

CHAPTER - 1

ACCOUNTING : AN INTRODUCTION



Unit 1

Meaning and Scope of Accounting

MEANING AND SCOPE OF ACCOUNTING

Learning Objectives :

After studying this unit, you will be able to :

- ◆ Understand the meaning and significance of accounting.
- ◆ Understand the meaning of book-keeping and the distinction of accounting with book-keeping.
- ◆ Appreciate the evolutionary process of accounting as a social science.
- ◆ Explain sub-fields of accounting.
- ◆ Identify the various user groups for whom accounting information is to be generated.
- ◆ Describe the various functions or purposes of accounting data.
- ◆ Understand the relationship of accounting with Economics, Statistics, Mathematics, Law and Management.
- ◆ Explain the limitations of accounting.
- ◆ Appreciate the enlarged boundary of accounting profession and the areas where in a chartered accountant plays an important role of rendering useful services to the society.

1. 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.'

An individual invests Rs. 2,00,000 for running a stationery business. On 1st January, he purchases goods for Rs. 1,15,000 and sells for Rs. 1,47,000 during the month of January. He pays shop rent for the month Rs. 5,000 and finds that still he has goods worth Rs. 15,000 in hand. The individual performs an economic activity. He carries on a few transactions and encounters with some events. Is it not logical that he will want to know the result of his activity?

We see that the individual, who runs the stationery business, earns a surplus of Rs. 42,000.



		Rs.
Goods sold		1,47,000
Goods in hand		<u>15,000</u>
		1,62,000
<i>Less</i> : Goods purchased	1,15,000	
Shop rent paid	<u>5,000</u>	<u>1,20,000</u>
Surplus		<u>42,000</u>

Earning of Rs. 42,000 surplus is an event; also having the stock in hand is another event, while purchase and sale of goods, investment of money and payment of rent are transactions.

Similarly, a municipal corporation got government grant Rs. 500 lakhs for adult education; it spent Rs. 250 lakhs for purchasing literacy kits, paid Rs. 200 lakhs to the tutors and is left with a balance of Rs. 50 lakhs. These are also transactions and events.

Similarly, the Central Government raised money through taxes, paid salaries to the employees, and spent on various developmental activities. Whenever receipts of the Government are more than expenses it has surplus, but if expenses are more than receipts it runs in deficit. Here raising money through various sources can be termed as transaction and surplus or deficit at the end of the accounting year can be termed as an event.

So, everybody wants to keep records of all transactions and events and to have adequate information about the economic activity as an aid to decision-making. Accounting discipline has been developed to serve this purpose as it deals with the measurement of economic activities involving inflow and outflow of economic resources, which helps to develop useful information for decision-making process.

Accounting has universal application for recording transactions and events and presenting suitable information to aid decision-making regarding any type of economic activity ranging from a family function to functions of the national government. But hereinafter we shall concentrate only on business activities and their accounting because the objective of this study material is to provide a basic understanding on accounting for business activities. Nevertheless, it will give adequate knowledge to think coherently of accounting as a field of study for universal application.

The growth of accounting discipline is closely associated with the development of the business world. Thus, to understand accounting as a field of study for universal application, it is best identified with recording of business transactions and communication of financial information about business enterprise to facilitate decision-making. The aim of accounting is to meet the information needs of the rational and sound decision-makers, and thus, called the **language of business**.

2. MEANING OF ACCOUNTING

The Committee on Terminology set up by the American Institute of Certified Public Accountants formulated the following definition of accounting in 1961:

“Accounting is the art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof.”

As per this definition, accounting is simply an art of record keeping. The process of accounting starts by first identifying the events and transactions which are of financial character and then be recorded in the books of account. This recording is done in Journal or subsidiary books, also known as primary books. Every good record keeping system includes suitable classification of transactions and events as well as their summarisation for ready reference. After the transactions and events are recorded, they are transferred to secondary books i.e. Ledger. In ledger transactions and events are classified in terms of income, expense, assets and liabilities according to their characteristics and summarised in profit & loss account and balance sheet. Essentially the transactions and events are to be measured in terms of money. Measurement in terms of money means measuring at the ruling currency of a country, for example, rupee in India, dollar in U.S.A. and like. The transactions and events must have at least in part, financial characteristics. The inauguration of a new branch of a bank is an event without having financial character, while the business disposed of by the branch is an event having financial character. Accounting also interprets the recorded, classified and summarised transactions and events.

However, the above-mentioned definition does not reflect the present day accounting function. The dimension of accounting is much broader than that described in the above definition. According to the above definition, accounting ends with interpretation of the results of the financial transactions and events but in the modern world with the diversification of management and ownership, globalisation of business and society gaining more interest in the functioning of the enterprises, the importance of communicating the accounting results has increased and therefore, this requirement of communicating and motivating informed judgement has also become the part of accounting as defined in the widely accepted definition of accounting, given by the American Accounting Association in 1966 which treated accounting as

“The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounts.”

In 1970, the Accounting Principles Board (APB) of American Institute of Certified Public Accountants (AICPA) enumerated the functions of accounting as follows:

“The function of accounting is to provide quantitative information, primarily of financial nature, about economic entities, that is needed to be useful in making economic decisions.”

Thus, accounting may be defined as the process of recording, classifying, summarising, analysing and interpreting the financial transactions and communicating the results thereof to the persons interested in such information.

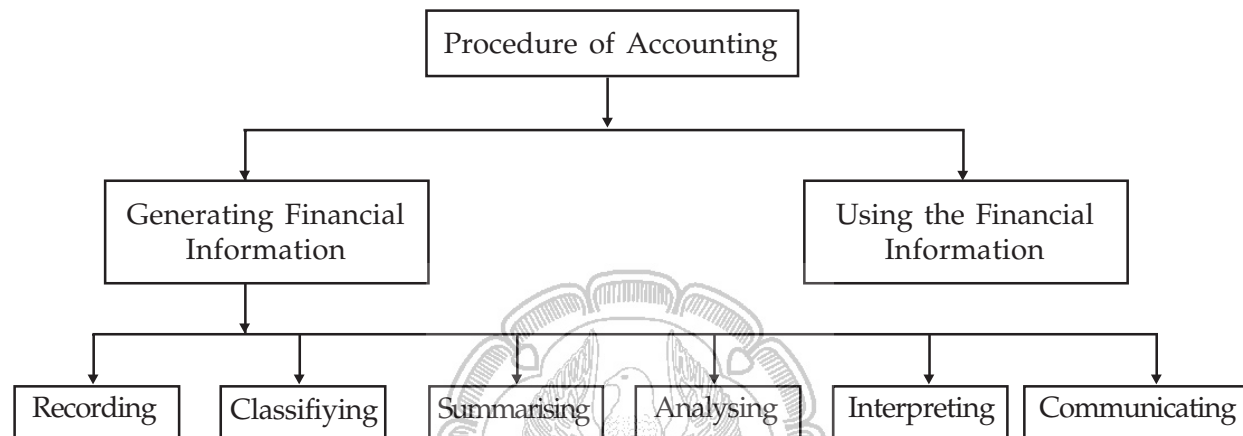


2.1 PROCEDURAL ASPECTS OF ACCOUNTING

On the basis of the above definitions, procedure of accounting can be basically divided into two parts:

- (i) Generating financial information and
- (ii) Using the financial information.

The procedural aspects of accounting can be explained with the help of the following chart :



2.1.1 Generating Financial Information

1. **Recording** – This is the basic function of accounting. All business transactions of a financial character, as evidenced by some documents such as sales bill, pass book, salary slip etc. are recorded in the books of account. Recording is done in a book called “Journal.” This book may further be divided into several subsidiary books according to the nature and size of the business. Students will learn how to prepare journal and various subsidiary books in chapter 2.
2. **Classifying** – Classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place so as to put information in compact and usable form. The book containing classified information is called “Ledger”. This book contains on different pages, individual account heads under which, all financial transactions of similar nature are collected. For example, there may be separate account heads for Salaries, Rent, Printing and Stationeries, Advertisement etc. All expenses under these heads, after being recorded in the Journal, will be classified under separate heads in the Ledger. This will help in finding out the total expenditure incurred under each of the above heads. Students will learn how to prepare ledger books in chapter 2.
3. **Summarising** – It is concerned with the preparation and presentation of the classified data in a manner useful to the internal as well as the external users of financial statements. This process leads to the preparation of the following financial statements:
 - (a) Trial Balance (b) Profit and Loss Account (c) Balance Sheet (d) Cash-flow Statement.

MEANING AND SCOPE OF ACCOUNTING

Students will learn how to prepare Trial Balance in chapter 2 and Financial Statements in chapter 6 while Cash-flow Statement will be discussed in the Integrated Professional Competence Course.

4. **Analysing** – The term ‘Analysis’ means methodical classification of the data given in the financial statements. The figures given in the financial statements will not help anyone unless they are in a simplified form. For example, all items relating to fixed assets are put at one place while all items relating to current assets are put at another place. It is concerned with the establishment of relationship between the items of the Profit and Loss Account and Balance Sheet i.e. it provides the basis for interpretation. Students will learn this aspect of financial statements in the later stages of the Chartered Accountancy Course.
5. **Interpreting** – This is the final function of accounting. It is concerned with explaining the meaning and significance of the relationship as established by the analysis of accounting data. The recorded financial data is analysed and interpreted in a manner that will enable the end-users to make a meaningful judgement about the financial condition and profitability of the business operations. The financial statement should explain not only what had happened but also why it happened and what is likely to happen under specified conditions. Students will learn this aspect of financial statements in the later stages of the Chartered Accountancy Course.
6. **Communicating** – It is concerned with the transmission of summarised, analysed and interpreted information to the end-users to enable them to make rational decisions. This is done through preparation and distribution of accounting reports, which include besides the usual profit and loss account and the balance sheet, additional information in the form of accounting ratios, graphs, diagrams, fund flow statements etc. Students will learn this aspect of financial statements in the later stages of the Chartered Accountancy Course.

The first two procedural stages of the process of generating financial information along with the preparation of trial balance are covered under book-keeping while the preparation of financial statements and its analysis, interpretation and also its communication to the various users are considered as accounting stages. Students will learn the term book-keeping and its distinction with accounting, in the coming topics of this unit.

2.1.2 Using the Financial Information

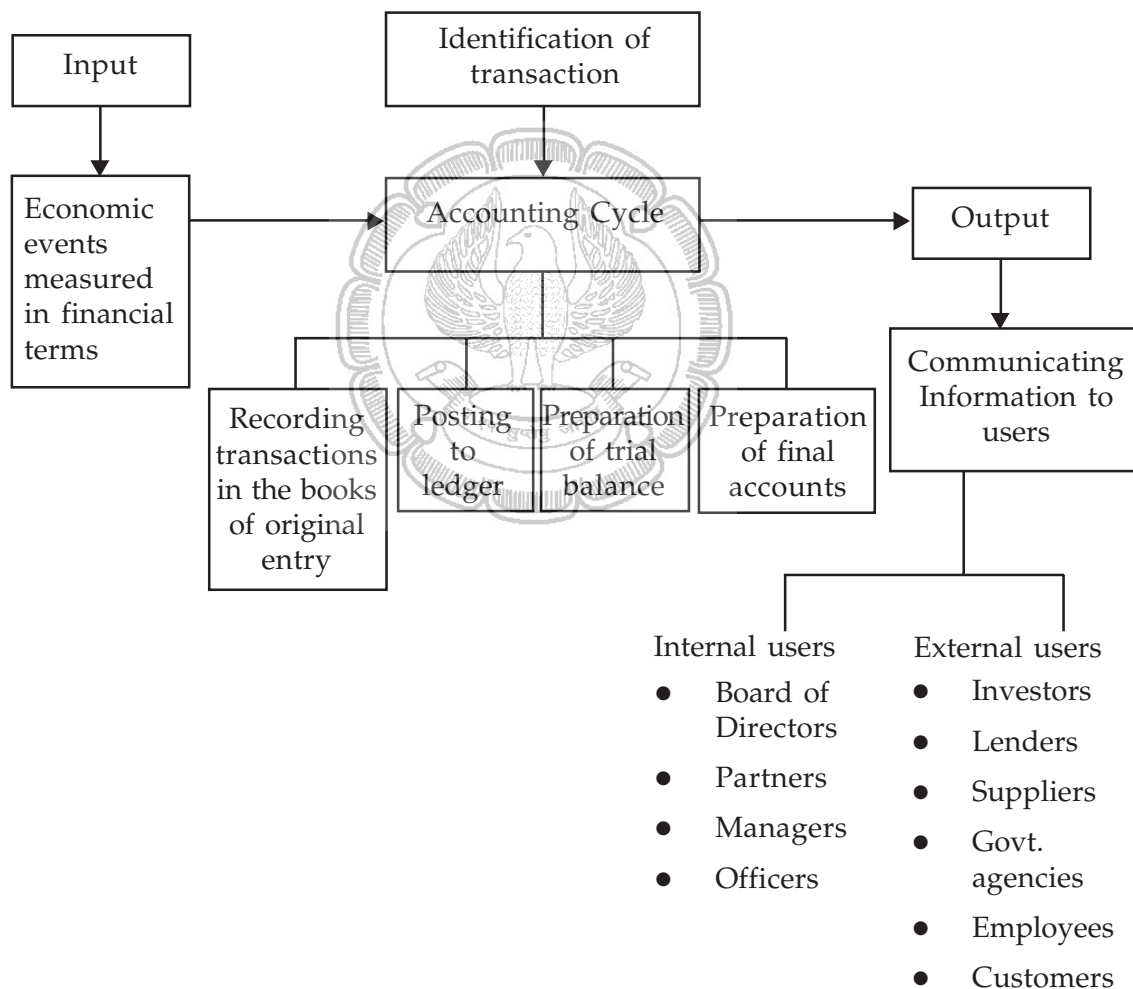
There are certain users of accounts. Earlier it was viewed that accounting is meant for the proprietor or owner of the business, but changing social relationships diluted the earlier thinking. It is now believed that besides the owner or the management of the business enterprise, users of accounts include the investors, employees, lenders, suppliers, customers, government and other agencies and the public at large. Accounting provides the art of presenting information systematically to the users of accounts. Accounting data is more useful if it stresses economic substance rather than technical form. Information is useless and meaningless unless it is relevant and material to a user’s decision. The information should also be free of any biases. The users should understand not only the financial results depicted by the accounting figures, but also should be able to assess its reliability and compare it with information about alternative opportunities and the past experience. The owners or the management of the enterprise,



commonly known as internal users, use the accounting information in an analytical manner to take the valuable decisions for the business. So the information served to them is presented in a manner different to the information presented to the external users. Even the small details which can affect the internal working of the business are given in the management report while financial statements presented to the external users contains key information regarding assets, liabilities and capital which are summarised in a logical manner that helps them in their respective decision-making. Students can study in detail about the different users of financial statements in para 9 of this chapter.

