

THEORETICAL FRAMEWORK



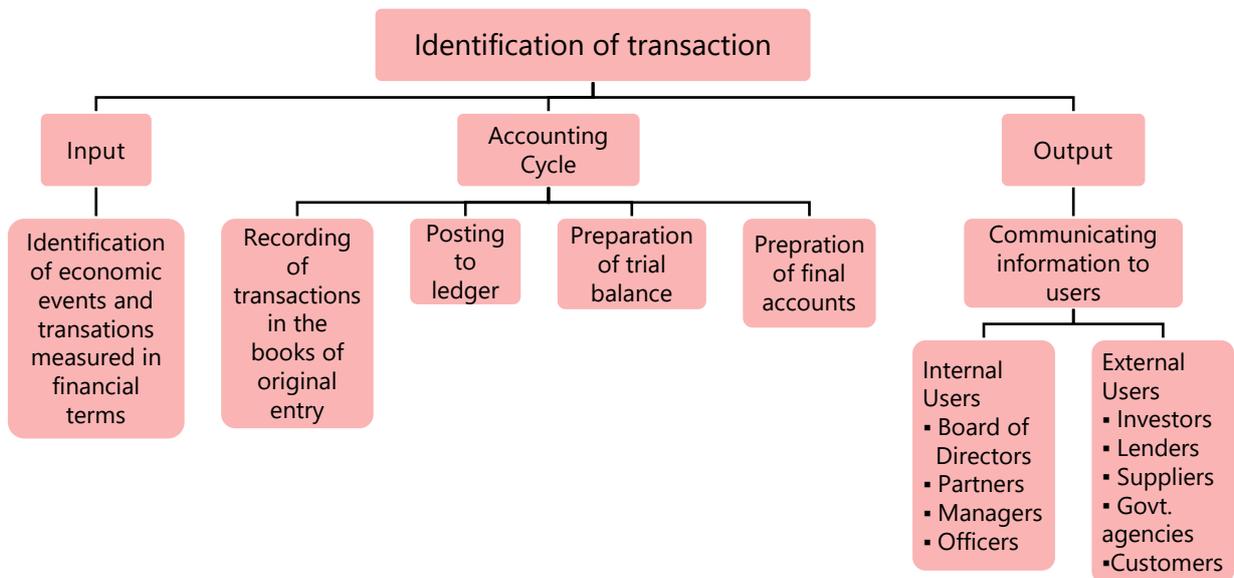
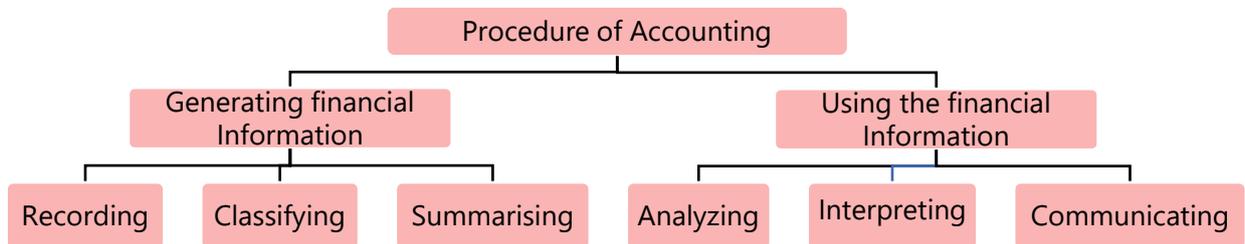
UNIT - 1 MEANING AND SCOPE OF ACCOUNTING

LEARNING OUTCOMES

After studying this unit, you would 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.
- ◆ 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.

UNIT OVERVIEW



1.1 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 company running a business in telecom sector, 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.'

Example 1

An individual invests ₹ 2,00,000 for running a stationery business. On 1st January, he purchases goods for ₹ 1,15,000 and sells for ₹ 1,47,000 during the month of January. He pays shop rent for the month ₹ 5,000 and finds that still he has goods worth ₹ 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 ₹ 42,000.

		₹
Goods sold		1,47,000
Goods in hand		15,000
		1,62,000
Less : Goods purchased	1,15,000	
Shop rent paid	5,000	(1,20,000)
Surplus		42,000

Earning of ₹ 42,000 surplus is an event; also having the inventories 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 ₹ 500 lakhs for adult education; it spent ₹ 250 lakhs for purchasing literacy kits, paid ₹ 200 lakhs to the tutors and is left with a balance of ₹ 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.

A telecom company would need to ensure that it is providing the services for its millions of users for post-paid and pre-paid connections. Each activity done by a user (call, message, data usage) results into an economic event. The entity needs to keep appropriate and timely records to be able to collect money from post-paid connection users for the services availed by them. Likewise, the company will need to ensure that pre-paid connection customers are provided the support and the records confirm how much balance still remains to be utilized.

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**.



1.2 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. Continuing with the same example of the telecom company, which needs to capture all transactions (transactions made by the user, raising invoice to the customer, receipt of money, payment towards salaries, marketing etc.). Likewise, the individual running the stationery business, would need to record all business transactions.

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. For example, the telecom company performing thousands of transactions on a daily basis, is not expected to publish all those transactions for the users to be able to make a decision. Surely, those transactions need to be summarized appropriately.

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 and 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 summarized transactions and events. However, the above-mentioned definition does not reflect the present day accounting function. 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, globalization of business and society gaining more interest in the functioning of the enterprises, the importance of communicating the accounting results has increased.

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.

The above definition requires accountants to assume a bigger responsibility than to merely do book-keeping. Accountants need to be ready to provide the information ready for the intended users to be able to make economic decisions.

1.2.1 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.

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 financial statements.
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.

- 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.

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. Since earlier businesses were simple and not scaled, probably that view could hold true for those.

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. For example, if an airlines company borrows money from a bank, buys oil from oil companies, sells tickets to the customers, has staff to be paid salaries to, all these group of people and entities are key stakeholders in that airlines business. They would like to know and understand whether the business of the company is going well or there are challenges for the company to run the business. 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.



1.3 EVOLUTION OF ACCOUNTING AS A SOCIAL SCIENCE

History & Development of Accounting

Accounting finds its roots as early as around 4000 BC, where Egyptians used some form of accounting for their treasuries. The in-charge of treasuries had to send day wise reports to their superiors known as Wazirs and monthly reports were sent to kings. Babylonia, known as the city of commerce, used accounting for business to identify the losses that took place due to frauds and lack of efficiency. Greece used accounting to divide the revenues received among treasuries, maintaining receipts, payments and balance of government financial transactions. Romans used memorandum or daybook where in receipts and payments were recorded. (700 B.C to 400 A.D).

China used sophisticated form of government accounting as early as 2000 B.C. Accounting practices in India could be traced back to a period where, Kautilya, a minister in Chandragupta's kingdom wrote a book named Arthashastra, which also described how accounting records had to be maintained.

Luca Pacioli's, a Franciscan friar (merchant class), book *Summa de Arithmetica, Geometria, Proportion at Proportionality* (Review of Arithmetic and Geometric proportions) in Venice (1494) is considered as the first book on double entry bookkeeping. A portion of this book contains knowledge of business and book-keeping. He used the terms Debit (Dr.) and Credit (Cr.) in his books. These were the concepts used in Italian terminology. Debit comes from the Italian *debito* which comes from the Latin *debita* and *debeo* which means owed to the proprietor. Credit comes from the Italian *credito* which comes from the Latin 'credo' which means trust or belief (in the proprietor or owed by the proprietor).

In explaining double entry system, Pacioli wrote that 'All entries... have to be double entries, that is if you make one creditor, you must make some debtor'. He also mentioned that a merchant's responsibility is to give glory to God in their enterprises, to be ethical in all business activities and to earn a profit. He discussed the details of memorandum, journal, ledger and specialised accounting procedures.

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. Although double-entry system was followed, 'stewardship accounting' served the purpose of businessmen and wealthy persons at that time. In most of the countries, 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 purpose, it contributes for social progress; also it is being adapted to keep pace with social progress. So, accounting is treated as a social science.

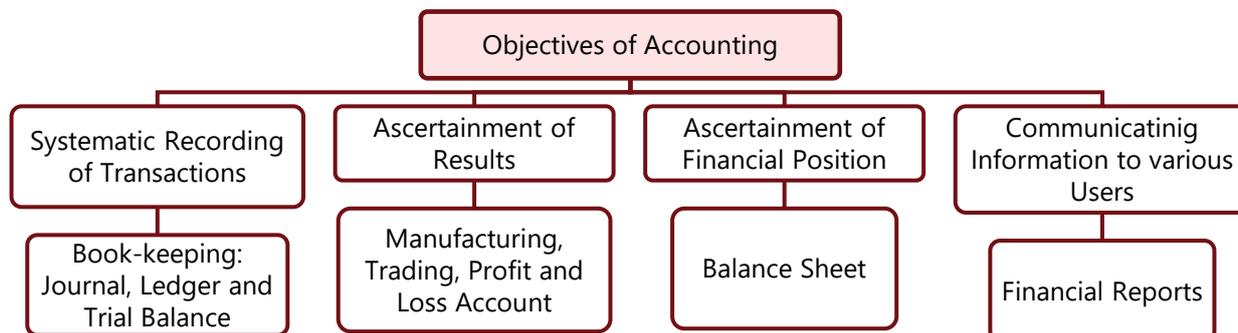


1.4 OBJECTIVES OF ACCOUNTING

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 summarized 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 (Sales) exceeds 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** – A 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.

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



1.5 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 and analysing trends.
- (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.

1.6 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. The term 'financial statements' means Profit and Loss Account, Balance Sheet and cash flow statements including Schedules and Notes forming part of Accounts.

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. 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 income and 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 this 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, 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.

1.6.1 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.



1.7 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 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





1.8 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 higher levels 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.”
- (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.



1.9 USERS OF ACCOUNTING INFORMATION

Generally users of accounts are classified into two categories, (a) internal users and (b) external users. Management accounting is concerned with 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 back 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.
- (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.
- (viii) **Management:** 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.



1.10 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.

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.

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 discriminate 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 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 for companies.

Banking, insurance and electric supply undertakings may 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.



1.11 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.
3. 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 inventories and the list is quite long.
6. Financial statements 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.



1.12 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.

1.12.1 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:

- (i) **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.

- (ii) **Statutory Audit:** Every limited company is required to appoint a chartered accountant or a firm of chartered accountants as their auditor who are statutorily required to report each year whether in their 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).

- (iii) **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.

- (iv) **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.

- (v) **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.
- (vi) **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.

(vii) 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 accountant has to sometimes 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.

1.12.2 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.

1.12.3 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.

1.12.4 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 goods and services. 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.

1.12.5 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.

