balance Sheet.
- (3) **Disclosure** :
 - Contingent Asset** : Should **not** be disclosed in the Balance Sheet But it may be disclosed in the report of the approving authority.

Contingent Liability : Should be **disclosed** in the Balance Sheet, as a Footnote or as a separate Schedule.

Note: Contingent Situation is a situation, in which the ultimate outcome, (whether gain or loss) one will known only on the occurrence or non-occurrence, of one or more uncertain future event. So, both Contingent Assets and Contingent Liabilities -

- (a) arise from past events,
- (b) existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future event, and
- (c) Such event is not wholly within the control of the enterprise.

11. Liabilities Vs Contingent Liabilities

1 Meaning :

Liabilities : It is the **present** financial obligation of an enterprise, which arises from past events.

Contingent Liabilities : Contingent Liability is a **Possible** obligation which arises from a past event.

2. Example :

Liabilities : Wages, Salaries, Rent, Electricity, etc. for the last month of the financial year, but paid in first month of next financial year.

Contingent Liabilities : Claims against enterprise not acknowledged as Debts. Guarantees given in respect of third parties, Liability in respect of Bills Discounted.

3. Measurement :

Liabilities : It **can** be measured with a reasonable degree of estimation.

Contingent Liabilities : It **cannot** be measured with a reasonable degree of estimation.

4. Disclosure :

Liabilities : **Disclosed** in the Liability Side of the Balance Sheet and hence it is part of Balance Sheet.

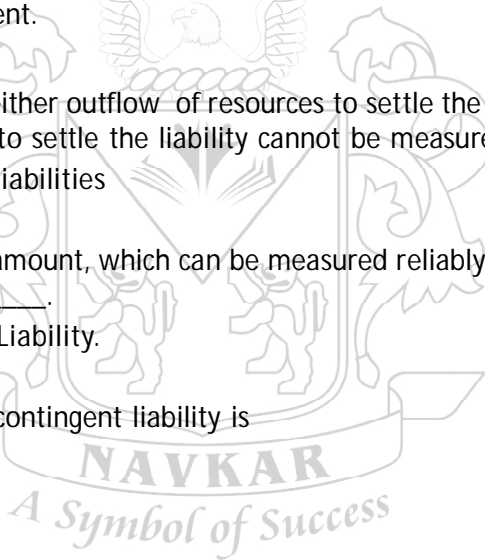
Contingent Liabilities : **Not a part of Balance Sheet**. It is only disclosed by way of Footnote to the Balance Sheet.

5. Effect on Profit :

Liabilities : A known liability is provided for, i.e. it **reduces** the profit.

Contingent Liabilities : Contingent Liability is **not** provided for. It has **no impact** on profits for the period.

CLASS WORK**MULTIPLE CHOICE QUESTIONS**

1. 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).
 2. 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.
 3. 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
 4. 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.
 5. In the financial statements, contingent liability is
 - (a) Recognized.
 - (b) Not recognised.
 - (c) Adjusted.
- 

HOME WORK**THEORETICAL QUESTIONS**

1. Differentiate between:
 - (i) Provision and Contingent Liability.
 - (ii) Liability and Contingent liability

UNIT : 6

ACCOUNTING POLICIES

INTRODUCTION

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.

1. Meaning and Need of Accounting Policies

1. Accounting Policies refer to - (a) the specific accounting **principles**, and (b) the **methods** of applying those principles, adopted by the enterprise in the preparation and presentation of Financial Statements.
2. **Example:** Inventory is valued at Cost or Net Realisable Value, whichever is lower. This is a principle. Cost can be determined either by First in First out (FIFO) method or Weighted Average Cost (WAC) or other suitable **methods**.
3. **Need for disclosure:** Accounting Policies should be disclosed in the Financial Statements due to following reasons -
 - (a) To promote better understanding of Financial Statements.
 - (b) To provide meaningful Inter-Firm Comparison.
 - (c) To ensure compliance with Law, for example, where in case of Companies, disclosure is mandatory.
 - (d) To comply with ICAI Requirements, in order to bring uniformity in disclosure.

2. Choice of Accounting Policies

1. **Alternative accounting policies:** The differing circumstances in which enterprises operate and the situation of diverse and complex economic activities of the Company has given rise to acceptability of alternative accounting principles and methods of applying those principles.
2. **Decision Making:** The choice of the alternative principles and methods calls for considerable judgement by the management of the enterprise.
3. **Reduction in alternatives:** Various Statements issued by ICAI, together with the measures of Government, other regulatory agencies and progressive managements have reduced the number of acceptable alternatives, particularly for corporate enterprises. However, the availability of alternative accounting policies can at best be reduced, **not eliminated**, as different enterprises operate in differing circumstances.
4. Illustrative List of areas of alternative accounting policies:
 - (a) Methods of Depreciation, depletion and amortisation.

