Accounting Principles

Financial accounting is information that must be processed and reported objectively. Third parties, who must rely on such information, have a right to be assured that the data is free from bias and inconsistency, whether deliberate or not. For this reason, financial accounting relies on certain standards or guides that are called 'Generally Accepted Accounting Principles' (GAAP).

Principles derived from tradition, such as the concept of matching. In any report of financial statements (audit, compilation, review, etc.), the preparer/auditor must indicate to the reader whether or not the information contained within the statements complies with GAAP.

- Principle of regularity: Regularity can be defined as conformity to enforced rules and laws.
- Principle of consistency: This principle states that when a business has fixed a specific method for the accounting treatment of an item, it will enter all similar items that follow, in exactly the same way.
- Principle of sincerity: According to this principle, the accounting unit should reflect in good faith the reality of the company's financial status.
- Principle of the permanence of methods: This principle aims at maintaining the coherence and comparison of the financial information published by the company.
- Principle of non-compensation: One should show the full details of the financial information and not seek to compensate a debt with an asset, revenue with an expense etc.
- Principle of prudence: This principle aims at showing the reality 'as is': one should not try to make things look rosier than they are. Typically, revenue should be recorded only when it is certain and a provision should be entered for an expense, which is probable.
- Principle of continuity: When stating financial information, one assumes that business will not be interrupted. This principle mitigates the principle of prudence: assets do not have to be accounted at their disposable value, but it is accepted that they are at their historical value.
- Principle of periodicity: Each accounting entry should be allocated to a given period and split accordingly if it covers several periods. If a client pre-pays a subscription (or lease, etc.), the given revenue should be split to the entire time-span and not accounted for entirely on the date of the transaction.

- Principle of full disclosure/materiality: All information and values pertaining to the financial position of a business must be disclosed in the records.

Introduction of Accounting Standards in India and International Accounting Standards

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

Accounting standards are being established both at national and international levels. However, the diversity of accounting standards among the nations of the world has been a problem for the globalization of the business environment. In India, the Accounting Standards Board (ASB) was constituted by the Institute of Chartered Accountants of India (ICAI) on 21st April 1977, which performs the function of formulating accounting standards. The Statements on accounting standards are issued by the Institute of Chartered Accountants of India (ICAI) to establish standards that have to be complied with, to ensure that financial statements are prepared in accordance with a commonly accepted accounting standard in India (India GAAP).

Accurate and reliable financial information is the lifeline of commerce and investing. Presently, there are two sets of accounting standards that are accepted for international use namely, the U.S., Generally Accepted Accounting Principles (GAAP) and the International Financial Reporting Standards (IFRS) issued by the London-based International Accounting Standards Board (IASB).

Generally, accepted accounting principles (GAAP) are diverse in nature but based on a few basic principles as advocated by all GAAP rules. These principles include consistency, relevance, reliability and comparability. Generally Accepted Accounting Principles (GAAP) ensures that all companies are on a level playing field and that the information they present is consistent, relevant, reliable and comparable.

IFRS are International Financial Reporting Standards, which are issued by the International Accounting Standards Board (IASB), a committee compromising of 14 members, from nine different countries, which work together to develop global accounting standards. The aim of this committee is to build universal standards that are translucent, enforceable, logical, and of high quality. Nearly 100 countries make use of IFRS. These countries include the European Union, Australia and South Africa. While some countries require all companies to stick to IFRS, others merely try to synchronize their own country's standards to be similar.

India is implemented IFRS since 2011. According to the Institute of Chartered Accountants of India (ICAI) President Ved Jain, "A common accounting standard is in the interest of the investors who are exploring investment opportunities in other geographical areas as well".

Thus, this move by India will harmonise its accounting standards with the internationally accepted accounting standards, which will lead to a globally accepted accounting system for the companies in India.

Concept and Convention for P & L A/c & Balance Sheet

An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity. They are followed like customs, tradition, etc. in a society. Accounting conventions are evolved through the regular and consistent practice over the years to facilitate uniform recording in the books of accounts. Accounting Conventions help in comparing accounting data of different business units or of the same unit for different periods. These have been developed over the years. The most important conventions which have been used for a long period are :

- Convention of consistency.
- Convention of full disclosure.
- Convention of materiality.
- Convention of conservatism.

