Theory Base of Accounting

Generally Accepted Accounting Principles- Introduction and Overview

Objectives

After going through this lesson, you shall be able to understand the following concepts.

- ✶ Introduction to GAAP
- ✶ Need for Accounting Principles
- ✶ Characteristics of Accounting Principles
- ✶ Accounting Concepts & Conventions

Introduction to GAAP

Generally Accepted Accounting Principles (GAAPs) are a set of basic rules and procedures prescribed by the Institute of Chartered Accountants of India (ICAI) which have to be followed while preparing financial statements. These are the accounting principles, concepts and conventions which ensure that financial reporting is transparent and consistent from one organisation to another. The management and the auditors are bound by the Companies Act of 2013 to follow GAAPs.

According to The American Institute of Certified Public Accountants "*Principles of Accounting are the general law or rule adopted or proposed as a guide to action, a settled ground or basis of conduct or practice*"

Need For Accounting Principles

The basic objective of accounting is to communicate information about the financial well-being of an enterprise to the users of the financial statements. As the accounting principles and assumptions followed across various enterprises are different due to biases and difference of opinion between the accountants. This gives rise to the need for a set of universally accepted guidelines and rules which help in making financial results of various enterprises comparable across industries and time period. In today's dynamic environment the needs and expectations of businesses from accounting keep on changing, hence the accounting principles have to be developed and changed according to the needs of business.

Characteristics of Accounting Principles

1. ***Flexible in Nature***: As we know businesses operate in a dynamic environment and in order to keep up with the ever changing needs of the business world and economy, the principles of accounting must be flexible in nature.

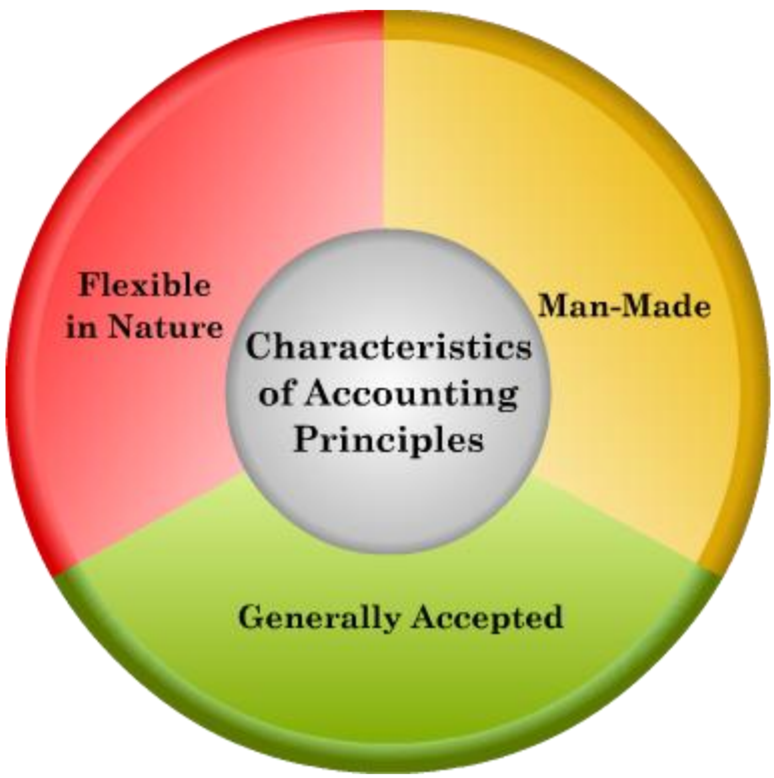
2. ***Man-made***: These principles have been developed by accountants and academicians over a long period of time through continuous application, while adapting to the ever changing needs of the businesses.

3. ***Generally Accepted***: These principles are universally accepted, free from personal bias. In order to be universal in character three basic criteria should be fulfilled which are as follows :

   a. Usefulness

   b. Objectivity and

   c. Feasibility

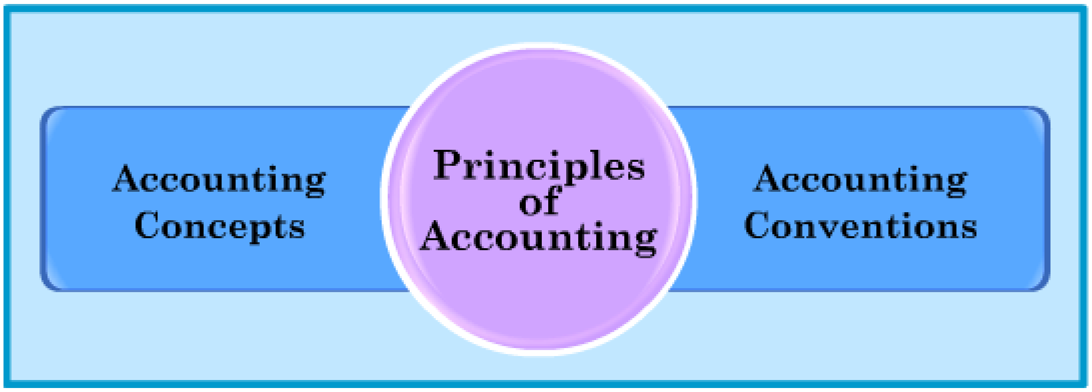


Accounting Concepts and Conventions

1. ***Accounting Concepts***: These are the basic propositions and fundamental assumptions on which accounting operate. Financial statements are prepared and transactions are recorded on the basis of these generally accepted rules of accountancy. By following accounting concepts we can ensure that the users of such

financial statements are better able to understand and compare the financial statements.

2. **Accounting Conventions:** Accounting conventions are the customs and traditions that guide an accountant while preparing the financial statements. These are those guidelines that have been arrived at after years of practice and will change in case of change in environment. These are not legally binding on an accountant but are just generally accepted practices.



Fundamental Accounting Assumptions

Objectives

After going through this lesson, you shall be able to understand the following Fundamental Accounting Assumptions.

- Going Concern
- Consistency
- Accrual

Going Concern

Going concern is the basic underlying assumption of accounting. Financial statements are prepared assuming that the business is a going concern i.e. the company intends to continue the business and will be able to do so. In short, it means business will continue indefinitely.

The business will continue operating and will not close but will realise assets and discharge liabilities in the normal course of operations.

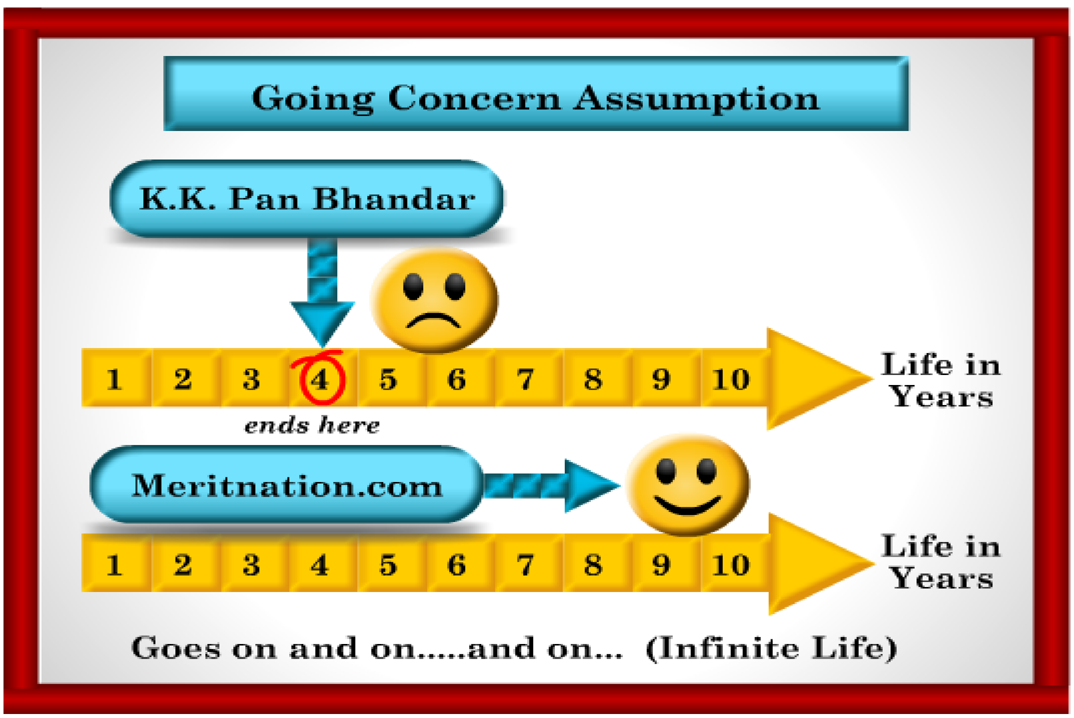
<u>Examples</u>

1. A nationalized company is in cash flow problems but the government of the country provided a guarantee to the company to help it out with all payments, the company is a going concern despite poor financial position.

2. An insurance company is in serious financial troubles and the government is not willing to bail it out. The Board of Directors have passed a resolution to liquidate the business. The insurance company is not a going concern.

3. An oil and gas firm operating in Sudan is stopped by a Sudanese court from carrying out operations in Sudan. The firm is not a going concern in Sudan, because it has to shut down.

4. A manufacturing company has a current ratio below 0.5. A creditor $1,000,000 demanded payment which the company could not make. The creditor requested the court to liquidate the business and recover his debts and the court grants the order. The company is no longer a going concern.