The entire procedure of accounting can be explained with the help of chart given below :

PROCESS OF ACCOUNTING



3. EVOLUTION OF ACCOUNTING AS A SOCIAL SCIENCE

In its oldest form accounting aided the stewards to discharge their stewardship function. The wealthy men employed stewards to manage their property; the stewards in turn rendered an account periodically of their stewardship. This 'Stewardship Accounting' was the root of financial accounting system. The presently followed system of double-entry book-keeping has been developed only in the 15th Century. However, historians found records of debit and credit dating back to the 12th Century. Although double-entry system was followed, 'stewardship accounting' served the purpose of businessmen and wealthy persons at that time. In India too, stewardship accounting was prevalent till the emergence of large-scale enterprises in the form of public limited companies.

In the second phase, the idea of financial accounting emerged with the concept of joint stock company and divorce of ownership from the management. To safeguard the interest of the shareholders and investors, disclosure of financial statements (mainly, profit and loss account and balance sheet) and other accounting information was moulded by law. Financial statements give periodic performance report by way of profit and loss account and financial position at the end of the period by way of Balance Sheet. It got the legal status due to changing relationships between the owners, economic entity and the managers. With the democratisation of society, the relationships between the enterprise on the one hand, the investors, employees, managers and governments on the other, have also undergone a sea-change. Also the prospective investors and other business contact groups want to know a lot about the business before entering into transactions. Thus, financial accounting emerged as an information system to identify, measure and communicate useful information for informed judgements and decisions by a broad group of users. In the third phase, accounting information was generated to aid management decision-making in particular. It contributed a lot to improve the quality of management decisions. This new dimension of accounting is called Management Accounting and it is the development of 20th Century only. It is pervasive enough to cover all spheres of management decisions.

Lastly, Social Responsibility Accounting is in the formative process, which aims at accounting for the social cost incurred by business as well as the social benefit, created by it. It emerges from the growing social awareness about the undesirable by-products of economic activities. While earning profit, an enterprise incurs numerous social costs like pollution, using the resources of society like materials, land, labour etc. To compensate for this social cost, in today's world, an enterprise is expected to generate some social benefits also like employment opportunities, recreation activities, more choice to customers at reasonable price, better quality products etc. Therefore it is demanded that the accounting system should produce a report measuring the social cost incurred and social benefits generated.

Social Science study man as a member of society; they concern about social processes and the results and consequences of social relationships. The usefulness of accounting to society as a whole is the fundamental criterion to treat it as a social science. Although individuals may benefit from the availability of accounting information, the accounting system generates information for social good. It serves social purposes, it contributes for social progress; also it is being adapted to keep pace with social progress. So, accounting is treated as a social science.



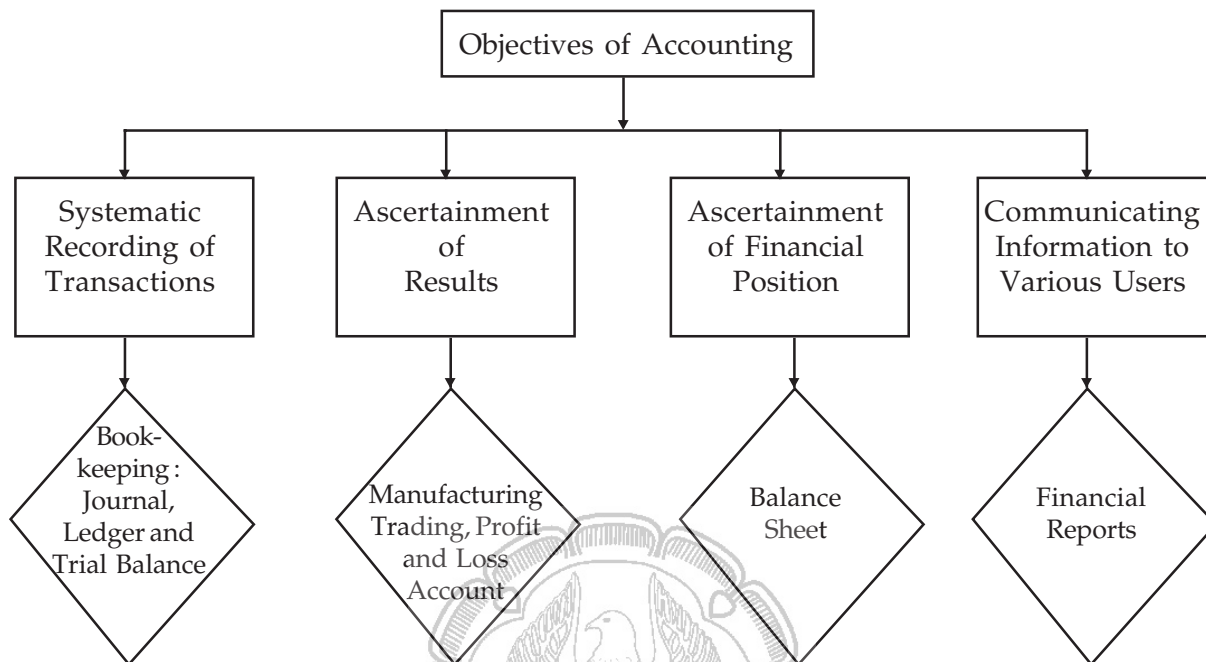
4. OBJECTIVES OF ACCOUNTING

The objectives of accounting can be given as follows:

1. **Systematic recording of transactions** – Basic objective of accounting is to systematically record the financial aspects of business transactions i.e. book-keeping. These recorded transactions are later on classified and summarised logically for the preparation of financial statements and for their analysis and interpretation.
2. **Ascertainment of results of above recorded transactions** – Accountant prepares profit and loss account to know the results of business operations for a particular period of time. If revenue exceed expenses then it is said that business is running profitably but if expenses exceed revenue then it can be said that business is running under loss. The profit and loss account helps the management and different stakeholders in taking rational decisions. For example, if business is not proved to be remunerative or profitable, the cause of such a state of affair can be investigated by the management for taking remedial steps.
3. **Ascertainment of the financial position of the business** – Businessman is not only interested in knowing the results of the business in terms of profits or loss for a particular period but is also anxious to know that what he owes (liability) to the outsiders and what he owns (assets) on a certain date. To know this, accountant prepares a financial position statement popularly known as Balance Sheet. The balance sheet is a statement of assets and liabilities of the business at a particular point of time and helps in ascertaining the financial health of the business.
4. **Providing information to the users for rational decision-making** – Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. Accounting aims to meet the information needs of the decision-makers and helps them in rational decision-making.
5. **To know the solvency position:** By preparing the balance sheet, management not only reveals what is owned and owed by the enterprise, but also it gives the information regarding concern's ability to meet its liabilities in the short run (liquidity position) and also in the long-run (solvency position) as and when they fall due.

MEANING AND SCOPE OF ACCOUNTING

An overview of objectives of accounting is depicted in the chart given below :



5. FUNCTIONS OF ACCOUNTING

The main functions of accounting are as follows:

- (a) **Measurement:** Accounting measures past performance of the business entity and depicts its current financial position.
- (b) **Forecasting:** Accounting helps in forecasting future performance and financial position of the enterprise using past data.
- (c) **Decision-making:** Accounting provides relevant information to the users of accounts to aid rational decision-making.
- (d) **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.
- (e) **Control:** Accounting also identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.
- (f) **Government Regulation and Taxation:** Accounting provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues.

6. BOOK-KEEPING

Book-keeping is an activity concerned with the recording of financial data relating to business operations in a significant and orderly manner. It covers procedural aspects of accounting



work and embraces record keeping function. Obviously book-keeping procedures are governed by the end product, the financial statements. In India, the term 'financial statements' means Profit and Loss Account and Balance Sheet including Schedules and Notes forming part of Accounts. As discussed earlier, Profit and Loss Account gives result of economic activities for a period and Balance Sheet states the financial position at the end of the period. Book-keeping also requires suitable classification of transactions and events. This is also determined with reference to the requirement of financial statements. A book-keeper may be responsible for keeping all the records of a business or only of a minor segment, such as position of the customers' accounts in a departmental store. A substantial portion of the book-keeper's work is of a clerical nature and is increasingly being accomplished through the use of a mechanical and electronic devices. Accounting is based on a careful and efficient book-keeping system.

The essential idea behind maintaining book-keeping records is to show correct position regarding each head of income and expenditure. A business may purchase goods on credit as well as in cash. When the goods are bought on credit, a record must be kept of the person to whom money is owed. The proprietor of the business may like to know, from time to time, what amount is due on credit purchase and to whom. If proper record is not maintained, it is not possible to get details of the transactions in regard to the expenses. At the end of the accounting period, the proprietor wants to know how much profit has been earned or loss has been incurred during the course of the period. For this lot of information is needed which can be gathered from a proper record of the transactions. Therefore, in book-keeping, the proper maintenance of books of account is indispensable for any business.

At CPT level, the major concern of the curriculum is with book-keeping and preparation of financial statements. It seems important to mention at this point that book-keeping and preparation of financial statements have legal implications also. Maintenance of books of accounts and the preparation of financial statements of a company are guided by the Companies Act, 1956, Co-operative society by Co-operative Societies Act, banks and insurance companies by special Acts governing these institutions and so on. However, for sole-proprietorship and partnership business, there is no specific legislation regarding maintenance of books of accounts and preparation of financial statements. However, the Income-tax Act, 1961 requires maintenance of books of accounts in some cases.

6.1 OBJECTIVES OF BOOK-KEEPING

1. **Complete Recording of Transactions** – It is concerned with complete and permanent record of all transactions in a systematic and logical manner to show its financial effect on the business.
2. **Ascertainment of Financial Effect on the Business** – It is concerned with the combined effect of all the transactions made during the accounting period upon the financial position of the business as a whole.

7. DISTINCTION BETWEEN BOOK-KEEPING AND ACCOUNTING

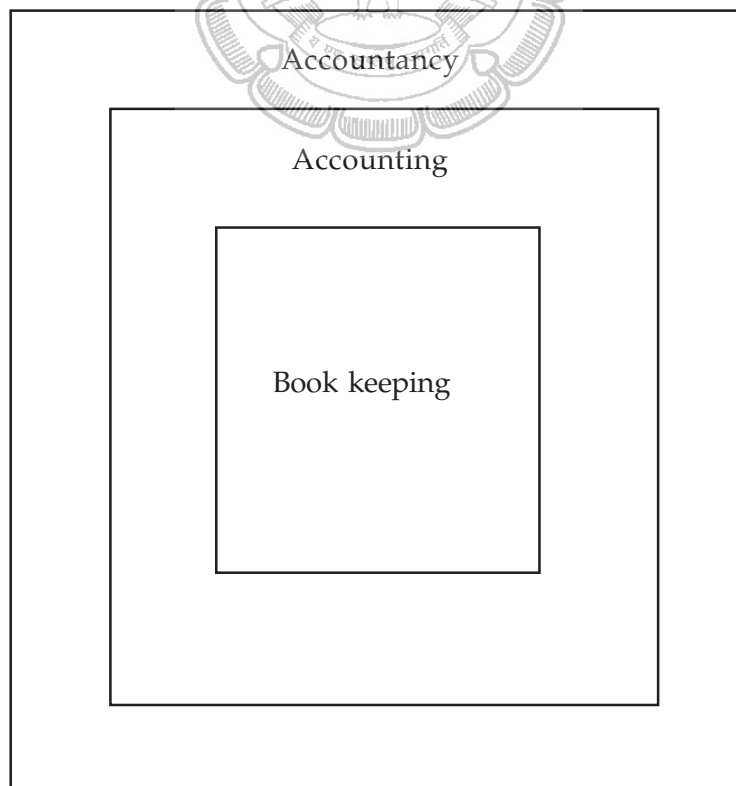
Some people mistake book-keeping and accounting to be synonymous terms, but in fact they are different from each other. Accounting is a broad subject. It calls for a greater understanding of records obtained from book-keeping and an ability to analyse and interpret the information

MEANING AND SCOPE OF ACCOUNTING

provided by book-keeping records. Book-keeping is the recording phase while accounting is concerned with the summarising phase of an accounting system. Book-keeping provides necessary data for accounting and accounting starts where book-keeping ends.

