

Chapter 9: Accounting Standards

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Accounting Standards

- ❑ Basic rules for preparing and presenting the financial statements kept on changing with the passage of time
- ❑ Changes were catalyzed by the changing business environment across the globe
- ❑ The Institute of Chartered Accountants of India (ICAI) issues the Accounting Standards in India
- ❑ It suggests the rules for recognition, measurement, treatment, presentation and disclosure of accounting transactions in the financial statements of an organization
- ❑ Facilitates the disclosure of financial information which is important but not required to be disclosed by law

Standards Preparation

- ❑ The Accounting Standards Board of ICAI (ASB) performs the functions of preparation of the accounting standards in India
- ❑ The ASB comprises of representatives from industries, Central Board of Direct Taxes, Company Law Board, Comptroller and Auditor General and other parties
- ❑ IASC (or IASB) is responsible for making the International Accounting Standards (IAS)
- ❑ It is a committee of professional accounting bodies of more than 75 countries
- ❑ Many countries either follow the IAS or prepare their local accounting standards as per the guidelines of the IAS

ICAI and Companies Act Link ...

- ❑ 29 AS's have been issued till March 2007 by the ASB in India
- ❑ Importance of AS comes due to the following portions of the Companies Act, 1956:
 - ❑ Section 211 (3A) requires that the financial statements of a company should be prepared as per the Standards
 - ❑ Section 217(2AA) (1) states that the directors should mention that during preparation of the annual accounts all the applicable accounting standards have been followed, in the Directors Responsibility Statement
 - ❑ Section 227(3) requires the auditors to report whether in their opinion the financial statements were prepared as per the AS

AS 1 on Disclosure of Policies

- ❑ There is no single list of accounting policies which are applicable under all the circumstances because of the fact that the enterprises operate in different situations
- ❑ The choice of accounting policies depends on the judgment of the management
- ❑ The objective of AS 1 is to promote better understanding of the financial statements by proper disclosure of significant accounting policies
- ❑ Such disclosure will facilitate a more meaningful comparison between financial statements of different enterprises

AS 1 – Highlights

- All significant accounting policies adopted should be disclosed
- Disclosure should form part of the financial statements and the significant policies should be disclosed at one place
- Any change in accounting policy having material effect on the financial statement of the current year should be disclosed and the amount be ascertained. If the amount is not ascertainable, the fact should be disclosed
- The basic assumptions underlying the presentation of financial statements such as Going Concern, Consistency, and Accrual are to be followed. If these basic assumptions are not followed then the facts are required to be disclosed.

Illustration

- ❑ Swastik Ltd. used to prepare its accounts on accrual basis. But for the year ended 31st March 20X5, it decides to maintain its books of accounts on cash basis. Accordingly, it discloses in the financial statements that cash basis of accounting is one of its significant accounting policy. As an auditor of the company, do you think the disclosure to be appropriate?
- ❑ The Companies Act requires the books of accounts to be maintained only on Accrual Basis. Therefore, it is not proper to maintain the books of accounts only on Cash basis
- ❑ As an auditor, the fact that the applicable Accounting Standards were not followed by the company should be clearly mentioned in the Report

AS 2 – Inventory Valuation

- ❑ Inventories do not include the specific machinery spares which can be used only in connection with an item of fixed asset.
- ❑ Valuation should be based on lower of 'cost' and 'net realizable value'
- ❑ The cost of inventories should comprise all costs of purchase (duties, taxes), cost of conversion (direct labour) and other costs
- ❑ Net realizable value means the estimated price that can be realized in ordinary course of business as reduced by the cost of completion and cost of sale
- ❑ Generally, the inventories are to be valued as per FIFO or weighted average cost

Nestle India Ltd.	all fig. in thousands	
	31.12.06	31.12.05
Current Assets, Loans & Advances		
Stores & Spare Parts	186466	157213
Stock In Trade		
Finished Goods	1406559	1285707
Work In Progress	284758	271418
Ram Materials	760746	643214
Packing Materials	123656	173441
	2762185	2530993