Consistency

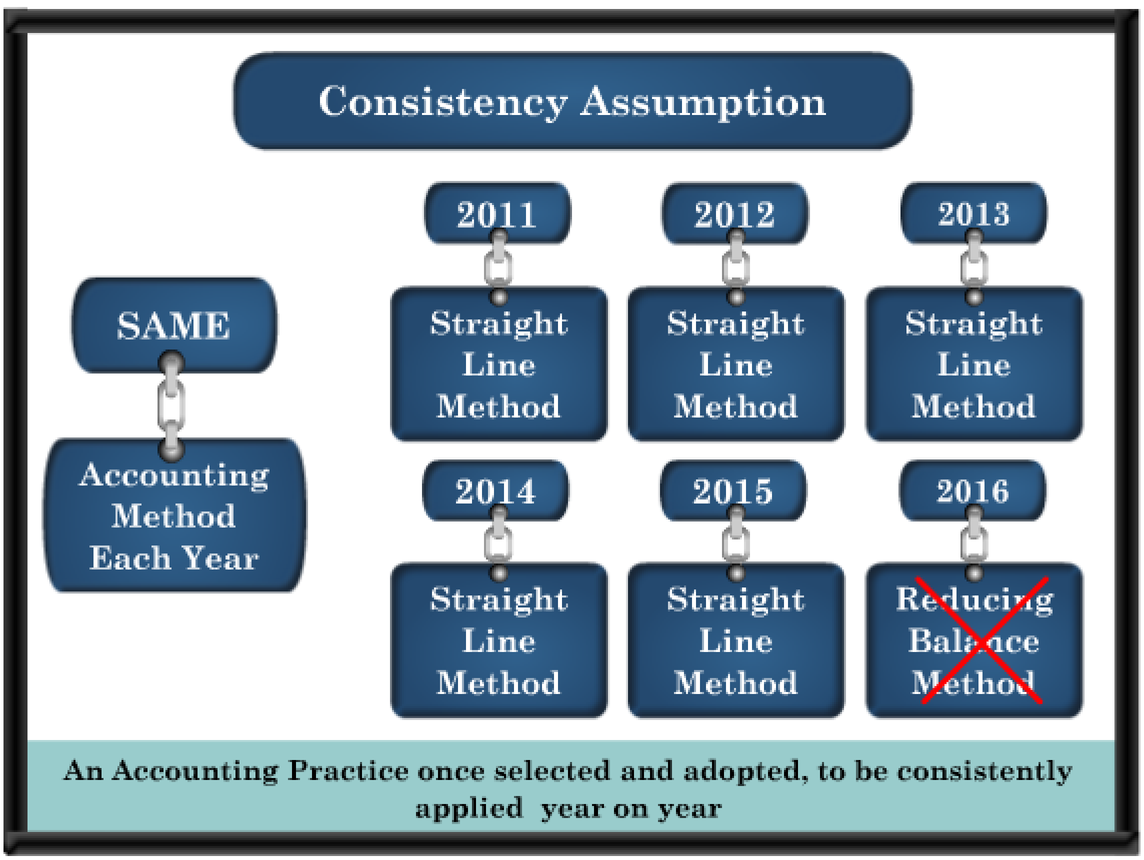
The convention of consistency means accounting practices once adopted must be applied consistently in future. An accurate presentation and comparison of financial position of an enterprise over a period of time can only be made if the accounting policies so followed are consistent over the years.

But the concept of consistency does not mean the business cannot change to a better method or presentation, the methods can be changed according to the requirements of business but the fact of such changes must be disclosed with reason in the financial statements.

Examples

1. Mr. Y is a garment retail trader. He uses Last-in-first-out method of inventory valuation in respect of stock at Retail outlet A and First-in-first-out inventory valuation method in respect of stock at Retail outlet B. In such a situation, if there is no valid reason for the different treatment of same stock located at different retail outlets, Mr. Y has to use any one of the valuation methods consistently for all stock.

2. Company X has been using Written down method for charging depreciation on Furniture. By applying consistency concept the company shall continue to use Written down method of depreciation in respect of Furniture in the following periods. In case company X wants to switch to some other method of charging depreciation, say straight line method, it must mention in its financial report, the reason for such change, the nature of the change and the effect of such change and other similar items.



Accrual

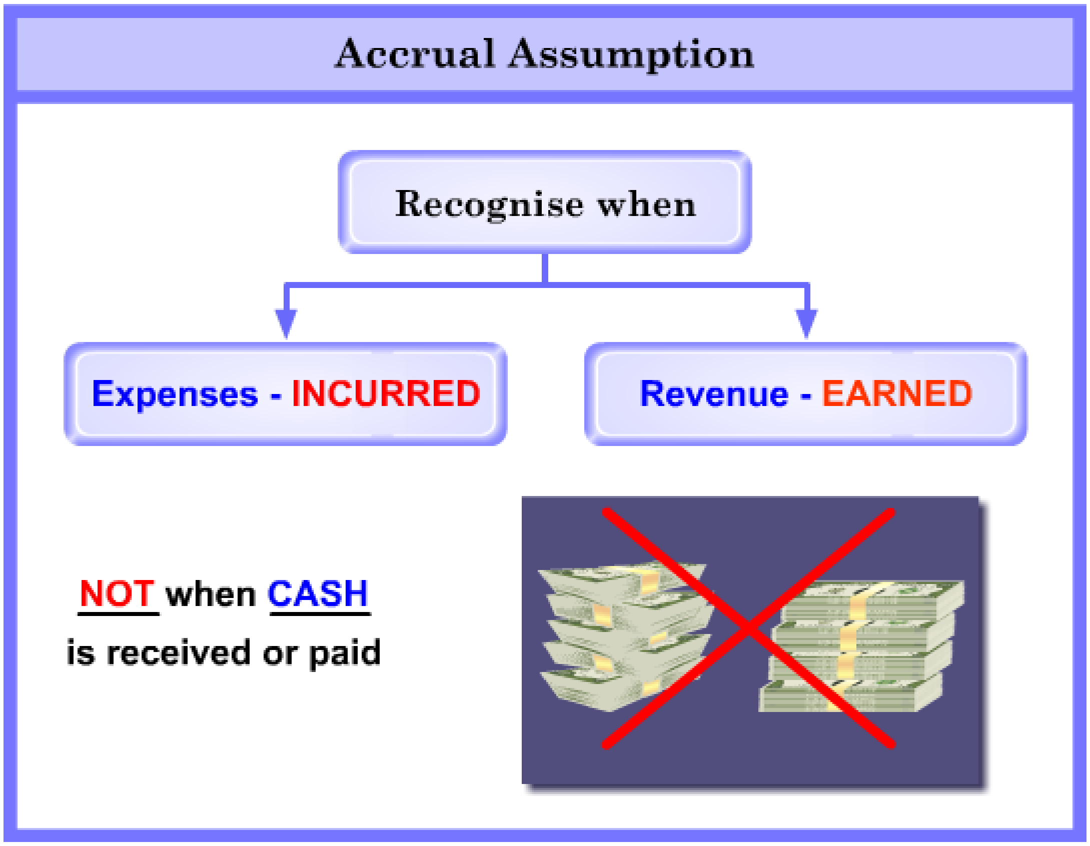
According to the accrual concept, a business transaction is recorded as and when it occurs and not when payment for the same is received/made. The sale from any transaction is recorded under this concept i.e. when the sale actually occurs and not when the payment for the same is received; similarly in case of an expense the transaction is recorded when the expense is incurred and not when payment for the same is made.

<u>Examples</u>

1. A Company records its electricity bills when it receives the bills, not when the payment for the same is made, as electricity service has already been provided to the company. In such a case, the company has to ignore the date on which the payment is being made.

2. A Mumbai based Law firm has obtained its premises on rent and has paid Rs 1,20,000 on 1st October. The premises has not been put to use yet so it hasn't recorded this payment. A half yearly report is prepared on 31st March, the firm expensed out six months' rent i.e. 60,000 [Rs 1,20,000/12*6] because time equivalent to 6 months has expired.

3. Air Asia sells its tickets days or even weeks before the actual flight date, but it does not record the receipts as revenue as the flight being the event on which revenue is based has not occurred till date.



Principles and Concepts of Accounting

Objectives

After going through this lesson, you shall be able to understand the following Principles & Concepts of Accounting.

- Business Entity Concept
- Money Measurement Concept
- Prudence or Conservatism
- Dual Aspect or Duality
- Matching Concept
- Historical Cost Concept
- Accounting Period Concept
- Full Disclosure Principle
- Materiality Concept
- Objectivity Concept
- Revenue Recognition or Realisation Concept

Business Entity Concept
According to the business entity concept, a business is a separate entity from its owners.

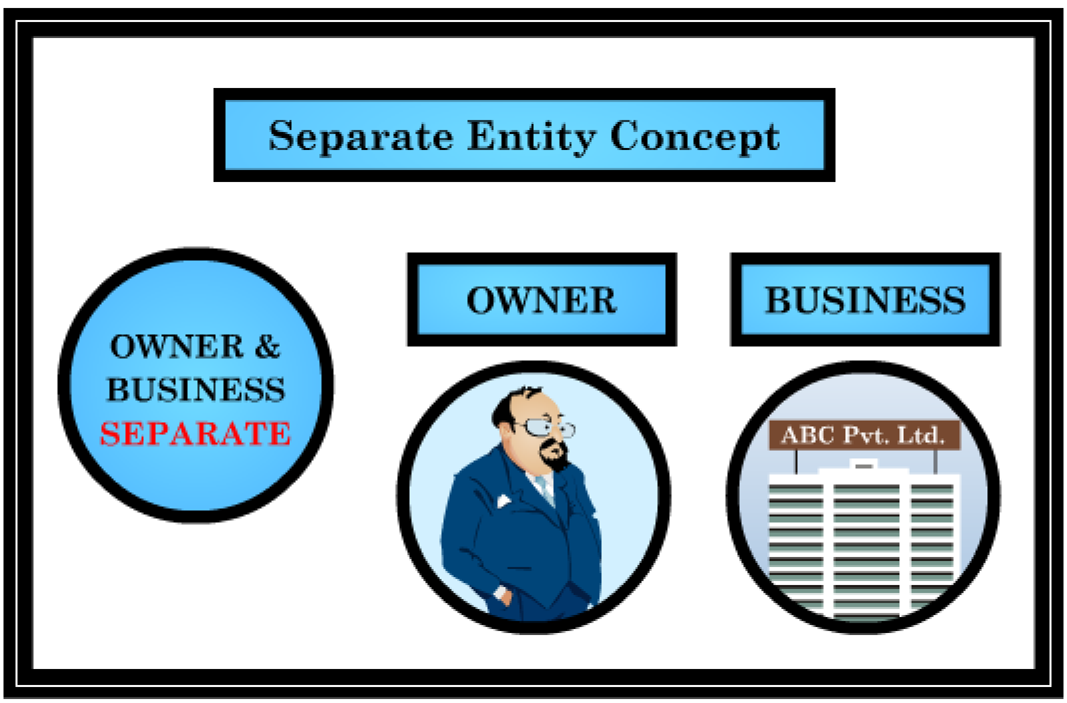
This basically means that personal transactions of the owners of the business are to be treated separately from the business transactions. While preparing accounts of any form of organisation be it Sole Proprietorship, Partnership, Company etc. we have to always treat the personal transactions of the owner as separate from the business transactions.

Examples

1. Mr. A, a lawyer has 5 rooms in his house, which he has rented for Rs 50,000 per month. He decided to start his own practice for which he decided to use one of the rooms. According to the business entity concept, only 1/5th of the rent i.e. Rs 10, 000 should be charged to business, as the other 4 rooms are used for personal purposes.