CONVENTION OF CONSISTENCY

The convention of consistency means that same accounting principles should be used for preparing financial statements year after year. A meaningful conclusion can be drawn from financial statements of the same enterprise when there is comparison between them over a period of time. But this can be possible only when accounting policies and practices followed by the enterprise are uniform and consistent over a period of time. If different accounting procedures and practices are used for preparing financial statements of different years, then the result will not be comparable.

Generally a businessman follows the undermentioned general practices or methods year after year.

(i) While charging depreciation on fixed assets or valuing unsold stock, once a particular method is used it should be followed year after year so that the financial statements can be analysed and compared provided the depreciation on fixed assets is charged or unsold stock is valued by using particular method year after year. This can be further clarified as : in case of charging depreciation on fixed assets accountant can decide to adopt any one of the methods of depreciation such as diminishing value method or straight line method.

Similarly, in case of valuation of closing stock it can be valued at actual cost price or market price or whichever is less. However precious metals like gold, diamond, minerals are generally valued at market price only.

Types of consistency : There are three types of consistency namely :

(i) **Vertical consistency** (Same organisation) : It is to be found within the group of inter-related financial statements of an organisation on the same date. It occurs when fixed assets have been shown at cost price and in the interrelated income statement depreciation has also been charged on the historical cost of the assets.

(ii) **Horizontal consistency** (Time basis) : This consistency is to be found between financial statements of one entity from period to period. Thus, it helps in comparing performance of the business between two years i.e. current year with past year.

(iii) **Dimensional consistency** (Two organisations in the same trade) : This consistency is to be found in the statements of two different business entities of the same period. This type of consistency assists in making comparison of the performance of one business entity with the other business entity in the same trade and on the same date.

Therefore, as per this convention the same accounting methods should be adopted every year in preparing financial statements. But it does not mean that a particular method of accounting once adopted can never be changed. Whenever a change in method is necessary, it should be disclosed by way of footnotes in the financial statements of that year.

Exercise

Fill in the blanks with suitable word/words

(i) Convention of consistency means that same accounting principles should be used for preparing financial statements ...………

(ii) Unsold goods are valued at cost price or ...……… whichever is ...………

(iii) Precious metals, like gold, mineral and others are generally valued at………… .

(iv) As per the convention of …………. year after year same methods are followed.

CONVENTION OF FULL DISCLOSURE

Convention of full disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information. **Adequate** means sufficient set of information to be disclosed. **Fair** indicates an equitable treatment of users. **Full** refers to complete and detailed presentation of information. Thus, the convention of full disclosure suggests that every financial statement should fully disclose all relevant information. Let us relate it to the business. The business provides financial information to all interested parties like investors, lenders, creditors, shareholders etc. The shareholder would like to know profitability of the firm while the creditor would like to know the solvency of the business. In the same way, other parties would be interested in the financial information according to their requirements. This is possible if financial statement discloses all relevant information in full, fair and adequate manner.

Let us take an example. As per accounts, net sales are Rs.150,000, it is important for the interested parties to know the amount of gross sales which may be Rs.200,000 and the sales return Rs.50,000. The disclosure of 25% sales returns may help them to find out the actual sales position. Therefore, whatever details are available, that must be honestly provided. Additional information should also be given in the financial statement. For example, in a balance sheet the basis of valuation of assets, such as investments, inventories, land and building etc. should be clearly stated. Similarly, any change in the method of depreciation or in making provision for bad debts or creating any reserve must also be shown clearly in the Balance Sheet. Therefore, in order to achieve the purpose of accounting, all the transactions of a business and any change in accounting policies, methods and procedures are fully recorded and presented in accounting.

To ensure proper disclosure of material accounting information, the Companies Act 1956, under schedule VI has provided a format for the preparation of Profit and Loss account and Balance Sheet of a company. It is necessary for every company to follow this format. The regulatory bodies like Securities and Exchange Board of India (SEBI) has also made compulsory for complete disclosures by registered companies.

Significance

- It helps in meaningful comparison of financial statements of the different business units.
- This can also help in the comparison of financial statements of different years of the same business unit.
- This convention is of great help to investor and shareholder for making investment decisions.
- The convention of full disclosure presents reliable information.

Exercise

(i) The shareholder would like to know about the …………… of the business.
(ii) The convention of full disclosure requires that there should be full, …………… and …………… disclosure of accounting information.
(iii) The creditors are interested to know the …………… of the business.
(iv) All relevant material facts should be …………… in the financial statement.
(v) The full disclosure convention presents …………… information.