- (b) Conversion or translation of Foreign Currency items.
- (c) Recognition of profit on Long-Term contracts.
- (d) Treatment of - (i) Expenditure during construction, (ii) Goodwill, (iii) Retirement Benefits, and (iv) Contingent Liabilities.
- (e) Valuation of - (i) Inventories, (ii) Investments, and (iii) Fixed Assets.

Note: Generally Companies disclose these accounting policies in the Notes on Accounts.

3. Principles for Selection of Accounting Policies

True and Fair View: The **primary consideration** in the selection of Accounting Policies by an enterprise is that the Financial Statements prepared and presented should represent a **true and fair view** as under -

In the case of the Balance Sheet	Of the State of Affairs of the enterprise as on a certain date.
In the case of Profit & Loss Account	Of the Profit or Loss for the period ended on that date.

Factors: To select and apply an accounting policy, the following points are considered - (**Secondary Consideration**)

- (a) Prudence (b) Substance over Form (c) Materiality

3. Change in Accounting Policies: Accounting policies have to be consistent from year to year. However, change in accounting policies can be made in the following situations -

- (a) If the adoption of a different accounting policy is required by Statute, or
- (b) For compliance with an Accounting Standard, or
- (c) If it is considered that the change would result in a more appropriate presentation of the Financial Statements.

4. Disclosure of Accounting Policies

1. Disclosure of Accounting Policies: All significant accounting policies adopted in the preparation and presentation of Financial Statements should be **disclosed** to facilitate better understanding of the Financial Statements.

2. Place of Disclosure: Disclosures should form part of the Financial Statements. It should be disclosed at **one place**, instead of being scattered over several Statements, Schedules and Notes.

3. Change in Accounting Policies: Change in an accounting policy should be disclosed -

- (a) When such change has a material effect in the current period and
- (b) When such change is reasonably expected to have a material effect in later periods.

4. Manner of Disclosure of change in accounting policies

Effect in Current Period : The impact of change on the Profit / Loss and the Balance Sheet items in current period should be quantified, to the extent ascertainable.

Where quantification is not possible, either wholly or in part, the **fact of such change** having a material effect should be disclosed.

Expected Effect in later periods : The fact of such change, and The fact that it is likely to have effect in later periods, should be appropriately disclosed in the period in which the change is adopted.

5. **Disclosure of Accounting Assumptions:** Fundamental Accounting Assumptions viz. Going Concern, Consistency and Accrual, if followed, need not be disclosed. Even if one of them is not followed, the fact should be disclosed. :
6. **Disclosure is not a Remedy:** Disclosure of Accounting Policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

5. Accounting Estimates

- (a) **Meaning: "Accounting Estimate"** means an **approximation** of the amount of an item in the absence of a precise means of measurement.
- (b) **Examples:** Depreciation - In this case, rate of depreciation is estimated based on the useful life of the asset.
- (c) Other examples are -
 1. Reduction in the value of Inventory and Debtors to their estimated realisable value.
 2. Provision for Taxation.
 3. Accrued Revenue.
 4. Provision for a loss from a lawsuit.
 5. Provision to meet Warranty Claims.
 6. Amortisation of certain items like Goodwill and Deferred Revenue Expenditure.
 7. Insurer's liability for Outstanding Claims.
 8. Provision for Retirement Benefits in the Financial Statements of Employers. For eg. Gratuity\
 9. Losses on Construction Contracts in Progress.

6. Fundamental Accounting Assumption Vs Accounting Policy

Point Fundamental	Accounting Assumption	Accounting Policy
Number	3	No specified list
Disclosure	Not required if followed	Required
If not followed /Changed	The fact to be disclosed with reasons	The fact of change in the accounting policy along with the effect of change to be disclosed
Choice	Mandatory from.	The Entity has an option to choose

7. Accounting Estimates Vs Accounting Policies

Particulars	Accounting Estimate	Accounting Policy
Meaning	Accounting Estimates refer to Financial Statement items, which cannot be measured with precision, but can be estimated	A Policy refers to a accounting principle and the method of applying that principle.