2. Mr. A has to pay membership fees of Rs 1,000 per month to Bar Council of India; he paid the same through his personal account. In such a situation the same has to be considered as his additional capital.

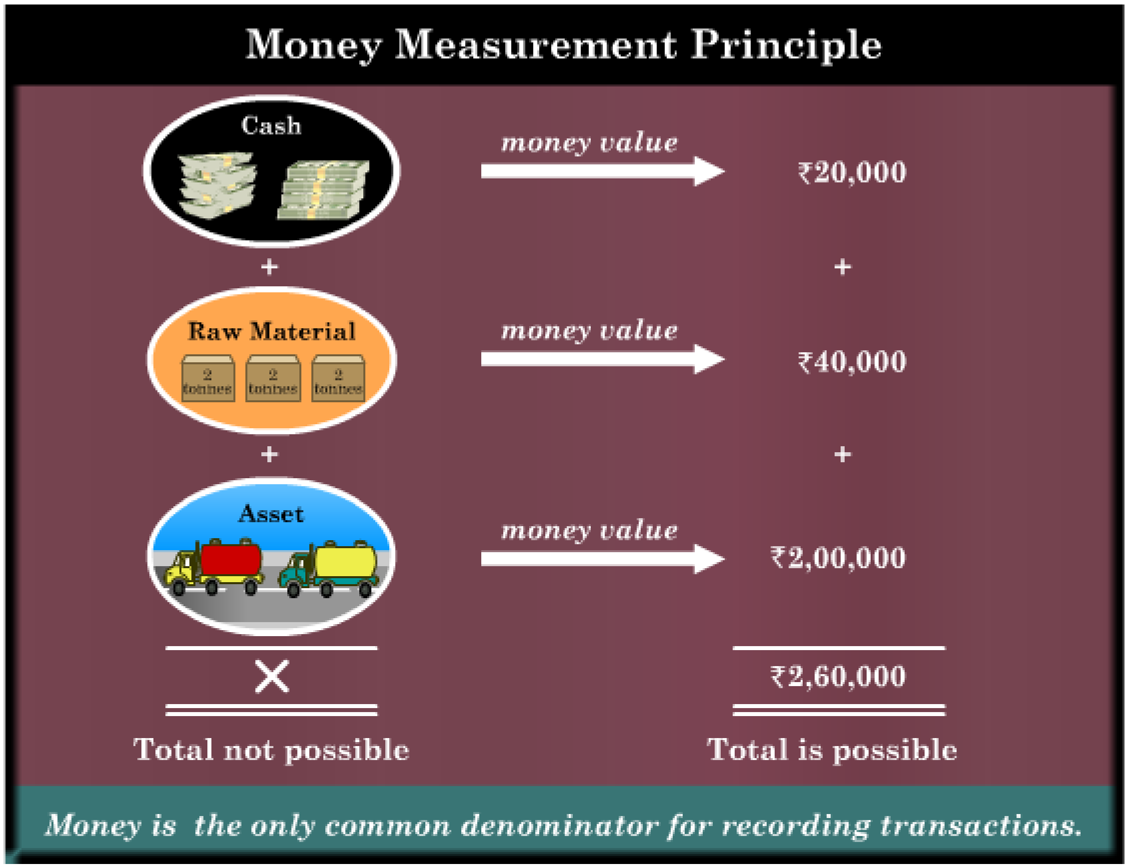
3. Mr. A received a telephone bill of Rs 2,500. The full amount was paid through his business account. Rs 2,000 are considered as drawings as only Rs 500 (1/5th) is related to his business and the remaining Rs 2,000 is for his personal reasons.



Money Measurement Concept
According to the money measurement concept, only the transactions that are measurable in money terms are to be recorded in the books of accounts of the business. On the other hand, those transactions that are not measurable in monetary terms are to be left out of record. There are two inherent limitations in this concept which are:

1. Items that cannot be expressed in terms of money cannot be recorded as accounting transactions. For example, employee skill level, working conditions, loyalty of customers, employee morale etc.

2. Money is assumed to have static value across the years but this doesn't hold good as the value of money keeps on changing day-by-day.

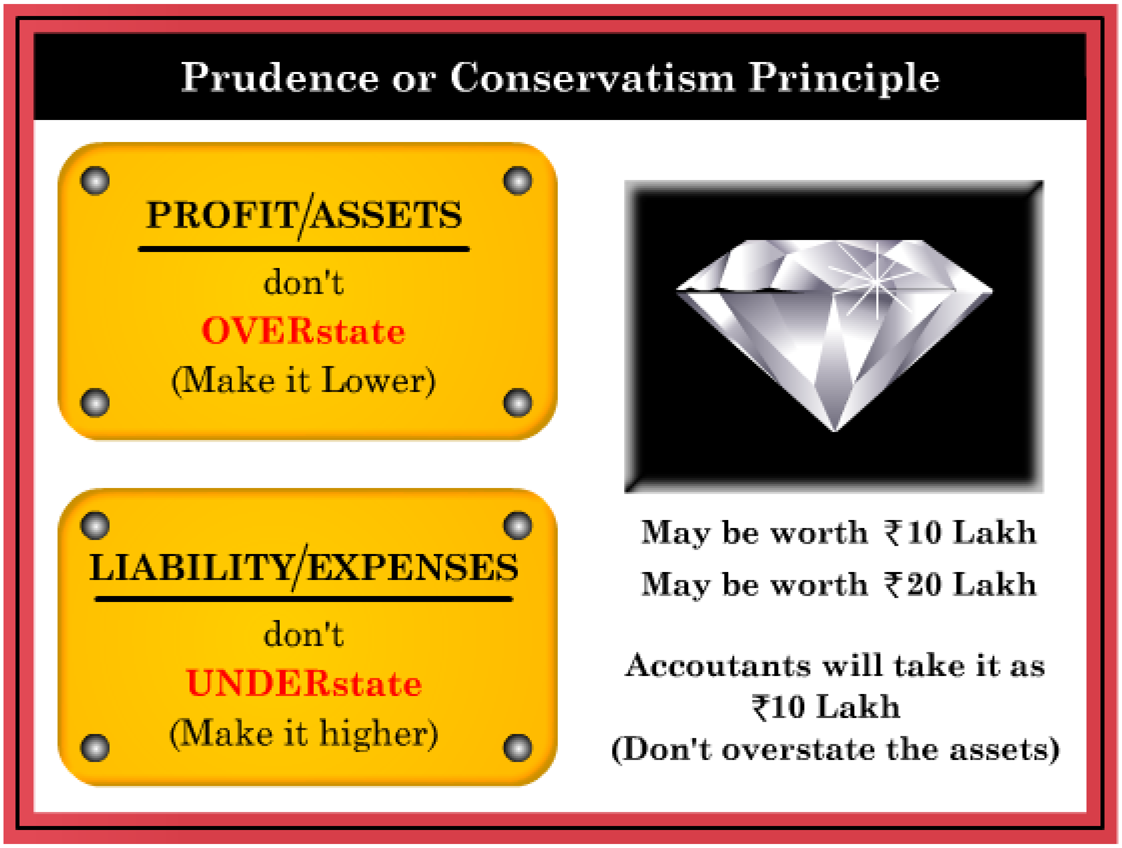


Prudence or Conservatism
While preparing accounting statements we make use of estimates as certain accounting data might be uncertain but it is important to disclose the same in order to present a true and fair view of actual position of the business. While making such estimates an accountant has to be prudent or must have a conservative outlook regarding the same.
The concept of Prudence states that "One shall not anticipate profit but shall always provide for all prospective losses". This makes sure that the assets and incomes are not overstated, while liabilities and losses are not understated.

Examples

1. Bad debts are bound to occur in any form of business. Due to the principle of prudence we make provision for bad debts which helps a business show its current position.

2. The value of assets is checked from time to time to make sure that their book value is not much different than their actual market value. In case of fixed assets, if the actual market value is very low then the assets have to be impaired.



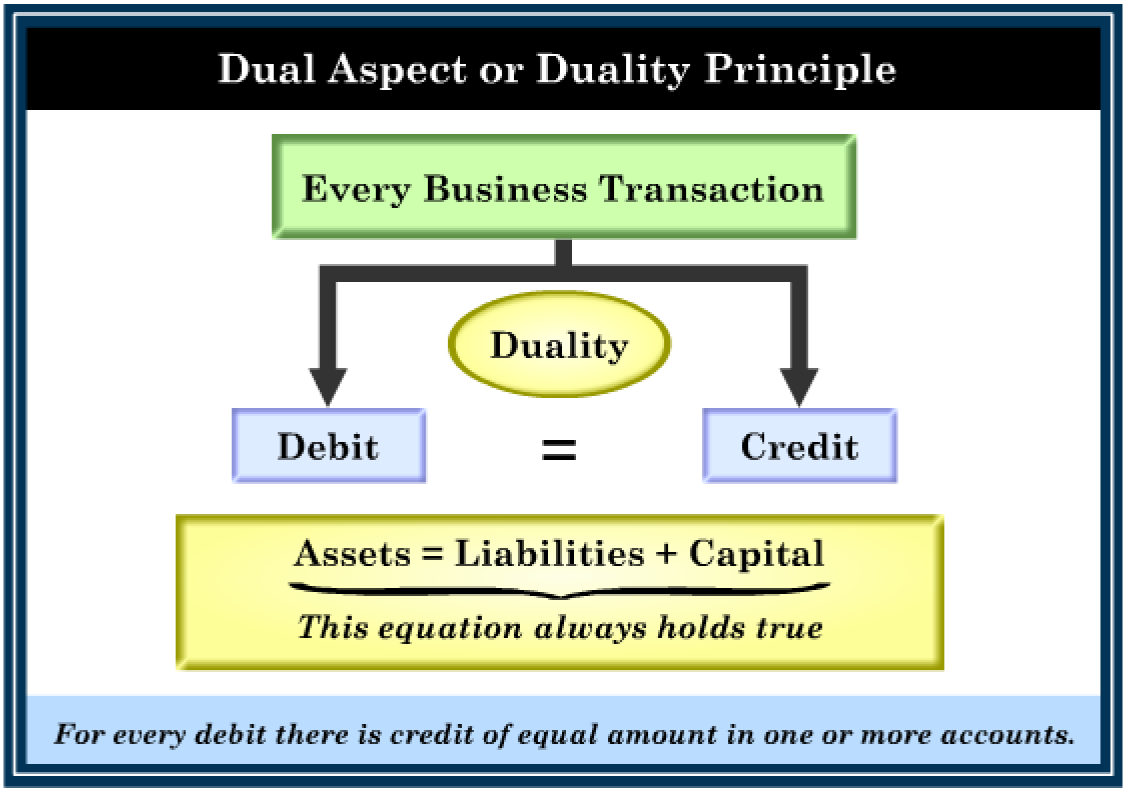
Dual Aspect or Duality

This concept states that every financial transaction has two fold effects. These two aspects always have equal effect. In simple terms we can state that for every debit there exists a credit.