CONVENTION OF MATERIALITY

The convention of materiality states that, to make financial statements meaningful, only material fact i.e. important and relevant information should be supplied to the users of accounting information. The question that arises here is what is a material fact. The materiality of a fact depends on its nature and the amount involved. Material fact means the information of which will influence the decision of its user.

For example, a businessman is dealing in electronic goods. He purchases T.V., Refrigerator, Washing Machine, Computer etc. for his business. In buying these items he uses larger part of his capital. These items are significant items; thus should be recorded in books of accounts in detail. At the same time to maintain day to day office work he purchases pen, pencil, match box, scented stick, etc. For this he will use very small amount of his capital. But to maintain the details of every pen, pencil, match box or other small items is not considered of much significance. These items are insignificant items and hence they should be recorded separately. Thus, the items that are significantly important in recording the details are termed as material facts or significant items. The items that are of less significance are immaterial facts or insignificant items.

Thus according to this convention important and significant items should be recorded in their respective heads and all immaterial or insignificant transactions should be clubbed under a different accounting head.

Significance

- It helps in minimising errors in calculation.
- It helps in making financial statements more meaningful.
- It saves time and resources.

Exercise

Fill in the blanks with suitable word/words

(i) ………… convention states that to make financial statements more meaningful, only significant and important items should be supplied to the users.

(ii) Convention of materiality states that insignificant items should be disclosed under …………

(iii) ………… convention keeps accounts and manager to focus on important /significant items.

(iv) ………… means the information which will influence the decision of its user.

CONVENTION OF CONSERVATISM

This convention is based on the principle that **“Anticipate no profit, but provide for all possible losses”**. It provides guidance for recording transactions in the books of accounts. It is based on the policy of playing safe in regard to showing profit. The main objective of this convention is to show minimum profit. Profit should not be overstated. If profit shows more than actual, it may lead to distribution of dividend out of capital. This is not a fair policy and it will lead to the reduction in the capital of the enterprise.

Thus, this convention clearly states that profit should not be recorded until it is realised. But if the business anticipates any loss in the near future, provision should be made in the books of accounts for the same. For example, valuing closing stock at cost or market price whichever is lower, creating provision for doubtful debts, discount on debtors, writing off intangible assets like goodwill, patent, etc. The convention of conservatism is a very useful tool in situation of uncertainty and doubts.

Significance

- It helps in ascertaining actual profit.
- It is useful in the situation of uncertainties and doubts.
- It helps in maintaining the capital of the enterprise.

Exercise

Give your decision in the following situations :

(i) A business has unsold stock at the end of year. The cost price is Rs.200000 and the market price is Rs 250000. At which price the unsold stock be recorded ?

(ii) What will be your decision if the cost price in the above case is Rs.210000 ?

(iii) A businessman anticipates that it may not be possible to collect Rs.50000 from one of his debtors will he record this transaction in books of account and at what value?

Accounting Standard issued by ICAI

Accounting Standard –2 : Valuation of Inventories

Objective:

The objective of this standard is to formulate the method of computation of cost of inventories/stock, to determine the value of closing stock/ inventory at which, the inventory is to be shown in balance sheet till its' sale and recognition as revenue.

Accounting Standard-2 is not applicable in following cases:

- Work-in-progress arising under construction contract including directly related to service contract (AS-7 Construction contracts).
- Work-in-progress arising in ordinary course of business for service providers (Incomplete consultancy services, Incomplete merchant bank activities, Medical services in progress)
- Financial Instrument held as stock-in-trade (Shares, Debentures, Bonds etc.)
- Producer's inventories like livestock, agricultural and forest products, mineral oils, ores and gases. Such inventories are valued at net realisable value.

Inventories include:

- Held for sale in the ordinary course of business (finished goods)
- In the process of production of such sale (raw material and work-in-progress)
- In the form of materials or supplies to be consumed in production process or in the rendering of services (stores, spares, raw material, consumables).
- Inventories do not include machinery.

Spare parts and servicing equipments —

Inventories consists of—

- goods purchased and held for resale
- Inventories also consists finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools held for use in the production process.
- ***Inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS-10, Property, Plant and Equipment (PPE).***
- Machinery spares, not specific to a particular item of fixed asset and which can be used generally for various items of fixed assets, should be treated as inventories for the purpose of AS-2. Such machinery spares should be charged to the statement of profit and loss as and when issued for consumption in the ordinary course of operations.

<u>Inventories should be valued at lower of cost and net realisable value.</u>

Steps for valuation of Inventories:

1. Determination of cost of inventories;
2. Determination of net realisable value;
3. Comparison between the cost and net realisable value. The comparison should be made item by item or by group of items.

