of these diverse accounting standards.

MEANING OF ACCOUNTING STANDARD

A standard is something which is used as the basis for comparison. It is a measure by which quality of other things is judged. Standard is a degree of excellence required. *Accounting standards are codified or written statements of accounting rules and guidelines for preparation and presentation of financial statements issued by an expert accounting body or by the government or other regulatory body.* They cover the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in the financial statements. Thus, they are uniform rules for financial reporting. They are applicable either to all or certain types of accounting entities.

OBJECTIVES OF ACCOUNTING STANDARDS

1. To standardise the diverse accounting policies and practices.
2. To eliminate, to the extent possible, the non-comparability of financial statements.
3. To enhance the reliability of financial statements.
4. To promote better understanding of financial statements.

BENEFITS OF ACCOUNTING STANDARDS

The following are the benefits of accounting standards :

1. **Elimination or Reduction of effect of diverse accounting policies and practices.** Accounting standards eliminate altogether or reduce to a

reasonable extent the effect of diverse accounting policies and make the financial statements more meaningful and comparable. Multiple options are either totally eliminated or at least reduced to a reasonable extent.

2. **Enhancement of creditability and reliability of financial statements.** As accounting standards provide uniform guidelines for recognition, measurement, treatment, preparation and presentation of financial statements, they enhance the creditability and reliability of financial statements. Accounting standards help in enhancing transparency.
3. **Ensure comparability.** Financial statements of different enterprises can be compared as all of them will prepare these statements based on uniform rules and guidelines. Comparability helps in evaluation of managerial stewardship.
4. **Facilitate informed decision making.** Accounting Standard facilitates informed decision making in lending and investment and thereby minimise the risk of financial distress.
5. **Promotion of sound financial system.** Accounting standards help to promote sound financial system domestically and financial stability internationally. However, adoption of standards in itself is not sufficient to ensure financial stability.
6. **Strengthen financial regulation.** Accounting standards play an important role in strengthening financial regulation and supervision.
7. **Reforms in accounting theory and practice.** A lot of research work is undertaken to study the effect of various alternatives of recognition, measurement, treatment, preparation and presentation of financial statements. This helps in evolving reform in accounting theory and practice.
8. **Disclosure beyond legal requirement.** Accounting standard may require disclosure beyond that required by law and thus make the financial statements more useful for the users.

DISADVANTAGES OF ACCOUNTING STANDARDS

1. **Rigidity.** Accounting standards may lead to rigidity. In other words, the accounting standards reduces flexibility.
2. **Differences in Accounting Standards.** There may be differences in accounting standards in different countries due to differences in traditions and legal system.

3. **Accounting Standards cannot override the law.** Accounting standards cannot override law unless the law itself provides that accounting standards will override law.
4. **Less Choice.** Choice between alternative treatments is eliminated or reduced to a large extent in a given situation.

COMPLIANCE WITH ACCOUNTING STANDARDS

The following points should be noted regarding compliance with accounting standards :

1. **Implications of mandatory status of accounting standards.** Accounting standards become mandatory from the respective dates mentioned in the standards. The effect of mandatory status of an accounting standard is that the financial statements must be prepared and presented as per the accounting standard. Further, a statutory auditor has to examine whether the accounting standards have been complied with by the enterprise in the preparation and presentation of financial statements covered by period of his audit. If there is any deviation from the accounting standard(s), the auditor must make adequate disclosure so that the users of the financial statements come to know about the deviation.

   Section 143(3)(*e*) of the Companies Act, 2013 also provides that the Auditor's Report shall state whether, in his opinion, the financial statements comply with the accounting standards.

   Further, as per section 134(5)(*a*), the Directors' Responsibility statement shall state that in the preparation of annual accounts, the applicable accounting standards have been followed along with proper explanation relating to material departures.

2. **Responsibility of compliance.** Management of the enterprise is responsible for ensuring compliance with accounting standards.
3. **Compliant Financial Statements.** The financial statements are said to compliant with the accounting standards when they comply with all the accounting standards.

ACCOUNTING STANDARDS BOARD OF INDIA

The Institute of Chartered Accountants of India constituted Accounting Standards Board (ASB) on 21st April, 1977 for the purpose of harmonising diverse accounting policies and also to meet the requirements of the various users of accounting information. It is composed of elected members of the Council of the ICAI nominated on the ASB, nominees of the Central Government representing Department of Company Affairs, the Office of the Comptroller (Controller) and Auditor General of India, the Central Board of Direct Taxes on the Council of ICAI, representatives of Institute of Cost and Works Accountants of India, Institute of Company Secretaries of India, Industry Association, Reserve Bank of India, Securities and Exchange Board of India, Central Board of Excise and Customs, academic institutions from universities and from Indian Institute of Management, financial institutions, eminent professionals co-opted by ICAI, Chairman of the Research Committee and Chairman of the Expert Advisory Committee of ICAI and representative of any other body as considered appropriate by the ICAI.

The main **functions** of the Accounting Standards Board include (*i*) to determine the areas in which accounting standards need to be developed; (*ii*) to formulate accounting standards for the purpose of assisting the Council of ICAI in evolving and establishing accounting standards in India; (*iii*) to examine how far the relevant International Accounting Standards/International Financial Reporting Standards can be adopted in the light of conditions and practices prevailing in India; (*iv*) to review the accounting standards in the context of changed circumstances at periodic intervals and if necessary revise them; (*v*) to issue guidance notes on the accounting standards, and (*vi*) to give clarifications on issues arising therefrom.