For example, Mr. A started his business with an amount of Rs 1,00,000; this will result in- an increase in the cash balance on the asset side by Rs 1, 00,000. Due to operation of duality, the owner's equity or capital will also increase by an equal amount. We can observe here that the two items that got affected are cash and capital account.

In a similar way, let's suppose Tom bought goods worth Rs 50,000 on credit then on one hand his assets will increase by Rs 50,000 while on the other hand his liabilities will also increase by Rs 50,000.

Hence the duality principle can be expressed in terms of fundamental Accounting Equation which can be written as follows: **Assets = Liabilities + Capital**

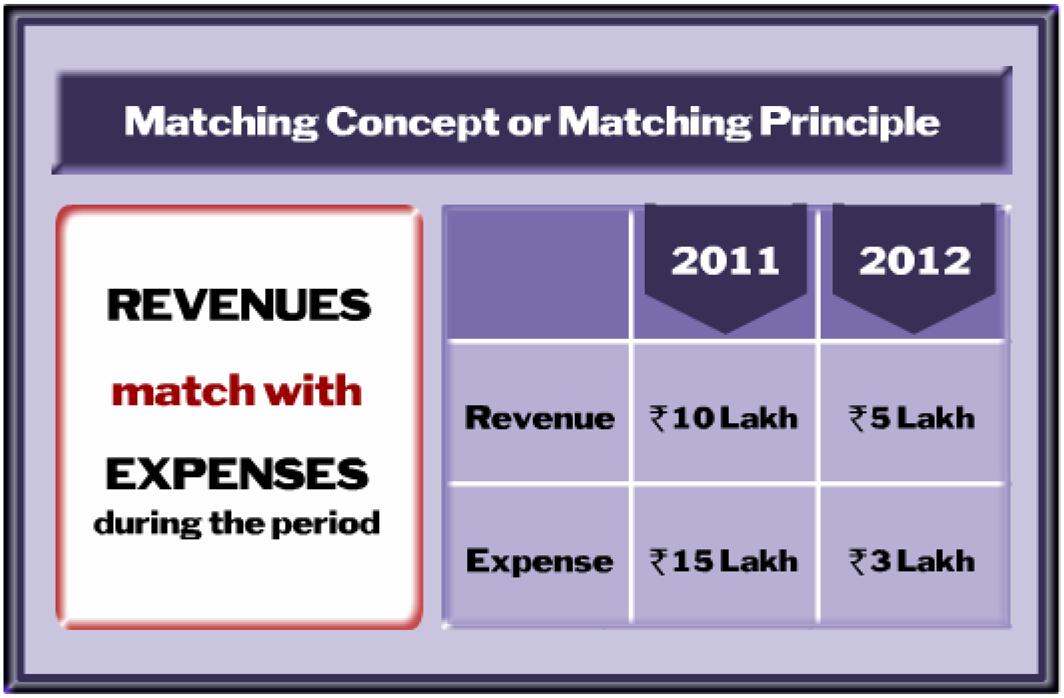


Matching Concept
According to the matching principle, the expenses which have been incurred to earn revenue shall be recorded in the same accounting period during which such revenue is recognised and not in the next or previous accounting period.

Examples

1. Sales worth Rs 5,00,000 is made in 2012. Total Inventory worth Rs 2,50,000 were purchased, of which Rs 50,000 remained in hand at the end of 2012.
   Rs 2,00,000 [i.e. Rs 2,50,000 minus Rs 50,000] is the cost of earning revenue worth Rs 5,00,000 and this 2,00,000 shall be recorded in 2012 resulting in gross profit of Rs 3,00,000.

2. A Law Firm pays Rs 50,000 per month as salary to each of the 4 lawyers employed by it. Rs 2,00,000 worth of monthly salaries must be matched with the revenue generated say Rs 4,00,000.



Historical Cost Concept
As discussed till now, accountancy relates to past events and the basic objective of preparation of financial statements is to enable comparability of financial data and consistency in adoption of financial policies. In order to achieve the above objectives the transactions shall be recorded on historical cost. In case in the subsequent period there is an increase in the value of the assets then the same shall not be recorded in the books of accounts.

<u>Examples</u>

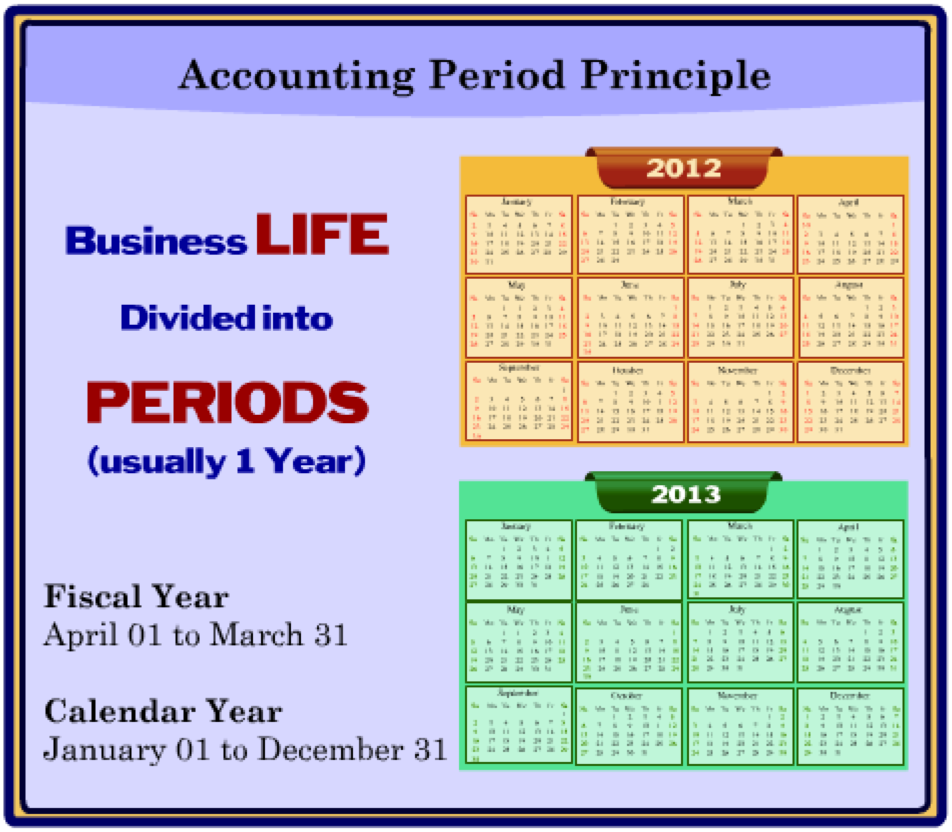
1. In May 2013, 1000 units of inventory were purchased by Mr. X for Rs 10 per unit, in June 2013 the value of Inventory rose to Rs 12 per unit. According to the historical cost concept, the inventory shall appear at Rs 10,000 not at Rs 12,000.

2. XYZ Ltd. developed ERP software at a cost of Rs 25,00,000, while the benefit that can be derived out of the same is Rs 75,00,000. In such a situation, we will recognise Rs 25,00,000 in the Balance sheet as the cost of ERP and not Rs 75,00,000.

Accounting Period Concept
Even though a business is assumed to continue forever (going concern assumption) but it is necessary to keep accounts in such a way that the results are known at frequent intervals. This time interval is known as "Accounting Period". While accounting periods might vary in terms of reporting dates but they must be consistent. The various users of accounting information require financial information at regular intervals, so we cannot wait for the liquidation of the company for the preparation of financial statements. Hence, as per the accounting period concept the financial statements are prepared at regular interval of time.

Examples

1. XYZ Ltd. refused to prepare books of accounts for the year ended 31 March 2013 saying that according to the concept of going concern its business is never ending entity and it shall go on forever so it shall not prepare the accounts. But, Mr. B clarified this doubt of XYZ Ltd. by quoting the Accounting Period Concept, thus XYZ Ltd. has to prepare its books of accounts for the year ending 31 March 2013.



Full Disclosure Principle
According to the principle of full disclosure, the financial statements shall disclose all material facts either on the face of it or in the notes to accounts. Full disclosure principle is of great relevance to materiality concept. Even though the provisions of Companies Act, 1956 has made many disclosures mandatory for the companies but still there are several ways in which the businesses can make better disclosure.

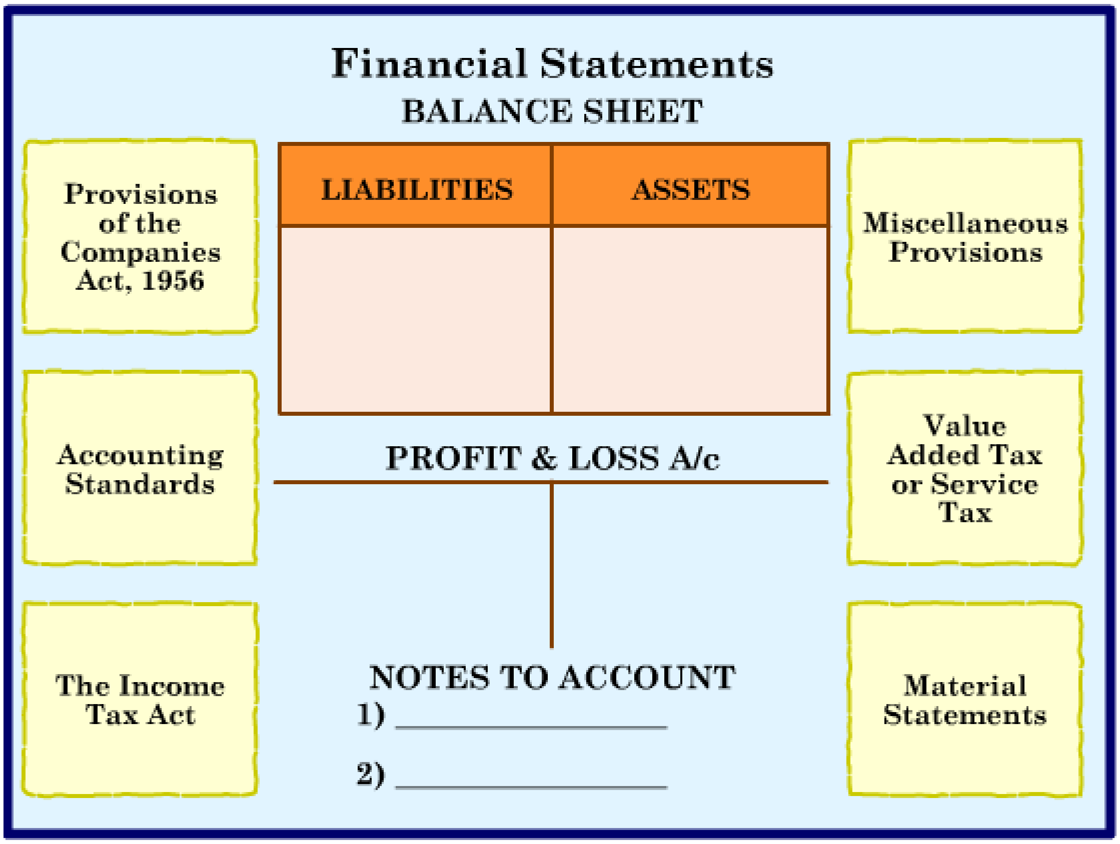
<u>Examples</u>

1. A business shall disclose all its accounting policies in order to help the users of financial statements to better understand the financial reports.