Cost of inventory consists the following —

1. Cost of purchase
2. Cost of conversion
3. Other costs incurred in bringing the inventories to their present location and condition

1. Cost of purchase includes —

- Purchase price, Duties and Taxes, Freight inward, other expenditures directly attributable to the acquisition.

Less:

- Duties and taxes recoverable by enterprises from taxing authorities**,** Trade discount**,** Rebate**,** Duty drawback**,** Other similar items.

2. Cost of conversion —

It consists of the cost directly related to the units + Systematic Allocation of fixed and variable production overheads that are incurred in converting material into finished goods.

Fixed Production overhead means Indirect cost of production that remains relatively constant regardless of volume of production. Allocation of fixed production overhead is done on normal capacity.

Variable Production overhead means indirect cost of production that varies directly or nearly directly with the volume of production. Allocation of variable production overhead is done on actual production.

In aces of Joint-products, when the cost of conversion of each product is not identifiable separately, total cost of conversion is allocated between the products on the rational and consistent basis.

If **by-products**, **scrap or waste materials** are not of material value, they are measured at net realisable value, then the net realisable value is deducted from cost of conversion. Net cost of conversion is distributed among the main products.

3. Other costs: Cost incurred in bringing the inventories to their present location and condition.

Items to be excluded from the cost of Inventories:

- Abnormal amounts of wasted materials, labour, other production costs;
- Storage cost;
- Administrative overhead;
- Selling and distribution cost;
- Interest and borrowing cost. However, if AS-16 allows such cost to be included it, can form part of the cost.

Cost formula

Specific identification method means directly linking the cost to the specific item of inventories.

If in any case, specific identification method is not applicable the cost of inventories is valued by the following methods:

- ✓ FIFO (First In First Out)
- ✓ Weighted Average cost.

When it is not practical to calculate the cost, the following methods may be followed to ascertain cost:

- ♦ StandardCost
- ♦ Retail Method

Net Realisable Value —

Net realisable value means the estimated selling price in ordinary course of business, **less** estimated cost of completion and estimated cost necessary to make the sale. It is estimated on the basis of most reliable evidence at the time of valuation. The estimation of net realisable value also considers the purpose for which the inventory is held. The estimation is made as at each balance sheet date.

Estimation of net realisable value —

♦ If finished product in which raw material and supplies used is sold at cost or above cost, then the estimated realisable value of raw material and supplies is considered more than its cost. Therefore inventories of raw material will be valued at cost.

♦ If finished product in which raw material and supplies used is sold below cost. Then the estimated realisable value of raw material or supplies is equal to replacement price of raw material or supplies and this raw material will be valued at replacement price.

Disclosure in the financial statement

- Accounting policy adopted in measuring inventories.
- Cost formula used.
- ***Classifications of inventories are:***

(i) ***Raw materials and components***
(ii) ***Work-in-progress***
(iii) ***Finished goods***
(iv) ***Stock-in-trade (in respect of goods acquired for trading)***
(v) ***Stores and spares***
(vi) ***Loose tools***
(vii) ***Others (specify nature)***

Accounting Standard 6: Depreciation Accounting

Introduction

1. This Standard deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply:—

- forests, plantations and similar regenerative natural resources;
- wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;
- expenditure on research and development;
- goodwill and other intangible assets;
- live stock.

This standard also does not apply to land unless it has a limited useful life for the enterprise.

2. Different accounting policies for depreciation are adopted by different enterprises. Disclosure of accounting policies for depreciation followed by an enterprise is necessary to appreciate the view presented in the financial statements of the enterprise.

Definitions

3. The following terms are used in this Standard with the meanings specified:

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<u>Depreciation</u> is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux ion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

<u>Depreciable assets</u> are assets which

(i) are expected to be used during more than one accounting period; and

(ii) have a limited useful life; and

(iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from *the use of the asset by the enterprise.*

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost[1] *in the financial statements, less the estimated residual value.*

4. Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets.

5. Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

- historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;
- expected useful life of the depreciable asset; and
- estimated residual value of the depreciable asset.

6. Historical cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof. The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

7. The useful life of a depreciable asset is shorter than its physical life and is:

- pre-determined by legal or contractual limits, such as the expiry dates of related leases;
- directly governed by extraction or consumption;
- dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and
- reduced by obsolescence arising from such factors as:
  - technological changes;
  - improvement in production methods;
  - change in market demand for the product or services output of the assets.
  - legal or other restrictions.