S.No.	Book-keeping	Accounting
1.	It is a process concerned with recording of transactions.	It is a process concerned with summarising of the recorded transactions.
2.	It constitutes as a base for accounting.	It is considered as a language of the business.
3.	Financial statements do not form part of this process.	Financial statements are prepared in this process on the basis of book-keeping records.
4.	Managerial decisions cannot be taken with the help of these records.	Management takes decisions on the basis of these records.
5.	There is no sub-field of book-keeping.	It has several sub-fields like financial accounting, management accounting etc.
6.	Financial position of the business cannot be ascertained through book-keeping records.	Financial position of the business is ascertained on the basis of the accounting reports.

Relationship of Accounting and Book-keeping can be depicted in the following chart as :





8. SUB-FIELDS OF ACCOUNTING

The various sub-fields of accounting are:

- (i) **Financial Accounting** – It covers the preparation and interpretation of financial statements and communication to the users of accounts. It is historical in nature as it records transactions which had already been occurred. The final step of financial accounting is the preparation of Profit and Loss Account and the Balance Sheet. It primarily helps in determination of the net result for an accounting period and the financial position as on the given date.
- (ii) **Management Accounting** – It is concerned with internal reporting to the managers of a business unit. To discharge the functions of stewardship, planning, control and decision-making, the management needs variety of information. The different ways of grouping information and preparing reports as desired by managers for discharging their functions are referred to as management accounting. A very important component of the management accounting is cost accounting which deals with cost ascertainment and cost control.

Management Accounting will be dealt with at Final level of the Chartered Accountancy Course.

- (iii) **Cost Accounting** – The terminology of Cost Accounting published by the Institute of Cost and Management Accountants of England defines cost accounting as:

“the process of accounting for cost which begins with the recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs.”

Cost Accounting will be covered at Integrated Professional Competence Course and Final Course of the Chartered Accountancy Curriculum.

- (iv) **Social Responsibility Accounting** – The demand for social responsibility accounting stems from increasing social awareness about the undesirable by-products of economic activities. As already discussed earlier, social responsibility accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created.
- (v) **Human Resource Accounting** – Human resource accounting is an attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice.

Human Resource Accounting will be discussed in the curriculum of Final level of the Chartered Accountancy Course.

9. USERS OF ACCOUNTING INFORMATION

Generally users of accounts are classified into two categories, (a) internal management and owners; and (b) external users or outsiders. Management accounting is concerned with

MEANING AND SCOPE OF ACCOUNTING

identifying information requirements as well as methods of providing such information to management while information requirements of the outside users are generally served by financial statements. Following are the various users of accounting information:

- (i) **Investors:** They provide risk capital to the business. They need information to assess whether to buy, hold or sell their investment. Also they are interested to know the ability of the business to survive, prosper and to pay dividend. In non-corporate sector, where ownership and management are not essentially separated, the owners still need information about performance of the business and its financial position to decide whether to continue or shut down.
- (ii) **Employees:** Growth of the employees is directly related to the growth of the organisation and therefore, they are interested to know the stability, continuity and growth of the enterprise and its ability to provide remuneration, retirement and other benefits and to enhance employment opportunities.
- (iii) **Lenders:** They are interested to know whether their loan-principal and interest will be paid when due.
- (iv) **Suppliers and Creditors:** They are also interested to know the ability of the enterprise to pay their dues, that helps them to decide the credit policy for the relevant concern, rates to be charged and so on. Sometimes, they also become interested in long-term continuation of the enterprise if their existence becomes dependent on the survival of that business. Suppose, small ancillary units supply their products to a big enterprise, if the big enterprise collapses, the fate of the small units also becomes sealed.
- (v) **Customers:** Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent on the supply of goods, suppose, a company produces some chemicals used by pharmaceutical companies and supplies chemicals on three month's credit. If all of a sudden it faces some trouble and is unable to supply the chemical, the customers will also be in trouble.
- (vi) **Government and their agencies:** They regulate the functioning of business enterprises for public good, allocate scarce resources among competing enterprises, control prices, charge excise duties and taxes, and so they have continued interest in the business enterprise.
- (vii) **Public:** The public at large is interested in the functioning of the enterprise because it may make a substantial contribution to the local economy in many ways including the number of people employed and their patronage to local suppliers.

Management as whole is also interested in the accounts for various managerial decisions. On the basis of the accounts, management determines the effects of their various decisions on the functioning of the organisation. This helps them to make further managerial decisions.

10. RELATIONSHIP OF ACCOUNTING WITH OTHER DISCIPLINES

Accounting is closely related with several other disciplines and thus to acquire a good knowledge in accounting one should be conversant with the relevant portions of such disciplines. In many cases they overlap accounting. The Accountant should have a working knowledge of the related



disciplines so that he can understand such overlapping areas and apply the knowledge of other disciplines in his own work wherever possible, or he can take the expert advice.

- (a) **Accounting and Economics:** Economics is viewed as a science of rational decision-making about the use of scarce resources. It is concerned with the analysis of efficient use of scarce resources for satisfying human wants. This may be viewed either from the perspective of a single firm or of the country as a whole.

Accounting is viewed as a system, which provides data to the users to permit informed judgement and decisions. Some non-accounting data are also relevant for decision-making. Still, accounting provides a major database.

Accounting overlaps economics in many respects. It contributed a lot in improving the management decision-making process. But, economic theories influenced the development of the decision-making tools used in accounting.

However, there exists a wide gulf between economists' and accountants' concepts of income and capital. Accountants got the ideas of value, income and capital maintenance from economists, but brushed suitably to make them usable in practical circumstances. Accountants developed the valuation, measurement and decision-making techniques which may owe to the economic theorems for origin but these are moulded in the work environment and suitably tempered with reference to relevance, verifiability, freedom from bias, timeliness, comparability, reliability and understandability.

An example may be given to explain the nexus between accounting and economics. Economists think that value of an asset is the present value of all future earnings which can be derived from such assets. Now think about a plant whose working life is more than one hundred years. How can you estimate future stream of earnings? So accountants developed the workable valuation base – the acquisition cost i.e., the price paid to acquire the assets.

At the macro-level, accounting provides the database over which the economic decision models have been developed; micro-level data arranged by the accounting system is summed up to get macro-level database.

Non-overlapping zones of accounting are not negligible. Development of the systems of recording, classifying and summarising transactions and events, harmonising the systems by uniform rules and communicating the data is essentially a non-overlapping area of accounting.

- (b) **Accounting and Statistics:** The use of statistics in accounting can be appreciated better in the context of the nature of accounting records. Accounting information is very precise; it is exact to the last paisa. But, for decision-making purposes such precision is not necessary and hence, the statistical approximations are sought.

In accounts, all values are important individually because they relate to business transactions. As against this, statistics is concerned with the typical value, behaviour or trend over a period of time or the degree of variation over a series of observations. Therefore, wherever a need arises for only broad generalisations or the average of relationships, statistical methods have to be applied in accounting data.

Further, in accountancy, the classification of assets and liabilities as well as the heads of income and expenditure has been done as per the needs of financial recording to ascertain financial results of various operations. Other types of classification like the geographical and historical ones and ad hoc classification are done depending on the purpose to make such classification meaningful.

Accounting records generally take a short-term view of events and are confined to a year while statistical analysis is more useful if a longer view is taken for the purpose. For example, to fit the trend line a longer period will be required. However, statistical methods do use past accounting records maintained on a consistent basis.

Accounting records are based on historical costs of fixed assets, while the current assets are valued at the current values. This creates some anomalous situations when prices are not stable over a period of time. The new methods of inflation accounting are an attempt to correct this situation. The correction of values is made on the basis of the current purchasing power of money or the current value of the concerned assets revalued from the data of purchase till the day of recording, charging depreciation on the current value, so that the present value of the asset is in line with the current value of money. All this would require the use of price indices or the price deflators, which are based on statistical calculations of price changes.

The functional relations showing mathematical relations of one variable with one or more other variables are based on statistical work. These relations are used widely in making cost or price estimates for some estimated future values assigned to the given independent variables. For example, given the functional relation of total cost to the price of an input, the effect of changes in future prices on the cost of production can be calculated.

In accountancy, a number of financial and other ratios are based on statistical methods, which help in averaging them over a period of time. Several accounting and financial calculations are based on statistical formulae.

Statistical methods are helpful in developing accounting data and in their interpretation. For example, time series and cross-sectional comparison of accounting data is based on statistical techniques. Now-a-days multiple discriminant analysis is popularly used to identify symptoms of sickness of a business firm. Therefore, the study and application of statistical methods would add extra edge to the accounting data.

- (c) **Accounting and Mathematics:** Double Entry book-keeping can be converted in algebraic form; in fact the first known book on this subject was part of a treatise on algebra. The fundamental accounting equation will be discussed in detail under 'Dual Aspect Concept' of this chapter.

Knowledge of arithmetic and algebra is a pre-requisite for accounting computations and measurements. Calculations of interest and annuity are the examples of such fundamental uses. While computing depreciation, finding out installments in hire-purchase and instalments payment transactions, calculating amount to be set aside for repayment of loan and replacement of assets and calculating lease rentals, mathematical techniques are frequently used. Accounting data are also presented in ratio form.



With the advent of the computer, mathematics is becoming a vital part of accounting. Instead of writing accounts in traditional fashion, the transactions and events can be recorded in the matrix form and the rules of matrix algebra can be applied for classifying and summarising data.

Now-a-days statistics and econometric models are largely used for developing decision models for the users of accounts. Also, Operations Research Techniques provide lot of decision models. Since accounting is meant for providing information to the users, to be effective, accounting data should feed the information requirements of such statistical, econometric and operations research models. Understanding mathematics has become a must to grasp the decision models framed by statisticians, econometricians and the O.R. experts.

Presently graphs and charts are being extensively used for communicating accounting information. In addition to statistical knowledge, knowledge in geometry and trigonometry seems to be essential to have a better understanding about the accounting communications system.

- (d) **Accounting and Law:** An economic entity operates within a legal environment. All transactions with suppliers and customers are governed by the Contract Act, the Sale of Goods Act, the Negotiable Instruments Act, etc. The entity itself is created and controlled by laws. For example, a partnership business is controlled by Partnership Act. A company is created by the Companies Act and also controlled by Companies Act.

Similarly, every country has a set of economic, fiscal and labour laws. Transactions and events are always guided by laws of the land. Very often the accounting system to be followed has been prescribed by the law. For example, the Companies Act has prescribed the format of financial statements.

Banking, insurance and electric supply undertakings also have to produce financial statements as prescribed by the respective legislations controlling such entities.

However, legal prescription about the accounting system is the product of developments in accounting knowledge. That is to say, legislation about accounting system cannot be enacted unless there is a corresponding development in the accounting discipline. In that way accounting influences law and is also influenced by law.

- (e) **Accounting and Management:** Management is a broad occupational field, which comprises many functions and encompasses application of many disciplines including those mentioned above. Accountants are well placed in the management and play a key role in the management team. A large portion of accounting information is prepared for management decision-making. Although management relies on other data sources, accounting data are used as basic source documents. In the management team, an accountant is in a better position to understand and use such data. In other words, since an accountant plays an active role in management, he understands the data requirements. So the accounting system can be moulded to serve the management purpose.

11. LIMITATIONS OF ACCOUNTING

There are certain misconceptions regarding financial statements. A common man presumes that an income statement shows the correct income or loss of the enterprise and that a balance sheet depicts a perfectly true and fair picture of financial standing of that enterprise. It must be recognised that the accounting as a language has its own limitations. The figures of profit or loss generated by the accounting process are subject to various constraints within which the accounting works. The assumptions and conventions, on which the accounting is based, become the limitations of accounting. The financial statements are never free from subjectivity factor as these are largely the outcome of personal judgement of the accountant with regard to the adoption of the accounting policies. Following are certain instances :

1. The factors which may be relevant in assessing the worth of the enterprise don't find place in the accounts as they cannot be measured in terms of money. The Balance sheet cannot reflect the value of certain factors like loyalty and skill of the personnel which may be the most valuable asset of an enterprise these days.
2. Balance Sheet shows the position of the business on the day of its preparation and not on the future date while the users of the accounts are interested in knowing the position of the business in the near future and also in long run and not for the past date. Business dynamics change within the time, annual reports reach to the ultimate users. To resolve this, auditors disclose the events occurring after the balance sheet date but before approval of financial statements in the financial reports.
3. Though with the emergence of some accounting standards like AS 11, AS 26, AS 28 etc., market/fair value of assets is taken into consideration but still there remains some subjectivity. Accounting ignores changes in some money factors like inflation etc.
4. There are occasions when accounting principles conflict with each other.
5. Certain accounting estimates depend on the sheer personal judgement of the accountant, e.g., provision for doubtful debts, method of depreciation adopted, recording certain expenditure as revenue expenditure or capital expenditure, selection of method of valuation of stock-in-hand and the list is quite long.
6. Financial statements only consider those assets which can be expressed in monetary terms. Human resources although the very important asset of the enterprise are not shown in the balance sheet. There is no generally accepted formula for the valuation of human resources in money terms.
7. Different accounting policies for the treatment of same item adds to the probability of manipulations. Though through various laws and Accounting Standards, efforts are made to reduce these options to minimum but certainly could not be reduced to one.