SUMMARY

- ◆ "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."
- ◆ Accounting procedure can be basically divided into two parts:
 - (i) Generating financial information and
 - (ii) Using the financial information.
- ◆ The objectives of accounting can be given as follows:
 - (i) Systematic recording of transactions
 - (ii) Ascertainment of results of above recorded transactions
 - (iii) Ascertainment of the financial position of the business
 - (iv) Providing information to the users for rational decision-making
 - (v) To know the solvency position

The main functions of accounting are as follows:

 - (i) Measurement
 - (ii) Forecasting
 - (iii) Decision-making
 - (iv) Comparison & Evaluation
 - (v) Control
 - (vi) Government Regulation and Taxation
- ◆ Objectives of Book-keeping:
 - (i) Complete Recording of Transactions and
 - (ii) Ascertainment of Financial Effect on the Business
- ◆ The various sub-fields of accounting are:
 - (i) Financial Accounting
 - (ii) Management Accounting

- (iii) Cost Accounting
- (iv) Social Responsibility Accounting
- (v) Human Resource Accounting

◆ The various users of accounting information:

- (i) Investors
- (ii) Employees
- (iii) Lenders
- (iv) Suppliers and Creditors
- (v) Customers
- (vi) Government and their agencies
- (vii) Public
- (viii) Management

◆ 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.

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.

TEST YOUR KNOWLEDGE

True and False

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

Multiple Choice Questions

1. *Which of the following is not a subfield of accounting?*
 - (a) *Management accounting.*
 - (b) *Cost accounting.*
 - (c) *Book-keeping*
2. *Purposes of an accounting system include all the following except*
 - (a) *Interpret and record the effects of business transaction.*
 - (b) *Classify the effects of transactions to facilitate the preparation of reports.*
 - (c) *Dictate the specific types of business enterprise transactions that the enterprises may engage in.*
3. *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.*
4. *All of the following are functions of Accounting except*
 - (a) *Decision making.*
 - (b) *Ledger posting.*
 - (c) *Forecasting.*
5. *Financial statements are part of*
 - (a) *Accounting.*
 - (b) *Book-keeping.*
 - (c) *Management Accounting.*
6. *Financial position of the business is ascertained on the basis of*
 - (a) *Records prepared under book-keeping process.*
 - (b) *Trial balance.*
 - (c) *Balance Sheet.*
7. *Users of accounting information include*
 - (a) *Creditors/Suppliers*

- (b) *Lenders/Customers*
- (c) *Both (a) and (b)*
8. *Financial statements do not consider*
- (a) *Assets expressed in monetary terms.*
- (b) *Liabilities expressed in monetary terms.*
- (c) *Assets and liabilities expressed in non-monetary terms*
9. *On January 1, Sohan paid rent of ₹5,000. This can be classified as*
- (a) *An event.*
- (b) *A transaction.*
- (c) *A transaction as well as an event.*
10. *On March 31, 2022 after sale of goods worth ₹2,000, he is left with the closing inventory of ₹10,000. This is*
- (a) *An event.*
- (b) *A transaction.*
- (c) *A transaction as well as an event.*
11. *Which of the following is not a business transaction?*
- (a) *Bought a machine of ₹10,000 for business*
- (b) *Paid towards salaries of employees ₹5,000*
- (c) *Paid son's fees from her personal bank account ₹8,000*
12. *Which qualitative characteristics of accounting information is reflected when accounting information is clearly presented?*
- (a) *Understandability*
- (b) *Relevance*
- (c) *Comparability*

Theoretical Questions

1. *Define accounting. What are the sub-fields of accounting?*
2. *Who are the users of accounting information?*
3. *Discuss briefly the relationship of accounting with*

(i) Economics (ii) Statistics (iii) Law

4. Discuss the limitations which must be kept in mind while evaluating the Financial Statements.
5. What services can a Chartered Accountant provide to the society?

ANSWER/HINTS

True and False

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

Multiple Choice Questions

1.	(c)	2.	(c)	3.	(a)	4.	(b)	5.	(a)	6.	(c)
7.	(c)	8.	(c)	9.	(b)	10.	(a)	11.	(c)	12.	(a)

Theoretical Questions

1. 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. Various subfields of accounting are listed as: Financial Accounting; Management Accounting; Cost Accounting; Social Responsibility Accounting and Human Resource Accounting.
2. Users of accounts can be listed as Investors, Employees, Lenders, Suppliers and Creditors, Customers, Govt. and their agencies, public and Management.
3. Refer para 1.10 for understanding the relationship of Accounting with Economics, Statistics and Law.
4. Limitations which must be kept in mind while evaluating the Financial Statements are as follows:
 - ◆ 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.
 - ◆ 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.
 - ◆ Accounting ignores changes in some money factors like inflation etc.
 - ◆ There are occasions when accounting principles conflict with each other.
 - ◆ Certain accounting estimates depend on the sheer personal judgement of the accountant.
 - ◆ Different accounting policies for the treatment of same item adds to the probability of manipulations.
5. 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. For details, refer Para 1.12.

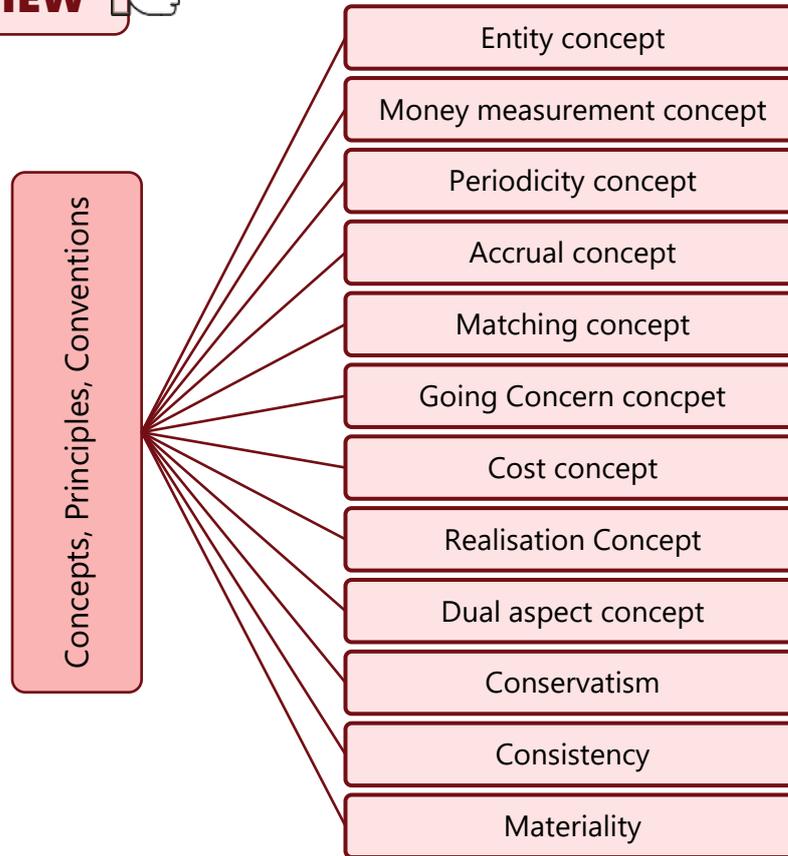
UNIT – 2 ACCOUNTING CONCEPTS, PRINCIPLES AND CONVENTIONS

LEARNING OUTCOMES

After studying this unit, you would be able to:

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

UNIT OVERVIEW



2.1 INTRODUCTION

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

Accounting is a language of the business. Financial statements prepared by the accountant communicate financial information to the various stakeholders for decision-making purpose. Therefore, it is important that financial statements prepared by different organizations should

be prepared on uniform basis. Also, there should be consistency over a period of time in the preparation of these financial statements. If every accountant starts following his own norms and notions for accounting of different items, then there will be an utter confusion.

To avoid confusion and to achieve uniformity, accounting process is applied within the conceptual framework of 'Generally Accepted Accounting Principles'(GAAPs). The term GAAPs is used to describe rules developed for the preparation of the financial statements and are called concepts, conventions, postulates, principles etc. These GAAPs are the backbone of the accounting information system, without which the whole system cannot even stand erectly. These principles are the ground rules, which define the parameters and constraints within which accounting reports are generated. Accounting principles are basic norms and assumptions on which the whole accounting system has been developed and established. Accountant also adheres to various accounting standards issued by the regulatory authority for the standardization of accounting policies to be followed under specific circumstances. These conceptual frameworks, GAAPs and accounting standards are considered as the theory base of accounting. Globally, for achieving the standardization, countries use the framework under International Financial Reporting Standards (IFRS). However, countries may apply their respective GAAPs and related conceptual frameworks. For example, in India, companies are required to use AS or Ind-AS frameworks as applicable.

2.2 ACCOUNTING CONCEPTS

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

2.3 ACCOUNTING PRINCIPLES

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

Accounting principles must satisfy the following conditions:

1. They should be based on real assumptions;

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



2.4 ACCOUNTING CONVENTIONS

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

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



2.5 CONCEPTS, PRINCIPLES AND CONVENTIONS - AN OVERVIEW

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

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

Entity concept keeps the business separate from its owner. In a way, the entity concept helps to ascertain how much amount of money is due to the owner in form of his capital and share of profits earned. It also helps to perform accounting from the point of view of the business and not that of the owner. For example, if a person runs a business and pays money from his own pocket for his son's school fee, it will not constitute a transaction in the books of the business. However, if the person withdraws

money from the business to pay for his son's school fee it will constitute a transaction to be recorded in the books of the business as amount withdrawn by the owner.

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

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

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

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

- (b) **Money measurement concept:** As per this concept, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions, even if, they affect the results of the business materially, are not recorded if they are not convertible in monetary terms.

For example, a business owning a factory on a piece of 1 acre of land, with an office building with 2 floors, having 20 computers, and 10 units of machine cannot show these items under different measurement units. These items need to be expressed in monetary terms. The factory price might be 50 Cr, cost of land might be 30 Cr, building

with a cost of 15 Cr, computers at a cost of 10 lac and machines with a cost of 10 Cr need to be recorded.

However, the concept has its own limitations. Transactions and events that cannot be expressed in terms of money are not recorded in the business books. For example; employees of the organization are, no doubt, the assets of the organizations but their measurement in monetary terms is not possible therefore, not included in the books of account of the organization. Measuring unit for money is taken as the currency of the ruling country i.e., the ruling currency of a country provides a common denomination for the value of material objects.

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

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

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

This concept ignores that money is an inelastic yardstick for measurement as it is based on the implicit assumption that purchasing power of the money is not of sufficient importance as to require adjustment. For example, a unit of land purchased 10 years ago for 40 Cr and a similar unit of land purchased now for 90 Cr will still be shown at the respective values, i.e., total of 130 Cr. Though in real world, the true value of the units together might be 180 Cr (90 + 90). Accordingly, accounting does not give a true and fair view of the affairs of the business.

As mentioned earlier, many material transactions and events are not recorded in the books of accounts just because they cannot be measured in monetary terms. Yet it is used for accounting purposes because it is not possible to adopt a better measurement scale.

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

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

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

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

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

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

Thus, the periodicity concept facilitates in:

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

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

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

is ₹ 60,000. It arose in the ordinary course of cloth business; Mr. X received ₹ 50,000 in cash and ₹ 10,000 by way of receivables.

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

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

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

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

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

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

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

As per Accrual Concept: Revenue – Expenses = Profit

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

Alternative as per Cash basis

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

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

- (i) when cash received before revenue is booked - a liability is created when cash is received in advance

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

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

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

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

Mr. P K started cloth business. He purchased 10,000 pcs. garments @ ₹ 100 per piece and sold 8,000 pcs. @ ₹ 150 per piece during the accounting period of 12 months 1st January to 31st December, 2022. He paid shop rent @ ₹ 3,000 per month for 11 months and paid ₹ 8,00,000 to the suppliers of garments and received ₹ 10,00,000 from the customers.