Frequency	<p>based on informed judgments.</p> <p>Change in Accounting Estimate is a routine matter in accounting which is substantially based on estimates. For example an estimate of Bad Debts is made on the basis of information at subsequent date, i.e. insolvency of a Debtor known afterwards.</p>	<p>Change in Accounting Policy is infrequent and amounts to almost a permanent change in the basis of accounting in the concerned area. For example, the accounting policy for charging depreciation may be changed from SLM to WDV Method.</p>
Causes / Reasons	<p>Change in A/cing Estimate arises due to -</p> <ul style="list-style-type: none"> ➞ change in circumstances on which the estimate was based, or ➞ availability of new information, etc. 	<p>Change in A/cing Policy is possible only for -</p> <ul style="list-style-type: none"> ➞ ensuring statutory compliance, or ➞ ensuring compliance with another AS, or ➞ more appropriate presentation of the Financial Statements.
Materiality	<p>The accounting picture may not get substantially altered by the change in the Accounting Estimate.</p>	<p>A change in Accounting Policy, generally, has a far reaching, material and long-term effect.</p>
Disclosure	<p>The nature and amount of a change in Accounting Estimate which has a material effect in the current period or expected material effect in future should be disclosed in the Financial Statements.</p>	<p>A change in Accounting Policy which has a material effect should be disclosed, along with the impact of, and adjustments resulting from that change in the current period Financial Statements.</p>

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CLASS WORK

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. (c) Both (a) and (b).
 - (b) Methods of applying those principles.

HOME WORK

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.

UNIT : 7

ACCOUNTING AS A MEASUREMENT DISCIPLINE

INTRODUCTION

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.

1. Elements of a Measurement Discipline

The three elements of Measurement Discipline and how Accounting satisfies these elements are as under -

	Element / Condition	Does Accounting satisfy the condition?
1.	Identification of objects or events to be measured.	Financial Transactions and Events are measured in Accounting. Non-financial transactions, however significant, are not considered.
2.	Selection of Standard or Scale to be used.	The ruling currency of the country is used as the basis of money measurement, in Accounting. However - (a) Money is not a stable scale having universal applicability. (b) Exchange Rates between different currencies are not constant.
3.	Evaluation of dimension of measurement standard	Money, as a valuation base, loses its value over period time. Hence, it is not stable in the dimension.

Conclusion: However, Accounting is not an exact measurement discipline because accounting measures information mostly in money terms which is - (a) not a stable scale (b) Not having universal applicability and (c) not stable in dimension for comparison over time.

2. Measurement Based in Accounting

	Base	Assets	Liabilities
1.	Historical Cost	Cash or Cash Equivalent paid, or Fair value of the Asset at the time of acquisition	Proceeds received in exchange for the obligation, or the amount of cash/cash equivalent expected to be paid to satisfy it in the normal course of business.
2.	Current Cost	cash or cash equivalent which is to be paid if the same or an equivalent asset was acquired currently (PURCHASE ANGLE)	Undiscounted amounts of Cash and Cash Equivalent that would be required to settle the obligation currently.
3.	Realisable value	Cash or Cash Equivalent that could currently be obtained by selling the assets in an orderly disposal (SALE ANGLE)	Undiscounted amounts of Cash and Cash Equivalent that would be required to settle the obligation in the normal course of business.
4.	Present Value	Present Discounted Value of Cash Inflows expected to be derived from such asset over its useful life	Present Discounted Value of cash Outflows expected to be required to settle the liabilities in the normal course of business.

Note: Different measurement based, like Historical cost /Current Cost/Net Realisable Value /Present Value, are used according to suitability (i.e. the situational needs) to depict true and fair view of the financial position of the reporting entity.

CLASS WORK**MULTIPLE CHOICE QUESTIONS**

1. Measurement discipline deals with
 - (a) Identification of objects and events.
 - (b) Selection of scale.
 - (c) Both (a) and (b)
2. All of the following are valuation principles except
 - (a) Historical cost.
 - (b) Present value.
 - (c) Future value.
3. Book value of machinery on 31st March, 2016 ₹ 10,00,000 Market value as on 31st March, 2016 if sold ₹ 11,00,000
As on 31st March, 2016, 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.
4. Mohan purchased a machinery amounting ₹ 10,00,000 on 1st April, 2001. On 31st March, 2016, 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.

HOME WORK

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.