In nutshell, it can be said that the language of accounting has certain practical limitations and, therefore, the financial statements should be interpreted carefully keeping in mind all various factors influencing the true picture.



12. ROLE OF ACCOUNTANT IN THE SOCIETY

There are only a few types of profession in the world which are held in high esteem in public eyes and there is no denying the fact that the accounting profession is one of them. Goethe had called the accountant's profession as 'the fairest invention of the human mind'. At the core of all types of learned profession, there is the desire of public good and of finding the best way to serve society. By the use of the science of accountancy and under the spell of its art, a dynamic pattern which assists business in planning its future is woven by accountants out of the inert mass of non-speaking silent figures. This is what makes their profession an instrument of socio-economic change and welfare of the society.

An accountant with his education, training, analytical mind and experience is best qualified to provide multiple need-based services to the ever growing society. The accountants of today can do full justice not only to matters relating to taxation, costing, management accounting, financial lay-out, company legislation and procedures but they can delve deep into the fields relating to financial policies, budgetary policies and even economic principles. The area of activities which can be undertaken by the accountants is not limited but it can also cover many additional facets.

12.1 AREAS OF SERVICE

The practice of accountancy has crossed its usual domain of preparation of financial statements, interpretation of such statements and audit thereof. Accountants are presently taking active role in company laws and other corporate legislation matters, in taxation laws matters (both direct and indirect) and in general management problems. Some of the services rendered by accountants to the society are briefly mentioned hereunder:

12.1.1 Maintenance of Books of Accounts : An accountant is able to maintain a systematic record of financial transactions in order to establish the net result of the transactions entered into during a period and to state the financial position of the concern as at a particular date.

For the fulfillment of the twin objective of ascertaining the profit earned or loss suffered and the financial position, it is necessary that all transactions be recorded in a systematic manner, which can be done only by an accountant. Proper maintenance of books of accounts assists management in planning, decision-making, controlling functions.

12.1.2 Statutory Audit : Every limited company is required to appoint a chartered accountant as an auditor who is statutorily required to report each year whether in his opinion the balance sheet shows a true and fair view of the state of affairs on the balance sheet date, and the profit and loss account shows a true and fair view of the profit or loss for the year.

Auditing is not confined to the accounts of companies; other organisations may also have their accounts audited, either because the law so requires (for example, the Co-operative Societies Act, the Income-tax Act, etc.) or because the proprietors wisely decided so (for example, a partnership firm or an individual trader).

12.1.3 Internal Audit : It is a management tool whereby an internal auditor thoroughly examines the accounting transactions and also the system, according to which these have been recorded with a view to ensure the management that the accounts are being properly maintained and the system contains adequate safeguards to check any leakage of revenue or

misappropriation of property or assets and the operations have been carried out in conformity with the plans of management.

Now-a-days internal auditing has developed as a service to management. The internal auditor constructively contributes in improving the operational efficiency of the business through an independent review and appraisal of all business operations.

12.1.4 Taxation : An accountant can handle taxation matters of a business or a person and he can represent that business or person before the tax authorities and settle the tax liability under the statute prevailing. He can also assist in avoiding or reducing tax burden by proper planning of tax affairs.

Accountants also have a social obligation to express their views on broad tax policy, on the effect of tax rate on business and the economy in general and on all other aspects of taxation in which they have knowledge superior to that of the general public.

12.1.5 Management Accounting and Consultancy Services : Management accountant performs an advisory function. He is largely responsible for internal reporting to the management for planning and controlling current operations, decision-making on special matters and for formulating long-range plans. His job is to collect, analyse, interpret and present all accounting information which is useful to the management. Accountant provides management consultancy services in the areas of management information system, expenditure control and evaluation of appraisal techniques for new investments and divestments, working capital management, corporate planning etc.

12.1.6 Financial Advice : Many people need help and guidance in planning their personal financial affairs. An accountant who knows about finances, taxation and family problems is well placed to give such advice. Some of the areas in which an accountant can render financial advice are:

- (a) **Investments:** An accountant can explain the significance of the formidable documents which shareholders receive from companies and help in making decisions relating to their investments.
- (b) **Insurance:** An accountant can provide information to his clients on various insurance policies and helps in choosing appropriate policy.
- (c) **Business Expansion:** As businesses grow in size and complexity and mergers are being considered, accountants are in the forefront in interpreting accounts, making suggestions as to the form of schemes and the fairness of proposals considering cost and financial consequences and generally advising their clients. They also advise on how to set about the problem of borrowing money or whether this is an appropriate method of finance. Accountants can render extremely useful service in connection of negotiations with foreign collaborators.
- (d) **Investigations:** Financial investigations are required for a variety of purposes. Examples are:
 - (i) To ascertain the financial position of a business, for the information of interested parties in connection with an issue of capital, the purchase or sale of the business or a reconstruction or amalgamation.



- (ii) To help the management to decide whether it is cheaper to manufacture an article or to buy out.
- (iii) To ascertain why profits have fallen.
- (iv) To achieve greater efficiency in management.
- (v) To ascertain whether fraud has occurred and if so, its nature and extent and to make suggestions which will help to prevent a recurrence.
- (vi) To value businesses and shares in private companies for purposes such as purchase, sale, estate duty or wealth tax etc.

For such problems requiring financial investigation, you need an accountant. His task as an independent professional is to establish the facts fairly and clearly for the benefit of those who have to make decisions and to give advice in many areas in which he has competence and experience.

- (e) Pension schemes: Specialist advice from actuaries, insurance agents or insurance company is needed before launching or amending a provident fund or pension scheme in a business. But before making a final decision, an accountant has to be consulted. Later on his help may be needed for managing the scheme or obtaining tax relief.

12.1.7 Other Services

- (a) *Secretarial Work* : Companies, clubs, and associations indeed, virtually all organisations involve secretarial work. Accountants frequently do this work.
- (b) *Share Registration Work* : Accountants are often used by many companies to undertake the work involved in registering share transfers and new issues.
- (c) *Company Formation* : In conjunction with legal advisers, accountants help in the formation of a company or advise against doing so.
- (d) *Receiverships, Liquidations, etc.* : An unpleasant subject. But someone has to take on the onerous duties of liquidator when a company is being wound up or receiver when a debenture holder exercises a right to recover a loan on which the borrower has defaulted. Accountant is just the man for the job. He is also just the man to help you to keep insolvency away if you consult him in time.
- (e) *Arbitrations* : At times, accountants are invited by parties to act as arbitrators in a dispute or settle disputes of various kinds.
- (f) *As Regards the Cost Accounts* : A cost accountant's job is to continuously report cost data and related information at frequent intervals to the management.
- (g) *Accountant and Information Services* : An accountant will be effective in his role if he supplies the information promptly and in an unambiguous language. He should develop a system by which there is a regular flow of information both horizontally and vertically.

The information system should be such that comparability of financial statement is possible both business-wise and year-wise so that it benefits both the management and the investors. Dependence on data from the computerised information system will put new responsibilities on an accountant but his product will command greater attention and respect.

12.2 CHARTERED ACCOUNTANT IN INDUSTRY

An accountant, though he is a part of the highest planning team is not a planner in an industry. He works with the functional departments and translates the organisation's aims in terms of financial expectations. Therefore, he has to make a thorough study of the business and of individuals in the functional departments, whether they are engineers or salesmen. A qualified accountant will be able to play an important role in performing important functions of a business relating to accounting, costing and budgetary control, estimating and treasury.

12.3 CHARTERED ACCOUNTANT IN PUBLIC SECTOR ENTERPRISES

Both in the developed and developing countries, public sector enterprises have become a special feature of the national economy. The system of financial and budgetary control and of accounting, auditing and reporting has, therefore, become a matter of interest and concern to the nation, and does not remain confined merely to a limited number of shareholders. The form of accounting followed by these corporations or companies is different from that of ordinary government accounting. It is the duty of the accountants to prepare the accounts and reports of these public corporations in such a way that they enable the general public to know how far the items appearing in the various types of records and financial statements justify their existence.

12.4 CHARTERED ACCOUNTANT IN FRAMING FISCAL POLICIES

Accountants have a positive role to play in the determination of proper fiscal policies and advancement of trade, commerce and industry. They should develop new techniques and prepare themselves for new fields of service towards their commitment to the concept of the public good and service. A business enterprise can be successful in the commercial sense only if accounting and business knowledge are pooled together. It is a social obligation for both accountants in industry and in practice to disclose greater information regarding the corporate results. The state of affairs of the economy can be ascertained only when such consolidated corporate information is disclosed.

12.5 CHARTERED ACCOUNTANT AND ECONOMIC GROWTH

In the present times accountants should conceive their duties as broadly as the conditions might require and do not restrict them to only literal compliance of the law. Their aim should be not to allow any individual to gain at the cost of the nation. Accountants have to accept a positive role and do their best to encourage efficiency in individual business units and encourage those social objectives which form the main foundation of a welfare state.

SELF EXAMINATION QUESTIONS

Pick up the correct answer from the given choices:

- Which of the following is not a subfield of accounting?
 - Management accounting.
 - Cost accounting.
 - Financial accounting.
 - Book-keeping.
- Purposes of an accounting system include all the following except
 - Interpret and record the effects of business transaction.



- (b) Classify the effects of transactions to facilitate the preparation of reports.
- (c) Summarize and communicate information to decision makers.
- (d) Dictate the specific types of business enterprise transactions that the enterprises may engage in.
3. Book-keeping 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.
- (d) None of the above.
4. All of the following are functions of Accounting except
- (a) Decision making. (b) Measurement.
- (c) Forecasting. (d) Ledger posting.
5. Financial statements are part of
- (a) Accounting. (b) Book-keeping.
- (c) All of the above. (d) None of the above.
6. Financial position of the business is ascertained on the basis of
- (a) Records prepared under book-keeping process.
- (b) Trial balance.
- (c) Accounting reports.
- (d) None of the above.
7. Users of accounting information include
- (a) Creditors. (b) Lenders.
- (c) Customers. (d) All of the above.
8. Financial statements do not consider
- (a) Assets expressed in monetary terms.
- (b) Liabilities expressed in monetary terms.
- (c) Only assets expressed in non-monetary terms.
- (d) Assets and liabilities expressed in non-monetary terms
9. On January 1, Sohan paid rent of Rs. 5,000. This can be classified as
- (a) An event. (b) A transaction.
- (c) A transaction as well as an event. (d) Neither a transaction nor an event.

MEANING AND SCOPE OF ACCOUNTING

10. On March 31, 2006 after sale of goods worth Rs. 2,000, he is left with the closing stock of Rs. 10,000. This is

- (a) An event. (b) A transaction.
(c) A transaction as well as an event. (d) Neither a transaction nor an event.

[Ans. 1. (d), 2. (d) , 3. (a), 4. (d), 5. (a), 6. (c), 7. (d), 8. (d), 9. (b), 10. (a)]



CHAPTER - 1

ACCOUNTING : AN INTRODUCTION



Unit 2

Accounting Concepts, Principles and Conventions

Learning Objectives

After studying this unit, you will be able to :

- ◆ Grasp the basic accounting concepts, principles and conventions and observe their implications while recording transactions and events.
 - ◆ Identify the three fundamental accounting assumptions:
 - Going Concern
 - Consistency
 - Accrual
- If these assumptions are followed, no disclosure is essential. If these are not followed specific disclosure is essential to highlight the deviations.
- ◆ Understand the qualitative characteristics that will help to develop the skill in course of time to prepare financial statements.

1. INTRODUCTION

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

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

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



2. ACCOUNTING CONCEPTS

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

3. ACCOUNTING PRINCIPLES

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

Accounting principles must satisfy the following conditions:

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

4. ACCOUNTING CONVENTIONS

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

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

5. CONCEPTS, PRINCIPLES AND CONVENTIONS - AN OVERVIEW

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

(a) **Entity concept** : Entity concept states that business enterprise is a separate identity apart from its owner. Accountants should treat a business as distinct from its owner. Business transactions are recorded in the business books of accounts and owner’s transactions in his personal books of accounts. The practice of distinguishing the affairs of the business from the

personal affairs of the owners originated only in the early days of the double-entry book-keeping. This concept helps in keeping business affairs free from the influence of the personal affairs of the owner. This basic concept is applied to all the organizations whether sole proprietorship or partnership or corporate entities.

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

Example: Mr. X started business investing Rs. 7,00,000 with which he purchased machinery for Rs. 5,00,000 and maintained the balance in hand. The financial position of the business (which is shown by Balance Sheet) will be as follows:

Balance Sheet

<i>Liability</i>	Rs.	<i>Assets</i>	Rs.
Capital	7,00,000	Machinery	5,00,000
		Cash	2,00,000
	<u>7,00,000</u>		<u>7,00,000</u>

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

Balance Sheet

<i>Liability</i>		Rs.	<i>Assets</i>	Rs.
Capital	7,00,000		Machinery	5,00,000
Less : Drawings	5,000	6,95,000	Cash	1,95,000
		<u>6,95,000</u>		<u>6,95,000</u>

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



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

These are not amenable to even arithmetic treatment. So transactions are to be recorded at uniform monetary unit i.e. in one currency. Suppose EURO 1 = Rs. 55.