NATIONAL FINANCIAL REPORTING AUTHORITY

The Companies (Amendment) Act, 1999 had made it mandatory for companies ... by the Central Government

PROCEDURE FOR ISSUING ACCOUNTING STANDARDS IN INDIA

The following is the procedure adopted by Accounting Standards Board for issuing accounting standards in India :

(1) Accounting Standards Board determines the broad areas in which accounting standards need to be developed and list them according to their priority.

(2) Accounting Standard Board forms Study Groups to consider specific subject. These study groups assist the ASB in formulation of accounting standards. Study Groups are made for wide participation by members of the ICAI and by others.

(3) A preliminary draft is prepared with the help of Study Group. The preliminary draft will include the following :

   (*a*) Objectives of the standard

   (*b*) Scope of the standard.

   (*c*) Definition of the terms used in the standard.

   (*d*) Recognition and measurement principles, wherever applicable.

   (*e*) The presentation and disclosure requirements in complying with the standard.

   (*f*) Date from which the standard will be effective.

(4) The preliminary draft prepared by the Study Group is considered by the Accounting Standards Board and is finalised based on the deliberations.

(5) The Accounting Standard Board will circulate the draft to the Council members of ICAI and to various outside agencies such as Department of Companies Affairs of the Central Government, Comptroller and Auditor General of India, Central Board of Direct Taxes, Institute of Company Secretaries of India, Institute of Cost and Works Accountants of India, Reserve Bank of India, Securities & Exchange Board of India, Standing Conference of Public Enterprises, Indian Banks' Association, Industry associations and any other body considered relevant by ASB keeping in view the nature of the accounting standard. The draft may be put on the website of the ICAI also for general awareness.

(6) After obtaining the comments and suggestions from the outside agencies the draft is finalised as an Exposure Draft. The Exposure Draft is published in the professional journals and circulated to members of the Institute, academicians, etc.

(7) After considering the comments on the exposure draft, the Accounting Standard Board suitably revises the exposure draft and prepares the final draft and submits it to the Council. The Council, after considering the final draft, issues it as an accounting standard under its authority.

National Financial Reporting Authority may recommend it, with or without modification, to the Ministry of Corporate Affairs for notifying the accounting standard.

APPLICABILITY OF ACCOUNTING STANDARDS TO ENTITIES

APPLICABILITY OF ACCOUNTING STANDARDS FOR COMPANIES

There are two sets of accounting standards under the Companies Act, 2013:

(*i*) Accounting Standards (AS)

(*ii*) Indian Accounting Standards (Ind AS)

(*i*) **Accounting Standards.** These are the Accounting Standards discussed above. These were notified as Companies (Accounting Standards) Rules, 2006 as amended by the notification dated 30th March, 2016. These are AS-1 to AS-5, AS-7, AS-9 to AS-29. ~~6~~ ~~8~~

These are deemed to be Accounting Standards specified under section 133 of the Companies Act, 2013 and Notified Accounting Standards for the purposes of section 129(1) and section 143(3)(*e*) of the Companies Act, 2013.

The aforesaid notified accounting standards are to a large extent *verbatim* reproduction of accounting standards issued by the Institute of Chartered Accountants of India.

The notified accounting standards are mandatory for all companies and their auditors except where there is exemption/relaxation. Exemptions/ relaxation have been given to small and medium companies.

(*ii*) **Indian Accounting Standards (Ind AS).** Indian Accounting Standards (In short, Ind AS) were notified by the Ministry of Corporate Affairs, Government of India as Companies (Indian Accounting Standards) Rules, 2015. These are from Ind AS-1 to Ind AS-41 and Ind AS-101 to Ind AS-115 as amended by the Companies (Ind AS) Amendment Rules, 2016 dated 30th March, 2016. Ind AS are named and numbered in the similar way as the corresponding International Financial Reporting Standards (in short, IFRS).

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

Statements of international accounting standards issued by the Board of International Accounting Standards Committee (1973-2001) are known as International Accounting Standards (IAS). However, the International Accounting Standards Board (IASB) itself took over the responsibility of formulation of international accounting standards w.e.f. April 1, 2001. IASB announced that its accounting standards would be designated as "International Financial ...l" (IFRS). IASB also adopted the standards issued by the

Existing Standards

In India, the Accounting Standards Board (ASB) of the Institute of Chartered Accountant of India (ICAI) is responsible for setting Accounting Standard (AS). The ASB comprises members of the Central Council of ICAI as well as certain members from the profession, industry and various other segments and government agencies.

The ASB of ICAI has issued 32 accounting standards so far. The list of accounting standards issued is given hereunder:

1. AS-1 Disclosure of Accounting Policies.
2. AS-2 (Revised), Valuation of Inventories.
3. As-3 (Revised) Cash Flow Statements.
4. AS-4 (Revised) Contingencies and Events Occurring after the Balance Sheet Date
5. AS-5 (Revised) Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.
6. AS-6 (Revised) Depreciation Accounting (now deleted)
7. AS-7 (Revised) Accounting for Construction Contracts.
8. AS-8 Accounting for Research and Development. (Withdrawn and included in AS26)
9. AS-9 Revenue Recognition.
10. AS-10 Accounting for Fixed Assets.
11. AS-11 (Revised) Accounting for the effects of changes in Foreign Exchange Rate,
12. AS-12 Accounting for Government Grants.
13. AS-13 Accounting for Investments.
14. AS-14 Accounting for Amalgamations.
15. AS-15 Employee Benefits (Revised) 2005.
16. AS-16 Borrowing Costs.
17. AS-17 Segment Reporting.
18. AS-18 Related Party Disclosures.
19. AS-19 Leases.
20. AS-20 Earnings Per Share.
21. AS-21 Consolidated Financial Statements.
22. AS-22 Accounting for Taxes on Income.
23. AS-23 Accounting for Investments in Associates in Consolidated Financial Statements.
24. AS-24 Discontinuing Operations.
25. AS-25 Interim Financial Reporting.