UNIT : 8

ACCOUNTING STANDARDS

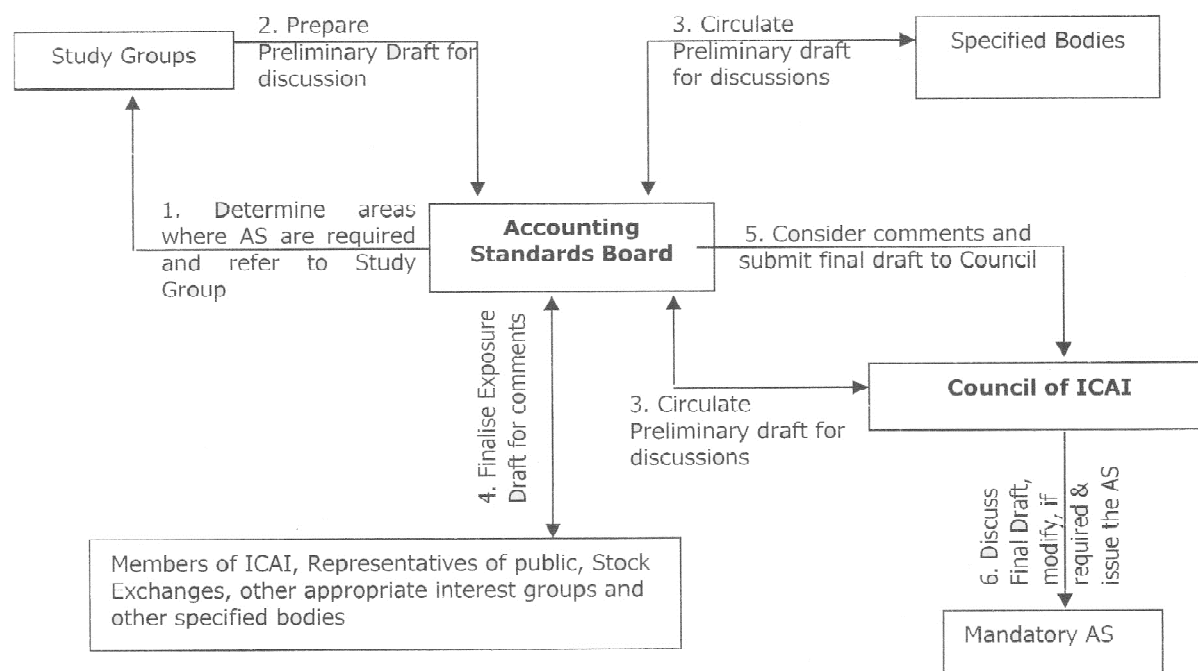
INTRODUCTION

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.

1. Accounting Standards

- Meaning :** Accounting Standards (AS) "represents the statements issued by the Institute of Chartered Accountants of India (ICAI), which contain basic principles for Accounting / disclosure for specific items in the Financial Statements.
- Applicability:** They shall apply to the General Purpose Financial Statements and other financial reporting
- Background:** At the international level, these accounting Standards are called as "International Accounting Standards (IAS) / International Financial Reporting Standards (IFRS)". Such standards are set up by the **International Accounting Standards Committee (IASC)**.
- Procedure:** The Accounting Standards Board (ASB) of the ICAI is responsible for identification and issue of Accounting Standards.

The procedure for issue of Accounting Standards is as under -



Advantages and Disadvantages of Accounting Standards

Objectives / Advantages	Disadvantages
1. To promote the dissemination of timely and useful financial information to all Stakeholders having an interest in a Company's economic performance	1. Where there are alternative solutions to specific accounting problems, each of these solutions may also be appropriate on the basis of sound arguments. A Standard which insists on one particular solution may be unduly
2. To reduce (or eliminate if possible), confusing variations in the accounting treatments used to prepare Financial Statements.	2. AS may be applied in a rigid and inflexible manner, since the demand for Standards comes largely from an insatiable appetite for rules, and lack of reliance on judgement in technical accounting matters.
3. To ensure disclosure of accounting principles and treatments where important information are not statutorily required to be disclosed.	3. AS cannot override the laws of the land. Where there are conflicts between the AS and the law, the AS may be purposeless
4. To facilitate comparison of financial statements of various enterprises in the same country or different countries.	

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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) Sheet Date	Contingencies and Events Occurring after the Balance
5.	AS 5 (Revised) Changes in Accounting Policies	Net Profit or Loss for the Period, Prior Period Items and

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
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.

CLASS WORK**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) Harmonies 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.

HOME WORK

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

UNIT : 9**INDIAN ACCOUNTING STANDARDS****INTRODUCTION**

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 reinstatements 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.

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.

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 listings. 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.

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.

DEVELOPMENT IN INDIAN ACCOUNTING STANDARDS (IND AS)

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.

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).

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.

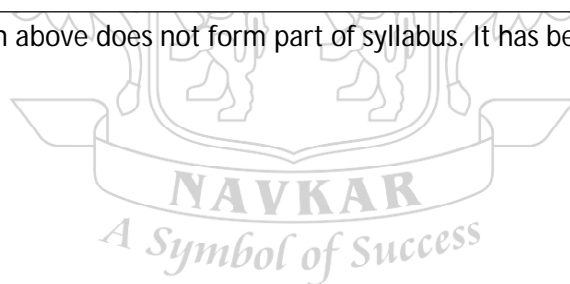
Similarly, Banking and Insurance regulatory authority have issued separate roadmaps for implementation of Ind AS for Banking and Insurance companies respectively.

4. 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
113	Fair Value Measurement
114	Regulatory Deferral Accounts
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
11	Construction Contracts
12	Income Taxes

16	Property, Plant and Equipment
17	Leases
18	Revenue
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.



CLASS WORK**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.

HOME WORK

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.



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