Total Sales = Rs. 50 lakhs plus 55 lakhs = Rs. 105 lakhs. Money Measurement Concept imparts the essential flexibility for measurement and interpretation of accounting data.

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

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

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

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

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

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

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

Thus, the periodicity concept facilitates in :

- (i) Comparing of financial statements of different periods
- (ii) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business
- (iii) Matching periodic revenues with expenses for getting correct results of the business operations

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

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

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

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

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

In the first example, Mr. X spent Rs. 50,000 to buy the merchandise; it is the expense of generating revenue of Rs. 60,000. In the second instance Rs. 16,00,000 are the expenses. Also whenever any asset is used it has a finite life to generate benefit. Suppose, the machine purchased by Mr. A in the third example will last for 10 years only. Then Rs. 10,000 is the expense he met. For the time being, ignore the idea of accounting period.

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

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

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

As per Accrual Concept : Revenue – Expenses = Profit

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



Alternative as per Cash basis

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

Revenue may not be realised in cash. Cash may be received simultaneously or

- (i) before revenues is created (A. 1)
- (ii) after revenue is created (A. 2)

Expenses may not be paid in cash. Cash may be paid simultaneously or (i) before expense is made (B. 1) (ii) after expense is made (B. 2)

A. 1 creates a liability when cash is received in advance. A. 2 creates an asset called Receivables or Trade Debtors. B. 1 creates an asset called Trade Advance when cash is paid in advance while B. 2 creates a liability called payables or Trade Creditors or outstanding liabilities. If the expenses remain unpaid in respect of goods, it is called Trade creditors, if it remains unpaid for other expenses, it is called Expense Creditors.

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

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

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

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

Mr. P K started cloth business. He purchased 10,000 pcs. garments @ Rs. 100 per piece and sold 8,000 pcs. @ Rs. 150 per piece during the accounting period of 12 months Ist January to 31st December, 2005. He paid shop rent @ Rs. 3,000 per month for 11 months and paid Rs. 8,00,000 to the suppliers of garments and received Rs. 10,00,000 from the customers.

Let us see how the accrual and periodicity concepts operate.

Periodicity Concept fixes up the time-frame for which the performance is to be measured and financial position is to be appraised. Here, it is January 2005-December, 2005. So revenues and expenses are to be measured for the year 2005 and assets and liabilities are to be ascertained as on 31st December, 2005.

Accrual Concept operates to measure revenue of Rs. 12,00,000 (arising out of sale of garments 8,000 Pcs × Rs. 150) which accrued during 2005, not the cash received Rs. 10,00,000 and also the expenses correctly. Shop rent for 12 months is an expense item amounting to Rs. 36,000, not Rs. 33,000 the cash paid.

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

Revenue – Expenses = Profit

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

Periodic Profit = Periodic Revenue – Matched Expenses

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

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

Thus, Profit = Revenue Rs. 12,00,000

Less : Expenses:

Merchandise	Rs. 8,00,000	
Shop Rent	Rs. 36,000	Rs. 8,36,000
		Rs. 3,64,000

Assets

Stock (2,000 pcs × Rs. 100)	Rs. 2,00,000
Debtors	Rs. 2,00,000
Cash (Cash Receipts Rs. 10,00,000 – cash payments Rs. 8,33,000)	Rs. 1,67,000
	Rs. 5,67,000

Liabilities :

Trade Creditors	Rs. 2,00,000
Expense Creditors	Rs. 3,000
Capital (for Profit)	Rs. 3,64,000
	Rs. 5,67,000

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

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

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



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

Balance Sheet

<i>Liability</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital	7,00,000	Machinery	5,70,000
		Cash	1,30,000
	<u>7,00,000</u>		<u>7,00,000</u>

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

(g) Cost concept : By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. Although there are various measurement bases, accountants traditionally prefer this concept in the interests of objectivity. When a machine is acquired by paying Rs. 5,00,000, following cost concept the value of the machine is taken as Rs. 5,00,000. It is highly objective and free from all bias. Other measurement bases are not so objective. Current cost of an asset is not easily determinable. If the asset is purchased on 1.1.82 and such model is not available in the market, it becomes difficult to determine which model is the appropriate equivalent to the existing one. Similarly, unless the machine is actually sold, realisable value will give only a hypothetical figure. Lastly, present value base is highly subjective because to know the value of the asset one has to chase the uncertain future.

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

- In an inflationary situation when prices of all commodities go up on an average, acquisition cost loses its relevance. For example, a piece of land purchased on 1.1.82 for Rs. 2,000 may cost Rs. 1,00,000 as on 1.1.2006. So if the accountant makes valuation of asset at historical cost, the accounts will not reflect the true position.
- Historical cost-based accounts may lose comparability. Mr. X invested Rs. 1,00,000 in a machine on 1.1.82 which produces Rs. 50,000 cash inflow during the year 2006, while Mr. Y invested Rs. 5,00,000 in a machine on 1.1.92 which produced Rs. 50,000 cash inflows during the year. Mr. X earned at the rate 20% while Mr. Y earned at the rate 10%. Who is more-efficient ? Since the assets are recorded at the historical cost, the results are not comparable. Obviously it is a corollary to (a).
- Many assets do not have acquisition costs. Human assets of an enterprise are an example. The cost concept fails to recognise such asset although it is a very important asset of any organization.

Many other controversial issues have arisen in financial accounting that revolves around the cost concept which will be discussed at the advanced stage. However, later on we shall see

that in many circumstances, the cost convention is not followed. See conservatism concept for an example, which will be discussed later on in this unit.

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

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

Example : Mr. X purchased a piece of land on 1.1.82 paying Rs. 2,000. Its current market value is Rs. 1,02,000 on 31.12.2006. Should the accountant show the land at Rs. 2000 following cost concept and ignoring Rs. 1,00,000 value increase since it is not realised? If he does so, the financial position would be :

Balance Sheet			
<i>Liability</i>	Rs.	<i>Asset</i>	Rs.
Capital	2,000	Land	2,000
	<u>2,000</u>		<u>2,000</u>

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

Balance Sheet			
<i>Liabilities</i>	Rs.	<i>Asset</i>	Rs.
Capital	2,000	Land	1,02,000
Unrealised Gain	1,00,000		
	<u>1,02,000</u>		<u>1,02,000</u>

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

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

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

- (1) It increases one Asset and decreases other Asset;
- (2) It increases an Asset and simultaneously increases Liability;
- (3) It decreases one Asset, increases another Asset;
- (4) It decreases one Asset, decreases a Liability.



Alternatively:

- (5) It increases one Liability, decreases other Liability;
- (6) It increases a Liability, increases an Asset;
- (7) It decreases Liability, increases other Liability;
- (8) It decreases Liability, decreases an Asset.

Example :

Balance Sheet

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital	1,50,000	Machinery	2,00,000
Bank Loan	75,000	Cash	1,00,000
Other Loan	75,000		
	<u>3,00,000</u>		<u>3,00,000</u>

Transactions :

- (a) A new machine is purchased paying Rs. 50,000 in cash
- (b) A new machine is purchased for Rs. 50,000 on credit, cash is to be paid later on
- (c) Cash paid to repay bank loan to the extent of Rs. 50,000
- (d) Raised bank loan of Rs. 50,000 to pay off other loan

Effect of the Transactions :

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

Balance Sheet (1 & 3)

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital	1,50,000	Machinery	2,50,000
Bank Loan	75,000	Cash	50,000
Other Loan	75,000		
	<u>3,00,000</u>		<u>3,00,000</u>

- (b) Increase in machine value and increase in creditors by Rs. 50,000.

Balance Sheet (2 & 6)

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital	1,50,000	Machinery	2,50,000
Creditors for machinery	50,000	Cash	1,00,000
Bank Loan	75,000		
Other Loan	75,000		
	<u>3,50,000</u>		<u>3,50,000</u>

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

Balance Sheet (4 & 8)

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital	1,50,000	Machinery	2,00,000
Bank Loan	25,000	Cash	50,000
Other Loan	75,000		
	<u>2,50,000</u>		<u>2,50,000</u>

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

Balance Sheet (5 & 7)

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital	1,50,000	Machinery	2,00,000
Bank Loan	1,25,000	Cash	1,00,000
Other Loan	25,000		
	<u>3,00,000</u>		<u>3,00,000</u>

So every transaction and event has two aspects.

This gives basic accounting equation :

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

or

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

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

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

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

Whatever is received as funds is either expended (Expenses) – Debited to Profit & Loss Account

Or Lost – Losses are transferred to Capital Account

Or saved – Shown on the Assets side of the Balance Sheet

Therefore, Capital + Income/Profits + Liabilities = Expenses + Net Loss + Assets

Or, Capital + Income – Expenses + Net Profits = Assets – Liabilities

Since the net profit / loss is transferred to equity, the net effect is

Equity + Liabilities = Assets



Illustration :

Develop the accounting equation from the following information: -

Particulars	April 01, 2005 Rs.	March 31, 2006 Rs.
Capital	1,00,000	?
12% Bank Loan	1,00,000	1,00,000
Creditors	75,000	70,000
Fixed Assets	1,25,000	1,10,000
Debtors	75,000	80,000
Stock	70,000	80,000
Cash & Bank	5,000	6,000

Find the profit for the year & the Balance sheet as on 31/3/06.

Solution :

For the year ended April 01, 2005 :

Equity = Capital Rs. 1,00,000

Liabilities = Bank Loan + Creditors

Rs. 1,00,000 + Rs. 75,000 = Rs. 1,75,000

Assets = Fixed Assets + Debtors + Stock + Cash & Bank

Rs. 1,25,000 + Rs. 75,000 + Rs. 70,000 + Rs. 5,000 = Rs. 2,75,000

Equity + Liabilities = Assets

Rs. 1,00,000 + Rs. 1,75,000 = 2,75,000

For the year ended April 01, 2006 :

Assets = Rs. 1,10,000 + Rs. 80,000 + Rs. 80,000 + Rs. 6,000 = Rs. 2,76,000

Liabilities = Rs. 1,00,000 + Rs. 70,000 = Rs. 1,70,000

Equity = Assets - Liabilities = Rs. 2,76,000 - Rs. 1,70,000 = Rs. 1,06,000

Profits = New Equity - Old Equity = Rs. 1,06,000 - Rs. 1,00,000 = Rs. 6,000

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

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

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

- (i) *Prudence*, i.e., judgement about the possible future losses which are to be guarded, as well as gains which are uncertain.
- (ii) *Neutrality*, i.e., unbiased outlook is required to identify and record such possible losses, as well as to exclude uncertain gains,
- (iii) *Faithful representation of alternative values*.

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

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

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

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

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

- a. To bring the books of accounts in accordance with the issued Accounting Standards.
- b. To compliance with the provision of law.
- c. When under changed circumstances it is felt that new method will reflect more true and fair picture in the financial statement.

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



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

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

6. FUNDAMENTAL ACCOUNTING ASSUMPTIONS

There are three fundamental accounting assumptions :

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

All the above three fundamental accounting assumptions have already been explained in this unit.

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

7. FINANCIAL STATEMENTS

The aim of accounting is to keep systematic records to ascertain financial performance and financial position of an entity and to communicate the relevant financial information to the interested user groups. The financial statements are basic means through which the management of an entity makes public communication of the financial information along with selected quantitative details. They are structured financial representations of the financial position and the performance of an enterprise. To have a record of all business transactions and also to determine whether all these transactions resulted in either 'profit or loss' for the period, all the entities will prepare financial statements viz., balance sheet, profit and loss account, cash flow statement etc. by following various accounting concepts, principles, and conventions which have been already discussed in detail in para 5.

7.1 QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

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

1. **Understandability** : An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that

users have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

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

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

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

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

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

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

An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements,



any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

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

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

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

5. **Materiality** : The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.
6. **Faithful Representation** : To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

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

7. **Substance Over Form** : If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial

interest in an immovable property are transferred but the documentations and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

8. **Neutrality** : To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.
9. **Prudence** : The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality of reliability.
10. **Full, fair and adequate disclosure** : The financial statement must disclose all the reliable and relevant information about the business enterprise to the management and also to their external users for which they are meant, which in turn will help them to take a reasonable and rational decision. For it, it is necessary that financial statements are prepared in conformity with generally accepted accounting principles i.e the information is accounted for and presented in accordance with its substance and economic reality and not merely with its legal form. The disclosure should be full and final so that users can correctly assess the financial position of the enterprise.

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

This principle is widely used in corporate organizations because of separation in management and ownership. The Companies Act, 1956 in pursuant of this principle has came out with the format of balance sheet and profit and loss account. The disclosures of all the major accounting policies and other information are to be provided in the form of footnotes, annexes etc. The practice of appending notes to the financial statements is the outcome of this principle.

