

ACCOUNTING STANDARD

The accounting concepts, principles, assumptions and conventions that are usually followed in writing the business transactions in books of accounts differ from country to country as one local customs is different from the other. Further, because of the globalization and cross border capital i.e. foreign investment, the world become so small and single.

Hence, it is necessary to follow rules relating to recognition, measurement and disclosures of accounting transaction which are comparable. This is possible with the help of accounting standards.

What is Accounting Standard?

Neither International Accounting Standard committee (IASC) nor Accounting standards board of India (ASB) made definition for the term accounting standard. However, it may be defined as uniform accounting measurement and practices introduced with a view to harmonise the diverse accounting policies and practices within a country in case of national standards or among different countries as in the case of international standards.

History of Accounting standard in India

The International Accounting Standard Committee was formed in June 1973 to which the Institute of Chartered Accountants of India was affiliated. When the ISAC issued accounting standard and were made applicable to Indian enterprises, there had been a stiff resistance from Indian corporate.

Therefore, in the year 1977, 12th April, The ICAI formed Accounting Standards Board of India (ASB) to formulate its own standards taking into consideration the IAS and the local laws, customs, usages, business environment and conditions.

If there needs any clarification or doubt arises about accounting standards, the ICAI issues Accounting standard Interpretations (ASI) and General clarifications (CG) on accounting standards from time to time.

To whom Accounting Standards are applicable?

Accounting standards are applicable to commercial, industrial or business enterprises. Even if a very small proportion of the activities of enterprises are considered to be commercial, industrial or business in nature, then accounting standards are applicable.

Charitable trust and co-operative societies:

In case of charitable trusts and co-operative societies, if their activities are purely charitable or non commercial then accounting standards are not applicable. Even if a very small proportion of the activities of trusts/co-operative societies are considered to be commercial, industrial or business in nature, then accounting standards are applicable.

Is Accounting Standard mandatory?

The ICAI is not being a regulatory body and cannot on its own force compel the Business enterprises to follow accounting standards unless they are supported by statutory approval. For example w.e.f.25th January 1996 as per section 145(2) of the Incometax Act 1961, it is mandatory for enterprises which adopt mercantile system of accounting to follow AS 1 i.e. discloses the accounting policies.

If there is any clash between accounting standard and statutory law such Incometax, Companies Act. etc., then the statutory law prevails over accounting standards.

Advantage of AS:

It brings uniformity in accounting practices and ensures transparency, consistency and comparability.

Provide a set of standard accounting policies, valuation norms and disclosure requirements.

Reduce or eliminate variations in the accounting treatments used to prepare financial statements.

In India, there are nearly 30 accounting standard issued by ASB. However, the following are the standards which are essential from examination point of view

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| AS 1 | Disclosure of accounting policies |
| AS 2 | Valuation of Inventories |
| AS 7 | Accounting for construction contracts |
| AS 9 | Revenue Recognition |
| AS 11 | The effect of changes in Foreign exchange rates |
| AS 19 | Leases |
| AS 22 | Accounting for Taxes on Income |

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| AS 1 DISCLOSURE OF ACCOUNTING POLICIES |
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There are different accounting policies which are applicable to different enterprises and in different circumstances for the same enterprises. For example, one company may follow SLM of depreciation another company may follow WDV method or the same company may follow SLM in the first year and WDV from the second year. However, there is no single list of accounting policies which are applicable to all circumstances. However, the accounting policies selected by the organisation should represent a true and fair view of the state of affairs of the enterprises. Hence, while selecting accounting policies, importance should be given for **produce, substance over form and materiality.**

The AS 1, emphasis that the enterprise should disclose all significant accounting policies adopted in the preparation and presentation of financial statements. The accounting policies forms part of financial statements and it should be disclosed at one place and not in a scattered manner. The business enterprises had to disclose the **fundamental accounting assumptions of going concern, consistency and accrual.**

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| A S 2 VALUATION OF INVENTORIES |
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Inventory includes

A] Those held for sale in the ordinary course of business i.e. goods held by a trader for resale, computer software held for resale or land other property held for resale.

B] Those held in the process of production – work in progress or semi finished products.

C] Those held in the form of materials or supplies to be consumed in the production of a particular product or in rendering particular service. i.e. raw materials, consumable, loose tools used in the production.

But as per AS 2 inventories does not include

A] Work in progress under construction contracts.

B] Shares, debentures and other financial instruments held a stock in trade.

C] Livestock, agricultural and forest products, mineral, oils, ores and gases.

How inventories valued under AS 2?

As per AS 2, Inventories are valued at cost price or net realizable value whichever is less. The basic idea is not to allow profit on inventories.