26. AS-26 Intangible Assets.
27. AS-27 Financial Reporting of Interest in Joint Venture,
28. AS-28 Impairment of Assets.
29. AS-29 Provisions, Contingent Liabilities and Contingent Assets.
30. AS-30 Financial Instruments: Recognition and Measurement.
31. AS-31 Financial Instruments: Presentation.
32. AS-32 Financial Instruments: Disclosures.

Ministry of corporate affairs *vide* notification dated 30-3-2016 notified Companies (Accounting Standards) Amendment Rules, 2016 has substituted Accounting Standards (AS) 10, Property, Plant & Equipment in place of AS 10, Accounting for Fixed Assets. Further Accounting Standard 6 on Depreciation Accounting, is omitted. These rules were notified by Central Government in consultation with National Advisory Committe on Accounting Standards. Accounting Standard (AS) 10, property, Plant and Equipment provides guidance on accounting for property, plant and equipment including accounting for depreciation thereon.

(in short, Ind AS) were notified by the Ministry of Corporate Affairs, Government of India as Companies (Indian Accounting Standards) Rules, 2015. These are from Ind AS-1 to Ind AS-41 and Ind AS-101 to Ind AS-115 as amended by the Companies (Ind AS) Amendment Rules, 2016 dated 30th March, 2016. Ind AS are named and numbered in the similar way as the corresponding International Financial Reporting Standards (in short, IFRS).

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

Statements of international accounting standards issued by the Board of International Accounting Standards Committee (1973-2001) are known as International Accounting Standards (IAS). However, the International Accounting Standards Board (IASB) itself took over the responsibility of formulation of international accounting standards w.e.f. April 1, 2001. IASB announced that its accounting standards would be designated as "International Financial Reporting Standards" (IFRS). IASB also adopted the standards issued by the Board of International Accounting Standards Committee and those standards continue to be designated as "International Accounting Standards" (IAS). IASB has so far issued 41 IAS out of which 12 IAS have been superseded and thus 29 IAS are effective. Besides, 8 IFRS have also been issued by 2010.

Thus, International Financial Reporting Standards are the accounting standards developed or adopted by an independent, not-for-profit organisation called the International Accounting Standards Board (IASB). It is a single set of global standards. More than 100 countries have permitted or require IFRS for public companies, exceeding a specified networth. International Financial Reporting Standards are important for large companies having subsidiary in different countries. A single set of accounting standards simplify accounting procedure because different set of financial statements based on different accounting standards need not be prepared for different countries.

International Financial Reporting Standards include (*i*) IFRS issued from 2001 onwards, (*ii*) IAS issued during 1973-2000, (*iii*) Interpretations made by International Financial Reporting Interpretations Committee (IFRIC) issued from 2001 onwards and (*iv*) Interpretations made by Standard Interpretations Committee (SIC).

FEATURES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

The main features of International Financial Reporting Standards are as follows:

1. **Principle-based.** International Financial Reporting Standards are based on clearly stated principles. Therefore, they are known as principle-based accounting standards. They are not rule-based accounting standards. IFRS provides general guidance for financial reporting, rather than setting rules for industry specific reporting.
2. **Substance over form.** International Financial Reporting Standards emphasize that transactions should be recorded on the basis of their economic reality and not on the basis of their legal form. For example, if an asset is purchased on hire-purchase, it is shown as an asset in the books of the hire purchaser even though he will become the owner after paying all the instalments.
3. **Fair values.** International Financial Reporting Standards are based primarily on accounting at fair values.
4. **Functional currency.** Under International Financial statements, assets, liabilities, revenues and expenses are reporting in the functional currency instead of local currency.
5. **Reassessment of useful life and depreciation.** Under International Financial Reporting Standards, the useful life and depreciation of property, plant and equipment is to be reassessed annually.

The statement "IFRS are based primarily on accounting at fair values" means that the International Financial Reporting Standards (IFRS) emphasize the use of fair value measurement for financial reporting. Fair value accounting involves estimating the current market value of an asset or liability, rather than using historical cost (the original purchase price).

IFRS ADOPTION/IFRS CONVERGENCE

"IFRS adoption" means adoption of International Financial Reporting Standards as it is *i.e.* in toto. "IFRS Convergence" means accounting standards of a country converged with IFRS, *i.e.*, Indian accounting standards more or less in line with the IFRS. India has decided to go for the latter route. **Indian accounting standards converged with IFRS are known as Ind-AS.** Thirty nine Indian Accounting Standards converged with IFRS were notified by the Ministry of Corporate Affairs on 16th February, 2015. The date of implementation of Ind-AS has also been notified by the Ministry on that date. Ind AS will be implemented in a phased manner, discussed later in this chapter.

Need for Ind AS or IFRS Convergence

Ind AS emphasizes fair value and transparency. More disclosures are required under Ind AS as compared to existing standards.

With the growing international trade and globalisation of business and capital markets, the financial statements prepared and presented according to the national accounting standards of a country no longer satisfy the needs of the users of other countries. Therefore, there is pressure to adopt to the new environment. The need of "IFRS adoption"/"IFRS Convergence" has arisen due to the following developments :

1. **Financial Globalisation.** Financial globalisation is the phenomenon of the 21st century. The opening up of East European and economies of China and India has accelerated the pace of integration of capital markets. Diversity in international accounting practices adversely affects capital flows. There is, therefore, need for a single set of high quality international accounting standards which will promote confidence in capital markets. Uniformity of accounting standards will increase the comparability of the financial statements.