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



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

SELF EXAMINATION QUESTIONS

I. Pick up the correct answer from the given choices :

1. (i) All the following items are classified as fundamental accounting assumptions except
(a) Consistency. (b) Business entity. (c) Going concern. (d) accrual.
- (ii) Two primary qualitative characteristics of financial statements are
(a) Understandability and materiality. (b) Relevance and reliability.
(c) Relevance and understandability. (d) Materiality and reliability
- (iii) Kanika Enterprises follows the written down value method of depreciating machinery year after year due to
(a) Comparability (b) Convenience. (c) Consistency. (d) All of the above.
- (iv) A purchased a car for Rs. 5,00,000, making a down payment of Rs. 1,00,000 and signing a Rs. 4,00,000 bill payable due in 60 days. As a result of this transaction
(a) Total assets increased by Rs. 5,00,000.
(b) Total liabilities increased by Rs. 4,00,000.
(c) Total assets increased by Rs. 4,00,000.
(d) Total assets increased by Rs. 4,00,000 with corresponding increase in liabilities by Rs. 4,00,000.
- (v) Mohan purchased goods for Rs.15,00,000 and sold $\frac{4}{5}$ th of the goods amounting Rs.18,00,000 and met expenses amounting Rs. 2,50,000 during the year, 2005. He counted net profit as Rs. 3,50,000. Which of the accounting concept was followed by him?
(a) Entity. (b) Periodicity. (c) Matching. (d) Conservatism.

(vi) A businessman purchased goods for Rs. 25,00,000 and sold 80% of such goods during the accounting year ended 31st March, 2005. The market value of the remaining goods was Rs. 4,00,000. He valued the closing stock at cost. He violated the concept of

- (a) Money measurement. (b) Conservatism.
(c) Cost. (d) Periodicity.

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

- (a) Increase in asset and increase in liability.
(b) Increase in liability and decrease in asset.
(c) Increase in asset and decrease in liability.
(d) Increase in one asset and decrease in another asset.

[Ans. 1. (i) (b), (ii) (b), (iii) (c), (iv) (d), (v) (c), (vi) (b), (vii) (a)]

2. (i) Assets are held in the business for the purpose of
- (a) Resale. (b) Conversion into cash.
(c) Earning revenue. (d) None of the above.
- (ii) Revenue from sale of products, is generally, realized in the period in which
- (a) Cash is collected. (b) Sale is made.
(c) Products are manufactured. (d) None of the above.
- (iii) The concept of conservatism when applied to the balance sheet results in
- (a) Understatement of assets. (b) Overstatement of assets.
(c) Overstatement of capital. (d) None of the above.
- (iv) Decrease in the amount of creditors results in
- (a) Increase in cash. (b) Decrease in cash.
(c) Decrease in assets. (d) No change in assets.
- (v) The determination of expenses for an accounting period is based on the principle of
- (a) Objectivity. (b) Materiality. (c) Matching. (d) Periodicity.
- (vi) Economic life of an enterprise is split into the periodic interval as per
- (a) Periodicity. (b) Matching. (c) Going concern. (d) Accrual.

[Ans. 2. (i) (c), (ii) (b), (iii) (a), (iv) (b), (v) (c), (vi) (c)]



3. (i) If an individual asset is increased, there will be a corresponding
- (a) Increase of another asset or increase of capital.
 - (b) Decrease of another asset or increase of liability.
 - (c) Decrease of specific liability or decrease of capital.
 - (d) Increase of drawings and liability.
- (ii) Purchase of machinery for cash
- (a) Decreases total assets. (b) Increases total assets.
 - (c) Retains total assets unchanged. (d) Decreases total liabilities.
- (iii) Consider the following data pertaining to Alpha Ltd.:

Particulars	Rs.
Cost of machinery purchased on 1 st April, 2009	10,00,000
Installation charges	1,00,000
Market value as on 31 st March, 2010	12,00,000

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

- (a) Cost (b) Matching. (c) Accrual (d) Periodicity.

[Ans. 3. (i) (b), (ii) (c), (iii) (a)]

II.

A proprietor, Mr. A has reported a profit of Rs. 1,25,000 at the end of the financial year after taking into consideration the following amount:

- (i) The cost of an asset of Rs. 25,000 has been taken as an expense.
- (ii) Mr. A is anticipating a profit of Rs. 10,000 on the future sale of a car shown as an asset in his books.
- (iii) Salary of Rs. 7,000 payable in the financial year has not been taken into account.
- (iv) Mr. A purchased an asset for Rs. 75,000 but its fair value on the date of purchase was Rs. 85,000. Mr. A recorded the value of asset in his books by Rs. 85,000.

On the basis of the above facts answer the following questions from the given choices:

- (i) What is the correct amount of profit to be reported in the books?
 - (a) Rs. 1,25,000, (b) Rs. 1,35,000, (c) Rs. 1,50,000, (d) Rs. 1,33,000,

- (ii) Which measurement base should be followed in the statement (iv)?
(a) Historical cost, (b) Current cost (c) Replacement cost (d) Present value
- (iii) Which concept should be followed in the statement (ii)?
(a) Conservatism, (b) Materiality, (c) Historical cost, (d) Accrual,
- (iv) Which concept should be followed in the statement (iii)?
(a) Materiality, (b) Historical cost, (c) Current cost, (d) Accrual,

[Ans. (i)-(d), (ii)-(a), (iii)-(b), (iv)-(d),]



CHAPTER - 1

ACCOUNTING : AN INTRODUCTION



Unit 3

Accounting
Standards-
Concepts,
Objectives, Benefits

Learning Objectives

After studying this unit you will be able to :

- ◆ Understand the Concept of Accounting Standards.
- ◆ Grasp the objectives, benefits and limitations of Accounting Standards.
- ◆ Learn the system of evolution of Accounting Standards by the Council of the Institute of Chartered Accountants of India.
- ◆ Familiarise with the brief overview of Accounting Standards in India.

(Note : The text of the Accounting Standards does not form part of the CPT curriculum. An overview of Accounting Standards has been given here for knowledge of the students only. The full text of all Accounting Standards will be dealt with in later stages of the Chartered Accountancy Course).

1. 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 state of affairs. In order to ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardise the accounting principles and policies. Accounting Standards (ASs) provide framework and standard accounting policies so that the financial statements of different enterprises become comparable.

2. CONCEPTS

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

- (i) recognition of events and transactions in the financial statements;
- (ii) measurement of these transactions and events;
- (iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader; and
- (iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.



3. OBJECTIVES

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

- (i) eliminate the non-comparability of financial statements and thereby improving the reliability of financial statements; and
- (ii) provide a set of standard accounting policies, valuation norms and disclosure requirements.

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

4. BENEFITS AND LIMITATIONS

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

- (i) Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.
- (ii) There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.
- (iii) The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

However, there are some limitations of setting of accounting standards:

- (i) Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- (ii) There may be a trend towards rigidity and away from flexibility in applying the accounting standards.
- (iii) Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

5. OVERVIEW OF ACCOUNTING STANDARDS IN INDIA

In India, the Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) on 21st April, 1977. The main function of ASB is to formulate accounting standards so that such standards may be established in India by the council of the ICAI. The council of the Institute of Chartered Accountants of India has, so far, issued thirty one

Accounting Standards. However, AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Thus effectively, there are 30 Accounting Standards at present. The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

Following is the list of Accounting Standards with their respective date of applicability.

List of Accounting Standards

Sl. No.	Number of the Accounting Standard (AS)	TITLE OF THE ACCOUNTING STANDARD
1.	AS 1	Disclosure of Accounting Policies
2.	AS 2 (Revised)	Valuation of Inventories
3.	AS 3 (Revised)	Cash Flow Statements
4.	AS 4 (Revised)	Contingencies and Events Occurring after the Balance Sheet Date
5.	AS 5 (Revised)	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
6.	AS 6 (Revised)	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	Accounting for Fixed Assets
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
16.	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



Sl. No.	Number of the Accounting Standard (AS)	TITLE OF THE ACCOUNTING STANDARD
23.	AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
24.	AS 24	Discontinuing Operations
25.	AS 25	Interim Financial Reporting
26.	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
30.	AS 30	Financial Instruments: Recognition & Measurement
31.	AS 31	Financial Instruments: Presentation
32.	AS 32	Financial Instruments: Disclosures

A brief overview of the above mentioned accounting standards is given below:

AS 1 Disclosure of Accounting Policies (Issued 1979)

This Standard is related with presentation/disclosure requirements of the significant accounting policies (specific accounting policies and the methods of applying those principles) followed in preparing financial statements. The true and fair state of affairs and the financial results of an entity is significantly affected by the accounting policies followed in accounting. The areas in which different accounting policies can be followed are accounting for depreciation, revaluation of inventories, valuation of fixed assets etc. The disclosure of the significant accounting policies should form part of the financial statement and any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in the later periods should be disclosed. If any of the fundamental accounting assumptions viz. going concern, consistency and accrual is not followed in financial statements, the fact should be specifically disclosed.

AS 2 Valuation of Inventories (Revised 1999)

AS 2 is a measurement related standard and specifies the methods of computation of cost of inventories and the method of determination of the value of inventory to be shown in the financial statements. As per the standard, the cost of inventories should comprise costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. Inventory is valued by following conservatism principle i.e., at lower of the cost or the market price. With a view to bring about uniformity in inventory valuation practices, the revised AS 2 drastically reduces the alternative choices. The revised standard permits the use of only FIFO or weighted average cost formula for determining the cost of inventories where the specific identification of cost of inventories is not possible. The standard also dispenses with the direct costing method and permits only the absorption costing method for arriving at the cost of finished goods.

AS 3 Cash Flow Statements (Revised 1997)

This standard deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows

during the period into operating, investing and financing activities. The cash flow statement is an important part of financial statement and helps in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of future cash flows of different enterprises. The requirement of presentation of cash flow statement would force the management to strive to improve the actual cash flows rather than the profits, which is ultimate goal of any business entity.

AS 4 Contingencies and Events occurring after the Balance Sheet date (Revised 1995)

Pursuant to AS 29 'Provisions, Contingent Liabilities and Contingent Assets becoming mandatory in respect of accounting periods commencing on or after 1st April, 2004, all paragraphs of AS 4 dealing with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by any other Indian AS. The project of revision of this standard by ASB in the light of newly issued AS 29 is under progress. Thus, the present standard (AS 4) deals with the treatment and disclosure requirements in the financial statements of events occurring after the balance sheet. Events occurring after the balance sheet date are those significant events (favourable as well as unfavourable) that occur between the balance sheet date and the date on which financial statements are approved by the approving authority (i.e. board of directors in case of a company) of any entity. The concept of events occurring after the balance sheet date with their treatment and disclosure in the financial statements have been discussed in detail under Unit 8 of Chapter 5.

AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies (Revised 1997)

This statement should be applied by an enterprise in presenting profit and loss from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, in accounting for changes in accounting estimates, and disclosure of changes in accounting policies. As per AS 5, prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of financial statements of one or more prior periods. Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. The prior period and extraordinary items are required to be disclosed in the profit and loss statement as part of the net profit for the period with separate disclosure of the nature and amount to show its impact on current year's profit or loss.

AS 6 Depreciation Accounting (Revised 1994)

This standard requires that the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset and the depreciation method selected should be applied consistently from period to period. If there is a change in the method of providing depreciation, such a change should be treated as a change in accounting policy and its effect (deficiency or surplus arising from retrospective recomputation of depreciation as per new method) should be quantified and disclosed. In case any depreciable asset is disposed off, discarded or demolished, the net surplus/deficiency, if material, should be disclosed separately. The depreciation method used and depreciation rates are also required to be disclosed in the financial statements.



AS 7 Construction Contracts (Revised 2002)

The standard prescribes the accounting treatment of revenue and costs associated with construction contracts by laying down the guidelines regarding allocation of contract revenue and contract costs to the accounting periods in which the construction work is performed, since the construction activity is generally contracted and completed in more than one accounting period. An enterprise is required to disclose the amount of recognised contract revenue with the methods used to determine that revenue and the methods applied in determining the stages of completion of contracts in progress. As per the standard, the gross amount due from and to customers for contract work are shown as asset and liability respectively.

AS 8 Accounting for Research and Development

This standard stands withdrawn w.e.f. 1st April, 2003 i.e. the date from which AS 26 on Intangible Assets becomes mandatory.

AS 9 Revenue Recognition (Issued 1985)

The standard deals with the basis for recognition of revenue arising in the course of ordinary activities, from the sale of goods; rendering of services; and income from interest, royalties and dividends in the profit and loss statement of an enterprise. According to the standard, revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalty and dividends. The revenue arising from construction contracts, hire purchase and lease agreements, government grants and subsidies and revenue of insurance companies from insurance contracts are outside the purview of AS 9. In addition to disclosures required by AS 1, AS 9 requires an enterprise to disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

AS 10 Accounting for Fixed Assets (Issued 1985)

The standard deals with the disclosure of the status of the fixed assets in terms of value. The standard does not take into consideration the specialised aspect of accounting for fixed assets reflected with the effects of price escalations but applies to financial statements on historical cost basis. It is important to note that from the date of AS 26 on Intangible Assets, becoming applicable, the relevant paragraphs of this standard (AS 10) dealing with patents and know-how have been withdrawn. An entity should disclose the following information relating to (i) the gross and net book values of fixed assets at beginning and end of an accounting period showing additions, disposals, acquisitions and other movements, (ii) expenditure incurred on account of fixed assets in the course of construction or acquisition, and (iii) revalued amounts substituted for historical costs of fixed assets with the method applied in computing the revalued amount in the financial statements:

AS 11 Effects of Changes in Foreign Exchange Rates (Revised 2003, Applicable w.e.f. 1st April, 2004)

An enterprise may carry on activities involving foreign exchange in two ways – by transacting in foreign currencies or by indulging in foreign operations. In order to include foreign currency

transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise's reporting currency and the financial statements of foreign operations must be translated into the enterprise's reporting currency. The standard deals with the issues involved in accounting for foreign currency transactions and foreign operations i.e., to decide which exchange rate to use and how to recognize the financial effects of changes in exchange rates in the financial statements. The standard requires the enterprises to disclose (i) the amount of exchange differences included in the net profit or loss for the period (ii) the amount of exchange differences adjusted in the carrying amount of fixed assets, (iii) the amount of exchange differences in respect of forward exchange contracts to be recognised in the profit or loss in one or more subsequent accounting periods (over the life of the contract).