Notes to Inventories

- ❑ Stores & Spare parts are stated at cost (through weighted average)
- ❑ Raw Materials – FIFO
- ❑ Work In Progress & Finished Goods –
Material cost + appropriate share of
production overheads & excise duty

Illustration

Dr. Mungeri Lal Laboratories Limited produces a chemical, "Jadoo". Jadoo's costing details are provided below:

- Raw material Rs 2
- Direct Labour Rs 1
- Direct Expenses Rs 3
- Fixed Overheads Rs 20,000
- Variable Overheads Rs 10,000

The normal capacity of the plant is to produce 10,000 units per annum but the actual production for the year was 5,000 units. The stock with Dr. Mungeri Lal Laboratories was 5000 units of stock at the end of the year. Calculate the value of the inventory stock.

Solution

- The fixed overheads are to be allocated on the basis of normal capacity while the variable overheads are to be allocated on the basis of actual capacity. Accordingly, the cost per unit is:

Particulars	Cost per unit	
Raw material	2	
Direct Labour	1	
Direct Expenses	3	
Fixed Overhead	2	(Rs. 20,000 for 10,000 units)
Variable Overheads	2	(Rs. 10,000 for 5,000 units)
Total per Unit	10	

The value of inventory is Rs 5000 x 10 or Rs. 50,000

AS 3: Statement of Cash Flow

- ❑ The cash flow statement explains the movement of cash under the heads: cash flow from operating, investing; and financing activities
- ❑ It contains the details of cash and cash equivalents that have increased or decreased during the period due to any of the above heads
- ❑ AS 3 is mandatory for...
- ❑ All the listed companies or companies that are in the process of issuing securities that will be listed on a recognized stock exchange in India
- ❑ All other commercial, industrial and business enterprises, whose turnover for the accounting period exceeds Rs. 50 crores

AS 4: Events after Balance Sheet Date

- ❑ Deals with events which takes place after the balance sheet date but before approval of balance sheet by the Board of Directors
- ❑ The prudent accounting policies require the making of provision for all known liabilities and losses even for those liabilities or events which are probable
- ❑ Adjustments are required for events occurring after the Balance Sheet date that provide information which materially affects the business
- ❑ Example: If a debtor becomes insolvent after the balance sheet date, adjustment should be made for loss on receivables in the balance sheet

AS 4: Events after Balance Sheet Date

- If the events do not relate to the conditions existing at the balance sheet date, no adjustments are required to be made
- Example: If a major fire occurs in the factory of a company one week after the closure of its books of accounts, damaging majority of its assets is not an event occurring after the Balance Sheet Date because as on the balance sheet date, there was no indication about the loss on account of fire. However, this incident materially affects the financial position of the company, so should be disclosed by way of notes to the accounts
- In the notes to accounts one should disclose the nature of the event and the estimated financial effect or a relevant statement that such an estimate cannot be made

AS 29: Provisions and Contingencies

- ❑ ICAI came out with a new standard AS 29
- ❑ It also applies to financial instruments (including guarantees) that are not carried at fair value
- ❑ Provisions are liabilities that can be measured only by using a substantial degree of estimation
- ❑ A provision should be recognized when:
 - ❑ an enterprise has a present obligation as a result of a past event;
 - ❑ it is probable that an outflow of resources will be required to settle the obligation;
 - ❑ a reliable estimate can be made of the amount of obligation