2. **Multinational Corporations.** In the early 1990s, there were an estimated 37,000 MNCs with about 1,70,000 affiliates and their number increased to 78,000 with nearly 7,80,000 affiliates by 2006. MNCs will probably be the greatest beneficiaries of IFRS convergence. Diversity in accounting standards in different countries leads to a tremendous drain on their resources. The preparation of consolidated financial statements would be greatly simplified if stand alone financial statements from all over the globe were prepared on a uniform basis. Further the cost of preparing the financial statements on a uniform basis would be less.

3. **Accounting Profession.** Convergence of accounting practices would foster the internationalisation of the accounting profession, as the difference in standards the world over will tend to narrow down and this will make it easier for professionals in one country to carry out his professional duties in other countries. Convergence of accounting practices will improve the quality of services provided by countries such as China and India and thus reduce the risk on account of accounting scandals that occurred in the recent past.

4. **Government and Revenue Authorities.** If the financial reporting and disclosure requirements are converged, the government would find it easier to understand and control them.

BENEFITS OF IND AS OR CONVERGENCE WITH IFRS

Adoption or convergence with IFRS helps the economy in general, investors, industry and the accounting professionals. The benefits of Ind AS 2 convergence with IFRS are described below :

1. **Benefits to economy.** Ind AS or convergence with IFRS benefits the economy by increasing the pace of growth of its global business. It facilitates maintenance of orderly and efficient capital market. It also helps to increase the pace of capital formation and thereby leads to

higher economic growth. It encourages foreign direct investment and investment in the capital market and thus leads to more foreign capital flows to the country.

2. **Benefits to investors.** Investors need relevant, reliable, timely and comparable financial information from enterprises-domestic or foreign. Financial statements prepared using common set of accounting standards such as Ind AS/IFRS would help the investors better understand investment opportunities as compared to financial statements prepared using a different set of accounting standards *i.e.* using national accounting standards.

3. **Benefits to industry.** As the financial statements comply with the global accounting standards they will be more transparent and reliable and thus create more confidence in the minds of the investors. This will help the industry in various ways which are listed below :

   (*a*) Industry would be able to raise capital from markets at a lower cost as information as per Ind AS/IFRS can be supplied by the companies easily.

   (*b*) The burden of financial reporting is reduced for companies with global operations with Ind AS or convergence with IFRS because it simplifies the process of preparation of standalone and consolidated financial statements. Consequently the cost of preparing the financial statements would be reduced.

   (*c*) The task of maintaining different set of financial statements would be eliminated by adoption of IFRS.

   (*d*) Ind AS or convergence with IFRS may reduce the risk premium and, consequently, the cost of capital.

4. **Benefits to accounting professionals.** Convergence of accounting practices would foster the globalisation of accounting profession, since the differences in accounting standards of different countries will narrow down. Convergence of accounting standards, therefore, will make easier for professionals in one country to work in other countries. Thus, their mobility to work in different parts of the world increases.

5. **Improves comparability.** Common accounting standards such as IFRS improves comparability of financial statements of a company with that of another company not only in the same country but in other countries also.

covered above, other than those companies already covered under the corporate roadmap given earlier.

Notes : (*i*) NBFCs having net worth below ₹ 250 crore and not covered under aforesaid provisions shall continue to apply accounting standards notified in December, 2006.

(*ii*) Urban co-operative banks and regional rural banks shall continue to apply accounting standards notified in December, 2006.

LIST OF IND-AS

The following is the list of Ind AS notified on 16-2-2015

- Indian Accounting Standard (Ind AS) 1 : **Presentation of Financial Statements**
- Indian Accounting Standard (Ind AS) 2 : **Inventories**
- Indian Accounting Standard (Ind AS) 7 : **Statement of Cash Flows**
- Indian Accounting Standard (Ind AS) 8 : **Accounting Policies, Changes in Accounting Estimates and Errors**
- Indian Accounting Standard (Ind AS) 10 : **Events after the Reporting Period**
- Indian Accounting Standard (Ind AS) 11 : **Construction Contracts**
- Indian Accounting Standard (Ind AS) 12 : **Income Taxes**
- Indian Accounting Standard (Ind AS) 16 : **Property, Plant and Equipment**
- Indian Accounting Standard (Ind AS) 17 : **Leases**
- Indian Accounting Standard (Ind AS) 18 : **Revenue**
- Indian Accounting Standard (Ind AS) 19 : **Employee Benefits**
- Indian Accounting Standard (Ind AS) 20 : **Accounting for Government Grants and Disclosure of Government Assistance**
- Indian Accounting Standard (Ind AS) 21 : **The Effects of Changes in Foreign Exchange Rates**
- Indian Accounting Standard (Ind AS) 23 : **Borrowing Costs**
- Indian Accounting Standard (Ind AS) 24 : **Related Party Disclosures**
- Indian Accounting Standard (Ind AS) 27 : **Separate Financial Statements**
- Indian Accounting Standard (Ind AS) 28 : **Investments in Associates and Joint Ventures**