Cost price means and includes cost of purchase, cost of conversion and other costs incurred in bringing the inventories to their present location and condition. It includes cost of product, duties and taxes, carriage inwards, trade discounts, rebates, etc.,

What are the costs not to be included?

Abnormal wastage of material

Storage cost

Administrative overhead

Selling and distribution costs.

Warranty expenses incurred after completion of sale

Net realizable value means the estimated selling price in the ordinary course of business less estimated costs necessary to make the product saleable. NRV are based on the most reliable evidence available at the time of estimation.

What are the methods followed in determining the cost of inventories?

Specific identification method

FIFO (First In First Out) method

Weighted Average method

Standard costing method

Retail method or adjusted selling price method

What are the methods not followed in determining the cost of inventories?

AS 2 doesn't permit the LIFO (Last In First Out) method and base stock method in computing the value of cost of inventories.

Whether excise duty should be included in the valuation of finished goods which are manufactured but lying in the factory or godown?

Yes. Since the liability for excise duty arises when the manufacture of the goods completed, it is necessary to create a provision for liability of unpaid excise duty.

A S 7 CONSTRUCTION CONTRACTS

The revised AS 7 is applicable with effect from 01/04/2003. Normally construction contracts are for a longer period. The construction may be commenced in one accounting year and ends on another accounting period. Therefore, the construction contract requires special treatment in accounting.

In construction contract, it is necessary to allocate the contract revenue and contract costs to the accounting periods in which the construction work is performed. For example, in the first year, if only 40% of the job is completed then revenue and cost of that 40% should be recorded in the first year itself.

What is construction contract as per AS 7?

It includes construction of single asset such as building, bridge, dam, pipeline, road, ship or tunnel.

It also includes services which are directly related to construction contract such as service of project manager or architects.

It also includes contract for destruction or restoration of assets.

Contract may be fixed price contract or cost plus contract

In case of fixed price contract, the price is fixed and agreed by contractor. In some cases cost escalation clauses may be included.

In case of cost plus contract the contractor is reimbursed with cost plus percentage of these costs or fixed fees.

What are contract costs?

Here cost includes the material cost, labour cost including site supervision, depreciation of plant and equipments used on the contract, cost of hiring plant and equipments, cost of design and technical cost directly related to the contract, cost of rectification and guarantee work. If any surplus material is sold or used plants are sold then the cost may be reduced to that extent.

In case there are certain costs which are common for different contracts such as insurance, cost of design not directly related then such cost should be allocated among the different contracts on some agreeable proportion.

What is contract revenue?

Contract revenue includes

- agreed price in the contract
- variation in contract
- contract claims and
- incentive payments

Provided they are capable of being measured in terms of money.

Variation in contract means, it is instructed by the customer to change the scope of work which may lead to increase in the contract revenue.

Contract claims means the amount the contractor receive from the customer or any other party which are not included in the agreed price. Customer may cause delay or errors in the design by the consultancy firms or disputes.

Incentive payments means the extra amount the contractor receives in addition to the agreed price. If the contract is completed before the stipulated period, etc.

How cost and revenue accounted for?

Contract revenue and costs are recorded in a year according to the percentage of work completed during that year. Expected loss also recorded as expenses immediately. For identifying the contract revenue and cost, percentage of completion method is adopted.

Example: Construction of two floor building for Rs.12 lakh – margin 20%

| Nature of work | Technical completion | Cost to complete |
|--------------------------------|-----------------------------|-------------------------|
| Foundation | 30% | 400000 |
| 1 st floor | 15% | 150000 |
| 2 nd floor | 15% | 150000 |
| Tiling, painting, fitting, etc | 40% | 400000 |
| Total | | 1000000 |

If foundation is completed then 80000/- gross profit would be recognized.

If 1st floor is completed then 30000/- gross profit would be recognized and so on.

Construction contract loss

If the total contract costs exceed contract revenue, the expected loss should be recognized immediately as expenses i.e. the year in which the contract is signed or obligation is commenced.

A S 9 REVENUE RECOGNITION

AS 9 deals with revenue earned in the course of the ordinary activities of an enterprises from the

- sale of goods
- rendering service
- yielding interest, royalties and dividends

but does not include revenue arising

- from construction contracts
- from hire purchase lease agreements
- government grants and subsidies
- revenue of insurance company from insurance contracts

When revenue is recognized in case of sale of goods?

In case of sale of goods the revenue is recognized when

- the seller transferred goods to the buyer for a price or
- All significant risks and rewards of ownership have been transferred to the buyer and the seller has no effective control of the goods.
- There is no uncertainty in the payments.