Let us see how the accrual and periodicity concepts operate.

Periodicity Concept fixes up the time-frame for which the performance is to be measured and financial position is to be appraised. Here, it is January 2022 - December, 2022. Therefore, revenues and expenses are to be measured for the year 2022 and assets and liabilities are to be ascertained as on 31st December, 2022.

Accrual Concept operates to measure revenue of ₹ 12,00,000 (arising out of sale of garments 8,000 Pcs × ₹ 150) which accrued during 2022, not the cash received ₹ 10,00,000 and also the expenses correctly. Shop rent for 12 months is an expense item amounting to ₹ 36,000, not ₹ 33,000 the cash paid.

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

Revenue – Expenses = Profit

But this unqualified equation may create misconception.

It should be defined as: Periodic Profit = Periodic Revenue – Matched Expenses

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

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

	₹	₹
Thus, Profit = Revenue		12,00,000
Less Expenses:		
Merchandise	8,00,000	
Shop Rent	36,000	(8,36,000)
		3,64,000
Assets:		
Inventory (2,000 pcs x ₹100)		2,00,000
Trade receivables		2,00,000
Cash (Cash Receipts ₹10,00,000 – cash payments ₹ 8,33,000)		1,67,000
		5,67,000
Liabilities:		
Trade Payables		2,00,000
Expenses Payables		3,000
Capital (Profit)		3,64,000
		5,67,000

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

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

intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used needs to be disclosed.

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

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

BALANCE SHEET

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

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

This can be understood differently with some examples we may have come across in real life. Recently during pandemic, many businesses were shutting down due to heavy losses. If the financial statement of these entities does not reveal the fact of winding up due to losses, it will mislead the stakeholders. And, a sudden news of the business shutting down would be a setback to those stakeholders.

Therefore, entities need to assess at the time of preparation of financial statements, whether they are likely to continue to operate their business. If the Going Concern assumption is under question, the same information should be communicated to the stakeholders.

- (g) **Cost concept:** By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. Although there are various measurement bases, accountants traditionally prefer this concept in the interests of objectivity. When a machine is acquired by paying ₹ 5,00,000, following cost concept the value of the machine is taken as ₹ 5,00,000. It is highly objective and free from all bias. Other measurement bases are not so objective. Current cost of an asset is not easily determinable. If the asset is purchased on 1.1.1995 and such model is not available in

the market, it becomes difficult to determine which model is the appropriate equivalent to the existing one. Similarly, unless the machine is actually sold, realisable value will give only a hypothetical figure. Lastly, present value base is highly subjective because to know the value of the asset one has to chase the uncertain future.

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

- (a) In an inflationary situation when prices of all commodities go up on an average, acquisition cost loses its relevance. For example, a piece of land purchased on 1.1.1995 for ₹ 2,000 may cost ₹ 1,00,000 as on 1.1.2022. So if the accountant makes valuation of asset at historical cost, the accounts will not reflect the true position.
- (b) Historical cost-based accounts may lose comparability. Mr. X invested ₹ 1,00,000 in a machine on 1.1.1995 which produces ₹ 50,000 cash inflow during the year 2022, while Mr. Y invested ₹ 5,00,000 in a machine on 1.1.2005 which produced ₹ 50,000 cash inflows during the year. Mr. X earned at the rate 50% while Mr. Y earned at the rate 10%. Who is more efficient? Since the assets are recorded at the historical cost, the results are not comparable. Obviously, it is a corollary to (a).
- (c) Many assets do not have acquisition costs. Human assets of an enterprise are an example. The cost concept fails to recognise such asset although it is a very important asset of any organization.

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

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

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

Example: Mr. X purchased a piece of land on 1.1.1995 paying ₹ 2,000. Its current market value is ₹ 1,02,000 on 31.12.2022. Should the accountant show the land at ₹ 2,000 following cost concept and ignoring ₹1,00,000 value increase since it is not realised? If he does so, the financial position would be:

BALANCE SHEET

Liabilities	₹	Asset	₹
Capital	2,000	Land	2,000
	2,000		2,000

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

BALANCE SHEET

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

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

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

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

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

Alternatively:

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

Example :**BALANCE SHEET**

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

Transactions:

- A new machine is purchased paying ₹ 50,000 in cash.
- A new machine is purchased for ₹ 50,000 on credit, cash is to be paid later on.
- Cash paid to repay bank loan to the extent of ₹ 50,000.
- Raised bank loan of ₹ 50,000 to pay off other loan.

Effect of the Transactions:

- Increase in machine value and decrease in cash balance by ₹ 50,000.

BALANCE SHEET (1 & 3)

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

- Increase in machine value and increase in Creditors by ₹ 50,000.

BALANCE SHEET (2 & 6)

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

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

BALANCE SHEET (4 & 8)

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

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

BALANCE SHEET (5 & 7)

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

We may conclude that every transaction and event has two aspects.

This gives basic accounting equation :

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

or

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

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

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

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

ILLUSTRATION 1

Develop the accounting equation from the following information: -

Particulars	March 31, 2021 (₹)	March 31, 2022 (₹)
Capital	1,00,000	?
12% Bank Loan	1,00,000	1,00,000

Trade Payables	75,000	70,000
Fixed Assets	1,25,000	1,10,000
Trade Receivables	75,000	80,000
Inventory	70,000	80,000
Cash & Bank	5,000	6,000

Required

Find the profit for the year & the Balance sheet as on 31/3/2022.

SOLUTION

For the year ended March 31, 2021:

Equity = Capital ₹ 1,00,000

Liabilities = Bank Loan + Trade Payables
 ₹ 1,00,000 + ₹ 75,000 = ₹ 1,75,000

Assets = Fixed Assets + Trade Receivables + Inventory + Cash & Bank
 ₹ 1,25,000 + ₹ 75,000 + ₹ 70,000 + ₹ 5,000 = ₹ 2,75,000

Equity + Liabilities = Assets
 ₹ 1,00,000 + ₹ 1,75,000 = 2,75,000

For the year ended March 31, 2022:

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

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

Equity = Assets – Liabilities = ₹ 2,76,000 – ₹ 1,70,000 = ₹ 1,06,000
 Profits = New Equity – Old Equity = ₹ 1,06,000 – ₹ 1,00,000 = ₹ 6,000

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

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

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

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

This concept is of wider importance to investors since they would need to take a decision about their money being invested in the business. Recording future profits when these have not been earned would suggest that the business is booming, and the investors would be tempted to put more money into the same. However, eventually if the profit is not earned, the investors are likely to lose their investments. At the same time, if the entity expects to make a loss in future, it is prudent to show that loss in the books in present itself. This acts as a safeguard for the investors as they would be prudent to make the investment decisions. For example: Mr. X runs a business of computers. He purchased 10 computers at a cost of ₹ 20,000 each and is expecting to be able to sell these computers at the current market price of ₹ 25,000 each. Note that the conservatism principle does not allow to recognise the profit on the computers unless the sale has been made. Since, this is a future profit, Mr. X needs to follow a prudent approach while recording the transactions in his books and ignore the profit until it is earned

However, before sale, the market price of the computers declines to ₹ 17,000 each. Under the conservatism approach, Mr. X needs to recognise that loss of ₹ 3,000 per computer, even though the sale has not been made.

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

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

The concept of consistency is applied particularly when alternative methods of accounting are equally acceptable. For example, a company may adopt any of several methods of depreciation such as written-down-value method, straight-line method, etc. Likewise, there are many methods for valuation of inventories. But following the principle of consistency it is advisable that the company should follow consistently

over years the same method of depreciation or the same method of valuation of Inventories which is chosen. However, in some cases though there is no inconsistency, they may seem to be inconsistent apparently. In case of valuation of Inventories if the company applies the principle 'at cost or market price whichever is lower' and if this principle accordingly results in the valuation of Inventories in one year at cost price and the market price in the other year, there is no inconsistency here. It is only an application of the principle.

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

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

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

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

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

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

2.6 FUNDAMENTAL ACCOUNTING ASSUMPTIONS

There are three fundamental accounting assumptions:

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

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

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

2.7 FINANCIAL STATEMENTS

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

2.7.1 Qualitative Characteristics of financial Statements

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

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

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

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

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

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

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

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

An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those 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 in pursuant of this principle came out with the format of balance sheet and profit and loss account. The disclosures of all the major accounting policies and other information are to be provided in the form of footnotes, annexures etc. The practice of appending notes to the financial statements is the outcome of this principle.

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

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

SUMMARY

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

The following are the widely accepted accounting concepts:

- | | |
|-------------------------|-------------------------------|
| (a) Entity concept | (b) Money measurement concept |
| (c) Periodicity concept | (d) Accrual concept |
| (e) Matching concept | (f) Going Concern concept |
| (g) Cost concept | (h) Realisation concept |
| (i) Dual aspect concept | (j) Conservatism |
| (k) Materiality | |
- ◆ Accounting principles are a body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist.”
 - ◆ Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time.
 - ◆ There are three fundamental accounting assumptions:

(i) Going Concern	(ii) Consistency	(iii) Accrual
-------------------	------------------	---------------
 - ◆ Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. Understandability, Relevance, Reliability, Comparability, Materiality, Faithful Representation, Substance over Form, Neutrality, Prudence, Full, fair and adequate disclosure and Completeness are the important qualitative characteristics of the financial statements.

TEST YOUR KNOWLEDGE

True and False

1. *The concept helps in keeping business affairs free from the influence of the personal affairs of the owner is known as the matching concept.*
2. *Entity concept means that the enterprise is liable to the owner for capital investment made by the owner.*
3. *Accrual means recognition as money is received or paid and not of revenue and costs as they are earned or incurred.*

4. *The Conservatism Concept states that no change should be counted unless it has materialized.*
5. *The concept of consistency implies non-flexibility as not to allow the introduction of improved method of accounting.*
6. *The materiality depends only upon the amount of the item and not upon the size of the business, nature and level of information, level of the person making the decision etc.*
7. *Accrual basis of accounting is the method of recording transactions by which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made.*

Multiple Choice Questions

1. (i) *All the following items are classified as fundamental accounting assumptions except*
 - (a) *Consistency.*
 - (b) *Business entity.*
 - (c) *Going concern.*
- (ii) *Two primary qualitative characteristics of financial statements are*
 - (a) *Understandability and materiality.*
 - (b) *Relevance and reliability.*
 - (c) *Neutrality and understandability.*
- (iii) *Kanika Enterprises follows the written down value method of depreciating machinery year after year due to*
 - (a) *Comparability.*
 - (b) *Convenience.*
 - (c) *Consistency.*
- (iv) *A purchased a car for ₹ 5,00,000, making a down payment of ₹ 1,00,000 and signing a ₹ 4,00,000 bill payable due in 60 days. As a result of this transaction*
 - (a) *Total assets increased by ₹ 5,00,000.*
 - (b) *Total liabilities increased by ₹ 4,00,000.*
 - (c) *Total assets increased by ₹ 4,00,000 with corresponding increase in liabilities by ₹ 4,00,000.*