- Indian Accounting Standard (Ind AS) 29 : **Financial Reporting in Hyper inflationary Economies**
- Indian Accounting Standard (Ind AS) 32 : **Financial Instruments : Presentation**
- Indian Accounting Standard (Ind AS) 33 : **Earnings per Share**
- Indian Accounting Standard (Ind AS) 34 : **Interim Financial Reporting**
- Indian Accounting Standard (Ind AS) 36 : **Impairment of Assets**
- Indian Accounting Standard (Ind AS) 37 : **Provisions, Contingent Liabilities and Contingent Assets**
- Indian Accounting Standard (Ind AS) 38 : **Intangible Assets**
- Indian Accounting Standard (Ind AS) 40 : **Investment Property**
- Indian Accounting Standard (Ind AS) 41 : **Agriculture**
- Indian Accounting Standard (Ind AS) 101 : **First-time Adoption of Indian Accounting Standards**
- Indian Accounting Standard (Ind AS) 102 : **Share-based Payment**
- Indian Accounting Standard (Ind AS) 103 : **Business Combinations**
- Indian Accounting Standard (Ind AS) 104 : **Insurance Contracts**
- Indian Accounting Standard (Ind AS) 105 : **Non-current Assets Held for Sale and Discontinued Operations**
- Indian Accounting Standard (Ind AS) 106: **Exploration for and Evaluation of Mineral Resources**
- Indian Accounting Standard (Ind AS) 107 : **Financial Instruments : Disclosures**
- Indian Accounting Standard (Ind AS) 108 : **Operating Segments**
- Indian Accounting Standard (Ind AS) 109 : **Financial Instruments**
- Indian Accounting Standard (Ind AS) 110 : **Consolidated Financial Statements**
- Indian Accounting Standard (Ind AS) 111 : **Joint Arrangements**
- Indian Accounting Standard (Ind AS) 112 : **Disclosure of Interests in Other Entities**
- Indian Accounting Standard (Ind AS) 113 : **Fair Value Measurement**
- Indian Accounting Standard (Ind AS) 114 : **Regulatory Deferral Accounts**
- Indian Accounting Standard (Ind AS) 115 : **Revenue from Contracts with Customers**

lating to business practices and accounting textbooks are other sources of the accounting principles.

9. They are generally acceptable.
10. The general acceptance of an accounting principle or practice usually depends on how well it meets the criteria of relevance, objectivity and feasibility.

Classification of Accounting Principles

One way of classifying accounting principles is as follows :

(1) Accounting Concepts

(2) Accounting Conventions.

ACCOUNTING CONCEPTS AND ACCOUNTING CONVENTIONS

Accounting concepts are the basic assumptions or principles on the basis of which transactions are recorded and financial statements are prepared.

Accounting conventions are the statements of practice or principles which are followed as accepted method or procedures by the enterprises over a period of time.

Accounting concept is an idea forming part of theory underlying a set of practices. Accounting convention is a statement of practice which is followed as an accepted method or procedure. The distinction between the accounting concept and convention is more of academic interest than practice. Certain other terms such as postulates, doctrines, rules, axioms, assumptions etc. are also used for accounting principles.

Accounting Concepts

The following are important generally accepted accounting concepts :

1. Accounting Entity Concept
2. Money Measurement Concept
3. Dual Aspect Concept
4. Cost Concept
5. Verifiable Objective Evidence Concept

6. Going Concern Concept
7. Accounting Period Concept or Periodicity
8. Realisation Concept or Revenue Recognition
9. Expense Recognition or Matching Concept
10. Accrual Concept

Accounting Conventions

The following are the accounting conventions :

1. Full Disclosure
2. Materiality
3. Consistency
4. Conservatism or Prudence

Fundamental Accounting Assumptions

According to Accounting Standard (AS-1) issued by the Institute of Chartered Accountants of India (ICAI) the following are the fundamental accounting assumptions :

(*a*) Going Concern,
(*b*) Consistency and
(*c*) Accrual

The significance of the fundamental accounting assumptions is that disclosure as a note is necessary if these assumptions have not been followed.

Accounting Concepts

The accounting concepts are discussed below :

1. **Separate Accounting Entity :** *As per this concept, an enterprise is treated separate from owners and other persons associated with it.* Accounts are kept for the organisation, as distinguished from the persons associated with it. For example, if A starts a business styled "A & Co.", accounts are prepared from the point of view of "A & Co." and not A. If accounting entity concept is not followed the financial statements will not give a true and fair view of the results of the operations of the business and true and fair view of the financial position of the business as the personal transactions of the sole-proprietor will be mixed with the transactions of the business.

   According to American Accounting Association, accounting entity is "an area of economic interest of a particular individual or group." It may be the business unit itself, *i.e.*, sole proprietorship firm, partnership firm, company or government business undertaking. It may be a part of a business, *i.e.*, a department. It can also be a non-business group, *i.e.*, a club, religious bodies or government.

All transactions are recorded from the point of the accounting entity and not from the point of owners or other persons associated with it. For example, when a person starts a business investing ₹ 5 lakhs, it is recorded in the business by debiting Cash Account and credit Capital Account. Similarly when goods are withdrawn by the proprietor, Drawings Account is debited and Purchases Account is credited. Again the rent of the building, which is used for business as well as residential purposes, is divided on some equitable basis between business expense and personal expense of the owner.

According to this postulate, the payments made to owners are treated either as repayment of capital or distribution of profits, as the case may be. They are not treated as business expenses.

This concept is applicable to all forms of organisation, *e.g.*, sole-proprietorship, partnership, limited liability partnership and joint stock company.

However, in the legal sense, separate legal entity is recognised in case of limited liability partnership and joint stock company. Law does not make a distinction between a sole proprietor and his business. But in accounting the business of sole-proprietor is treated as separate accounting entity. Similar is the position in case of partnership formed under Indian Partnership Act, 1932, *i.e.* partners of the firm are not considered as separate entities in the eyes of law but for accounting purposes partnership firm is considered as a separate accounting entity.

