

AS-1

# DISCLOSURE OF ACCOUNTING POLICIES

The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users, in making economic decisions.

Financial statements portray the effect of past events and transactions. Accounting policies and methods adopted by an enterprise, in turn, influence the effect of past events and transactions. Users must be able to compare the:

## Scope

- financial statements of any **one enterprise** through time so that trends and movements in performance and position can be identified, and
- status of **different enterprises** for an evaluation of relative financial position and performance.

The disclosure by an entity of its accounting policies, enable users to-

- understand the past
- extrapolate to the future

A critical qualitative characteristic of “comparability” is that users be informed of not merely the accounting principles and methods adopted by the enterprises, but the changes in such policies introduced and the monetary effect of such changes, as well.

This standard deals with the disclosure of significant accounting policies followed in preparation and presentation of financial statements. The purpose is to promote a better understanding of financial statements by establishing through an Accounting Standard (AS), a mandatory requirement that all significant accounting policies ought to be disclosed as also the manner in which such accounting policies are to be disclosed in the financial statements.

## Accounting Policies

Accounting policies refer to:

- Specific accounting principles, and
- Methods adopted by enterprises, in applying these principles in the preparation and presentation of financial statements.

Accounting Policy Components	
Principle	Method of applying principle
Providing depreciation on an	Straight line,

asset to account for loss in value	Written down value basis or any other appropriate method
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### Disclosure needs arise because accounting policies can differ

Accounting principles and methods can differ between one enterprise and another, in the areas of recognition, treatment or valuation of assets, or recognition of transactions or events. An illustrative list of examples is given below:

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| i. Accounting conventions followed                         | x. Recognition of a liability for retirement benefits         |
| ii. Basis of accounting—Historical or Current cost         | xi. Recognition of profit on long-term contracts              |
| iii. Valuation of inventory                                | xii. Absorption of costs incurred on research and development |
| iv. Valuation of investments                               | xiii. Treatment of preliminary, or, capital issue expenses    |
| v. Valuation of fixed assets including revaluation         | xiv. Treatment of Lease rental income or lease rental payment |
| vi. Policies relating to depreciation of fixed assets      | xv. Treatment of expenditure during construction              |
| vii. Translation of foreign currency transactions or items | xvi. Treatment of contingent liabilities                      |
| viii. Treatment of Government grants                       |   |
| ix. Treatment of goodwill                                  |   |

### Fundamental Accounting Concepts

AS-1 highlights three important practical rules. [The term “rules” is used consciously to focus on the fact that over time, these are capable of variation and evolve as the depth and profundity of accounting practice increases].

- ***Going Concern Concept***

We apply this concept on the basis that the reporting entity is normally viewed to be continuing in operation **in the foreseeable future**, and without there being any intention or necessity for it to either liquidate or curtail materially its scale of business operations.

- ***Accrual Concept***

This is relevant in the area of revenue and costs. These are accrued, i.e., recognised, as they are earned or incurred (and not as cash is received or paid). Also, they are recorded in the period to which they relate.

- ***Consistency Concept***

There should be consistency of accounting treatment of comparable (similar) items, not only within each accounting period, but also from one period to another.

These concepts, which are fundamental to accounting, are the broad-based assumptions, underlying preparation of financial statements periodically. Financial statements are assumed to be prepared by adhering, among others, to these concepts.

Unless any contrary position is unequivocally brought to notice, the user can validly presume that these principles have been followed. Consequently, if any one of these principles is not adhered to, such a fact ought to be disclosed.

### **Selection of appropriate accounting policies**

Financial statements (e.g., annual accounts) are internationally recognised as a “composite whole” with, Balance Sheet, Statement of Profit and Loss, Notes on accounts, and cash flow picture, as its constituent elements. Entities governed by the provisions of Companies Act, or other Statutes while complying with the detailed provisions in the relevant statutes, should also ensure that the accounts do give a true and fair view of the financial position and performance. A remote possibility of a conflict between compliance with detailed provisions in the Statutes and the achievement of truth and fairness cannot perhaps be taken as entirely non-existing. In such a situation, there is an overriding obligation to provide a “**true and fair view**” to users of financial statements.