- (v) Mohan purchased goods for ₹15,00,000 and sold 4/5th of the goods amounting ₹18,00,000 and met expenses amounting ₹ 2,50,000 during the year, 2022. He counted net profit as ₹ 3,50,000. Which of the accounting concept was followed by him?
- (a) Entity.
 - (b) Periodicity.
 - (c) Matching.
- (vi) A businessman purchased goods for ₹25,00,000 and sold 80% of such goods during the accounting year ended 31st March, 2022. The market value of the remaining goods was ₹ 4,00,000. He valued the closing Inventory at cost. He violated the concept of
- (a) Money measurement.
 - (b) Conservatism.
 - (c) Cost.
- (vii) Capital brought in by the proprietor is
- (a) Increase in asset and increase in liability
 - (b) Increase in liability and decrease in asset
 - (c) Increase in asset and decrease in liability
- (viii) During the life-time of an entity, accounting provides financial statements in accordance with which basic accounting concept:
- (a) Conservatism
 - (b) Matching
 - (c) Accounting period
- (ix) A concept that a business enterprise will not be liquidated in the near future is known as :
- (a) Going concern
 - (b) Economic entity
 - (c) Monetary unit

2. (i) *Assets are held in the business for the*
- (a) *Resale.*
 - (b) *Conversion into cash*
 - (c) *Earning revenue.*
- (ii) *Revenue from sale of products, is generally, realised in the period in which*
- (a) *Cash is collected.*
 - (b) *Sale is made*
 - (c) *Products are manufactured.*
- (iii) *The concept of conservatism when applied to the balance sheet results in*
- (a) *Understatement of assets.*
 - (b) *Overstatement of assets.*
 - (c) *Overstatement of capital.*
- (iv) *Decrease in the amount of trade payables results in*
- (a) *Increase in cash.*
 - (b) *Decrease in bank over draft account.*
 - (c) *Decrease in assets.*
- (v) *The determination of expenses for an accounting period is based on the principle of*
- (a) *Objectivity.*
 - (b) *Materiality.*
 - (c) *Matching.*
- (vi) *Economic life of an enterprise is split into the periodic interval to measure its performance is as per*
- (a) *Entity.*
 - (b) *Matching.*
 - (c) *Periodicity.*
3. (i) *If an individual asset is increased, there will be a corresponding*
- (a) *Increase of another asset or increase of capital.*
 - (b) *Decrease of another asset or increase of liability.*
 - (c) *Decrease of specific liability or decrease of capital.*

- (ii) *Purchase of machinery for cash*
- (a) *Decreases total assets.*
 - (b) *Increases total assets.*
 - (c) *Retains total assets unchanged.*
- (iii) *Consider the following data pertaining to Alpha Ltd.:*

<i>Particulars</i>	<i>₹</i>
<i>Cost of machinery purchased on 1st April, 2021</i>	<i>10,00,000</i>
<i>Installation charges</i>	<i>1,00,000</i>
<i>Market value as on 31st March, 2022</i>	<i>12,00,000</i>

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

- (a) *Cost.*
- (b) *Matching.*
- (c) *Accrual.*

Theoretical Questions

1. *Write short notes on:*
 - (i) *Fundamental accounting assumptions.*
 - (ii) *Periodicity concept.*
 - (iii) *Accounting conventions.*
2. *Distinguish between:*
 - (i) *Money measurement concept and matching concept*
 - (ii) *Going concern and cost concept*
3. *Briefly explain the qualitative characteristics of the financial statements.*

ANSWERS/HINTS

True and False

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

Multiple Choice Questions

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

Theoretical Questions

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

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

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

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

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

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

(ii) **Distinction between Going concern and cost concept**

Going Concern Concept

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

Cost concept

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

3. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. For details, refer para 2.7.1.

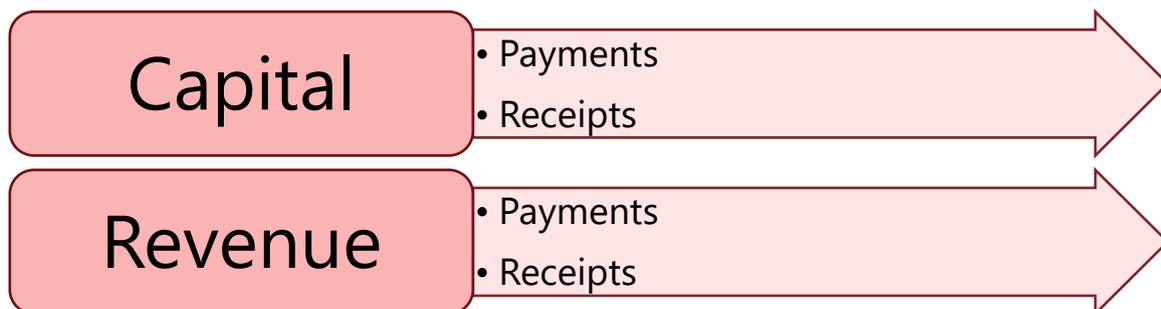
UNIT – 3 CAPITAL AND REVENUE EXPENDITURES AND RECEIPTS

LEARNING OUTCOMES

After studying this unit, you will be able to:

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

UNIT OVERVIEW



3.1 INTRODUCTION

Accounting aims in ascertaining and presenting the results of the business for an accounting period. For ascertaining the periodical business results, the nature of transactions should be analyzed whether they are of capital or revenue nature. Revenue Expense relates to the operations of the business of an accounting period or to the revenue earned during the period or the items of expenditure, benefits of which do not extend beyond that period. Capital Expenditure, on the other hand, generates enduring benefits and helps in revenue generation over more than one accounting period. Revenue Expenses must be associated with a physical activity of the entity. Therefore, whereas production and sales generate revenue in the earning process, use of goods and services in support of those functions causes expenses to occur.

Expenses are recognised in the Profit & Loss Account through matching principle which tells us when and how much of the expenses to be charged against revenue. A part of the expenditure can be capitalised only when these can be traced directly to definable streams of future benefits.

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

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



3.2 CONSIDERATIONS IN DETERMINING CAPITAL AND REVENUE EXPENDITURES

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

- (a) **Nature of business:** For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is a very important criteria in separating an expenditure between capital and revenue.
- (b) **Recurring nature of expenditure:** If the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting year. Monthly salary or rent is the example of revenue expenditure as they are incurred every month while purchase of assets is not the transaction done regularly therefore, classified as capital expenditure unless materiality criteria defines it as revenue expenditure.

- (c) **Purpose of expenses:** Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature. However, determination of the cost of maintenance and ordinary repairs which should be expensed, as opposed to a cost which ought to be capitalised, is not always simple.
- (d) **Effect on revenue generating capacity of business:** The expenses which help to generate income/ revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On the other hand, if expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure.
- When expenditure on improvements and repair of a fixed asset is done, it has to be charged to Profit and Loss Account if the expected future benefits from fixed assets do not change, and it will be included in book value of fixed asset, where the expected future benefits from assets increase.
- (e) **Materiality of the amount involved:** Relative proportion of the amount involved is another important consideration in distinction between revenue and capital.



3.3 CAPITAL EXPENDITURES AND REVENUE EXPENDITURES

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

3.3.1 Key differences between Capital and Revenue Expenditures

Key Differences	Capital Expenditure	Revenue Expenditure
Period of benefit	Any expenditure incurred to provide a benefit over a long-term period is capital expenditure.	Any expenditure incurred to provide a benefit during the current period is revenue expenditure.

Enhancement Maintenance	vs	Capital expenditure is incurred for the purpose of increasing the capacity of the business. Alternatively, it also includes an expenditure to reduce the costs of the business.	Revenue expenditure is incurred to maintain the earning capacity of the business.
Examples		Purchase of machine, car, furniture, etc.	Repairs and maintenance, salary of accounting staff, etc.

ILLUSTRATION 1

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

- (1) *Overhaul expenses of second-hand machinery purchased are Revenue Expenditure.*
- (2) *Money spent to reduce working expenses is Revenue Expenditure.*
- (3) *Legal fees to acquire property is Capital Expenditure.*
- (4) *Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.*
- (5) *Amount spent for replacement of worn out part of machine is Capital Expenditure.*
- (6) *Expense incurred on the repairs and white washing for the first time on purchase of an old building are Revenue Expenses.*
- (7) *Expenses in connection with obtaining a license for running the cinema is Capital Expenditure.*
- (8) *Amount spent for the construction of temporary huts, which were necessary for construction of the Cinema House and were demolished when the cinema house was ready, is Capital Expenditure.*

SOLUTION

- (1) **False:** Overhaul expenses are incurred to put second-hand machinery in working condition to derive enduring long-term advantage. So it should be capitalised.
- (2) **False:** It may be reasonably presumed that money spent for reducing revenue expenditure would have generated long-term benefits to the entity. So this is capital expenditure.
- (3) **True:** Legal fee paid to acquire any property is part of the cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.

- (4) **False:** Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any enduring benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.
- (5) **False:** Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.
- (6) **False:** Repairing and white washing expenses for the first time of an old building are incurred to put the building in usable condition. These are the part of the cost of building. Accordingly, these are capital expenditure.
- (7) **True:** The Cinema Hall could not be started without license. Expenditure incurred to obtain the license is pre-operative expense which is capitalised. Such expenses are amortised over a period of time.
- (8) **True:** Cost of temporary huts constructed which were necessary for the construction of the cinema house is part of the construction cost of the cinema house. Therefore such costs are to be capitalised.

ILLUSTRATION 2

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

- (1) *Expenses incurred in connection with obtaining a license for starting the factory for ₹10,000.*
- (2) *₹1,000 paid for removal of Inventory to a new site.*
- (3) *Rings and Pistons of an engine were changed at a cost of ₹5,000 to get fuel efficiency.*
- (4) *Money paid to Mahanagar Telephone Nigam Ltd. (MTNL) ₹8,000 for installing telephone in the office.*
- (5) *A factory shed was constructed at a cost of ₹1,00,000. A sum of ₹5,000 had been incurred in the construction of temporary huts for storing building material.*

SOLUTION

- (1) Money paid ₹ 10,000 for obtaining license to start a factory is a capital expenditure. This is an item of expenditure incurred to acquire the right to carry on business.
- (2) ₹ 1,000 paid for removal of Inventory to a new site is revenue expenditure. This is neither bringing enduring benefit nor enhancing the value of the asset.

- (3) ₹ 5,000 spent in changing Rings and Pistons of an engine to get fuel efficiency is capital expenditure. This is an expenditure on improvement of a fixed asset. It results in increasing profit-earning capacity of the business by cost reduction.
- (4) Money deposited with MTNL for installation of telephone in office is not expenditure. This is treated as an asset and the same is adjusted over a period of time against actual telephone bills.
- (5) Cost of construction of building including cost of temporary huts is capital expenditure. Building is fixed asset which will generate enduring benefit to the business over more than one accounting period. Construction of temporary huts is incidental to the main construction. Such cost is also capitalised with the cost of building.

ILLUSTRATION 3

Best Tech Solutions buys and sells computers as a part of its business. It purchased 20 computers for resale to its customers. Cost of each computer is ₹ 20,000. It also purchased a computer costing ₹ 24,000 for its accountant to be able to maintain the accounting records and printing of invoices. Suggest whether above transactions qualify as capital expenditure or revenue expenditure transactions?