2. **Money Measurement :** *According to money measurement principle, only those transactions which can be measured in terms of money are recorded in the books of account.* Money has been adopted in accounting as the basic unit of measurement as it is monetary expression of transactions or economic events.

   In financial accounting, all transactions or economic events are measured in terms of money as it provides a common unit by means of which heterogeneous facts about a business can be expressed as numbers which can be added and subtracted. Rupee is the common unit of measurement for transactions or economic events in India, because it is the legal tender and used as a medium of exchange in market transactions. If money is not used as a common unit of measurement it would be impossible to record various types of transactions. A common measuring unit helps to quantify in term of money various types of data for determination of profit or loss and financial position. For example, if a business entity owns a plot of land measuring 500 sq. m., a three-storey building, two cars, 50 personal computers, 20 tables and 80 chairs, 10,000 kg. of certain types of goods and a cash of ₹ 1,00,000. Since these assets are expressed in different units and therefore the total assets of the business cannot be determined by adding physical units. If these assets are expressed in monetary units, *i.e.*, in rupees such as plot of land of ₹ 500 lakhs, building of ₹ 400 lakhs; cars of ₹ 10 lakhs; computers of ₹ 10 lakhs; tables of ₹ 2 lakhs; chairs of ₹ 2 lakhs; goods or stock-in-trade of ₹ 200 lakhs and cash of ₹ 1 lakh. After expressing in monetary units these assets can be added. This is a better way of knowing the total assets of the business. Similarly liabilities are expressed in monetary units.

However, using money as a unit of measurement has the following limitations :

(*a*) ***All transactions or events cannot be expressed in terms of money.*** In accounting, those transactions or events are recorded which can be expressed in terms of money. But all transactions or events cannot be expressed in terms of money. For example, accounting does not record the state of its owner's health in case of sole proprietorship or managing directors' health in case of company form of organisation. Similarly, it does not record that one top executive is not on speaking terms with another top executive. Again, it does not reveal that a competitor has come out with a better product. Accounting, therefore, does not give a complete picture about an organisation.

(*b*) ***Money is not a stable unit of measurement.*** The purchasing power or value of money does not remain stable. The value changes due to changes in general level of prices in the economy. In case of inflation the value of money decreases; and this happens in developing country like India. Money serves as an effective common denominator if the purchasing power of money remains almost stable. But in actual practice there has been significant decline in purchasing power of rupee in India. As a result, the financial statements do not show accurate picture of business. But in spite of fluctuations in the value of money it is used as unit of measurement in accounting as there is no other generally acceptable unit. For example, when a plot of land is purchased for ₹ 50 lakhs it is recorded as an increase in land and decrease in cash. The land continues to appear in the books at ₹ 50 lakhs even after five years when the market price of the land has risen two-fold. Taking another example, a plot of land of 500 sq. m. purchased for ₹ 20 lakhs in 1995 and another plot of land of 200 sq. m. purchased for the same price in 2010 are both shown in accounting records at ₹ 20 lakhs each.

3. **Dual Aspect :** As stated in the previous chapter assets are the economic resources controlled by an organisation. There are two types of claims against the assets. Liabilities are the claims of the creditors or outsiders against the assets and equity (*i.e.* capital reserves and surplus) is the claim of the owners against the assets. All the assets of the business are claimed by creditors or outsiders and owners. Therefore, the relationship between assets, liabilities and equity (*i.e.* capital + reserves and surplus) can be expressed in the form of accounting equation as follows :

Equity + Liabilities = Assets

Or

Equity = Assets – Liabilities

According to dual aspect principle, every transaction has a two-fold effect. Accounting system is designed in such a way that both aspects i.e. changes in assets and changes in liabilities and equity, as the case may be, of each transaction is recorded. This system of recording is known as the double entry system of accounting.

For example, when ₹ 10,00,000 is contributed by its owner in a sole-proprietorship concern it results in increase in cash by ₹ 10,00,000 and there is claim of the owner in the form of capital by the same amount of ₹ 10,00,000. If a bank loan of ₹ 5,00,000 is arranged it results in an increase in bank balance of ₹ 5,00,000 and an obligation to pay the bank loan of the same amount of ₹ 5,00,000.

In accounting, assets are the resources controlled by an enterprise. Land, buildings, plant and machinery, equipment, investments, inventory, debtors, bills receivable, cash, bank balance and prepaid expenses are some of the examples of the usual asset accounts. Liabilities are what an enterprise owes to creditors, borrowers and other outside parties. Some of the usual liability accounts are : Loan taken, creditors, bills payable, unearned revenue. Equity is the difference between a firm's assets and liabilities. Equity accounts include owner's or owners' capital account(s) in case of sole-proprietorship and partnership firms and share capital in case of joint stock company. Reserve accounts and profit and loss account are other usual equity accounts. (For more details see chapter on Accounting Equation)

4. **Cost Concept :** *According to the cost principle (i) an asset is ordinarily recorded at the price paid for it, i.e., at its historical cost; and (ii) all subsequent accounting (for example, charging depreciation) for the asset is also based upon this cost.* For example, if a plot of land is purchased

for ₹ 2 lakhs, this amount is not affected by subsequent changes in the market value of the plot of land. In case of assets which have long but limited life, depreciation is charged which is based *inter alia* on the cost of the asset. Thus, the cost of the asset is systematically reduced over the life of the asset by charging depreciation. Thus, depreciation is the process of allocation of cost of asset over the life of the asset. It is not a process of valuation of asset. Depreciation expense is charged in Profit and Loss Account and the balance of the unallocated cost *i.e.* written down value of the asset is shown in the Balance Sheet. Alternatively, asset is shown at its original cost less accumulated depreciation to date. Thus, an asset is not usually shown at its net realisable value or its current replacement cost.