2. Contingent liabilities, contingent assets and other legal obligations etc. must be disclosed in the financial statements so that it helps the users to make an informed choice.

3. Events that have occurred after the preparation of financial statements but before the issue of financial statements are to be disclosed in the financial statements.

4. ABC Ltd sold one of its subsidiaries G Ltd to Mrs. A (director Mr. A's wife), then such information should be disclosed in the financial statements.



Materiality Concept
The main aim of preparation of financial statements is to enable the end users of the financial statements in making informed decisions. Thus, all such information which has the ability to affect the end users decisions is material in nature and must be disclosed in the financial statements.

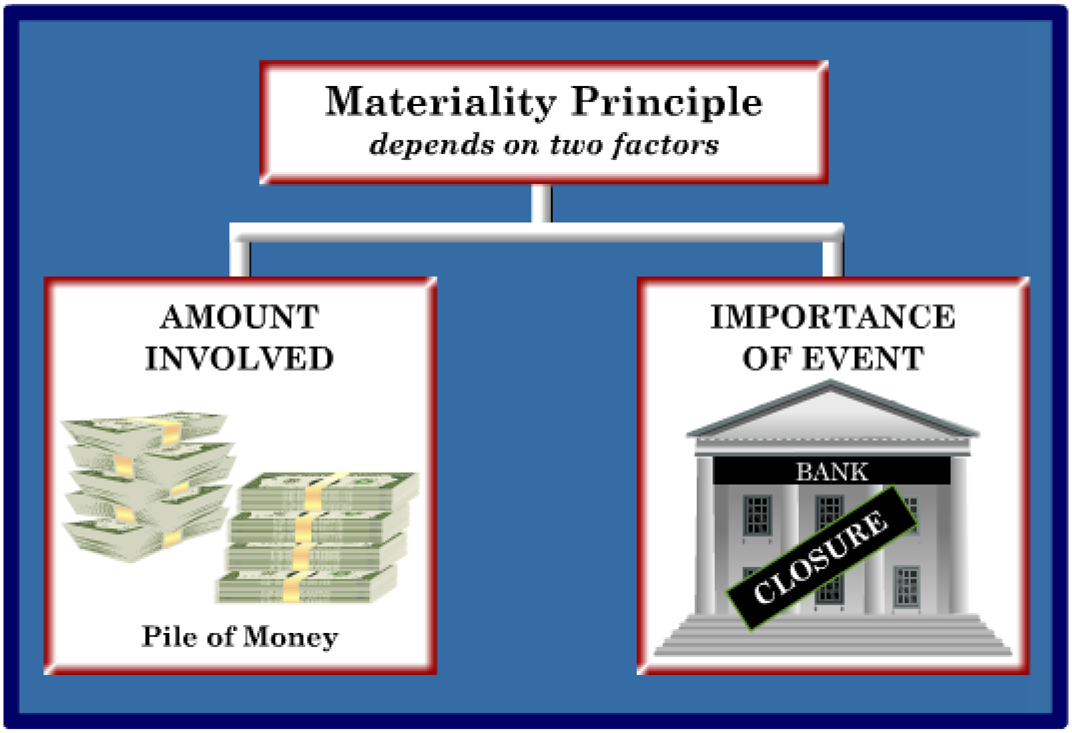
The decision whether information is relevant or not involves an element of judgement. This depends on two factors i.e. the amount involved or importance of the event.

Examples

1. XYZ Ltd Company is involved in exploration of gold mines in Zambia, the government of Zambia has passed a new legislation that will place a ban on export of gold from the country that will seriously jeopardise the future prospects of the company. In such a case, this being material information shall be disclosed in the financial statements of XYZ Ltd.

2. The remuneration paid to the directors and key employees shall be disclosed in the financial statements as this is a material figure for various stakeholders.

3. The various accounting policies employed by organisations must be disclosed in the financial statements in order to enable a better understanding of financial position of the company.



Objectivity Concept
According to the objectivity principle, the accounting should be free from personal bias. That is, the accounting transaction should be supported with written documents such as cash memo, invoices etc. It basically means that the accounting entries shall be based on facts rather than being open to interpretation, as interpretations are nothing but opinions.

<u>Examples</u>

1. Mr. X bought a plot of land 5 years ago for Rs 20,00,000. Today, he gets the valuation of plot done from 5 different valuators who all are experts in their field. But, at the end of the day they are giving an opinion only on the value of land which is subjective. The only thing objective here is the value of land 5 Years ago i.e. Rs 20, 00,000 and the same should be taken into consideration.

2. Miss A is an accountant responsible for auditing the accounts of XYZ Ltd. She asks for invoices and other documents to support the purchases and sales. XYZ Ltd requests her to take the numbers as given as it will involve too much work for them to search for related documents. Subsequently, she took the totals as given violating the objectivity principle because financial statements must be based on verifiable and reliable documents and not on someone’s opinion or interpretation.

Revenue Recognition or Realisation Concept
According to the concept of revenue recognition, revenue is to be recognised only when rewards and benefits associated with the items sold and services provided are transferred i.e. when the right to receive money is established. In other words, at the point where the seller has completed his part of the transaction.

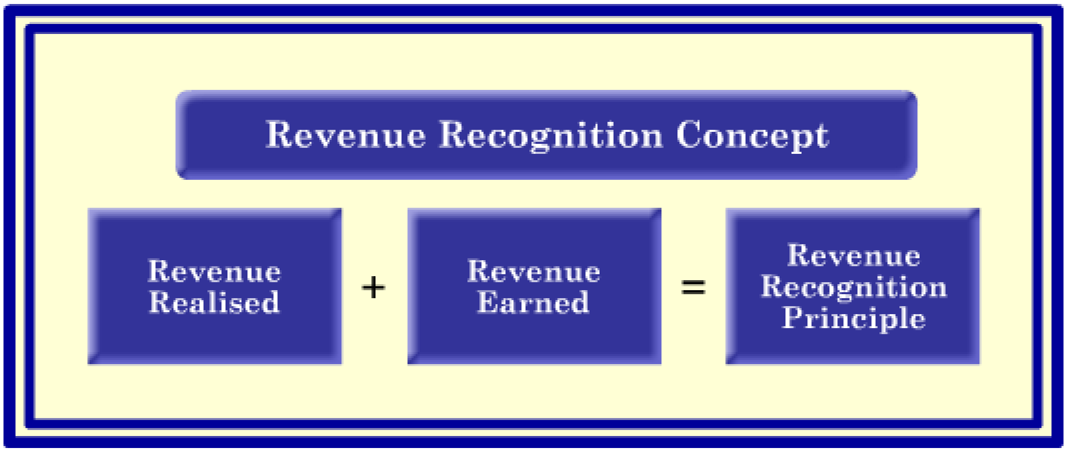
It is to be noted that receipt of revenue and receipt of an amount are two distinct aspects.

<u>Examples</u>

1. When Vodafone sells you the talk time through scratch cards, it does not recognise the revenue when the scratch card is sold, but it is recognised when the subscriber makes a call and consumes talk time.

2. India Today Receives an annual subscription of Rs 240 from Mr. X during the beginning of the year but it recognises revenue worth Rs 20 (i.e. Rs 240/12) each month.

3. Star Sports recognises the revenue when the advertisement is actually aired. That is, it does not matter whether the payment is received in advance or after the broadcast of advertisement.



Systems of Book Keeping and Basis of Accounting

Objectives

After going through this lesson, you shall be able to understand the following concepts.

- Single Entry System of Accounting
- Double Entry System of Accounting
- Cash Basis of Accounting
- Accrual Basis of Accounting
- Difference between Accrual & Cash Basis

Single Entry System

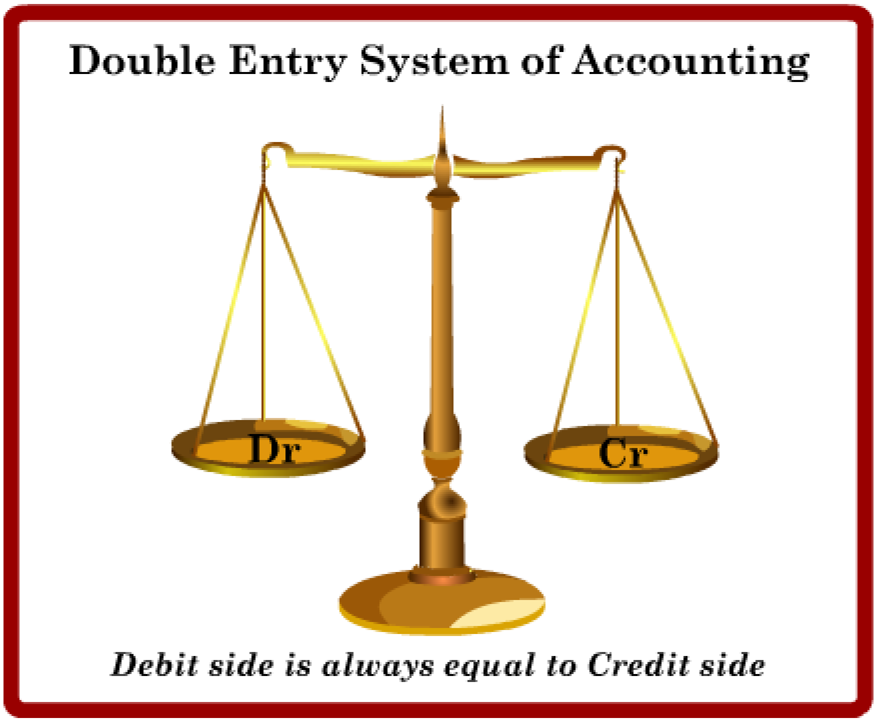
This system of accounting is also known as Incomplete Recording System. Under this system, only personal accounts and cash book are maintained in contrast to the maintaining of all the accounts as under the conventional system of accounting. This system of accounting relies on one sided accounting entry to maintain financial information.