SOLUTION

Best Tech Solutions is in the business of buying and selling of computers. Any computers purchased for resale to its customers will qualify as revenue expenditure. Hence, a purchase of $20,000 \times 20 = ₹ 4,00,000$ will be a part of revenue expenditure.

At the same time, the computer purchased for maintaining the records and invoicing is to be able to operate the business for a longer period of time. Therefore, the purchase of ₹ 24,000 qualifies as a capital expenditure. This amount will be a part of assets in the Balance Sheet.



3.4 CAPITAL RECEIPTS AND REVENUE RECEIPTS

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

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

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

Sale Proceeds	₹ 92,000
Cost	(₹ 90,000)
Profit	<u>₹ 2,000</u>

ILLUSTRATION 4

State with reasons whether the below items relating to the business of AB Ltd are capital or revenue receipts?

- A machine with a book value of ₹ 10 lakh is sold for ₹ 12 lakh.
- Premium amounting to ₹ 1 Lakh received on issue of shares
- An amount of ₹ 20,000 received from goods sold in cash.
- An amount of ₹ 5 lac received on the maturity of fixed deposit from bank. Also, an interest of ₹ 40,000 was received in addition to the maturity amount of the fixed deposits.

SOLUTION

- The amount of ₹ 12 lac is a capital receipt. There is a profit on sale of the machine to the extent of ₹ 2 lac (12 – 10)
- Premium received on issue of shares is an example of capital receipt.
- Amount received from cash sale is a revenue receipt.
- Amount received on the maturity of fixed deposit is the recovery of the deposit amount, and is a capital receipt. Interest income is an example of revenue receipt.

ILLUSTRATION 5

Good Pictures Ltd., constructs a cinema house and incurs the following expenditure during the first year ending 31st March, 2022.

- Second-hand furniture worth ₹ 9,000 was purchased; repainting of the furniture costs ₹1,000. The furniture was installed by own workmen, wages for this being ₹200.
- Expenses in connection with obtaining a license for running the cinema worth ₹ 20,000. During the course of the year the cinema company was fined ₹ 1,000, for contravening rules. Renewal fee ₹2,000 for next year also paid.
- Fire insurance, ₹1,000 was paid on 1st October, 2021 for one year.

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

Point out how you would classify the above items.

SOLUTION

- (1) The total cost of the furniture should be treated as ₹ 10,200 i.e., all the amounts mentioned should be capitalised since without such expenditure the furniture would not be available for use. If ₹ 1,000 and ₹ 200 have been respectively debited to the Repairs Account and the Wages Account, these accounts will be credited to the Furniture Account.
- (2) License for running the cinema house is necessary, hence its cost should be capitalised. But the fine of ₹ 1,000 is revenue expenditure. The renewal fee for the next year is also revenue expenditure but pertains to the next year; hence, it is a prepaid expense.
- (3) Half of the insurance premium pertains to the year beginning on 1st April, 2021. Hence such amount should be treated as prepaid expense. The remaining amount is revenue expense for the current year.
- (4) Since the temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

ILLUSTRATION 6

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

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

SOLUTION

- (1) Overhauling expenses are incurred for the engine of a motor car to derive better fuel efficiency. These expenses will reduce the running cost in future and thus the benefit is in form of enduring long-term advantage. So this expenditure should be capitalised.
- (2) Inauguration expenses incurred on the opening of a new unit may help to explore more customers. This expenditure is in the nature of revenue expenditure, as the expenditure may not generate any enduring benefit to the business over more than one accounting period.
- (3) The amount paid to workers on voluntary retirement is in the nature of revenue expenditure. Since the magnitude of the amount of expenditure is very significant, it may be better to defer it over future years.

ILLUSTRATION 7

Classify the following expenditures and receipts as capital or revenue:

- (i) ₹ 10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets.
- (ii) Amount received from Trade receivables during the year.
- (iii) Amount spent on demolition of building to construct a bigger building on the same site.
- (iv) Insurance claim received on account of a machinery damaged by fire.

SOLUTION

- (i) Capital expenditure.
- (ii) Revenue receipt.
- (iii) Capital expenditure.
- (iv) Capital receipt.

ILLUSTRATION 8

Are the following expenditures capital in nature?

- (i) M/s ABC & Co. run a restaurant. They renovate some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 10 to 13. The total expenditure was ₹20,000.
- (ii) M/s New Delhi Financing Co. sold certain goods on installment payment basis. Five customers did not pay installments. To recover such outstanding installments, the firm spent ₹10,000 on account of legal expenses.
- (iii) M/s Ballav & Co. of Delhi purchased a machinery from M/s Shah & Co. of Ahmedabad. M/s Ballav & Co. spent ₹40,000 for transportation of such machinery. The year ending is 31st Dec, 2022.

SOLUTION

- (i) Renovation of cabins increased the number of cabins. This has an effect on the future revenue generating capability of the business. Thus, the renovation expense is capital expenditure in nature.
- (ii) Expense incurred to recover installments due from customer do not increase the revenue generating capability in future. It is a normal recurring expense of the business. Thus, the legal expenses incurred in this case is revenue expenditure in nature.
- (iii) Expenses incurred on account of transportation of fixed asset is capital expenditure in nature.

SUMMARY

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

TEST YOUR KNOWLEDGE

True and False

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

Multiple Choice Questions

1. *Money spent ₹ 10,000 as traveling expenses of the directors on trips abroad for purchase of capital assets is*
 - (a) *Capital expenditures*
 - (b) *Revenue expenditures*
 - (c) *Prepaid revenue expenditures*

2. *Amount of ₹5,000 spent as lawyers' fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is*
 - (a) *Capital expenditures*
 - (b) *Revenue expenditures*
 - (c) *Prepaid revenue expenditures*
3. *Entrance fee of ₹2,000 received by Ram and Shyam Social Club is*
 - (a) *Capital receipt*
 - (b) *Revenue receipt*
 - (c) *Capital expenditures*
4. *Subsidy of ₹ 40,000 received from the government for working capital by a manufacturing concern is*
 - (a) *Capital receipt*
 - (b) *Revenue receipt*
 - (c) *Capital expenditures*
5. *Insurance claim received on account of*
 - (a) *Capital receipt*
 - (b) *Revenue receipt*
 - (c) *Capital expenditures*
6. *Interest on investments received from*
 - (a) *Capital receipt*
 - (b) *Revenue receipt*
 - (c) *Capital expenditures*
7. *Amount received from IDBI as a medium term loan for augmenting working capital is*
 - (a) *Capital expenditures*
 - (b) *Revenue expenditures*
 - (c) *Capital receipt*
8. *Revenue from sale of products, ordinarily, is reported as part of the earning in the period in which*
 - (a) *The sale is made.*
 - (b) *The cash is collected.*
 - (c) *The products are manufactured.*

9. *If repair cost is ₹25,000, whitewash expenses are ₹5,000, (both these expenses relate to presently used building) cost of extension of building is ₹ 2,50,000 and cost of improvement in electrical wiring system is ₹19,000; the amount to be expensed is*
- (a) ₹2,99,000.
(b) ₹44,000.
(c) ₹30,000.

Theoretical Questions

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

ANSWERS/HINTS

True and False

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

Multiple Choice Questions

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

Theoretical Questions

1. The basic considerations in distinction between capital and revenue expenditures are:
 - (a) Nature of business.
 - (b) Recurring nature of expenditure.
 - (c) Purpose of expenses.
 - (d) Effect on revenue generating capacity of business.
 - (e) Materiality of the amount involved.

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

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

UNIT – 4 CONTINGENT ASSETS AND CONTINGENT LIABILITIES

LEARNING OUTCOMES

After studying this unit, you will be able to:

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

UNIT OVERVIEW

Contingent Asset

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

Contingent Liability

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



4.1 CONTINGENT ASSET

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

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

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



4.2 CONTINGENT LIABILITIES

The term 'Contingent liability' can be defined as

- "(a) a **possible obligation** that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
- (b) a **present obligation** that arises from past events but is not recognised because:
- (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - (ii) a reliable estimate of the amount of the obligation cannot be made."

For example- Mr. X sells a machine to Mr. Y. Any damages incurred by Mr. Y while using the machine need to be compensated by Mr. X. A few days later from the date of sale of machine, Mr. X received a notice from Mr. Y who is claiming damages of ₹ 20 lac. The notice mentioned that a worker met with an accident during the use of the machine and is required to be compensated.

The receipt of this notice does not suggest that Mr. X is liable to pay the amount, although this needs to be investigated and confirmed, as whether the damage arose due to any defect in the machine or it is due to negligence while operating the machine. Although, the receipt of the notice results into an event which requires recognition of a contingent liability since **there is a possible obligation**, and that can only be confirmed in future.

Taking another example let us assume Mr. AB sells cars to its customers. One of the cars caught fire due to malfunctioning of a faulty part during the test drive by one of the customers. The customer has filed a court case seeking a claim of ₹ 50 lac due to the incidence.

While Mr. AB acknowledges that there is a **present obligation**, it is not certain that whether he is expected to pay for any damages. The final outcome will only be known during the court proceedings.

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

An enterprise should not recognise a contingent liability in balance sheet, however it is required to be disclosed in the notes to accounts, unless possibility of outflow of a resource embodying economic benefits is remote. These liabilities are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable.

If it becomes probable that an outflow or future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in financial statements of the period in which the change in probability occurs except in the extremely rare circumstances where no reliable estimate can be made.



4.3 DISTINCTION BETWEEN CONTINGENT LIABILITIES AND LIABILITIES

The distinction between a liability and a contingent liability is generally based on the judgement of the management. A liability is defined as the present financial obligation of an enterprise, which arises from past events. The settlement of a liability results in an outflow from the enterprises of resources embodying economic benefits. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

Examples of contingent liabilities are claims against the enterprise not acknowledged as debts, guarantees given in respect of third parties, liability in respect of bills discounted and statutory liabilities under dispute etc. In addition to present obligations that are recognized as liabilities in the balance sheet, enterprises are required to disclose contingent liability in their balance sheets by way of notes.



4.4 DISTINCTION BETWEEN CONTINGENT LIABILITIES AND PROVISIONS

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

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

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

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

SUMMARY

- ◆ A contingent asset may be defined as a possible asset that arises from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.
- ◆ A contingent liability is a possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.
- ◆ A liability is the present financial obligation of an enterprise, which arises from past events whereas contingent liability is a possible obligation arising from past events.
- ◆ Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation whereas Contingent liability is a possible obligation that may or may not crystallise depending on the occurrence or non-occurrence of one or more uncertain future events.