AS 12 Accounting for Government Grants (Issued 1991)

AS 12 deals with accounting for government grants and specifies that the government grants should not be recognised until there is reasonable assurance that the enterprise will comply with the conditions attached to them, and the grant will be received. The standard also describes the treatment of non-monetary government grants; presentation of grants related to specific fixed assets, related to revenue, related to promoters' contribution; treatment for refund of government grants etc. The enterprises are required to disclose (i) the accounting policy adopted for government grants including the methods of presentation in the financial statements; (ii) the nature and extent of government grants recognised in the financial statements, including non-monetary grants of assets given either at a concessional rate or free of cost.

AS 13 Accounting for Investments (Issued 1993)

The statement deals with accounting for investments in the financial statements of enterprises and related disclosure requirements. The enterprises are required to disclose the current investments (realisable in nature and intended to be held for not more than one year from the date of its acquisition) and long terms investments (other than current investments) distinctly in their financial statements. An investment property should account for as long-term investments. The cost of investments should include all acquisition costs (including brokerage, fees and duties) and on disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to profit and loss statement.

AS 14 Accounting for Amalgamations (Issued 1994)

AS 14 deals with accounting for amalgamation and the treatment of any resultant goodwill or reserves and is directed principally to companies although some of its requirements also apply to financial statements of other enterprises. An amalgamation may be either in the nature of merger or purchase. The standard specifies the conditions to be satisfied by an amalgamation to be considered as amalgamation in nature of merger. An amalgamation in nature of merger is accounted for as per pooling of interests method and in nature of purchase is dealt under purchase method. The standard also describes the disclosure requirements for both types of amalgamations in the first financial statements.

AS 15 Employee Benefits (Revised 2005)

The standard requires enterprises to recognise (i) a liability when an employee has provided services in exchange for employee benefits to be paid in future, and (ii) an expense when enterprise consumes the economic benefit arising from services provided by an employee in



exchange for employee benefits. Employee benefits can be classified under (i) short-term employee benefits (e.g. wages, salaries etc.), (ii) post-employment benefits (e.g. gratuity, pension etc.), (iii) long-term employee benefits (e.g. long-term leave, long-term disability benefits etc.), and (iv) termination benefits (e.g. VRS payments). The standard lays down recognition and measurement criteria and disclosure requirement for all the four types of employee benefits.

AS 16 Borrowing Costs (Issued 2000)

The standard prescribes the accounting treatment for borrowing costs (i.e. interest and other costs) incurred by an enterprise in connection with the borrowing of funds. This standard deals with the issues related to identification of asset which qualifies for capitalisation of interest, determination of the period for which interest can be capitalized and determination of the amount that can be capitalised. The amount of borrowing costs eligible for capitalisation should be determined in accordance with provisions of AS 16 and other borrowing costs (not eligible for capitalisation) should be recognised as expenses in the period in which they are incurred.

AS 17 Segment Reporting (Issued 2000)

This standard requires that the accounting information should be reported on segment basis. AS 17 establishes principles for reporting financial information about different types of products and services an enterprise produces and different geographical areas in which it operates. The information helps users of financial statements, to better understand the performance and assess the risks and returns of the enterprise and make more informed judgements about the enterprise as a whole. The standard is more relevant for assessing risks and returns of a diversified or multilocational enterprise which may not be determinable from the aggregated data.

AS 18 Related Party Disclosures (Issued 2000)

This standard prescribes the requirements for certain disclosures which must be made in the financial statements of reporting enterprise for transactions between the reporting enterprise and its related parties. The requirements of the standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company. Since the standard is more subjective, particularly with respect to identification of related parties, obtaining corroborative evidence becomes very difficult for the auditors. Thus successful implementation of AS 18 is dependent upon how transparent the management is and how vigilant the auditors are.

AS 19 Lease (Issued 2001)

AS 19 prescribes the accounting and disclosure requirements for both finance leases and operating leases in the books of the lessor and lessee. The classification of leases adopted in this standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor and the lessee. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. An operating lease is a lease other than finance lease. At the inception of the lease, assets under finance lease are capitalised in the books of lessee with corresponding liability for lease obligations as against the operating lease, wherein lease payments are recognised as an expense in profit and loss account on a systematic basis (i.e. straight line) over the lease term without capitalizing the asset. The lessor should recognize receivable at an amount equal to net investment in the lease in case of finance

lease, whereas under operating lease, the lessor will present the leased asset under fixed assets in his balance sheet besides recognizing the lease income on a systematic basis (i.e. straight line) over the lease term. The person (lessor/lessee) presenting the leased asset in his balance sheet should also consider the additional requirements of AS 6 and AS 10.

AS 20 Earnings Per Share (Issued 2001)

The objective of this standard is to describe principles for determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise. Earnings per share (EPS) is a financial ratio indicating the amount of profit or loss for the period attributable to each equity share and AS 20 gives computational methodology for determination and presentation of basic and diluted earnings per share.

AS 21 Consolidated Financial Statements (Issued 2001)

AS 21 deals with preparation and presentation of consolidated financial statements with an intention to provide information about the activities of group (parent company and companies under its control referred to as subsidiary companies). Consolidated financial statements are presented by a parent (holding company) to provide financial information about the economic activities of the group as a single economic entity. A parent which presents consolidated financial statements should present their statements in accordance with this standard but in its separate financial statements, investments in subsidiaries should be accounted as per AS 13.

AS 22 Accounting for Taxes on Income (Issued 2001)

AS 22 seeks to reconcile the taxes on income calculated as per the books of account with the actual taxes payable on the taxable income as per the provisions applicable to the entity for the time being in force. This standard prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period. The concept of matching is more peculiar in cases of income taxes since in a number of cases, the taxable income may be significantly different from the income reported in the financial statements due to the difference in treatment of certain items under taxation laws and the way it is reflected in accounts.

AS 23 Accounting for Investments in Associates in Consolidated Financial Statements (Issued 2001)

AS 23 describes the principles and procedures for recognising investments in associates (in which the investor has significant influence, but not a subsidiary or joint venture of investor) in the consolidated financial statements of the investor. An investor which presents consolidated financial statements should account for investments in associates as per equity method in accordance with this standard but in its separate financial statements, AS 13 will be applicable.

AS 24 Discontinuing Operations (Issued 2002)

The objective of this statement is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings, generating capacities, and financial position by segregating information about discontinuing operations from information about continuing operations. This standard is applicable to all discontinuing operations, representing separate major line of business or geographical area of operations of an enterprise.



AS 25 Interim Financial Reporting (Issued 2002)

An enterprise may be required or may elect to present information at interim dates as compared with its annual financial statements due to timeliness and cost considerations. The standard prescribes the minimum contents of an interim financial report and requires that an enterprise which elects to prepare and present an interim financial report, should comply with this standard. It also lays down the principles for recognition and measurement in a complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors and others to understand an enterprise's capacity to generate earnings and cash flows, its financial condition and liquidity.

AS 26 Intangible Assets (Issued 2002)

The standard prescribes the accounting treatment for intangible assets that are not dealt with specifically under other accounting standards, and requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The standard specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets. This standard should be applied by all enterprises in accounting intangible assets, except (a) intangible assets that are covered by another AS, (b) financial assets, (c) rights and expenditure on the exploration for or development of minerals, oil, natural gas and similar non-regenerative resources, (d) intangible assets arising in insurance enterprise from contracts with policyholders, (e) expenditure in respect of termination benefits.

AS 27 Financial Reporting of Interests in Joint Ventures (Issued 2002)

AS 27 set out principles and procedures for accounting of interests in joint venture and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors regardless of the structures or forms under which the joint venture activities take place. The standard deals with three broad types of joint ventures – jointly controlled operations, jointly controlled assets and jointly controlled entities. An investor in joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with AS 13, AS 21 and AS 23.

AS 28 Impairment of Assets (Issued 2002)

AS 28 prescribes the procedures to be applied to ensure that the assets of an enterprise are carried at an amount not exceeding their recoverable amount (amount to be recovered through use or sale of the asset). The standard also lays down principles for reversal of impairment losses and prescribes certain disclosures in respect of impaired assets. An enterprise is required to assess at each balance sheet date whether there is an indication that an enterprise may be impaired. If such an indication exists, the enterprise is required to estimate the recoverable amount and the impairment loss, if any, should be recognised in the profit and loss account. This standard should be applied in accounting for impairment of all assets except inventories (AS 2), assets arising under construction contracts (AS 7), financial assets including investments covered under AS 13, and deferred tax assets (AS 22). There are chances that the provision on account of impairment losses may increase sickness of companies and potentially sick companies may actually become sick.

AS 29 Provisions, Contingent Liabilities and Contingent Assets (Issued 2003)

The objective of AS 29 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. This standard applies in accounting for provisions and contingent liabilities and contingent assets resulting from financial instruments (not carried at fair value) and insurance enterprises (other than those arising from contracts with policyholders). The standard will not apply to provisions/liabilities resulting from executing controls and those covered under any other accounting standard.

AS 30 Financial Instruments: Recognition and Measurement (Issued 2008)

Accounting Standard 30 is issued by the Council of the Institute of Chartered Accountants of India, which comes into effect in respect of accounting periods commencing on or after 1.4.2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory in respect of accounting periods commencing on or after 1.4.2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity, as defined in the standard.

The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

AS 31 Financial Instruments: Presentation (Issued 2008)

Accounting Standard 31 is issued by the Council of the Institute of Chartered Accountants of India, which comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a small and medium-sized entity, as defined in the standard.

The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

AS 32 Financial Instruments: Disclosures (Issued 2008)

Accounting Standard 32 is issued by the Council of the Institute of Chartered Accountants of India, which comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a small and medium-sized entity, as defined in the standard.

The objective of this Standard is to require entities to provide disclosures in their financial



statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

SELF EXAMINATION QUESTIONS

I. Pick up the correct answer from the given choices:

1. (i) Accounting Standards in India are issued by
 - (a) Central Govt.
 - (b) State Govt.
 - (c) Institute of Chartered Accountants of India.
 - (d) Reserve Bank of india.
- (ii) Accounting Standards
 - (a) Harmonise accounting policies.
 - (b) Eliminate the non-comparability of financial statements.
 - (c) Improve the reliability of financial statements.
 - (d) All of the above.
- (iii) How many Accounting Standards have been issued by ICAI ?
 - (a) 25.
 - (b) 20.
 - (c) 32.
 - (d) 2.
- (iv) It is essential to standardize the accounting principles and policies in order to ensure
 - (a) Transparency.
 - (b) Consistency.
 - (c) Comparability.
 - (d) All of the above.
- (v) All of the following are limitations of Accounting Standards except
 - (a) The choice between different alternative accounting treatments is difficult.
 - (b) There may be trend towards rigidity.
 - (c) Accounting Standards cannot override the statute.
 - (d) All of the above.

[Ans. 1. (i) (c), (ii) (d), (iii) (c), (iv) (d), (v) (d)]

CHAPTER - 1

ACCOUNTING : AN INTRODUCTION



Unit 4

Accounting Policies



Learning Objectives

After studying this unit, you will be able to:

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

1. MEANING

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

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

- (1) Methods of depreciation, depletion and amortisation;
- (2) Valuation of inventories;
- (3) Treatment of goodwill;
- (4) Valuation of investments;
- (5) Valuation of fixed assets.

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

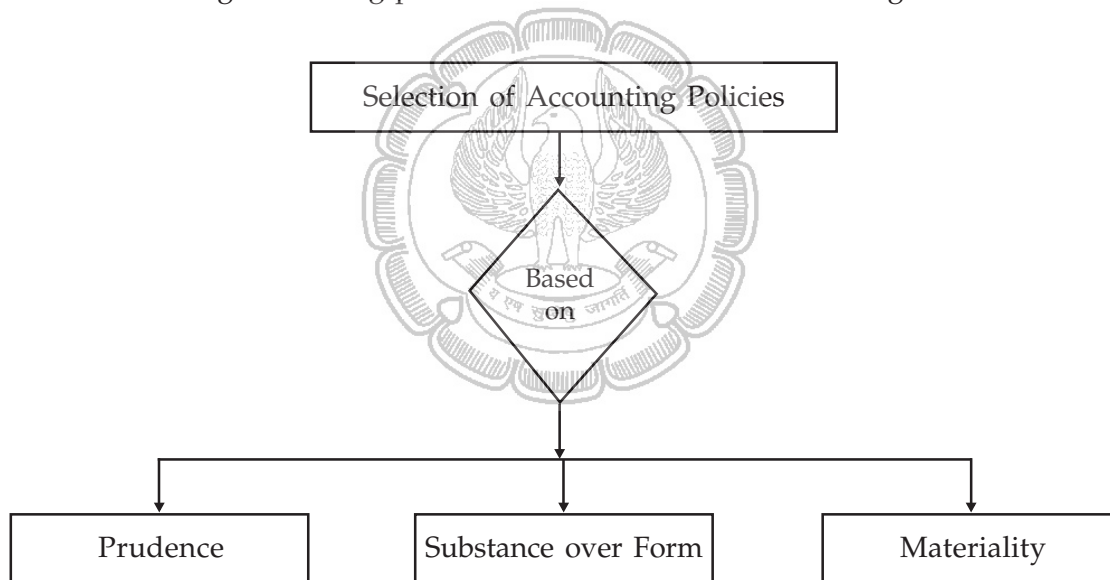
Suppose an enterprise holds some investments in the form of shares of a company at the end of an accounting period. For valuation of shares, the enterprise may adopt FIFO, LIFO, average method etc. The method selected by that enterprise for valuation is called an accounting policy. Different enterprises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

2. SELECTION OF ACCOUNTING POLICIES

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

It is believed that no unified an exhaustive list of accounting policies can be suggested which has universal application. Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz., *Prudence, Substance over form, and Materiality*. All these three characteristics have already been explained in Unit 2 of Chapter 1. The financial statements should be prepared on the basis of such accounting policies, which exhibit true and fair view of state of affairs of Balance Sheet and the Profit & Loss Account.