According to Kohler "*Single entry system is a system of book keeping in which as a rule only records of cash and personal accounts are maintained. It is always an incomplete double entry, varying with circumstances*"

Double Entry System

Double Entry System was first codified by the Franciscan friar Luca Pacioli in the 15^{th} Century. According to this system of book-keeping, every financial transaction has two equal and opposite effects. It is used to satisfy the basic accounting equation i.e. Assets = Liabilities + Capital

The balance of all debits and credits in double entry book keeping system is always equal, as debit in one account will be balanced by credit in another account. Under the double entry system of book keeping, it is easier to detect errors and prepare financial statements directly from the books of accounts.



Cash Basis of Accounting

The cash basis of accounting recognises revenue and expenses at the time of actual receipt or payment of cash.

The cash basis of accounting is less accurate than accrual basis of accounting as they affect the company's books only when complete exchange of value has occurred. Cash basis of accounting might be easier and cheaper to maintain but the needs of users of financial statements are not satisfied due to inaccurate nature of this method.

Example

A construction company secures a contract for construction of a stretch of Delhi Metro and will receive the payment for the same from DMRC at the completion of construction. Using cash basis of accounting, revenue would be recognised only on the completion of the project, while the expenses will be recorded as and when they have been paid out. Generally, projects take more than a year to complete; in such scenarios the income statement of the company would be misleading as the company will incur large losses in one year and abnormally high profits in the next year.

Advantages of Cash Basis of Accounting

1. It is relatively easy to record transactions using this basis of accounting because no adjustments have to be made with respect to outstanding expenses (expenses due but not paid), prepaid expenses (expenses not due but paid in advance), etc.
2. It is mostly followed by the firms that have majority of their transactions on cash basis. For e.g.: A Shopkeeper selling confectionery, etc.
3. It rules out the personal judgments and perceptions of the practitioner and makes the accounting process much more objective.

Limitations of Cash Basis of Accounting

1. The Matching Principle of Accounting is not followed because all the revenues of the period might not match with the costs of the period if cash has not been received or paid respectively for them.
2. No distinction will be made in the revenue and capital items and so there will not be any consistency in the profits of the two years.
3. It does not present true and fair picture of the business since non cash transactions like credit sales or purchases, etc., are not taken into consideration.

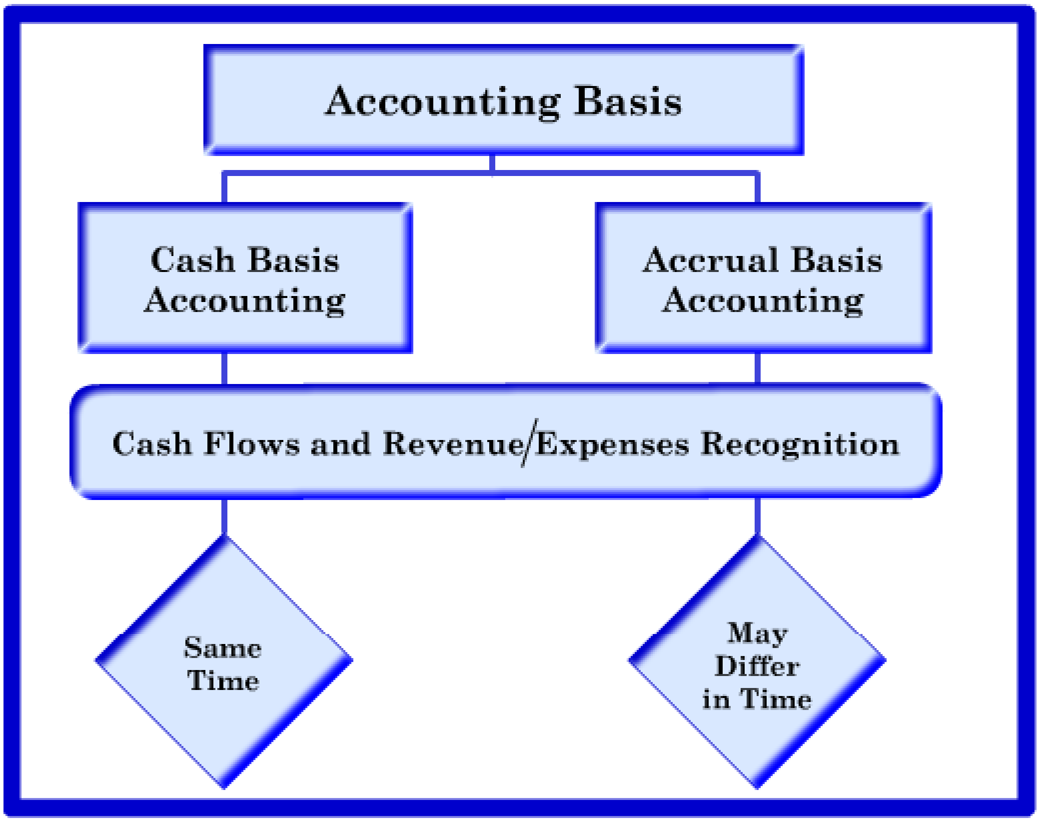
Accrual Basis of Accounting

According to the accrual concept, revenue and cost are recognised as and when they occur instead of when they are actually paid or received in cash. The revenue is generated and the costs are incurred when the legal right to receive or obligation to pay is established.

<u>Examples</u>

1. A Company records its electricity bills when it receives the bills, not when the payment is made, as electricity service has already been provided. In such a case, the company has to ignore the date on which the payment is being made.

2. A Mumbai based Law firm has obtained its premises on rent and has paid Rs 1,20, 000 on 1st October. The premises has not been put to use yet so it hasn't been recorded as expense. A half yearly report is prepared on 31st March, the firm expensed out six months' rent i.e. 60,000 [Rs 1,20,000/12*6] because time equivalent to 6 months has expired.



Advantages of Accrual Basis of Accounting

1. Since it records all the transactions pertaining to the accounting year whether cash or non cash, it is widely accepted. For example: Purchase of goods for credit.
2. It discloses the true profit or loss of the business by recording all the transactions.
3. It presents the true financial position of the business by taking into account all transactions like outstanding expenses, prepaid expenses, etc.
4. It follows the Matching Principle concept and is considered a more scientific approach of accounting.

Disadvantages of Accrual Basis of Accounting

1. It is a relatively complex system since it includes treatment of non cash transactions in the books of accounts.
2. Profit/Loss cannot be assessed quickly since all the adjustments have to be made before arriving at the financial position of the business. For example: Salary Paid: Rs. 3000; Salary Outstanding: Rs. 400; Then total salary to be recorded will be Rs. 3400.

Difference between Accrual & Cash Basis

Basis Of Difference	Accrual Basis	Cash Basis
Preferred by	Businesses involving both cash and credit transactions.	Businesses involving predominantly cash transactions.
Reliability	As this method involves preparation of all accounts, it is comparatively much more reliable as it helps us ascertain correct profit.	This method involves preparation of only cash account and personal accounts, thus it is not a reliable basis for preparation of accounts. It does not lead us to correct profit.
Users	A profit oriented business enterprise usually prepares its accounts on accrual basis.	Professionals like Doctors, Lawyers etc, small ventures of temporary nature, some non-trading enterprises or institutions with service motive usually follow this method.
Adjustments	This method involves adjustment of accounts for preparation of financial statements.	It is a simple method as it does not involve many adjustments.

Accounting Standards- Introduction, Purpose and Importance

Objectives

After going through this lesson, you shall be able to understand the following concepts.

- Meaning of Accounting Standards
- Nature & Scope of Accounting Standards
- Uses of Accounting Standards
- Limitations of Accounting Standards
- Accounting Standards Issued by The Institute of Chartered Accountants of India (ICAI)

Meaning of Accounting Standards
The main objective of preparation of financial statements is to summarise the financial

position of a business enterprise for an accounting period in monetary terms. In order to compare the financial position of an enterprise with that of another enterprises, there needs to be a consistency in the method of preparation of financial statements across various companies. In order to make these methods and principles uniform and consistent across organisations the accounting standards have evolved.

Accounting Standards are the statements of code of practice from the regulatory accounting bodies that are to be observed in the preparation and presentation of financial statements. In layman terms, accounting standards are the written documents issued by the expert institutes (ICAI) or other regulatory bodies covering various aspects of measurement, treatment, presentation and disclosure of accounting transactions.

According to Kohler, "*A code of conduct imposed on an accountant by customs, law and professional bodies*"

Nature & Scope of Accounting Standards

The below mentioned are the basic points explaining the nature of accounting standards.