Further, if an asset is acquired and nothing is paid for it, it is not recorded as an asset. For example, internally generated goodwill is not recorded in the books of accounts. In other words, goodwill is recorded in the books only when it is purchased, *i.e.* when consideration in the form of money or money's worth is paid for it.

The cost principle is modified in practice by the principle of conservatism, according to which stock is valued at cost or market price whichever is less. Sometimes assets are revalued also.

The cost principle satisfies the criteria of objectivity and feasibility as compared to that of relevance. According to Robert K Anthony, "adherence to the cost concept indicated a willingness on the part of the accounting professionals to sacrifice some degree of relevance in exchange for greater objectivity and feasibility." Thus historical cost is adopted as a base of measurement of assets because it is objective. Moreover, it is very easy to determine the historical cost of the asset as compared to net realisable value or current replacement cost of the asset.

The cost principle is widely used as basis of valuation of non-monetary fixed assets such as plant and machinery, furniture and motor vehicles. The cost principle is modified in case of non-monetary current assets. Therefore, stock-in-trade is valued at lower of cost or market value. Monetary assets include debtors, bills receivable, cash in hand and bank balance. Debtors and bills receivable are claims to a fixed number of rupees at a certain time. Debtors are valued after deducting provision for bad and doubtful debts.

As per AS-10 (revised), cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction.

The **advantages or, justification** of cost concept are : (*a*) it brings objectivity in measurement of assets; (*b*) there is no need of determining the market value of the assets; and (*c*) it recognises the fact that fixed assets of the enterprise are acquired for use and not for sale in the ordinary course of business.

The **disadvantages** of cost concept are : (*a*) in case of fluctuations in the general level of prices especially inflation the historical cost of the assets such as land and buildings is not relevant; and (*b*) in case of an asset acquired without consideration, it is not recorded.

5. **Verifiable Objective Evidence :** *According to this principle, there must be objective evidence of transactions which are capable of verification.* In other words, entries which are recorded in financial accounting from transactions must be supported by documentary evidence such as vouchers, invoices, cash memos etc. Similarly the information reported in financial statements must be based upon objectively determined evidence.

6. **Going Concern :** This is one of the fundamental accounting assumption as per ICAI. This is also known as continuity assumption. *According to this principle, unless there is good evidence to the contrary it is assumed that an entity will continue to operate for a fairly long period in future.* As per this concept, there is no need to measure at all times the current worth of the entity to a buyer. Assets are not shown at their current realisable value as they are held in going concern for earning revenue and not for resale. For example, the current resale value of fixed assets are irreverent because they are used as part of the manufacturing process in a manufacturing unit.

   However, if there is a strong evidence that an entity is going to be liquidated, then its assets should be shown at their liquidation value and liabilities at the amount required for settling them immediately.

   This concept has the following implications in accounting :

   (*a*) Distinction between capital expenditure and revenue expenditure is made.

   (*b*) Assets are classified as current assets and non-current assets. Similarly liabilities are classified into current liabilities and non-current liabilities.

   (*c*) Fixed assets are acquired for use and not for sale in the ordinary course of business.

   (*d*) Cost of the depreciable assets is allocated over the useful life of the asset in a systematic manner.

   (*e*) Fixed assets are not shown at their liquidation value in the Balance Sheet.

7. **Accounting Period or Periodicity :** Accounting period is the time span for which financial statements are prepared. Since the going concern postulate assumes that the life of an entity is fairly long, accountants choose some convenient segment of time to measure the net profit for that period. The time interval chosen is called the accounting period which is usually one year for external reporting. *Thus, according to accounting period postulate financial statements should be prepared at regular intervals to provide information about financial position and performance of an organisation.*

   The following are outcomes of adopting this concept :

   (*a*) Profit and loss Account is prepared periodically (usually for a year) to know the results of the operations of the business as various types of decisions are taken based on this.

   (*b*) Preparation of financial statements on yearly basis is necessary to settle the liabilities for income or corporate tax.

   Difficulties due to periodicity. As the life of an organisation is artificially split into periodic intervals, most of the problems of income measurement arises due to this postulate. The main difficulty is that of deciding revenue and expenses for an accounting period. Allocating the cost to a particular accounting period is difficult and may be arbitrary. For example, calculation of depreciation to be charged depends on cost of the asset, life of the asset, and scrap value of the asset. Life of the asset and scrap value of the asset cannot be precisely ascertained. Therefore, the amount of depreciation charge will also be an estimate. However, the information provided by the financial statements at regular intervals is more useful for the users of accounting information than the exact information available at the time of liquidation of business.

8. **Realisation Concept or Revenue Recognition Principle :** *According to Revenue Recognition Principle, revenue is considered to have been earned on the date when it is realised, i.e. on the date when goods have been supplied or services have been rendered.*

   AS-9 defines revenue as "the gross inflow of cash, receivable, or other consideration, arising out of activities of an enterprise from the sale of goods, from the rendering of services and from use by others, of enterprise resources yielding interest, royalties and dividends."

   Realisation deals with the timing of recognition of revenue. According to Robert N. Anthony "revenue is considered as being earned on the date at which it is realised, that is, the date when the goods or services are furnished to the customers in exchange for cash or for other valuable consideration".