Example of different situations:

1] In case of consignment sale: Revenue is recognized only when the goods are sold by consignee and not when the goods are delivered to the consignee as he is only an agent.

2] In case of cash on delivery sales: Revenue should be recognized until the seller or his agent receives cash.

3] In case of installment sales: when the consideration is received in installments, at the time of sale sales price – interest should be recognized as sale. The interest portion will be recognized as revenue proportionately.

4] In case of special order contract: Revenue should not be recognized until goods are manufactured, identified and ready for delivery.

5] In case of goods sent on approval basis: Revenue should not be recognized until formally accepted by the buyer, or time period has elapsed.

When revenue is recognized in case of rendering of services?

In case of rendering services, revenue is recognized either by proportionate completion method or by completed service contract method.

Proportionate complete method: here revenue is recognized in proportion to the degree completion of service during the period for which accounts are prepared.

Complete service contract method: here revenue is recognized only when the service contract is completed or substantially completed.

Example of different situations:

1] In case of installation fees: revenue is recognized only when the equipment is installed and accepted by the customer.

2] Advertisement, insurance agency commission: In case of advertisement commission revenue is recognized when the advertisement appears before public. In case of insurance it is recognized from the date of commencement or renewal of the service.

3] Tuition fees: revenue recognized over the period of instruction

When revenue is recognized in case of interest, royalty and dividend?

Interest = in case of interest revenue is recognized on time proportion based amount due and rate of interest.

Royalty = on accrual basis in accordance with the terms of agreement

Dividend = Dividend from investment in shares are recognized when the owners right to receive payment is ensured and established.

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| <p style="text-align: center;">A S 11 EFFECT OF CHANGE IN FOREIGN EXCHANGE RATES</p> |
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It is mandatory and comes into effect from 01/04/2004. When an enterprises carry out its business internationally, its transactions may be dealt in foreign currency or its entire operation may be carried out in a foreign country in the currency of such country. The AS 11 deals with issues involved in accounting for foreign currency transactions and foreign operations.

How to record the foreign currency transactions?

As per AS 11, foreign currency transactions which are outstanding on the balance sheet date should be recorded using the closing rate . If the closing rate is unrealistic, the transactions are to be recorded at the price at which the assets may be realised or liabilities may be disbursed on the balance sheet date.

How to record the foreign currency operations?

It may be classified as integral foreign operations and non-integral foreign operations. Integral operation means the operation in the foreign country is carried out just like a branch, or extension counter. When it is non-integral it functions as a separate entity in the foreign country.

Integral foreign operation is recorded as if it is foreign currency transactions.

In case of non-integral foreign operations, the assets and liabilities should be translated at the closing rate and the income and expenses should be translated using the rate prevailing on the date of transactions.

AS 11 specifies that the amount of exchange difference included in the net profit or loss should be disclosed in the financial statement.

AS 19 LEASES

Lease is an agreement in which the lessor gives the property to the lessee for a certain period for a certain sum of money. Normally, the ownership is with the lessor. But in reality, lessee enjoys all rights over the property as an owner of the assets, hence it is important to know about lease and the guideline given by AS. AS 19 is to be followed compulsorily with effect from 01/04/2001 in respect of all assets leased. Lease is broadly classified into two financial lease and operating lease. However, **AS 19 is not applicable in respect of**

A] Lease agreements to explore for or use of natural resources such as oil, gas, timber, metals and other mineral

B] Licence agreement for items such as motion picture films video manuscripts, recordings, patents and copyrights

C] Lease agreement to use lands.

What is financial lease?

A lease can be classified as finance lease if it transfers substantially all risks and rewards incident to ownership. Title of the asset may or not be transferred. Even in some cases, the ownership may continue with the lessor, but lease may be considered as financial lease, when the lease period covers most of the useful economic life of the assets. For example, a car is leased for 15 years and no ownership is transferred, it is considered as financial lease because the useful life of car may 15 or 20 years.

Bargain purchase option: the lessee may be given an option to purchase the asset at a price which is lower than the fair value at the end of the lease, such option is called bargain purchase option.

How to record financial lease in the books of lessee?

It is considered as asset and liability in the books of lessee at an amount equal to the fair value of the asset.

How to record financial lease in the books of lessor?

Financial lease will be accounted for similar to hire purchase transactions in the books of lessor.

What is operating lease?

All leases other than financial lease are termed as operating lease. Here the assets may be leased out to multiple lessees during its economic life. This lease otherwise called as non-payment lease.

How to record operating lease in the books of lessee?

The lease payment is considered as expenses and shown in the profit and loss account.