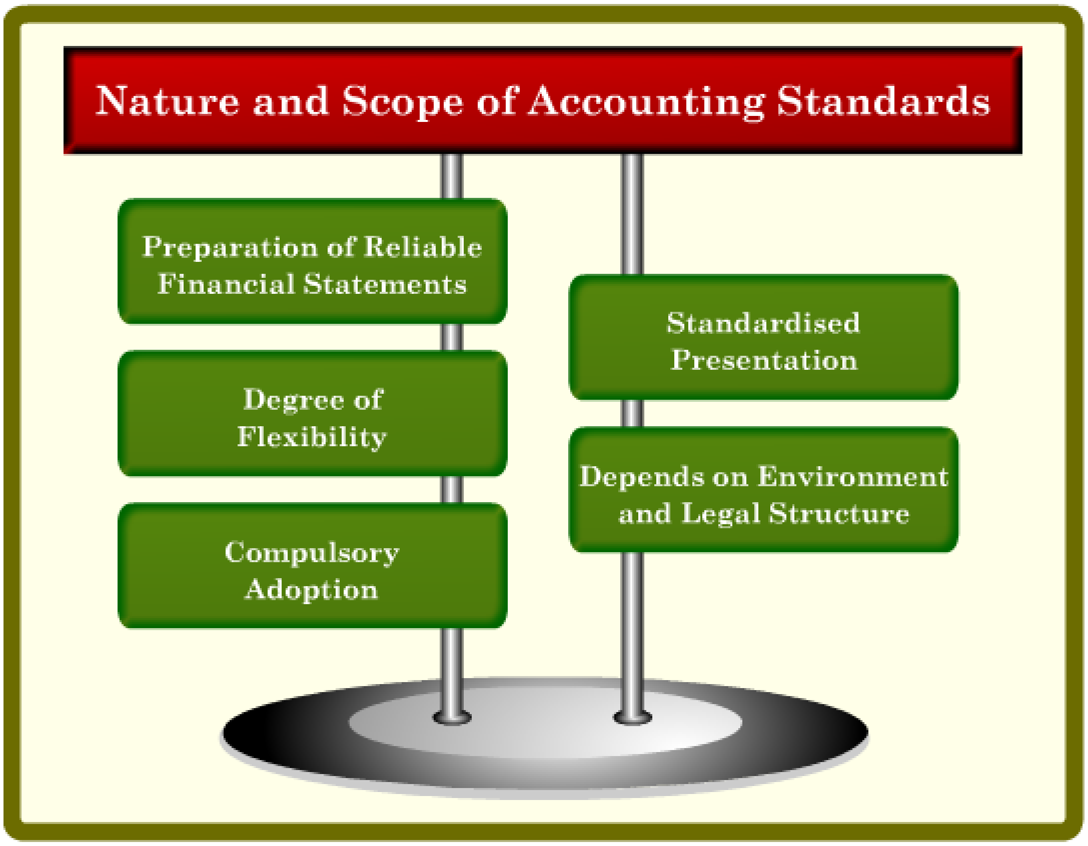
1. Accounting standards are a set of guidelines that help in the **preparation of reliable financial statements.**

2. Accounting standards help in bringing a **standardisation of presentation** and help in removal of variations that exist in treatment of accounting information.

3. Accounting standards depend on the **environment and legal structure** of the country in which the business operates. Due to constant changes in the environment of our country, the accounting standards are updated by the ICAI from time to time. In case of dispute between the Law of Land and Accounting Standards, the law will prevail.

4. It is **compulsory** for various companies to adopt accounting standards.

5. Accounting standards are **flexible,** as alternate presentations and practices are acceptable and an enterprise is free to adopt any method as long as it follows it consistently. In case the accounting practices are changed, the change must be quantified and disclosed in the financial statements.



Need for Accounting Standards

Accounting Standards are required to ensure the compliance of following information with the qualitative characteristics of accounting:

1. Profit or Loss of the business enterprise
2. Financial Position of the business enterprise
3. Inflow and outflow of Cash

All the above information must comply with the qualitative characteristics of accounting i.e. Reliability; Relevance; Understandability; and Comparability. Accounting Standards also assures its various users about the truth and fairness of the information contained in the Financial Statements of the business enterprise. These standards maintain uniformity in the process of accounting records as well as it assists in the comparison of books of accounts of different business enterprises.

Uses of Accounting Standards

Accounting standards serve the following purposes.

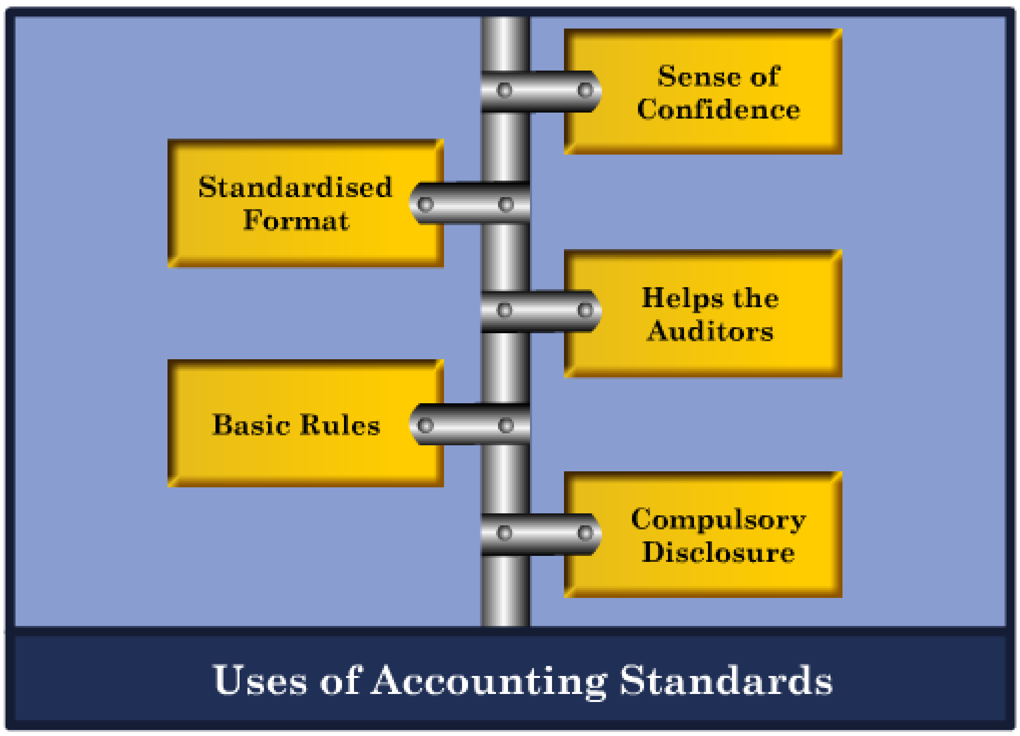
1. They provide a **standardised format** which is to be followed while preparation of accounts, minimising the variations in the method of preparation of accounts.

2. Accounting standards provide the **basic rules** on the basis of which financial statements are prepared.

3. They make it **compulsory** for the companies to make a **disclosure** of the accounting policies followed while preparation of financial statements.

4. When a company complies with the accounting standards while preparation of financial statements it creates a **sense of confidence** among the users of financial statements.

5. They **help the auditors** in auditing the books of accounts as consistent use of same accounting policies helps an auditor in forming an opinion about the financial statements.



Objectives of Accounting Standards

1. We establish standards so that we can **compare our performance with something** which is uniform for all. For example: Our marks are expressed in percentage which is a common unit of measurement for all so that the students can compare their performance with other students during the year. Similarly, these accounting standards are followed universally and this thus, makes comparison between the two firms possible.
2. Financial statements are the only **source for the stakeholders to know about the business.** These accounting standards ensure that they are prepared in a manner that people can rely and make sense out of them. For example: Researchers trying to

understand the corporate governance practices of the business can rely on these statements.

3. Imagine a situation where in a classroom the teacher asks her students to study at their own will. In such a case, it would only lead to ruckus in the class. Similarly, if accounting policies and practices are left at the discretion of the business entities then they might go haywire and there will be no uniformity at all. As a result, of these standards the **diverse practices have been kept at bay.**

Benefits of Accounting Standards

1. <u>Elimination of variation in accounting treatment</u>: Accounting standards eliminate variations in accounting treatment as it works on a set of accounting principles and methods which are followed throughout the entire accounting fraternity. These standards are uniformly followed which further eliminates variation in preparation and presentation of books of accounts.
2. <u>Full disclosure of accounting principles</u>: AS-1 requires full disclosure of accounting principles and policies which are helpful for the various users of accounting information such as present and potential investors of a business. However, such information may not be compulsory for disclosure by the law of the country.
3. <u>Inter and intra firm comparison</u>: Accounting standards form a strong base for comparison of books of accounts maintained by different departments within firms (intra) or between two different firms (inter).

Limitations of Accounting Standards

1. <u>Inflexible Framework</u>: An accountant has to follow that method only which is mentioned in the accounting standards while preparing accounts. It is not necessary that a method appropriate in one situation would be applicable in other situations as well.

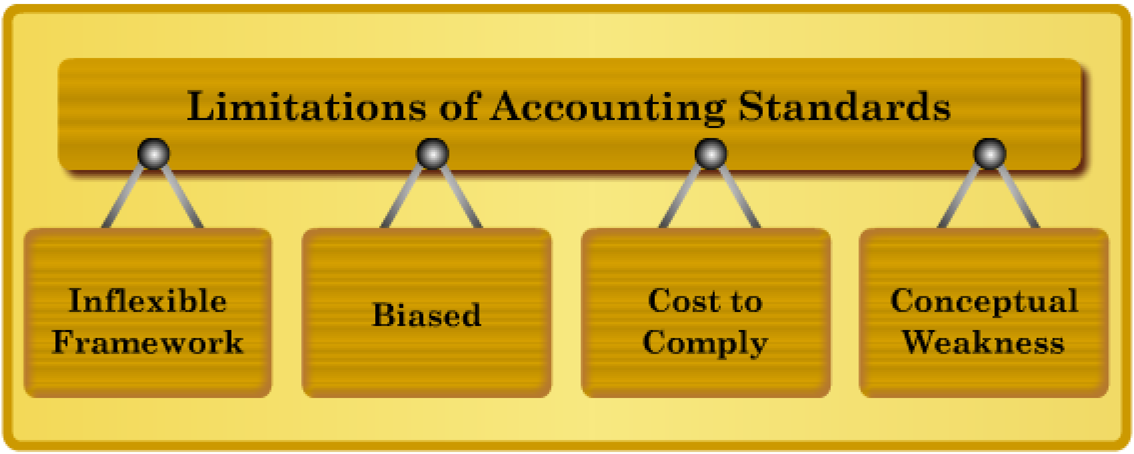
2. <u>Biased</u>: Accounting standards may be subject to lobbying or government pressure. Thus, in order to give unfair advantages to big corporate houses the standards might be compromised.

3. <u>Cost to Comply</u>: We live in a dynamic environment and in order to keep up with the needs of business from time to time, new accounting standards are issued by the ICAI and in order to comply with these the company has to incur various costs. Sometimes a company has to design new procedures, which require large financial investment in the form of employee training cost, labour cost, system upgradation etc.

4. <u>Conceptual Weakness</u>: Earlier standards were not based on a sound conceptual framework of accounting but the ICAI is committed to rectify these.

5. Affected by errors: Accounting Standards have been developed by human beings. So, there can be a chance of errors while developing these standards.

6. Drafted within the ambit of law- Accounting Standards must adhere with the law of country. It cannot go beyond the boundaries prescribed by law of the country.