It is this overriding obligation that constitutes the “**major consideration**” in the determination and selection of accounting policies that are appropriate to an entity, event or transaction. Rightly, therefore, AS-1 lays emphasis on true and fair view being kept in primary focus for adoption of any accounting policy.

Consider an entity using projector lights, the useful life of which is governed by the number of hours it is in use. The basis for an appropriate accounting policy for depreciating such an asset would be the actual number of hours such an asset is put to use. Selection of a straight-line method, allowing for a five-year life would apparently be inappropriate. Consider another case of usage of a machinery wear and tear of which is higher in initial years, relative to later years. Selection of written down value method of depreciation would be appropriate in this case, as opposed to a straight-line method. Viewed in this backdrop, true and fair principle would get vitiated if the accounting policy selected is inappropriate.

An enterprise has, therefore, to exercise scrupulous care in the selection and application of accounting principles and methods. Such a selection is guided by “three major considerations”.

#### **(a) Prudence**

Prudence is the inclusion of a degree of caution in the exercise of judgements needed in making estimates required under conditions of uncertainty.

By exercising prudence, an enterprise does not recognise profits on the basis of anticipation. These are recognised only when realised **though not necessarily in cash**. However, all known losses are anticipated and provided for.

**For example**, in determining the carrying amount of inventory, the profit margins are ignored and yet, the realisable value if less than cost is taken cognizance of.

**(b) Substance over form**

If information is to represent faithfully the transactions or events, it is essential that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

**For example**, where rights and interests in a property stands transferred while legal documentation for the transfer is yet to be completed, the transaction should be recorded as a sale in the books of transferor and acquisition in the books of transferee. While distinguishing an amalgamation in the nature of merger, from one that of purchase, we do look at the substance of the transaction (i.e. whether the shareholders come together in a substantially equal partnership to share risks and benefits), over its form. Under AS-7(R) Construction Contracts, this concept of substance over form has been fittingly adopted in the determination of “what constitutes a single contract” for recognition of costs and revenues,

**(c) 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 taken by the user, based on such financial statements. Accordingly, financial statements should disclose all material items, i.e., knowledge of which might influence the decision of the user of financial statements.

Three major considerations in selecting accounting policies are highlighted in the Standard. Other qualitative characteristics of accounting information, such as (i) relevance, (ii) neutrality, (iii) completeness, and (iv) reliability are equally critical to users in order that financial statements are meaningful. In the selection and adoption of accounting policies these aspects should also be kept in view. (also see Chart at the end of this Chapter)

**Disclosure of Accounting Policies**

All significant policies adopted in the preparation and presentation of financial statements should be disclosed at one place and should form part of the financial statements.

It is customary to furnish a summary of the accounting policies in respect of the following areas:

- Accounting Convention
- Basis of Accounting
- Fixed Assets
- Depreciation
- Revaluation of Assets
- Investments
- Inventories
- Revenue Recognition
- Investment Income
- Borrowing Cost
- Proposed Dividend
- Retirement Benefits
- Lease Rentals (Lease Income)
- Research and Development Costs
- Taxes on income
- Foreign currency translation
- Claims
- Segment Reporting
- Financial and Management Information Systems

- Intangible assets

### Changes in the Accounting Policies - Dealt with in AS- 5.

- An enterprise is free to change its accounting policies, unless it violates any statutory provisions, or codes laid down in a mandatory Accounting Standard, and provided of course such a change leads to better and more meaningful presentation of accounting information. If, however, such a change may have a material effect on the financial statements of the current accounting period or later periods, such changes should be disclosed.
- Where a change in the accounting policies carries with it a material impact on the performance and operations in the current period, the amount by which any item in the financial statement is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable wholly or partly, the fact should be indicated. If a change in the accounting policy has material effect only on the financial statements of a subsequent period, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