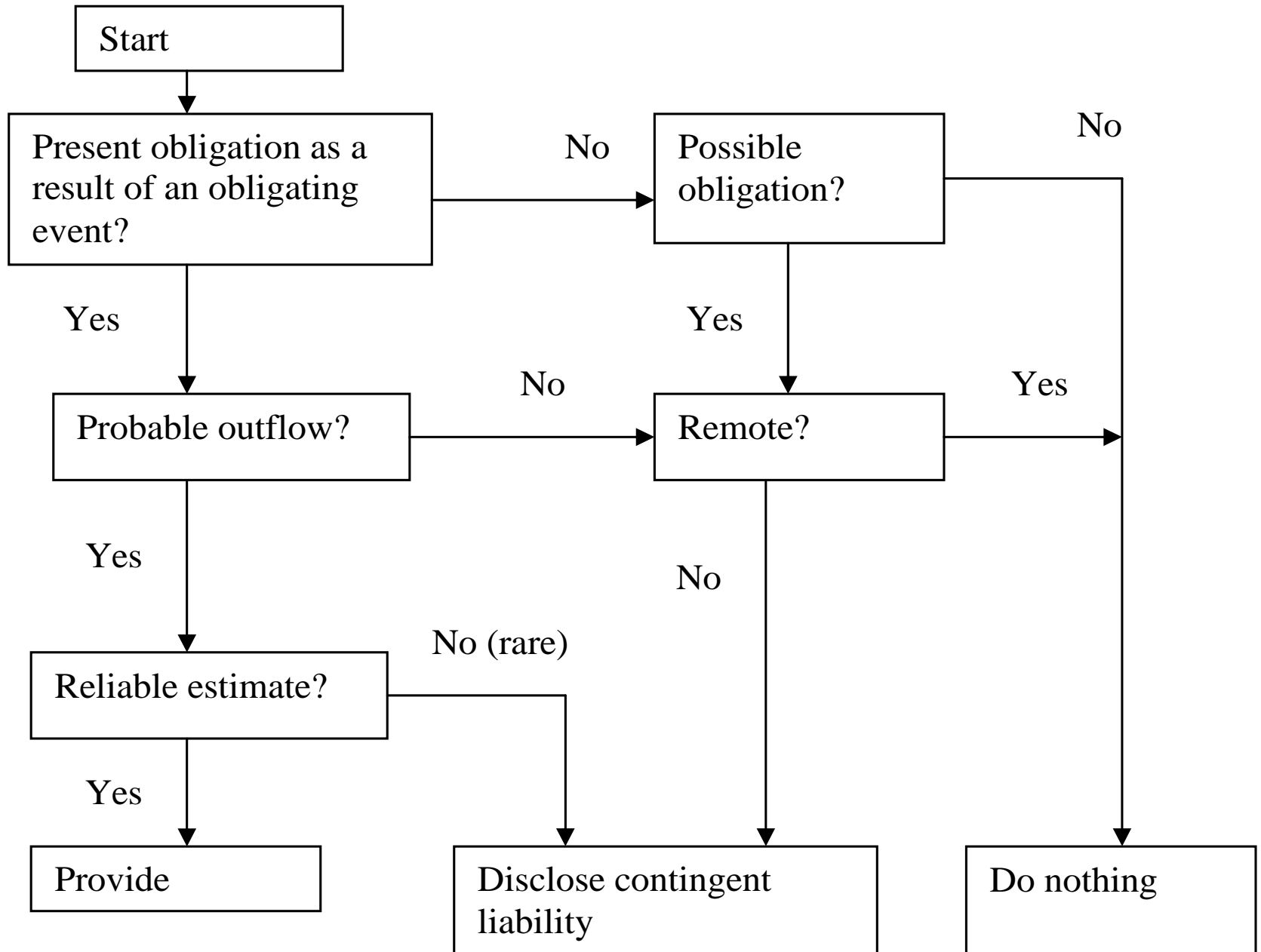
'Provisions' in AS 29

- ❑ Provision amount recognized should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date
- ❑ Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur
- ❑ Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate
- ❑ If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed

'Contingent Liability' in AS 29

- A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
- A present obligation that arises from past events but is not recognized because:
 - It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - A reliable estimate of the obligation amount cannot be made
- An enterprise should not recognize (i.e., provide for) a contingent liability