The basis for selecting accounting policies can be shown in the following chart as :



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

1. Inventories are valued at cost except for finished goods and by-products. Finished goods are valued at lower of cost or market value and by-products are valued at net realisable value.
2. Investments (long term) are valued at their acquisition cost. Provision for permanent diminution in value has been made wherever necessary.

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



3. CHANGE IN ACCOUNTING POLICIES

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

- (a) It is required by some statute or for compliance with an Accounting Standard.
- (b) Change would result in more appropriate presentation of financial statement.

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

The examples in this regard may be given as follows:

1. Omega Enterprises revised its accounting policy relating to valuation of inventories to include applicable production overheads. The change has resulted in an increase in value of inventory and consequently profit before tax by Rs. 58.43 lakhs.
2. Alpha Enterprises changed the method of depreciation from straight-line method to written-down value method, with effect from 1.4.2005. The depreciation has been recomputed from the date of commissioning of these assets at WDV rates applicable to those years. Consequent to this there has been an additional charge for depreciation during the year of Rs. 350.12 crore due to said change which relates to the previous years and an equal amount has been withdrawn from the General Reserve and credited to Profit & Loss Account. Had there been no change in the method of depreciation, the charge for the year would have been lower by Rs. 95.42 crore excluding the charge relating to the previous years. Consequently, the Net Block of Fixed Assets and Reserves and Surplus are lower by Rs. 445.54 crore.

SELF EXAMINATION QUESTIONS

I. Pick up the correct answer from the given choices:

- (i) A change in accounting policy is justified
 - (a) To comply with accounting standard.
 - (b) To ensure more appropriate presentation of the financial statement of the enterprise.
 - (c) To comply with law.
 - (d) All of the above.
- (ii) Accounting policy for inventories of Xeta Enterprises states that inventories are valued at the lower of cost determined on weighted average basis or not realizable value. Which accounting principle is followed in adopting the above policy?
 - (a) Materiality.

ACCOUNTING POLICIES

- (b) Prudence.
 - (c) Substance over form.
 - (d) All of the above.
- (iii) The areas wherein different accounting policies can be adopted are
- (a) Providing depreciation.
 - (b) Valuation of inventories.
 - (c) Valuation of investments.
 - (d) All of the above.
- (iv) 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 a business entity.
 - (d) Understate financial position a business entity.
- (v) Accounting policies refer to specific accounting
- (a) Principles.
 - (b) Methods of applying those principles.
 - (c) Both (a) and (b).
 - (d) None of the above.

[Ans. 1. (i) (d), (ii) (b), (iii) (d), (iv) (b), (v) (c)]

CHAPTER - 1

ACCOUNTING : AN INTRODUCTION



Unit 5

Accounting as a
Measurement
Discipline - Valuation
Principles,
Accounting Estimates

Learning Objectives

After going through this unit, you will be able to :

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

1. MEANING OF MEASUREMENT

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

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

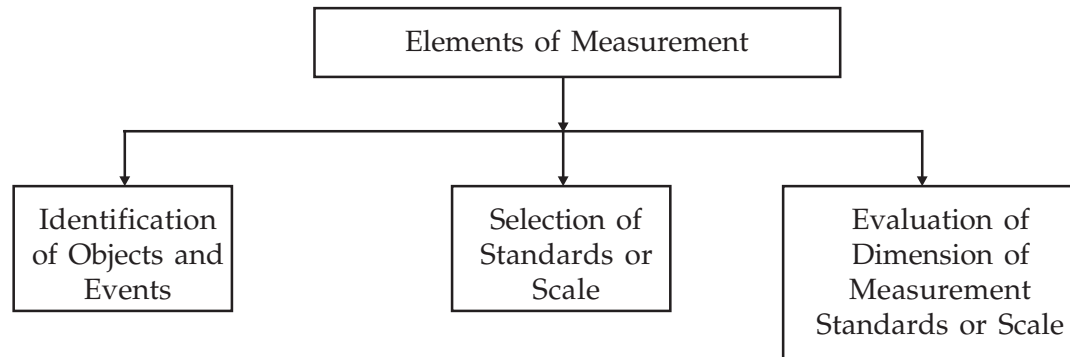
Kohler defined measurement as the assignment of a system of ordinal or cardinal numbers to the results of a scheme of inquiry or apparatus of observations in accordance with logical or mathematical rules – [A Dictionary of Accountant].

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

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

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

- (1) Identification of objects and events to be measured;
- (2) Selection of standard or scale to be used;
- (3) Evaluation of dimension of measurement standard or scale.



2. OBJECTS OR EVENTS TO BE MEASURED

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

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

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

3. STANDARD OR SCALE OF MEASUREMENT

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

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

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

4. DIMENSION OF MEASUREMENT SCALE

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

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

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

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

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

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

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

5. ACCOUNTING AS A MEASUREMENT DISCIPLINE

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



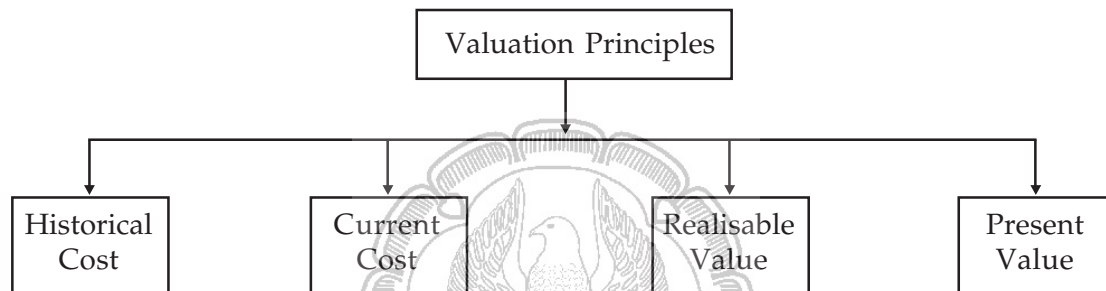
part of accounting, which do not fall within the purview of measurement discipline. Therefore we cannot simply say that accounting is a measurement discipline.

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

6. VALUATION PRINCIPLES

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

- (i) *Historical Cost*: It means acquisition price. For example, the businessman paid Rs. 7,00,000



to purchase the machine, its acquisition price including installation charges is Rs. 8,00,000. The historical cost of machine would be Rs. 7,00,000.

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

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

- (ii) *Current Cost*: Take that Mr. X purchased a machine on 1st January, 1995 at Rs. 7,00,000. As per historical cost base he has to record it at Rs. 7,00,000 i.e. the acquisition price. As on 1.1.2006, Mr. X found that it would cost Rs. 25,00,000 to purchase that machine. Take also that Mr. X took loan from a bank as on 1.1.95 Rs. 5,00,000 @ 18% p.a repayable at the end of 15th year together with interest. As on 1.1.2006 the bank announces 1% prepayment

penalty on the loan amount if it is paid within 15 days starting from that day. As per historical cost the liability is recorded at Rs. 5,00,000 at the amount or proceeds received in exchange for obligation and asset is recorded at Rs. 7,00,000.

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

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

- (iii) *Realisable Value*: Suppose Mr. X found that he can get Rs. 20,00,000 if he would sell the machine purchased, on 1.1.95 paying Rs. 7,00,000 and which would cost Rs. 25,00,000 in case he would buy it currently. Take also that Mr. X found that he had no money to pay off the bank loan of Rs. 5,00,000 currently.

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

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

- (iv) *Present Value*: Suppose we are talking as on 1.1.2003 - take it as time for reference. Now think the machine purchased by Mr. X on 1.1.93 can work for another 10 years and is supposed to generate cash @ Rs. 1,00,000 p.a. Also take that bank loan of Rs. 5,00,000 taken by Mr. X is to be repaid as on 31.12.2007. Annual interest is Rs. 90,000.

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

The term 'discount', 'cash inflow' and 'cash outflow' need a little elaboration. Rs. 100 in hand as on 1.1.2003. is not equivalent to Rs. 100 in hand as on 31.12.2003. There is a time gap of one year. If Mr. X had Rs. 100 as on 1.1.03 he could use it at that time. If he received it only on 31.12.2003, he had to sacrifice his use for a year. The value of this sacrifice is called 'time value of money'. Mr. X would sacrifice i.e. he would agree to take money on 31.12.2003 if he had been compensated for the sacrifice. So a rational man will never exchange Rs. 100 as on 1.1.2003 with Rs. 100 to be received on 31.12.2003 Then Rs. 100 of 1.1.2003 is not equivalent to Rs. 100 of 31.12.2003. To make the money receivable at a future date equal with the money of the present date it is to be devalued. Such devaluation is called discounting of future money.

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



A = Amount

P = Principal

i = interest / 100

n = Time

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

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

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

Suppose i = 20%, now what is the present value of Rs. 1,00,000 to be received as on 31.12.2003 (Take 1.1.2003 as the time of reference).

$$P = \frac{1,00,000}{(1+.2)^1}$$

= Rs. 83,333

Similarly,

<i>Time of Receipt</i>	<i>Money Value</i> Rs.	<i>Present Value</i> Rs.
31.12.2004	1,00,000	69,444
31.12.2005	1,00,000	57,870
31.12.2006	1,00,000	48,225
31.12.2007	1,00,000	40,188
31.12.2008	1,00,000	33,490
31.12.2009	1,00,000	27,908
31.12.2010	1,00,000	23,257
31.12.2011	1,00,000	19,381
31.12.2012	1,00,000	16,150

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

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

Perhaps you also know the annuity rule:

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

A = Annuity

i = interest

t = time 1, 2, 3,n.

$$A \times \frac{1 - \frac{1}{(1+i)^n}}{i}$$

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

$$1,00,000 \times \frac{1 - \frac{1}{(1+.2)^{10}}}{.2} = \text{Rs. } 4,19,246$$

Similarly, the present value of bank loan is

$$90,000 \times \frac{1 - \frac{1}{(1+.2)^5}}{.2} + \frac{5,00,000}{(1+.2)^5}$$

$$= \text{Rs. } 2,69,155 + \text{Rs. } 2,00,939$$

$$= \text{Rs. } 4,70,094$$



Thus we get the four measurements

	Historical cost Rs.	Current cost Rs.	Realisable value Rs.	Present value Rs.
Asset: Machine	7,00,000	25,00,000	20,00,000	4,19,246
Liability: Bank Loan	5,00,000	4,50,000	5,00,000	4,70,094

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

7. MEASUREMENT AND VALUATION

Value relates to the benefits to be derived from objects, abilities or ideas. To the economist, value is the utility (i.e; satisfaction) of an economic resource to the person contemplating or enjoying its use. In accounting, to mean value of an object, abilities or ideas, a monetary



surrogate is used. That is to say, value is measured in terms of money. Suppose, an individual purchased a car paying Rs. 2,50,000. Its value lies in the satisfaction to be derived by that individual using the car in future. Economists often use ordinal scale to indicate the level of satisfaction. But accountants use only cardinal scales. If the value of car is taken as Rs. 2,50,000 it is only one type of value called acquisition cost or historical cost. So value is indicated by measurement. In accounting the value is always measured in terms of money.

8. ACCOUNTING ESTIMATES

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

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

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

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

- (1) A company incurs expenditure of Rs. 10,00,000 on development of patent. Now the company has to estimate that for how many years the patent would benefit the company. This estimation should be based on the latest information and logical judgement.
- (2) A company dealing in long-term construction contracts, uses percentage of completion method for recognizing the revenue at the end of the accounting year. Under this method the company has to make adequate provisions for unseen contingencies, which can take place while executing the remaining portion of the contract. Since provisioning for unseen contingencies requires estimation, there may be excess or short provisioning, which is to be adjusted in the period when it is recognised.
- (3) Company has to provide for taxes which is also based on estimation as there can be some interpretational differences on account of which tax authorities may either accept the expenditure or refuse it. This will ultimately lead to different tax liability.



(iii) The historical cost of machinery is

- (a) Rs. 10,00,000. (b) Rs. 20,00,000.
(c) Rs. 15,00,000. (d) Rs. 12,00,000.

(iv) The realizable value of machinery is

- (a) Rs. 10,00,000. (b) Rs. 20,00,000.
(c) Rs. 15,00,000. (d) Rs. 12,00,000.

[Ans 1. (i) (d), (ii) (c), (iii) (c), 2. (i) (b), (ii) (d), (iii) (a), (iv) (c)]