### Comparison of AS 1 with IAS and US GAAP

<i>AS 1</i>	<i>IAS 1</i>	<i>US GAAP</i>
Defines accounting policies, as specific accounting principles and methods of applying these principles adopted by enterprises in preparation and presentation of financial statements	Defines overall considerations for financial statements, besides prescribing minimum structure and content of financial statements. In addition, a statement showing changes in equity is also to be presented as a part of financial statements	Defines accounting policies as specific accounting principles that are judged by the management of the enterprise to be the most appropriate in the circumstance to present fairly financial position, and results of operations in accordance with GAAP and are accordingly adopted for preparing financial statements.
Choice of appropriate accounting policies calls for considerable judgement by the management of the enterprise	Require specific disclosure for departure from IFRS, critical judgement made by management in applying accounting policies.	Unusual or innovative applications of generally accepted accounting principles are additionally to be disclosed
True and fair view, going concern, consistency, accrual, prudence, materiality and substance over form are highlighted.	No item should be disclosed as extraordinary item.	

### Supplemental information

- The Standard is mandatorily applicable to and is required to be complied with by, all enterprises.
- ICAI has constituted a Study Group for revision of AS-1.

For a better appreciation of AS-1, readers should also refer to AAS 13 (Audit Materiality), AAS 16 (Going Concern), Provisions of Sub section (3) of Section 209 of the Companies Act (books of accounts to be maintained on accrual basis), Parts I, II and III of Schedule VI

to the Act (legal requirement as to the format and materiality element of disclosure) and 217(2AA) of the Act (legal relevance of selection and application of accounting policies).

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## QUESTION BANK

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### Review of Policies

1. *Comment on the appropriateness of the following accounting policies. Where inappropriate, give reasons.*
  - a) *Amount of exchange differences arising on translation on Balance Sheet date is taken to profit and loss account excepting in case of gain on current assets and liabilities in a country from where, on account of restrictions, the ability of the overseas unit is seriously impaired in transferring funds. In addition, as a matter of abundant prudence, gain on long-term liabilities is held as a reserve in order to meet any translation loss that may arise in one or more subsequent periods.*
  - b) *Construction contracts entered into on or after 1<sup>st</sup> April 2003, and the entire duration of which falls within one single accounting year, are accounted for on completed contract method, and all other construction contracts are accounted for on percentage of completion method.*
  - c) *In the area of construction contracts, revenue from fixed price construction contracts is recognised on the percentage of completion method, measured by reference to the percentage of labour hours incurred up to the reporting date, to estimated total labour hours for each contract.*
  - d) *Effective 1st April 2003, the Company has adopted and applied the prescriptions under AS-26 (Intangible Assets), and expenses incurred on intangible items from the said date are recognised as Intangible Assets, only if future economic benefits from such items flow to the enterprise and the costs are measurable. Keeping materiality of items in view, all expenses recognised as Intangible Assets are written off, where the initial cost of recognition is Rs.5,000 or less, even if they do not meet the criteria.*
  - e) *The company have prepared and reported segment information in conformity with the accounting policies adopted for preparing and presenting financial statements of the company as a whole. In the case of assets, which are used jointly by two business segments, values are apportioned between the two on a rational and realistic basis, while the joint revenues, which do not pertain to either, are taken on Head Office account.*

### **Solution**

Evaluation of accounting policies:

- a) Inappropriate. Unrealised gains on long term liabilities cannot be held as a reserve, but should be credited to P&L from year to year.
- b) Inappropriate. Even in cases where the contract duration is less than one single accounting year, it is essential to adopt only Percentage Completion method. Such a need arises, for Interim Financial Reporting (AS 25 – where an interim period is treated as an accounting period, shorter than one full accounting year).
- c) Appropriate.

- d) Appropriate. However, an item to be recognised as an intangible asset, should pass both (a) definition and (b) recognition criteria. The policy talks only about recognition criteria. Further, the policy cannot cite, materiality and value being less than Rs. 5000 as reasons for write off, in cases where an item cannot be in the first place recognised as an IA.
- e) Inappropriate. In the case of assets, which are used jointly by two business segments, values can be apportioned between the two only if the revenues generated from the assets are similarly apportioned.