Main Recognition Requirements for Provisions and Contingent Liabilities



'Contingent Asset' in AS 29

- A possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not completely within the control of the enterprise
- Example: A claim that an enterprise is pursuing through legal processes, where the outcome is uncertain
- Are not recognized in financial statements since this may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate
- Usually disclosed in the report of the Board of Directors

Disclosure Requirements

- For each class of provision, an enterprise should disclose:
 - the carrying amount at the beginning and end of the period;
 - additional provisions made in the period; amounts used (i.e. incurred and charged against the provision) during the period; and unused amounts reversed during the period
- An enterprise should disclose the following for each class of provision:
 - a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
 - an indication of the uncertainties about those outflows

Disclosure Requirements

- An enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:
 - an estimate of its financial effect;
 - an indication of the uncertainties relating to any outflow
- In extremely rare cases, disclosure of some or all of the information can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability
- In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute

Illustration

- Narayan Bhandar Ltd. is a reputed retail store. It starts a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally well known and hence it invites large number of customers and hence good business this year. The owner is confused regarding the accounting of this policy – please help
- The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice
- An outflow of resources in settlement is quite probable
- Thus, a provision is recognized for the best estimate of the costs of refunds

AS 5: Net Income & Changes in Policies

- It requires the classification and disclosure of certain items within profit or loss
 - Ordinary Activities – Undertaken by an enterprise as part of its business. It also includes those activities that are incidental to the main business.
 - Extra-ordinary activities – Are different, Activities not expected to recur frequently or repeatedly.
 - Prior period items – Are the income or expenses that arise in the current period as a result of the errors or omissions in preparation of the financial statements in one or more previous year.

Implications of AS 5

- Where the items of income and expense within profit and loss from ordinary activities are of such nature, size or incidence that their disclosure is relevant to explain the performance of the enterprise for a period, the nature and amount of such items should be disclosed separately. For example –
 - Writing down the inventories to their net realizable value
 - Disposal of fixed assets
 - Litigation settlements
- The nature of prior period items and its amount should be separately disclosed in the profit & loss account in a manner that their impact on the current profit and loss can be perceived

Illustration

- ❑ Alibaba Limited filed a case against Alladin & Company for breach of contract in the year 20X5-X6. The amount of claim was Rs. 10 lakhs but no entry was passed in the books for the year 20X5-X6. Alibaba won the case in 20X6-X7 and Alladin was required to pay the money which was received in the same year. The finance manager of Alibaba is confused about the treatment for the amount gained. Please help him
- ❑ Non-passing of entry in any year does not necessarily make it a prior period item because in the given case, there was no certainty in the year 20X5-X6 regarding the amount to be received on account of filing the case and winning it
- ❑ The amount should be credited for the year 20X6-X7

AS 6 – Depreciation Accounting

- If the management, after making an estimate, feels that the rates of depreciation should be higher than the rates prescribed by the Companies Act, then it is allowed to do so
- But if it wants to lower the rate, the same is required to be in accordance with the requirements of the Companies Act
- Once a depreciation method is followed, the same should be used consistently.
- Any change in the method is allowed only if: -
 - it is required by the statute,
 - needed for compliance with the AS, or
 - for a better presentation of the financial statements

AS 6 Implications

- Where the method of depreciation is changed, the depreciation is re-calculated according to the new method as if the same is used from the date of the asset coming into use
- The surplus (or deficiency) arising due to the change in method is accounted for in the profit & loss account during the year of change
- AS 6 is not applicable on
 - Forests and similar regenerative natural resources
 - Wasting assets such as expenditure on exploration for oil
 - Expenditure on research and developments
 - Goodwill
 - Live stock

Disclosure Requirements – AS 6

- ❑ The depreciation method used is to be mentioned along with the total amount for each class of asset, gross amount of each class of depreciable asset, and the accumulated depreciation
- ❑ If the historical value of an asset is changed because of additions and change in duties, then the depreciation on the revised unamortized depreciable amount is provided prospectively over the residual life of the assets.
- ❑ If the modernization of a fixed asset has material effect on the amount of depreciation, it should be disclosed
- ❑ Change in the method needs to be disclosed clearly with the reasons for the change being mentioned