TEST YOUR KNOWLEDGE

True and False

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

Multiple Choice Questions

1. *Contingent asset usually arises from unplanned or unexpected events that give rise to*
 - (a) *The possibility of an inflow of economic benefits to the business entity.*
 - (b) *The possibility of an outflow of economic benefits to the business entity.*
 - (c) *Either (a) or (b).*

2. *If an inflow of economic benefits is probable then a contingent asset is disclosed*
- (a) *In the financial statements.*
 - (b) *In the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise).*
 - (c) *In the cash flow statement.*
3. *In the case of _____, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.*
- (a) *Liability*
 - (b) *Provision*
 - (c) *Contingent liabilities*
4. *Present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation is termed as _____.*
- (a) *Provision.*
 - (b) *Liability.*
 - (c) *Contingent liability.*
5. *In the financial statements, contingent liability is*
- (a) *Recognised.*
 - (b) *Not recognised.*
 - (c) *Adjusted.*

Theoretical Questions

Differentiate between:

- (i) *Provision and Contingent Liability.*
- (ii) *Liability and Contingent liability.*

ANSWERS/HINTS

True and False

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

Multiple Choice Questions

1.	(a)	2.	(b)	3.	(c)	4.	(a)	5.	(b)		
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Theoretical Questions

1. Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation. On the other hand, a Contingent liability is a possible obligation that may or may not crystallize depending on the occurrence or non-occurrence of one or more uncertain future events.
2. A liability is defined as the present financial obligation of an enterprise, which arises from past events. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

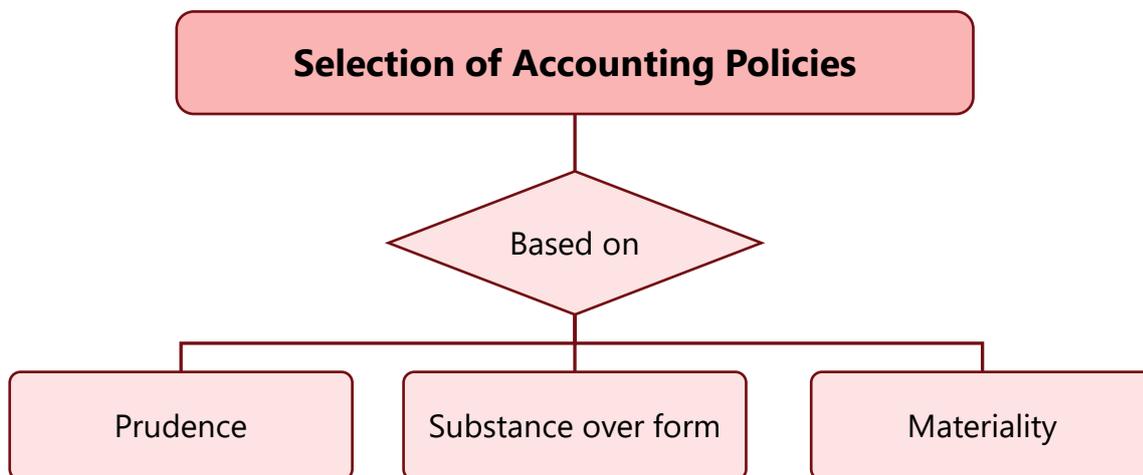
UNIT – 5 ACCOUNTING POLICIES

LEARNING OUTCOMES

After studying this unit, you will be able to:

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

UNIT OVERVIEW





5.1 MEANING OF ACCOUNTING POLICIES

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

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

- (1) Valuation of Inventories;
- (2) Valuation of Investments.

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

Suppose an enterprise holds some investments in the form of shares of a company at the end of an accounting period. For valuation of shares, the enterprise may adopt FIFO, average method etc. The method selected by that enterprise for valuation is called an accounting policy.



5.2 SELECTION OF ACCOUNTING POLICIES

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

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

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

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

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



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

For example, Omega Enterprises revised its accounting policy relating to valuation of inventories to include applicable production overheads. It intends to do as it believes that such change would result in a more appropriate presentation of its financial statements.

SUMMARY

- ◆ Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions.
- ◆ Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz., Prudence, Substance over form, and Materiality.

- ◆ A change in accounting policies should be made in the following conditions:
 - (a) It is required by some statute or for compliance with an Accounting Standard.
 - (b) Change would result in more appropriate presentation of financial statement.

TEST YOUR KNOWLEDGE

True and False

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

Multiple Choice Questions

1. *A change in accounting policy is justified*
 - (a) *To comply with accounting standard and law.*
 - (b) *To ensure more appropriate presentation of the financial statement of the enterprise.*
 - (c) *Both (a) and (b).*
2. *Accounting policy for inventories of Xeta Enterprises states that inventories are valued at the lower of cost determined on weighted average basis or net realizable value. Which accounting principle is followed in adopting the above policy?*
 - (a) *Materiality.*
 - (b) *Prudence.*
 - (c) *Substance over form.*

3. *The areas wherein different accounting policies can be adopted are*
 - (a) *Providing depreciation.*
 - (b) *Valuation of inventories.*
 - (c) *Both the option.*
4. *Selection of an inappropriate accounting policy decision may*
 - (a) *Overstate the performance and financial position of a business entity.*
 - (b) *Understate/overstate the performance and financial position of a business entity.*
 - (c) *Overstate the performance of a business entity.*
5. *Accounting policies refer to specific accounting*
 - (a) *Principles.*
 - (b) *Methods of applying those principles.*
 - (c) *Both (a) and (b).*

Theoretical Questions

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

ANSWERS/HINTS

True and False

1. False: There cannot be single list of accounting policies, which are applicable to all enterprises in all circumstances. There would always be different policies chosen by different industries under different circumstances.
2. False: Accounting policy has big impact on value of items goes under financial statements, hence it impacts financial performance and financial position of the business.
3. False: A change in accounting policies should be made in the following conditions:
 - (a) It is required by some statute or for compliance with an Accounting Standard.
 - (b) Change would result in more appropriate presentation of financial statement.

4. True: An enterprise may adopt FIFO or weighted average method for inventory valuation and the method selected for valuation is called an accounting policy.
5. False: It could understate/overstate the performance and financial position of a business entity.

Multiple Choice Questions

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

Theoretical Questions

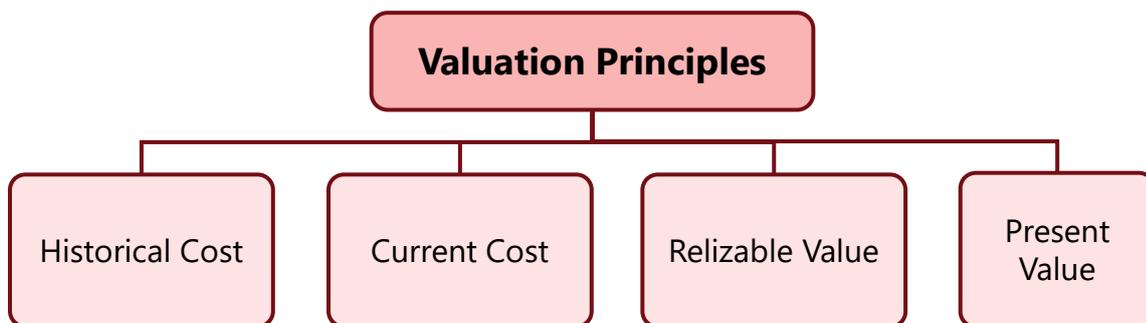
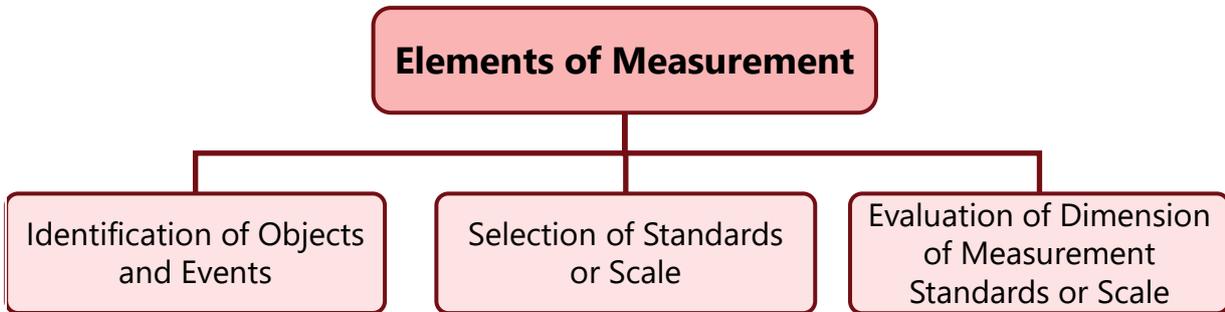
1. Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. For details, refer para 5.1.
2. Change in accounting policy may have a material effect on the items of financial statements. For example, if cost formula used for inventory valuation is changed from weighted average to FIFO. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts.

UNIT – 6 ACCOUNTING AS A MEASUREMENT DISCIPLINE – VALUATION PRINCIPLES, ACCOUNTING ESTIMATES

LEARNING OUTCOMES

After studying this unit, you will be able to:

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

UNIT OVERVIEW**6.1 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.



6.2 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.



6.3 STANDARD OR SCALE OF MEASUREMENT

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

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

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



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

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

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

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

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

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

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

6.5 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.

6.6 VALUATION PRINCIPLES

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

- (i) Historical Cost;
- (ii) Current Cost;
- (iii) Realizable Value;
- (iv) Present Value.

Let us discuss these principles in detail.

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

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

When a businessman, takes ₹ 5,00,000 loan from a bank @ 10% interest p.a., it is to be recorded at the amount of proceeds received in exchange for the obligation. Here the obligation is the repayment of loan as well as payment of interest at an agreed rate i.e. 10%. Proceeds received are ₹ 5,00,000 - it is historical cost of the transactions.

Take another case regarding payment of income tax liability. You know every individual has to pay income tax on his income if it exceeds certain minimum limit. But the income tax liability is not settled immediately when one earns his income. The income tax authority settles it some time later, which is technically called assessment year. Then how does he record this liability? As per historical cost base it is to be recorded at an amount expected to be paid to discharge the liability.

Companies usually apply historical cost method in case of long-term assets like machinery, furniture, licenses etc.

- (ii) *Current Cost:* Take that Mr. X purchased a machine on 1st January, 2011 at ₹ 7,00,000. As per historical cost base he has to record it at ₹ 7,00,000 i.e. the acquisition price. As on 1.1.2022, Mr. X found that it would cost ₹ 25,00,000 to purchase that machine. Take also that Mr. X took loan from a bank as on 1.1.2011 ₹ 5,00,000 @ 18% p.a. repayable at the end of 15th year together with interest. As on 1.1.2022 the bank announces 1% prepayment penalty on the loan amount if it is paid within 15 days starting from that day. As per historical cost the liability is recorded at ₹ 5,00,000 at the amount or proceeds received in exchange for obligation and asset is recorded at ₹ 7,00,000.

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

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

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

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

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

Realisable value concept is commonly applied in case of inventories. Inventories are measured at the lower of cost and net realisable value.

- (iv) *Present Value:* Suppose we are talking as on 1.1.2022 - take it as time for reference. Now think the machine purchased by Mr. X can work for another 10 years and is supposed to generate cash @ ₹ 1,00,000 p.a. Also take that bank loan of ₹ 5,00,000 taken by Mr. X is to be repaid as on 31.12.2028. Annual interest is ₹ 90,000.

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

The concept of Present Value is common in case of accounting for investments and loans.

The term 'discount', 'cash inflow' and 'cash outflow' need a little elaboration. ₹ 100 in hand as on 1.1.2022 is not equivalent to ₹ 100 in hand as on 31.12.2022. There is a time gap of one year. If Mr. X had ₹ 100 as on 1.1.2022 he could use it at that time. If he received it only on 31.12.2022, 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 31.12.2022 if he had been compensated for the sacrifice. So a rational man will never exchange ₹ 100 as on 1.1.2022 with ₹ 100 to be received on 31.12.2022. Then ₹ 100 of 1.1.2022 is not equivalent to ₹ 100 of 31.12.2022. To make the money receivable at a future date equal with the money of the present date it is to be devalued. Such devaluation is called discounting of future money.