### Change in Accounting Policy

2. *Western CK Ltd., have been consistently following a method of assigning costs to inventories using Standard Cost system, with an in built normal overhead absorption rate on labour-hour basis. During the year ended 31<sup>st</sup> March 2004, the company modified the absorption basis from labour-hour rates, to machine hour rates. The method of assigning costs was allowed to remain undisturbed on Standard Cost system. Comment if this is tantamount to a change in accounting policy within the meaning of AS 2 (Revised), effective from 1st April 1999.*

#### **Solution**

AS 2 provides for two cost formulae, namely, FIFO and Weighted Average. In paragraph 18, the Standard refers to Standard Cost method as a technique of measuring cost, if results approximate values as per FIFO or weighted average. It may appear that Western CK Ltd. has not changed the accounting policy, and the cost formula used in the valuation of inventories. Going by the spirit behind the prescriptions in the Standard, it is but appropriate to reckon a change in the basis of "Standard Cost" of a unit, as a change in "cost formula", and to make a disclosure, together with the accounting effect thereof, as a part of accounting policy under AS 2.

### Appropriateness of going concern assumption

3. *Preparation of financial statements in a situation where going concern assumption is inappropriate.*

*A joint venture company promoted by a government undertaking and a private promoter has two manufacturing units. The management of the day-to-day affairs of the company was vested with the private promoter until 17.2.1997 which was subsequently taken over by the government undertaking owing to large-scale misappropriations committed by the private promoter. The company is now being run by the board of directors who are the nominees of the government undertaking. Due to the large-scale misappropriations, the resources of the company had drained and the bankers had also frozen the limits resulting in the eventual suspension of the operations of the company from September 1998. The company's case was referred to Board for Industrial and Financial Reconstruction (BIFR) and BIFR, vide its order dated 26.7.2000 had pronounced that the company was fit to be wound up. BIFR has accordingly advised the Hon'ble High Court of Chennai to appoint the official liquidator for winding up of the company.*

*The company is in the process of compiling its accounts for the 18 months period from 1.10.1998 to 31.3.2000 and has been advised by certain experts that the principle of 'going concern' would not apply to the company, which has been endorsed by the company's board of directors also. However, there are conflicting views on compilation of accounts in the case where the principle of 'going concern' does not apply. One view*

*is that the company should prepare the profit and loss account and disclose all known liabilities and provide for the same, Whereas the other view is that the company should only prepare the receipt and payments account and quantify the liabilities and disclose the same by way of explanatory note in the notes to accounts. During the period under question, the company had a marginal turnover of Rs.3.84 lac from existing inventory.*

*Advice :*

- (a) Whether the fundamental accounting assumption of going concern would be valid for the company.*
- (b) If the principle of 'going concern' does not apply to the company, whether the company should prepare a receipts and payments account or profit and loss account.*
- (c) If the company is required to prepare a receipts and payments account, how the liabilities should be disclosed and provided for.*
- (d) Whether the company would be justified in imputing a value to the inventory and sundry debtors despite the fact that the company is not in operation since September, 1998.*
- (e) If the answer to the above question is in the negative, whether the company would be justified in writing off the entire imputed value of debtors and inventory.*

***Solution :***

- (a) The fundamental accounting assumption of going concern would not be appropriate in the facts and circumstances of the company for the preparation and presentation of financial statements.
- (b) The company should prepare the balance sheet and profit and loss account on liquidation basis and the basis for preparation of such financial statements should be disclosed.
- (c) In view of (b) above, receipts and payments accounts should not be prepared. Liabilities should be valued on liquidation basis. I.e., how much would be payable to the creditors in the event of liquidation.
- (d) The company should value all assets and liabilities including inventories and sundry debtors on the basis used for preparation of financial statements, i.e., liquidation basis (realisable value).
- (e) Since the answer to (d) is not in the negative, the question does not arise.