AS 9 : Revenue Recognition

- In case of sale of goods, the following conditions be satisfied:
 - The goods are transferred to the buyer for a price wherein all the significant risks and rewards of ownership has been transferred to the buyer.
 - No significant uncertainty exists regarding the amount of consideration that will be derived from the sale of goods
- Revenue from sale transaction should be recognized provided that at the time of execution, it is not unreasonable to expect the ultimate collection (of receivable)
- In case of any doubt, the recognition should be postponed till the certainty is achieved

AS 9 : Revenue Recognition

- In case of services, the execution (performance) is measured either under completed service contract method or under the proportionate completion method whichever relates revenue to the work carried out.
- Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognized when no significant uncertainty as to its measurability or collect-ability exists. Recognition is based on:
 - Interest: On time-period proportionate basis
 - Royalties: As per the terms of agreement on accrual basis
 - Dividend: When the owners right to receive is established

Sale of Goods ...

- If delivery is delayed at buyers request and the buyer takes title and accepts billing -
 - The revenue should be recognized irrespective of the fact that the physical delivery is not made
- If delivery is subject to conditions of installation and inspection -
 - Revenue is not recognized until the customer accepts the delivery and the installation as well as inspection are completed
 - In some cases, the installation process is so simple that the revenue can be recognized even if the inspection and installation are pending

AS 10 : Fixed Assets

- ❑ Planned Revaluation – An entire class of asset should be revalued or the selection of assets for revaluation should be made on a systematic basis and the basis be disclosed
- ❑ In case of revaluation, the increase in value should be credited to the revaluation reserve.
- ❑ Disposal of Fixed Assets – The difference between the net proceeds and the net book value should be charged to the profit & loss account
- ❑ For any amount standing to the credit of revaluation reserve account relating to the asset disposed, then the loss amount is charged from revaluation reserve. Balance in the account should be transferred to General Reserve Account.

AS 10 Requirements ...

- ❑ Joint ownership of fixed assets – The enterprises share in such asset and the proportion of original cost and accumulated depreciation are to be disclosed
- ❑ Goodwill – Only the amount of purchased goodwill is to be shown. If a business is purchased, the amount of goodwill is calculated by the excess of price paid over the value of assets taken.
- ❑ Patents – Direct costs attributable to patents should be capitalized and written off over their legal term or working life
- ❑ Know-How – Amount paid for plans, layouts, designs should be capitalized under the relevant asset head and the depreciation is calculated on the whole amount

AS 22 : Taxes on Income

- The difference between the tax expenses (which is calculated as per the books of accounts) and current tax liability as per Income-tax Act is called deferred tax (assets/liability).
- → Tax expense for any year = Current Tax + Deferred Tax.
- Deferred tax (asset/ liability) arises only when there is a difference in the taxes due to the timing difference. Permanent difference does not result in any tax (Asset/Liability).
- Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. For example, while computing taxable income, the tax laws disallows a part of an item of expenditure.

Disclosure Requirements

- ❑ Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. It should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities
- ❑ The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts
- ❑ The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws

Example ...

Moolchand Cements Tax as per Books of Accounts

Year ending 31st March	20X8	20X9	20X0
Profit	400000	400000	400000
Less: Depreciation	100000	100000	100000
Taxable Profit	300000	300000	300000
Tax @ 30%	90000	90000	90000

Moolchand Cements Tax as per the Income Tax Act

Year ending 31st March	20X8	20X9	20X0
Profit	400000	400000	400000
Less: Depreciation	300000	0	0
Taxable Profit	100000	400000	400000
Tax @ 30 %	30000	120000	120000

Journal Entry (1st Year)

- In the first year, we need to create a deferred tax liability of Rs. 60,000
- This difference is because of the difference in the depreciation rates (Rs. 3,00,000 – 1,00,000) at the tax rates applicable
- In this case we pass the following journal entry...