According to realisation concept revenue is considered as earned on the date when the seller of goods or services gets the right to receive money for the supply of goods or rendering of services. Revenue is recognised in case of sale of goods when an exchange between the buyer and seller has taken place and the earning process of revenue is complete or virtually complete. Thus, revenue is recognised at the point of sale of goods or rendering of services as the earning process is considered to be complete at that point of time.

Accounting Standard-9 (AS-9) lays down rules for recognition of revenue arising in the course of ordinary activities of the enterprise from (*i*) sale of goods, (*ii*) rendering of service, and (*iii*) use of resources of the enterprises by others yielding interest, royalties and dividend. Recognition of revenue requires that revenue is measurable. The consideration receivable from the sale of goods, the rendering of services and use by others of resources of the enterprise should be reasonably determinable for recognition of revenue. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

In the following exceptional cases revenue is said to be realised at a different point of time :

(*a*) ***Long-term service or construction contracts.*** Where a contract is large enough to extend over a number of years, it is usual to credit a part of the profit to the profit and loss account each year. If any loss is incurred the whole of the loss is debited to profit and loss account. Unless a portion of the profit on uncompleted contract is taken, the accounts may show low profits in years when no major contract is completed and very high profits in the year in which the contract is completed. Therefore, it is considered prudent to transfer a conservative part of the estimated profit on large contracts at the end of each year.

(*b*) ***Gold mining.*** In case of gold mining revenue is recognised at the point of production itself.

(*c*) ***Hire purchase.*** In case of sale of goods of small values on hire purchase revenue is recognised in proportion to the amount becoming due. It is so because the ultimate collectivity of revenue is in doubt.

(*d*) ***Professionals.*** In case of professionals such as doctors, engineers, chartered accountants, advocates revenue is recognised when it is actually collected and not when services are rendered by them.

It is because the professionals are not sure of getting the payment from their clients.

9. **Expense Recognition or Matching Concept** : An expense is incurred when goods or services are consumed or used in the process of obtaining revenue during the accounting period. It decreases owner's equity. Expense (or expired cost) gives benefit during the accounting period; for example, wages and salaries paid to the employees, rent of the premises etc. Thus, expense is an item of cost applicable to the current accounting period. It is also termed as revenue expenditure. *Expense should be recognised in the period in which associated revenue is recognised.* Costs are matched with revenues. According to the American Accounting Association, "Expense is given recognition in the period in which there is (*a*) a direct identification or association with the revenue of the period, as in the case of merchandise delivered to the customer, (*b*) an indirect association with the revenue of the period, as in the case of salaries or rent, or (*c*) measurable expiration of asset cost even though not associated with production of revenue for the current period, as in the cases of losses from flood or fire."

Thus, cost incurred or expired cost or expenses may be classified into following three categories :

(*a*) ***Costs which can be directly associated with the revenues earned.*** Costs which can be directly associated with the revenues earned are recognised as expense in the same accounting period in which associated revenue is earned. For example, when sales value of a certain product is reported as revenue in a particular accounting period, the cost of that product is reported as an expense in the profit and loss account of the same accounting period.

(*b*) ***Cost which cannot be directly associated with the revenue, but can be associated with the accounting period..*** All expenses are not directly associated with specific revenues. Some items of expenses like rent, salaries, depreciation etc. are associated with a certain accounting period. These are the cost of operating the business during the concerned accounting period and hence are related in general way to the revenues of the period. These expenses are known as period expenses.

(*c*) ***Cost which are neither directly associated with the associated revenue nor associated with operations of a period and cannot be associated with revenue of some future period.*** If an item of cost is incurred but neither the direct association with revenue is possible nor it is associated with the operations of a period, the cost item is debited to the Profit and Loss Account if it cannot be associated with the revenue of some future period. For example, loss by fire or loss by theft are debited to Profit and Loss Account in the period in which the loss occurs even though they have no connection with the revenue of that period or with the operations of the period.

Matching principle is the result of the accounting period or periodicity concept. Matching of cost with related revenues is done either on (*i*) cash basis; or (*ii*) accrual basis; or (*iii*) hybrid basis. It is usually done on accrual basis. **According to the matching principle the expenses for an accounting period are matched against related revenues.** For example, if goods costing ₹ 20,000 are sold for ₹ 25,000, it is first determined when ₹ 25,000 is to be recognised as revenue, then ₹ 20,000 cost of goods sold is matched with those revenues as an expenses resulting in ₹ 5,000 gross profit from sale. Since the accounts are usually prepared on accrual basis, the expenses incurred in an accounting period are matched with the revenues recognised in that period. Matching principle is essential part of the accrual basis of accounting, and therefore, accrual and matching principles are used by certain accountants/academicians interchangeably. Revenues are measured in accordance with the realisable principle and then costs are associated with these revenues. Costs are matched with revenues and usually not vice versa.

10. **Accrual Concept :** Accrual basis of accounting is one of the fundamental assumptions as per the Institute of Chartered Accountants of India (ICAI). **According to this concept, revenues are credited to the period in which they are earned whether they have been actually received or not. Similarly, expenses are charged to the period to which they relate whether they have been actually paid or not.** In other words, this principle recognises revenues and expenses as earned or incurred respectively ignoring the date of receipt or payment. The difference between the total revenue earned and total expenses incurred is the profit or loss for the period. *Under this principle outstanding and prepaid expenses, accrued income and income received in advance are adjusted for ascertaining the profit or loss for the period.* The accrual principle is one of the consequences of accounting period postulate.

Note : For more details about Accrual Concept *see* Accrual Basis of Accounting in Chapter 1.