How to record operating lease in the books of lessor?

The asset will be shown in the balance sheet at a fixed price. The lease payment will be shown as income in the profit and loss account.

AS 22 ACCOUNTING FOR TAXES ON INCOME

The profit computed as the per accounting law will always differ from the profit computed under the taxation law mainly because of two reasons

1] Difference between items of revenues and expenses as appearing the profit and loss account and items which are considered as revenues, expenses or deduction for tax purposes. For example, Incometax paid can be shown in the profit and loss account as per accounting rules but not so as per Incometax Act.

2] Difference between the amount in respect of a particular item of revenue or expenses as per accounting rule and the Incometax law. For example, VRS compensation paid can be deducted wholly in the year in which it

is paid by the company as per accounting rules but it should be deducted in 5 equal installment as per Incometax law.

These difference may be termed as timing differences and permanent differences.

Timing differences:

Timing difference is that difference between taxable income and accounting income for a period. The difference arises in one period and which may be reversed in subsequent period. For example, if provision for bad debts is created, then your profit will be reduced to that extent and so the tax liability but tax liability will actually be reduced only when there is bad debt which may happen even in the next accounting period.

Permanent differences:

It is difference between taxable income and accounting income for a period that originate in one period and not reverse subsequently.

What the AS 22 says:

Deferred tax assets or liabilities should be disclosed in the financial statements as notes to the accounts. Further, evidence supporting the recognition of deferred tax assets should be disclosed.

Example: tax rate 30%

| Assets and liabilities | As per financial | As per Incometax | Difference | Deferred tax assets | Deferred tax liabilities |
|------------------------|------------------|------------------|------------|---------------------|--------------------------|
| Fixed assets | 1000000 | 800000 | | | |
| Less: Dep. | 400000 | 700000 | | | |
| | 600000 | 100000 | 500000 | | 150000 |
| Investment | 300000 | 300000 | | | |
| Less: provi. | 60000 | 0 | 60000 | 18000 | |
| Debtors | 310000 | 310000 | | | |
| Less: Provi.. | 30000 | 0 | 30000 | 9000 | |
| VRS expense | 400000 | 80000 | 320000 | 96000 | |

Objective type Questions

1. The first accounting standard (AS 1) issued by the institute of Chartered Accountant of India is on

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|--------------------------------------|-----------------------------|------------------------|--|
| A] Disclosure of accounting policies | B] Valuation of inventories | C] Revenue recognition | D] change in financial position of an entity |
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2. Accounting standard 2 provides that inventories should be valued at

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|--|--|---------------------------------|---------------------------|
| A] lower of historical cost and net realizable value | B] lower of historical cost and market value | C] only estimated selling price | D] all of the above three |
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3. Out of the banks, financial institutions and enterprises carrying on insurance business, accounting standard on leases i.e. AS 19 is applicable to

| | | | |
|---------------------------------|-------------------------------|--|--------------|
| A] banks and insurance business | B] financial institution only | C] enterprises carrying on insurance business only | D] all three |
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4. AS 22 recognises that taxable and accounting income may not be same because requirements of tax laws may differ from the accounting policies applied to determine accounting income. The reason for such difference can be

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| A] permanent difference | B] timing differences | C] both (a) and (b) | D] none |
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5. As per AS 11 regarding the effect of changes in the foreign exchange rates, an enterprises having transactions in foreign currency as well as foreign operations should express such transactions and financial statements involving foreign operation in

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| A] the foreign currency only | B] the reporting currency | C] in the currency of its choice | D] in US dollars only |
|------------------------------|---------------------------|----------------------------------|-----------------------|

6. Accounting standards are

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|---|---|---|------------------|
| A] Basis for selection of accounting policy | B] set of broad accounting policies to be followed by an entity | C] basis for establishing and managing entity | D] all the above |
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7. As per AS 2, taxes on income would include

| | | | |
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| A] all domestic taxes on returned income | B] all foreign taxes on returned income | C] all domestic and foreign taxes based on taxable income | D] all domestic and foreign taxes on assessed income |
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8. Accounting standard on leases i.e. AS 19 is applicable to lease /licensing agreements

| | | | |
|-----------------|-------------------|-----------------------------|---------|
| A] to use lands | B] to explore oil | C] for motion picture films | D] none |
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9. Change in exchange rate after the balance sheet date but before approval of financial statements

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| A] Do not require adjustments as it is a non-adjusting event that occurs after |
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| | the year end |
| B | Required adjustments in view of schedule VI of Companies Act 1956 |
| C | Require adjustment and disclosure in the report of approving authority as it is an adjusting event |
| D | None of the above |