8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with

similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.

9. Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life.

10. Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

11. The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

12. There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straightline method and the reducing balance method. The management of a business selects the most appropriate method(s) based on various important factors e.g., (i) type of asset, (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business. A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired.

The statute governing anenterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.

13. Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, is disclosed separately.

14. The method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency is charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus is credited to the statement of profit and loss. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

15. Where the historical cost of an asset has undergone a change due to circumstances specified in para 6 above, the depreciation on the revised unamortised depreciable amount is provided prospectively over the residual useful life of the asset.

Accounting Standard (AS) 9 : Revenue Recognition

Introduction

1. This Standard deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Standard is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

- the sale of goods,
- the rendering of services, and
- the use by others of enterprise resources yielding interest, royalties and dividends.

2. This Standard does not deal with the following aspects of revenue recognition to which special considerations apply:

- Revenue arising from construction contracts;
- Revenue arising from hire-purchase, lease agreements;
- Revenue arising from government grants and other similar subsidies;
- Revenue of insurance companies arising from insurance contracts.

3. Examples of items not included within the definition of “revenue” for the purpose of this Standard are:

- Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;

- Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;
- Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;
- Realised gains resulting from the discharge of an obligation at less than its carrying amount;
- Unrealised gains resulting from the restatement of the carrying amount of an obligation.

Definitions

4. The following terms are used in this Standard with the meanings specified:

<u>Revenue</u> is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

<u>Completed service contract method</u> is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed.

<u>Proportionate completion method</u> isa method of accounting which

recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract.

5. Revenue recognition is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue

6. Sale of Goods

A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes.

At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Standard, are sometimes recognised in the statement of profit and loss and appropriately

7. Rendering of Services

Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

(i) *Proportionate completion method*—Performance consists of the execution of more than one act. Revenue is recognised propor- tionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

(ii) *Completed service contract method*—Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.

8. The Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

The use by others of such enterprise resources gives rise to:
(i) interest—charges for the use of cash resources or amounts due to the enterprise;
(ii) royalties—charges for the use of such assets as know-how, patents, trade marks and copyrights;
(iii) dividends—rewards from the holding of investments in shares.

Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Usually, discount or premium on debt securities held is treated as though it were accruing over the period to maturity.

Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.

Dividends from investments in shares are not recognised in the statement of profit and loss until a right to receive payment is established.

When interest, royalties and dividends from foreign countries require exchange permission and uncertainty in remittance is anticipated, revenue recognition may need to be postponed.

Illustrations

These illustrations do not form part of the Accounting Standard. Their purpose is to illustrate the application of the Standard to a number of commercial situations in an endeavour to assist in clarifying application of the Standard.

A. Sale of Goods

1. *Delivery is delayed at buyer's request and buyer takes title and accepts billing*

Revenue should be recognised notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

2. *Delivered subject to conditions*

(a) installation and inspection i.e. goods are sold subject to installation, inspection etc.

Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. In some cases, however, the installation process may be so simple in nature that it may be appropriate to recognise the sale notwithstanding that installation is not yet completed (e.g. installation of a factory-tested television receiver normally only requires unpacking and connecting of power and antennae).

(b) on approval

Revenue should not be recognised until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

(c) guaranteed sales i.e. delivery is made giving the buyer an unlimited right of return

Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale

but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment, in which case it should be treated as indicated below.

(d) consignment sales i.e. a delivery is made whereby the recipient undertakes to sell the goods on behalf of the consignor

Revenue should not be recognised until the goods are sold to a third party.

(e) cash on delivery sales

Revenue should not be recognised until cash is received by the seller or his agent.

3. *Sales where the purchaser makes a series of instalment payments to the seller, and the seller delivers the goods only when the final payment is received*

Revenue from such sales should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.

4. *Special order and shipments i.e. where payment (or partial payment) is received for goods not presently held in stock e.g. the stock is still to be manufactured or is to be delivered directly to the customer from a third party*

Revenue from such sales should not be recognised until goods are manufactured, identified and ready for delivery to the buyer by the third party.

5. *Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date*

For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognised as revenue.

6. *Sales to intermediate parties i.e. where goods are sold to distributors, dealers or others for resale*

Revenue from such sales can generally be recognised if significant risks of ownership have passed; however in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

7. *Subscriptions for publications*

Revenue received or billed should be deferred and recognised either on a straight line basis over time or, where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

8. *Instalment sales*

When the consideration is receivable in instalments, revenue attributable to the sales price exclusive of interest should be recognised at the date of sale. The interest element should be recognised as revenue, proportionately to the unpaid balance due to the seller.