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

A = Amount

P = Principal

i = interest / 100

n = Time

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

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

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

Suppose i = 20%, now what is the present value of ₹ 1,00,000 to be received as on 31.12.2022 (Take 1.1.2022 as the time of reference).

$$P = \frac{1,00,000}{(1+20)^1} = ₹ 83,333$$

Similarly,

Time of Receipt	Money Value ₹	Present Value ₹
31.12.2023	1,00,000	69,444
31.12.2024	1,00,000	57,870
31.12.2025	1,00,000	48,225
31.12.2026	1,00,000	40,188
31.12.2027	1,00,000	33,490
31.12.2028	1,00,000	27,908
31.12.2029	1,00,000	23,257
31.12.2030	1,00,000	19,381
31.12.2031	1,00,000	16,150

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

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

Perhaps you also know the annuity rule:

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

A = Annuity

i = interest

t = time 1, 2, 3,n.

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

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

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

Similarly, the present value of bank loan is

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

$$= ₹ 2,69,155 + ₹ 2,00,939 = ₹ 4,70,094$$

Thus, we get the four measurements as on 1.1.2022:

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

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



6.7 MEASUREMENT AND VALUATION

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



6.8 ACCOUNTING ESTIMATES

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

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

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

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

1. A company incurs expenditure of ₹ 10,00,000 on development of patent. Now the company has to estimate that for how many years the patent would benefit the company. This estimation should be based on the latest information and logical judgement.
2. A company dealing in long-term construction contracts, uses percentage of completion method for recognizing the revenue at the end of the accounting year. Under this method the company has to make adequate provisions for unseen contingencies, which can take place while executing the remaining portion of the contract. Since provisioning for unseen contingencies requires estimation, there may be excess or short provisioning, which is to be adjusted in the period when it is recognised.
3. A 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.
4. Company XY Ltd purchases a machine for ₹ 10 lac in 2021. The procurement head suggested that the machine is expected to offer benefits up to next 10 years. After 3 years of its use, the machine has become obsolete as new technologies are now available providing better productivity than the existing machine. Hence, it is now expected that the machine can only offer benefits for further 3 years. This is a change in estimate in the useful life of the machine.

SUMMARY

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

TEST YOUR KNOWLEDGE

True and False

1. *There are four generally accepted measurement bases.*
 - (i) *Historical Cost;*
 - (ii) *Current Cost;*
 - (iii) *Realizable Value;*
 - (iv) *Future Value.*
2. *Historical Cost means price paid at time acquisition.*
3. *As per future value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal.*
4. *At Present value, liabilities are carried at the value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.*
5. *ABC purchased a machinery amounting ₹10,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for ₹20,00,000. Historical cost of machine is 20,00,000*
6. *ABC purchased a machinery amounting ₹10,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for ₹20,00,000. Current cost of machine is ₹ 20,00,000*
7. *Change in accounting estimate has to be given retrospective effect.*

Multiple Choice Questions

1. (i) *Measurement discipline deals with*
 - (a) *Identification of objects and events.*
 - (b) *Selection of scale.*
 - (c) *Both (a) and (b)*
- (ii) *All of the following are valuation principles except*
 - (a) *Historical cost.*
 - (b) *Present value.*
 - (c) *Future value.*

- (iii) *Book value of machinery on 31st March, 2022* ₹ 10,00,000
Market value as on 31st March, 2022 if sold ₹ 11,00,000
As on 31st March, 2022, if the company values the machinery at ₹ 11,00,000, which of the following valuation principle is being followed?
- (a) *Historical Cost.*
 - (b) *Present Value.*
 - (c) *Realisable Value.*
2. *Mohan purchased a machinery amounting ₹ 10,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for ₹ 20,00,000 but the realizable value of the machinery (purchased on 1.4.2001) was estimated at ₹ 15,00,000. The present discounted value of the future net cash inflows that the machinery was expected to generate in the normal course of business, was calculated as ₹ 12,00,000.*
- (i) *The current cost of the machinery is*
 - (a) ₹ 10,00,000.
 - (b) ₹ 20,00,000.
 - (c) ₹ 15,00,000.
 - (ii) *The present value of machinery is*
 - (a) ₹ 10,00,000.
 - (b) ₹ 20,00,000.
 - (c) ₹ 12,00,000.
 - (iii) *The historical cost of machinery is*
 - (a) ₹ 10,00,000.
 - (b) ₹ 20,00,000.
 - (c) ₹ 15,00,000.
 - (iv) *The realizable value of machinery is*
 - (a) ₹ 10,00,000.
 - (b) ₹ 20,00,000.
 - (c) ₹ 15,00,000.

Theoretical Questions

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

ANSWER/HINTS

True and False

1. False: There are four generally accepted measurement bases .
 - (i) Historical Cost;
 - (ii) Current Cost;
 - (iv) Realizable Value;
 - (iv) Present Value.
2. True: Historical cost means the acquisition price.
3. False: At Realisable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal.
4. False: Liabilities are carried at the present discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.
5. False: Historical cost is ₹10,00,000.
6. True: Since similar machine is purchased at 20,00,000, the current cost of machine is ₹ 20,00,000.
7. False: Change in accounting estimate has not to be given retrospective effect.

Multiple Choice Questions

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

Theoretical Questions

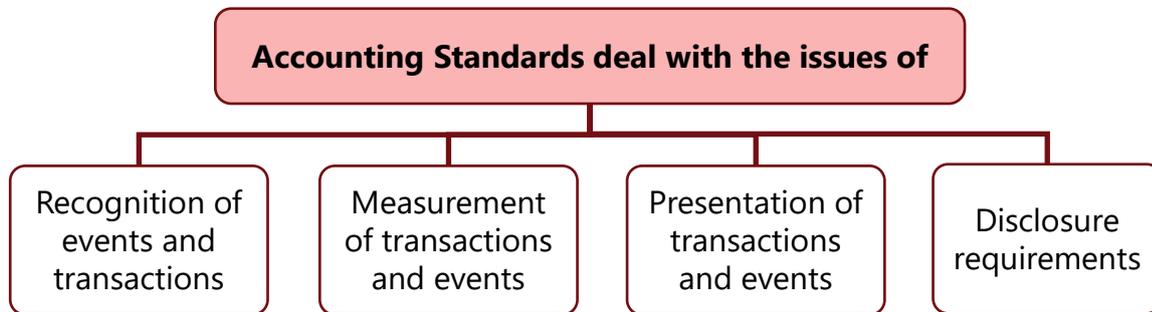
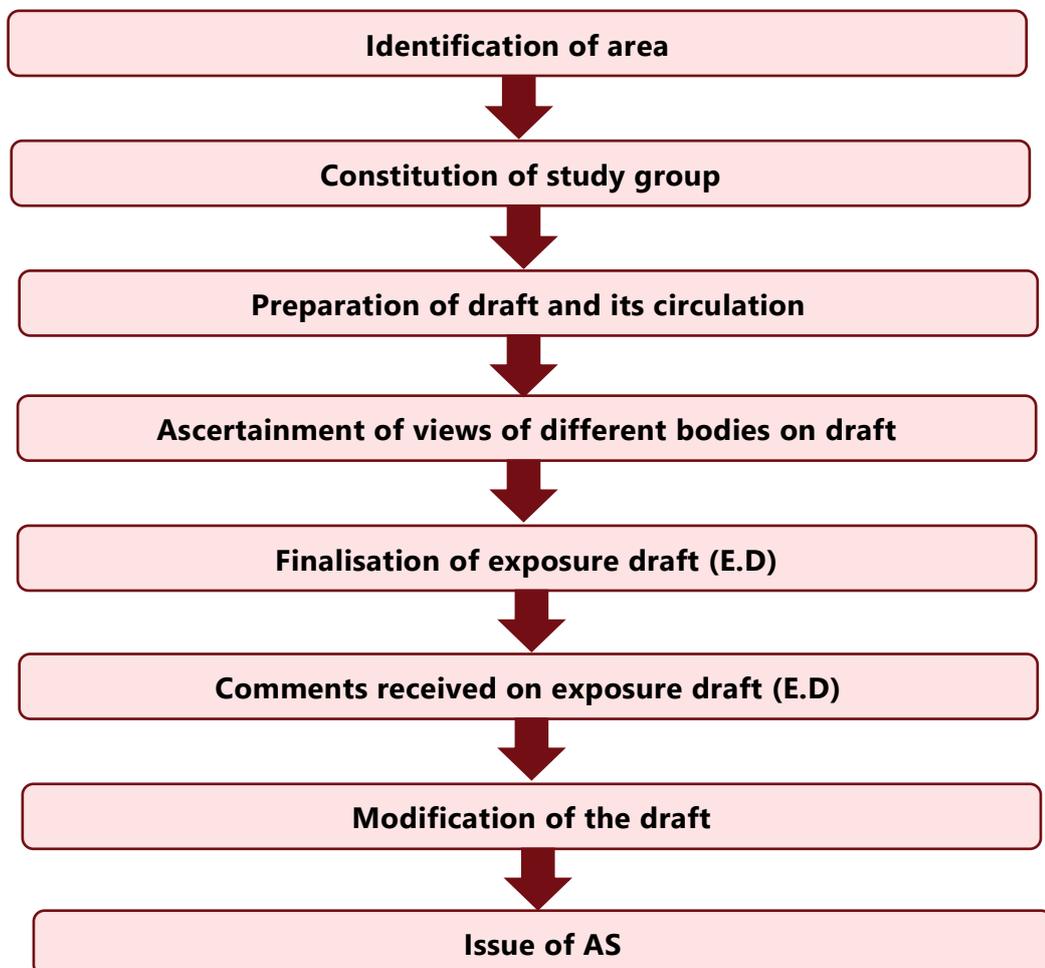
1. Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Three elements of measurement are: (1) Identification of objects and events to be measured; (2) Selection of standard or scale to be used; (3) Evaluation of dimension of measurement standard or scale.
2. Alternative measurement bases are: (i) Historical Cost; (ii) Current cost (iii) Realisable (Settlement) Value and (iv) Present Value. Refer para 6.6 for details.