10. Which is not fundamental accounting assumption?

| | | | |
|------------------|----------------|----------------|------------|
| A] Going concern | B] materiality | C] consistency | D] accrual |
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11. Which of the following cost should be excluded from the cost of the construction contract?

| | | | |
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| A] site labour cost including supervision | B] cost of material used in construction | C] depreciation of plant and equipment used in the contract | D] cost incurred in securing the contract, pre contract cost |
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12. Revenue from sale of good should be recognised when

| | |
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| A | all significant risk and rewards of ownership in goods have been transferred to buyer |
| B | The seller retains no effective control of goods transferred to a degree usually associated with ownership |
| C | No significant uncertainty exists regarding the collection of amount consideration |
| D | All of the above |

13. Which of the following would be considered as the date of inception of the lease as per AS 19

| | | | |
|----------------------------|---|---------------------------|---------|
| A] date of lease agreement | B] date of commitment by the parties for the provision of lease | C] earlier of (a) and (b) | D] none |
|----------------------------|---|---------------------------|---------|

14. for the purpose of AS 9 revenue does not include

| | | | |
|---------------------------------|--|---|-------------------|
| A] entrance and membership fees | B] advertising and insurance agency commission | C] realised gain resulting from the discharge of an obligation at less than its carrying amount | D] warranty sales |
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15. For the purpose of AS revenue implies

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| A | Gross inflow of cash receivables or other consideration in the course of ordinary activities of an enterprises |
| B | Net inflow of cash receivables or other consideration in the course of ordinary activities of an enterprises |
| C | Gross inflow of cash receivables or other consideration in the course of ordinary investing and financial activities of an enterprises |

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| D | Revenue arising from construction contract |
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16. Contract revenue consists of the

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| A | Revenue arising due to escalation clause |
| B | Decrease in contract revenue due to penalties |
| C | Claims that contractor seeks to collect from the customer as reimbursement of cost not included in contract price |
| D | All the above |

17 As per AS 7 which of the following are always part of construction contract

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| A | Borrowing cost allocated to construction contract as per AS 16 |
| B | Allocated overheads |
| C | Cost incurred before award of contract |
| D | (a) and (b) above |

18. Identify the area where different accounting policies can be followed

| | | | |
|------------------------------------|-----------------------------|---------------------------|---------------------|
| A] treatment of retirement benefit | B] valuation of inventories | C] method of depreciation | D] all of the above |
|------------------------------------|-----------------------------|---------------------------|---------------------|

19. As per AS 19, in finance lease, leased asset:-

| | | | |
|--|--|---|--|
| A] is shown in balance sheet of lessee | B] is shown in the balance sheet of lessor | C] not shown in the balance sheet of either | D] disclosed as contingent asset by the leasee |
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20. The exchange rate to be used for the conversion of tangible fixed assets in case of integral foreign operation would be

| | | | |
|--|-----------------|-----------------|-----------------|
| A] on the date of purchase of fixed assets | B] closing rate | C] opening rate | D] average rate |
|--|-----------------|-----------------|-----------------|

21. Accounting standard are to be used

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|--------------------------------------|--|---|---|
| A] for computation of taxable income | B] for calculation of net profits available for payment of dividends | C] in the presentation of general purpose financial statement | D] for preparing only the cash flow statement |
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22. While assessing income under the Incometax Act, if there is a conflict between accounting standards and the provisions of Incometax Act, then

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|---|-------------------------------|---|--|
| A] the accounting standard will prevail | B] Incometax act will prevail | C] conflict would be referred to the court of law | D] it would be left to the discretion to the Assessing officer |
|---|-------------------------------|---|--|

23. Which accounting standard issued by Institute of Chartered accountants of India is applicable to amalgamation of companies

| | | | |
|---------|---------|----------|----------|
| A] AS 8 | B] AS23 | C] AS 29 | D] AS 14 |
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24. The controversy in preparation of account of Satyam was centered on

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| A | Accounting standard on disclosure of accounting policies |
| B | Accounting on revenue recognition |
| C | Accounting standard for accounting for effect of change in foreign exchange rates |
| D | Accounting standard of accounting for taxes on income |

| | | | | | | | | | |
|-------|-------|-------|-------|------|-------|-------|-------|-------|-------|
| 1] a | 2] a | 3] d | 4] c | 5] b | 6] d | 7] d | 8] d | 9] d | 10] b |
| 11] d | 12] d | 13] a | 14] d | 15] | 16] d | 17] d | 18] d | 19] a | 20] b |
| 21] c | 22] b | 23] d | 24] d | | | | | | |