9. *Trade discounts and volume rebates*

Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

B. Rendering of Services

1. *Installation Fees*

In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer.

2. *Advertising and insurance agency commissions*

Revenue should be recognised when the service is completed. For advertising agencies, media commissions will normally be recognised when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission, which will be recognised when the project is completed. Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

3. *Financial service commissions*

A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a

single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made or added to a loan or other account and settled in stages. The recognition of such revenue should therefore have regard to:
(a) whether the service has been provided "once and for all" or is on a "continuing" basis;
(b) the incidence of the costs relating to the service;
(c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

4. *Admission fees*

Revenue from artistic performances, banquets and other special events should be recognised when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

5. *Tuition fees*

Revenue should be recognised over the period of instruction.

6. *Entrance and membership fees*

Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally capitalised. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services.

Need/Importance/Utility of Accounting Standard :

Accounting is the art of recording transactions in the best manner possible, so as to enable the reader to arrive at judgments/come to conclusions, and in this regard it is utmost necessary that there are set guidelines. These guidelines are generally called accounting standards.

Accounting Standards are exceedingly useful because they attempt to standardize and regulate accounting definitions, assumptions, and methods. The accounting standards enable us to assume that there is consistency from year to year in the methods used to prepare a company's financial statements. Although variations may exist, we can make reasonably confident conclusions when comparing one company to another, or comparing one company's financial statistics to the statistics for its industry, thanks to accounting standards. Without the standards, users of financial statements such as the public, commercial banks and other statutory institutions would need to learn the accounting rules of each and every client or company they deal with and comparisons between these companies would be very difficult.

1. **To Increase the credibility of Financial Statements** : Ultimately, the importance of accounting standards lies in the value that it brings to financial documents for the various audiences like present shareholders, prospective shareholders, creditors, customer, employees etc. They make many decision based on it. An absence of accounting standards would make the work of investors, regulators, taxpayers, reporters and others more difficult and more risky. For instance, without standards, an investor who has studied the financial statements of a large publicly traded company would not know whether to trust the findings on those statements. Standards mean that taxpayers can see how their tax rupees are being spent, and regulators can ensure that laws are followed. By employing accounting standards, investors' interests are ensured as the documents they review are definitely accurate and genuine. As investors, they are interested to know that their money will eventually earn and go back to them. Accounting standards increase the investors' confidence in the business. Accounting

standard make it possible for users to get the reliable accounting data and can protect their interest.

2. **Useful to Auditors** : If the auditors cannot detect any malpractice or frauds in accounts, they may be held liable to compensate their clients. Their prestige is adversely affected in the profession and may be liable for punishment as per the provision of the Companies Act. However, Auditors are well aware with the accounting standards they can perform their duty with perfection and can help to avoid malpractice by many companies.

3. **Comparability** : Paramount (vital) to the role of accounting standards is the universality that it brings to financial record keeping. Governmental organizations must follow accounting procedures that are the same as their counterparts, and non-governmental organizations must do the same. The result is that it is easy to compare the financial standing of similar entities. This helps both external and internal observers weigh the state of an entity in the context of other comparable entities.

4. **Transparency** : Accounting standards are designed to enforce transparency in organizations. The principles, procedures and standards that make up the generally accepted accounting principles were chosen with the purpose of ensuring that organizations lean in the direction of openness when deciding how to provide information to observers. This kind of transparency is especially important in the case of public entities, such as governments or publicly traded companies. Standards limit the freedom and flexibility of entities to use clever accounting to move items around or even to hide them.

5. **Relevance** : Standards work to help entities provide the most relevant information in the most reasonable way possible. In this way, an organization guided by accounting standards will generate the kind of financial information that observers are most interested in examining. Entities ultimately should provide information in a way that most fairly and clearly represents the current financial standing of the operation. The standards make it more difficult for organizations to misdirect observers and to fool them with data that does not have sufficient relevancy.

6. **Useful in determining Efficiency of Management :** The use of accounting standards will enable a business to see or assess its performance. By doing so, they can also compare and contrast their business' performance with other companies or competitors. It further helps a business see its strengths and weaknesses. By also comparing past and current performances, a business can assess the success of its strategies. The profitability, progress, solvency, soundness, liquidity of business is measured from the accounts only.