UNIT – 7 ACCOUNTING STANDARDS

LEARNING OUTCOMES

After studying this unit, you will be able to:

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

UNIT OVERVIEW **Formulation of Accounting Standards**



7.1 INTRODUCTION OF ACCOUNTING STANDARDS

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

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

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



7.2 OBJECTIVES OF ACCOUNTING STANDARDS

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

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

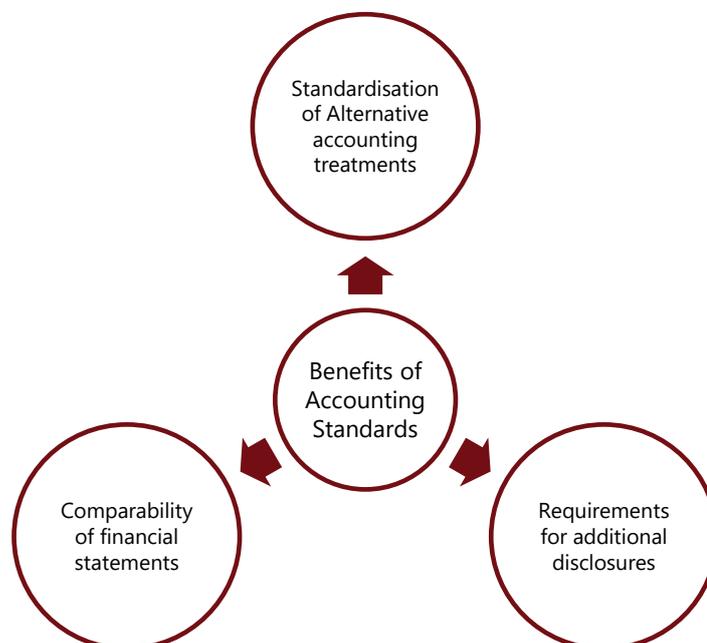
Accounting standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises.



7.3 BENEFITS AND LIMITATIONS OF ACCOUNTING STANDARDS

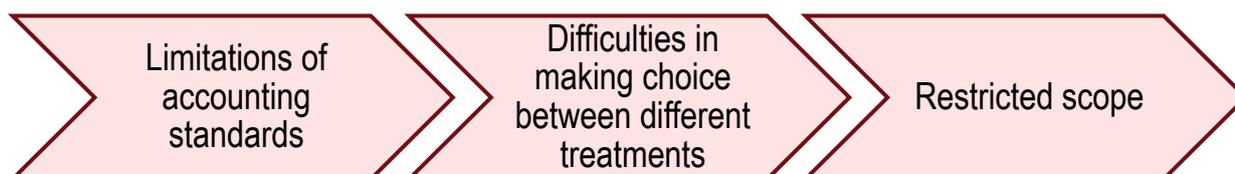
Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards, the accountant has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

- (i) **Difficulties in making choice between different treatments:** Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- (ii) **Restricted scope:** Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.



7.4 PROCESS OF FORMULATION OF ACCOUNTING STANDARDS IN INDIA

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

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

- ◆ Identification of broad areas by ASB for formulation of AS.
- ◆ Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards. The draft normally includes objective and scope of the standard, definitions of the terms used in the standard, recognition and measurement principles wherever applicable and presentation and disclosure requirements.

- ◆ Consideration of the preliminary draft prepared by the study group of ASB and revision, if any, of the draft on the basis of deliberations.
- ◆ Circulation of draft of accounting standard (after revision by ASB) to the Council members of the ICAI and specified outside bodies such as Department of Company Affairs (DCA), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc. for comments.
- ◆ Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard.
- ◆ Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments.
- ◆ Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
- ◆ Consideration of the final draft of the proposed standard and by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB is done.
- ◆ The accounting standard on the relevant subject (for non-corporate entities) is then issued by the ICAI. For unlisted corporate entities, having net worth of less than 250 crores the accounting standards are issued by The Central Government of India.

There are three sets of Accounting Standards to cater different categories of entities based on their nature, size, and legal framework under which they operate, ensuring that each entity follows appropriate accounting principles for financial reporting These are:

- (i) *Indian Accounting Standards (Ind AS) are applicable to all listed companies and Non-Banking Financial Companies (NBFCs) and to unlisted companies and unlisted NBFCs with net worth of INR 250 crores or more.*
- (ii) *Accounting Standards (AS) notified under Companies (Accounting Standards) Rules, 2021, are applicable to the companies other than those following Ind AS, as given in point (i). These companies are required to apply Accounting Standards (AS) notified under the Companies Act as Companies (Accounting Standards) Rules, 2021.*
- (iii) *Accounting Standards (AS) prescribed by ICAI are applicable for entities other than companies.*



7.5 LIST OF ACCOUNTING STANDARDS IN INDIA

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

Following is the list of applicable Accounting Standards:

List* of Accounting Standards

Sl. No.	Number of the Accounting Standard (AS)	Title of the Accounting Standard
1.	AS 1	Disclosure of Accounting Policies
2.	AS 2 (Revised)	Valuation of Inventories
3.	AS 3 (Revised)	Cash Flow Statements
4.	AS 4 (Revised)	Contingencies and Events Occurring after the Balance Sheet Date
5.	AS 5 (Revised)	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
6.	AS 7 (Revised)	Accounting for Construction Contracts
7.	AS 9	Revenue Recognition
8.	AS 10	Property, Plant and Equipment
9.	AS 11 (Revised)	The Effects of Changes in Foreign Exchange Rates
10.	AS 12	Accounting for Government Grants
11.	AS 13	Accounting for Investments
12.	AS 14	Accounting for Amalgamations
13.	AS 15 (Revised)	Employee Benefits
14.	AS 16	Borrowing Costs
15.	AS 17	Segment Reporting
16.	AS 18	Related Party Disclosures
17.	AS 19	Leases
18.	AS 20	Earnings Per Share
19.	AS 21	Consolidated Financial Statements

20.	AS 22	Accounting for Taxes on Income
21.	AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
22.	AS 24	Discontinuing Operations
23.	AS 25	Interim Financial Reporting
24.	AS 26	Intangible Assets
25.	AS 27	Financial Reporting of Interests in Joint Ventures
26.	AS 28	Impairment of Assets
27.	AS 29	Provisions, Contingent Liabilities & Contingent Assets

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

****Indian Accounting Standards (IND AS)**

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

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

List of Ind as on 1st August, 2024

Ind AS	Title of Ind AS
101	First -Time Adoption of Indian Accounting Standards
102	Share- Based Payment
103	Business Combinations

Ind AS	Title of Ind AS
104	Insurance Contracts
105	Non-current Assets Held for Sale and Discontinued Operations
106	Exploration for and Evaluation of Mineral Resources
107	Financial Instruments: Disclosures
108	Operating Segments
109	Financial Instruments
110	Consolidated Financial Statements
111	Joint Arrangements
112	Disclosure of Interests in Other Entities
113	Fair Value Measurement
114	Regulatory Deferral Accounts
115	Revenue from Contracts with Customers
116	Leases
1	Presentation of Financial Statements
2	Inventories
7	Statement of Cash Flows
8	Accounting Policies, Changes in Accounting Estimates and Errors
10	Events after the Reporting Period
12	Income Taxes
16	Property, Plant and Equipment
19	Employee Benefits
20	Accounting for Government Grants and Disclosure of Government Assistance
21	The Effects of Changes in Foreign Exchange Rates
23	Borrowing Costs
24	Related Party Disclosures
27	Separate Financial Statements
28	Investment in Associates and Joint Ventures
29	Financial Reporting in Hyperinflationary Economies
32	Financial Instruments: Presentation
33	Earnings per Share
34	Interim Financial Reporting

Ind AS	Title of Ind AS
36	Impairment of Assets
37	Provisions, Contingent Liabilities and Contingent Assets
38	Intangible Assets
40	Investment Property
41	Agriculture

****Accounting Standards for Local Bodies**

Accounting Standards for local bodies are Accounting Standards that are applicable to the local bodies whose primary objective is to deliver services to the public, rather than to make profits and generate a return on equity to investors. Consequently, the performance of such entities can be only partially evaluated by examination of financial position, financial performance and cash flows.

List of Accounting Standards for Local Bodies (ASLB) as on 1st August, 2024

ASLB	Title of ASLB
1	Presentation of Financial Statements
2	Cash Flow Statements
3	Accounting Policies, changes in Accounting Estimates and Errors
4	The Effects of Changes in Foreign Exchange Rates
5	Borrowing Costs
9	Revenue from Exchange Transactions
11	Construction Contracts
12	Inventories
13	Leases
14	Events After the Reporting Date
16	Investment Property
17	Property, Plant and Equipment
18	Segment Reporting
19	Provision, Contingent Liabilities and Contingent Assets
20	Related Party Disclosures
21	Impairment of Non-Cash-Generating Assets
23	Revenue from Non-Exchange Transaction (Taxes and Transfers)

ASLB	Title of ASLB
24	Presentation of Budget Information in Financial Statements
26	Impairment of Cash-Generating Assets
31	Intangible Assets
32	Service Concession Arrangements: Grantor
33	First-Time Adoption of Accrual Basis Accounting Standards for Local Bodies (ASLBs)
34	Separate Financial Statements
35	Consolidated Financial Statements
36	Investment in Associates and Joint Ventures
37	Joint Arrangements
38	Disclosure of Interests in Other Entities
39	Employee Benefits
40	Entity Combinations
42	Social Benefits
	Financial Reporting under Cash Basis of Accounting

****Note: Ind AS and ASLB given above do not form part of the syllabus. They have been discussed here for the knowledge of students only.**

SUMMARY

- ◆ Accounting Standards (ASs) provide framework and standard accounting policies for treatment of transactions and events so that the financial statements of different enterprises become comparable. Accounting Standards standardise diverse accounting policies with a view to:
 - (i) eliminate the non-comparability of financial statements
 - (ii) provide a set of standard accounting policies, valuation norms and disclosure requirements
- ◆ By setting the accounting standards, the accountant has following benefits:
 - (i) Comparability of financial statements
 - (ii) Requirements of additional disclosures
- ◆ Following are the limitations of accounting standards
 - (i) Difficulties in making choice between different treatments.
 - (ii) Accounting standards cannot override the statute

TEST YOUR KNOWLEDGE

True and False

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

Multiple Choice Questions

1. Accounting Standards for Non-Corporate entities in India are issued by
 - (a) Central Govt.
 - (b) State Govt.
 - (c) Institute of Chartered Accountants of India.
2. Accounting Standards
 - (a) Harmonise accounting policies.
 - (b) Eliminate the non-comparability of financial statements.
 - (c) Both the above.
3. It is essential to standardize the accounting principles and policies in order to ensure
 - (a) Transparency.
 - (b) Consistency.
 - (c) Both the above.

Theoretical Questions

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

ANSWERS/HINTS

True and False

1. True: Accounting standards are documents covering recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements.
2. False: Accounting standards can never override the statute. The standards are required to be framed within the ambit of prevailing statutes.
3. False: Difficulties in making choice between different treatments is one of the limitation of accounting standard.
4. False: Benefits of accounting standards are:
 - Standardisation of alternative accounting treatments
 - Comparability of financial statements
 - Requirements for additional disclosures.
5. False: ASB stands for Accounting Standard Board.
6. False: limitations of accounting standards
 - Difficulties in making choice between different treatments
 - Restricted scope

Multiple Choice Questions

1.	(c)	2.	(c)	3.	(c)						
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Theoretical Questions

1. Accounting Standards are selected set of accounting policies or broad guidelines regarding the principles and methods to be chosen out of several alternatives. The main objective of Accounting Standards is to establish standards which have to be complied with, to ensure that financial statements are prepared in accordance with generally accepted accounting principles. Accounting Standards seek to suggest rules and criteria of accounting measurements. These standards harmonize the diverse accounting policies and practices at present in use in India.
2. The main advantage of setting accounting standards is that the adoption and application of accounting standards ensure uniformity, comparability and qualitative improvement in the preparation and presentation of financial statements. The other advantages are:
Reduction in variations; Disclosures beyond that required by law and Facilitates comparison.