Profit & loss account (Debit)	90000	
Current Tax Account (Credit)		30000
Deferred Tax Liability (Credit)		60000

(Being the amount of tax including deferred tax charged to the profit and loss for the year)

AS 26 : Intangible Assets

- ❑ An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.
- ❑ AS 26 is to be applied by all enterprises for intangible assets except those enterprises dealing with financial assets and mining and other exploration rights
- ❑ An intangible asset should be measured initially at cost
- ❑ Internally generated intangibles such as goodwill, brands, mastheads, and publishing titles, should not be recognized as an asset

AS 26 – Highlights

- An intangible asset arising from development can be recognized only if that enterprise can demonstrate its feasibility, ability to sell, generation of future economic benefits, intention and availability of resource for completion and ability to measure the expenditure
- If any expenditure on an intangible asset is recognized as expense in any year the same cannot be part of cost of an intangible asset at a later date. Subsequent expenditure can be added to the cost only if it is probable that the expenditure will generate future benefits that are in excess of the original estimates
- An intangible asset to be amortized on a straight-line method

AS 21 : Consolidated Statements

- These consolidated statements are intended to present financial information about a parent and its subsidiaries as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources
- AS 21 should be applied in accounting for investments in subsidiaries in the separate financial statements of a parent
- AS 21 does not deal with accounting for investments in joint ventures and investment in associates
- The consolidated financial statements are presented, to the extent possible, in the same format as that adopted by the parent for its separate financial statements

Consolidation Procedures

- While in a parent's separate financial statements, investments in subsidiaries would be accounted for in accordance with AS 13 for Investments but in preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line by line basis by adding together like items of assets, liabilities, income and expenses.
- Some of the steps to be taken are as follows:
- The cost to the parent of its investment in each subsidiary and the parent's portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, should be eliminated

Steps...

- Any excess of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as goodwill to be recognized as an asset in the consolidated financial statements
- Intragroup balances and intragroup transactions and resulting unrealized profits should be eliminated in full. Unrealized losses resulting from intragroup transactions should also be eliminated
- Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies then that fact should be disclosed.

Disclosure Requirements

- A list of all subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;
- Where applicable, the nature of the relationship between the parent and a subsidiary, if the parent does not own, more than one-half of the voting power of the subsidiary;
- The names of the subsidiaries of which reporting date(s) is/are different from that of the parent and the difference in reporting dates

Auditor Qualifications and Notes

- ❑ SEBI had announced that the listed companies will have to disclose audit qualifications in the audited financial statements along with the impact of the auditors qualification on their profit or loss
- ❑ This has resulted in all listed companies to mandatorily disclose audit qualifications in their published annual results
- ❑ Notes to accounts are the place where all the matters which are disputed or needs further disclosure can be seen
- ❑ If an auditor gives a qualification in the auditors description on the firm's financial statements and accounting practices then the management also has a chance to represent its views in the 'notes to accounts'

Computerization of Accounts

- ❑ Computerized accounting systems are just automated book-keeping procedures
- ❑ It results in immense speed and improved accuracy in the accounting process
- ❑ However, the fundamental problems associated with traditional manual accounting processes (such as, a wrong journal entry) remains
- ❑ Computerization of accounts can be of various stages – right from ‘running of the whole system on computers’ to ‘just do some sales invoicing’. It could mean ‘automating just the main ledgers’ or ‘it could mean a order processing-cum-stock control system’

Computerization of Accounts

- ❑ An increasing number of enterprises have largely shifted to computerized accounting systems
- ❑ Small businesses can buy 'off-the shelf' accounting packages
- ❑ Medium sized business opt for customized accounting packages
- ❑ Large sized companies get customized accounting programs as part of their ERP
- ❑ The disadvantages are required to be taken care before implementation of an accounting package
- ❑ A good manager is expected to overcome most of these disadvantages using his knowledge, skill, experience and position in the organization

Thank You