Applicability of Accounting Standards

Accounting Standards are applicable to the following organizations:

Sole proprietorship unit
Hindu undivided family
Partnership firm
Companies
Societies
Charitable organization
Trusts
International Financial Reporting System
Association of persons
Cooperative societies

Accounting Standards Issued By the Institute of Chartered Accountants of India (ICAI)

The following are the mandatory Accounting Standards (AS) as on July 1, 2012 by The Institute of Chartered Accountants of India (ICAI) -

- AS 1 Disclosure of Accounting Policies

- AS 2 Valuation of Inventories

- AS 3 Cash Flow Statements
- AS 4 Contingencies and Events Occurring after the Balance Sheet Date
- AS 5 Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies
- AS 6 Depreciation Accounting
- AS 7 Construction Contracts (revised 2002)
- AS 9 Revenue Recognition
- AS 10 Accounting for Fixed Assets
- AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003),
- AS 12 Accounting for Government Grants
- AS 13 Accounting for Investments
- AS 14 Accounting for Amalgamations
- AS 15 Employee Benefits (revised 2005)
- AS 16 Borrowing Costs
- AS 17 Segment Reporting
- AS 18 Related Party Disclosures
- AS 19 Leases
- AS 20 Earnings Per Share
- AS 21 Consolidated Financial Statements
- AS 22 Accounting for Taxes on Income
- AS 23 Accounting for Investments in Associates in Consolidated Financial Statements
- AS 24 Discontinuing Operations
- AS 25 Interim Financial Reporting

- AS 26 Intangible Assets

- AS 27 Financial Reporting of Interests in Joint Ventures

- AS 28 Impairment of Assets

- AS 29 Provisions, Contingent Liabilities and Contingent Assets

The below mentioned are the Accounting Standards that are not mandatory as on July 01, 2012:

- AS 30 Financial Instruments: Recognition and Measurement and Limited Revisions to AS 2, AS 11 (revised 2003), AS 21, AS 23, AS 26, AS 27, AS 28 and AS 29

- AS 31, Financial Instruments: Presentation

- AS 32, Financial Instruments: Disclosures, and limited revision to Accounting Standard (AS) 19, Leases

IFRS, Concepts and their Convergence with Indian AS

Objectives

After going through this lesson, you shall be able to understand the following concepts.

- Overview
- Underlying Assumptions in IFRS
- IFRS Based Financial Statements
- IFRS & Indian Context
- List of Indian Accounting Standards (Ind-AS)

Overview

By now, we have been able to understand that accountancy is the language of business. But in today's globalised environment, business does not operate in just one country rather they operate around the world. However, it must be emphasised that around the globe different countries follow different accounting standards. This leads to a need for global set of standards commonly referred to as '***International Financial Reporting Standards (IFRS)***'. IFRS are designed to serve as a common global language of business affairs so that accounts of various companies are understandable and comparable across international boundaries. National accounting standards prevailing in different countries are being replaced by these International Financial Reporting Standards.

International Financial Reporting Standards (IFRS) are a set of standards developed by International Accounting Standard Board (IASB) stating how a particular transaction shall be treated or an event shall be reported in financial statements.

The basic aim of IFRS is to enable comparison of financial statements not just in our country but around the globe. This is quite difficult as every country today has its own standards, for example, in US, US GAAPs are followed and similarly in India, Indian GAAPs are followed. So, it becomes very difficult to comprehend all such standards which are being followed around the world in one set of rules.

Underlying Assumptions in IFRS

1. **Measuring unit assumption:** Measuring unit is the current purchasing power. It means that assets and liabilities are not to be shown at the historical cost in the Balance sheet but at their current or fair value.

2. **Units of Constant Purchasing Power:** It requires that inflation prevailing in the country should be accounted for i.e. value of capital should be adjusted to inflation at the end of financial year.

3. **Going concern:** It is assumed that life of the business is infinite i.e. the entity will continue to exist for an indefinite period in future.

4. **Accrual assumption:** Transactions are recorded on accrual basis i.e. as and when they occur and the actual date of payment or receipt is immaterial.

Need of International Financial Reporting Standards (IFRS)

1. <u>Check on manipulation in financial statements</u>: IFRS helps to keep a check on the manipulation associated with the figures related to financial statements. This encourages a consistency in the recognition and measurement of financial statements.
2. <u>Global harmony, uniformity and comparability</u>: IFRS help the economies of the world to establish global harmony, uniformity and comparability in the process of preparation of their financial statements.
3. <u>Flow of foreign investment</u>: The Financial Reporting Standards and Accounting Standards together create a sense of security in the minds of foreign investors which facilitate a free flow of direct as well as indirect flow of foreign investments across the countries.

IFRS Based Financial Statements

1) Statement of Financial Position (Balance Sheet)

2) Statement of Comprehensive Income (Profit and Loss Account)

3) Statement of Changes in Equity

4) Statement of Cash Flows

5) Notes and Significant Accounting Policies

Measurement of the Elements of IFRS Based Financial Statements

IFRS as discussed earlier have evolved because of the world coming closer and closer as a result of the globalization. For comparison of the firms across the globe, it thus, becomes essential for them to prepare their financial statements uniformly.
Various elements like assets and liabilities, etc., contained in the IFRS based financial statements can be measured using the bases as mentioned below to different extents:

1. **Historical Cost:** This is in conformity with the Historical cost concept studied in the previous chapter. So, going with it we record all our assets at an amount we paid to acquire them and liabilities at the amount of money we received in lieu of the obligation. For example: Furniture purchased for Rs. 8000 then this will be the amount so recorded.

2. **Current Cost:** As we are all well aware by now, that the prices of the goods that we own like television, laptops, etc., never stays the same. It is for this reason, that we sometimes carry our assets in the Balance Sheet at the price or amount we will currently pay for them. Also, the liabilities are carried at before discount value for the settlement of the obligation.

3. **Settlement (Realisable) Value:** Here, the computation is based on what we would get in return if the assets are sold and what we will pay for our liabilities in the future if calculated at present. Based on this, assets are carried at the present discounted value (i.e. the value of Rs. 1 earned today is much more than that earned in the future owing to uncertainties) of the net cash inflows that it would generate in the normal course of the business. Similarly, liabilities are carried at the present discounted value (i.e. what we pay tomorrow is much less than what we pay today.) of the future net cash outflows that we are expected to pay in the normal course of the business.

IFRS & Indian Context

Implementation of IFRS by the Indian corporate sector has been rolled out in phases. Initially, not every company was required to adopt IFRS while preparing its books of accounts. However, very lately i.e. from the financial year (2016-17) adoption of IFRS has been mandated by the ICAI.

In this context, it must be noted that either the IFRS can be directly adopted as issued by the International Board of Accounting Standards or the existing accounting standards can be altered (or converged) so as to conform to the provisions as contained in the newly issued IFRS. Such accounting standards are known as IND-AS.

IFRS versus Indian Generally Accepted Accounting Principles (GAAP)

Basis	IFRS	Indian GAAP/ Accounting Standard
1. Scope	Nearly 120 countries or jurisdictions allow or require their domestic companies to comply with IFRS and 90 countries have fully adopted it.	It is followed by the Indian companies only and hence is very limited in the scope.
2. Created by	International Accounting Standards Board (IASB) has developed it.	It was developed by the Ministry of Corporate Affairs (MCA).
3. Recording of Assets and Liabilities	Assets and Liabilities are recorded at the fair value at the date of Balance Sheet. This means that the values have to be revised every year.	Assets and Liabilities are recorded at their historical cost.
4. Treatment of Depreciation	Since the value is revised every year so no depreciation is charged on the cost of asset but is valued on that date and the difference between opening and closing valuation is debited or credited to P&L A/c.	Depreciation is charged on the cost of the asset.
5. First time Adoption	It gives very clear and lucid instructions on how to adopt these standards for the very first time.	No such instructions are given on first time adoption.
6. Disclosure requirements	Companies following IFRS have to give a note that their financial statements comply with IFRS.	No such note is to be give as it is presumed that the companies in India are complying with it.
7. Currency used in the presentation	Financial statements are normally expressed in the functional currency i.e. the currency of the economy in which the business entity operates but if not then it has to be converted using the exchange rates.	Financial statements are expressed in the Indian rupee hence no question of the exchange rates.

List of Indian Accounting Standards (Ind –AS)

Indian Accounting Standards (Ind-AS)	Name	International Accounting Standards (IAS) / International Financial Reporting Standards (IFRS)	Existing Accounting Standards (AS)
Ind As-1	Presentation of Financial Statements	IAS 1	AS 1
Ind As-2	Inventories	IAS 2	AS 2
Ind As-7	Statement of Cash Flows	IAS 7	AS 3
Ind As-8	Accounting Policies, Changes in Accounting Estimates and Errors	IAS 8	AS 5
Ind As-10	Events after the Reporting Period	IAS 10	AS 4
Ind As-11	Construction Contracts	IAS 11	AS 7
Ind As-12	Income Taxes	IAS 12	AS 22
Ind As-16	Property, Plant and Equipment	IAS 16	AS 6, 10
Ind As-17	Leases	IAS 17	AS 19
Ind As-18	Revenue	IAS 18	AS 9
Ind As-19	Employee Benefits	IAS 19	AS 15
Ind As-20	Accounting for Government Grants and Disclosure of Government Assistance	IAS 20	AS 12
Ind As-21	The Effects of Changes in Foreign Exchange Rates	IAS 21	AS 11
Ind As-23	Borrowing Costs	IAS 23	AS 16
Ind As-24	Related Party Disclosures	IAS 24	AS 18
Ind As-27	Consolidated and Separate Financial Statements	IAS 27	AS 21
Ind As-28	Investments in Associates	IAS 28	AS 23

Ind As-29	Financial Reporting in Hyperinflationary Economies	IAS 29	–
Ind As-31	Interests in Joint Ventures	IAS 31	AS 27
Ind As-32	Financial Instruments: Presentation	IAS 32	AS 31
Ind As-33	Earnings per Share	IAS 33	AS 20
Ind As-34	Interim Financial Reporting	IAS 34	AS 25
Ind As-36	Impairment of Assets	IAS 36	AS 28
Ind As-37	Provisions, Contingent Liabilities and Contingent Assets	IAS 37	AS 29
Ind As-38	Intangible Assets	IAS 38	AS 26
Ind As-39	Financial Instruments: Recognition and Measurement	IAS 39	AS 30
Ind As-40	Investment Property	IAS 40	–
Ind As-101	First-time Adoption of Indian Accounting Standards	IFRS 1	–
Ind As-102	Share based Payment	IFRS 2	–
Ind As-103	Business Combinations	IFRS 3	AS 14
Ind As-104	Insurance Contracts	IFRS 4	–
Ind As-105	Non-Current Assets Held for Sale and Discontinued Operations	IFRS 5	AS 24
Ind As-106	Exploration for and Evaluation of Mineral Resources	IFRS 6	–
Ind As-107	Financial Instruments: Disclosures	IFRS 7	AS 32
Ind As-108	Operating Segments	IFRS 8	AS 17