



CENTRAL INSTITUTE FOR RURAL ELECTRIFICATION

Issues related to Applications of Accounting Standards

M.R.Vikram

Accounting Standard 1

Disclosure of Accounting Policies

Requirements as per AS

AS 1 principally requires the disclosure of significant accounting policies and specifies the manner of their disclosure.

A clear statement of significant accounting policies followed in the preparation and presentation of financial statements is necessary irrespective of the type of entity presenting the financial statements

All significant accounting policies should be disclosed at one place

Shortcomings of ESSAR

ESAAR does not require disclosure of accounting policies prescribed therein, as only departures therefrom are required to be disclosed.

ESAAR allows not to follow the prescribed accounting policies on the ground of impracticability and for presenting true and fair view of accounts

Accounting Standard 2

Valuation of Inventories

Requirements as per AS

As per AS 2 cost of purchase of materials, including fuel should include duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to acquisition. Other costs incurred to bring the inventories of fuel and materials to their present location and condition should also be included in cost of inventories.

Shortcomings of ESSAR

ESAAR does not permit inclusion of incidental expenses, other than freight, in the cost of fuel even if directly related to acquisition. ESAAR also does not allow inclusion of any incidental expense in the cost of materials even if directly related to acquisition.

Accounting Standard 2

Valuation of Inventories



As per AS 2 the inventories are required to be valued at the lower of cost and net realisable value.

ESSAR requires valuation of inventories of fuel and other materials at cost ignoring their net realisable value, therefore, these would be valued at cost even in cases where their net realisable value has decreased.

Accounting Standard 3

Cash Flow Statements

Requirements as per AS

An enterprise should prepare a cash flow statement and present it in addition to the balance sheet and profit and loss account.

Cash comprises cash on hand and demand deposits with banks. Cash equivalents are "short term, highly liquid investments that are readily convertible into known amounts of cash and which subject to an insignificant risk of changes in value".

Accounting Standard 3

Cash Flow Statements

Example:

Preference shares of a Company acquired shortly before their specified redemption date.

Accounting Standard 3

Cash Flow Statements

Cash flow statement should report the cash flows during the period classified by

- Operating Activities
- Investing Activities
- Financing Activities

Accounting Standard 3

Cash Flow Statements

Operating Activities:

Operating activities are “the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

Examples:

Cash receipts from the sale of goods rendering of services, royalties, fees and commissions, cash payments to suppliers of good etc.

Accounting Standard 3

Cash Flow Statements



Investing Activities:

Investing activities are “the acquisition and disposal of long-term assets and other investments and included in cash equivalents.

Examples:

Cash payments/receipts arising from acquisition or construction /disposal of fixed assets (including intangibles),

Cash payments/receipts arising from acquisition or construction /disposal of shares, warrants or debt instruments of other enterprises,

Accounting Standard 3

Cash Flow Statements



Financing Activities:

Financing Activities are “activities that result in changes in the size and composition of the owners’ capital (including preference share capital in case of company) and borrowings of the enterprise.

Examples:

Cash proceeds from issuing shares, debentures, loans notes, bonds and other short or long-term borrowings, and cash repayments of amounts borrowed

Accounting Standard 3

Cash Flow Statements


Shortcomings of ESSAR

As per the requirements of ESSAR, 1985 "Statement of Sources and Uses of Funds" is required to be prepared. Also called as Funds Flow Statement.

The above Statement has the following drawbacks

Accounting Standard 3

Cash Flow Statements



Funds flow data based on movements in working capital can obscure movements relevant to the liquidity and viability of an entity.

Example:

A significant decrease in cash available may be masked by an increase in stock of debtors

Entities may therefore, run out of cash while reporting increases in working capital. Similarly, a decrease in working capital does not necessarily indicate a cash shortage and danger of failure.

Accounting Standard 3

Cash Flow Statements

b) A Funds flow statement is based on the difference between two balance sheets. It reorganises such data, but does not provide new data.

The cash flow statement and associated notes required by AS 3 may include data not disclosed in a funds flow statement.

Accounting Standard 3

Cash Flow Statements

Advantages of Cash Flow Statement over Funds Flow Statement:

- a) As cash flow monitoring is a normal feature of business life and not a specialised accounting technique, cash flow is a concept which is more widely understood than are changes in working capital.
- b) Cash flows can be a direct input into a business valuation model and, therefore, historical cash flows may be relevant in a way not possible for funds flow data.



Accounting Standard 4

Contingencies and Events Occurring after the Balance Sheet Date

Definitions:

Contingency :

“a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.”

Contingencies are conditions or situations at the Balance Sheet date, the financial effect of which would be determined by future events which may or may not occur.



Accounting Standard 4

Contingencies and Events Occurring after the Balance Sheet Date

Events occurring after the Balance Sheet Date:

are "those significant events, both favourable and unfavourable, that occur between the balance sheet date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity."

Accounting Standard 4

Contingencies and Events Occurring after the Balance Sheet Date

Contingent Loss Vs Contingent Gain

Contingent Loss should be provided for in the Profit and Loss Account if;

- a) It is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and
- b) a reasonable estimate of the amount of the resulting loss can be made.

Contingent gains should not be recognised in the financial statements



Accounting Standard 4

Contingencies and Events Occurring after the Balance Sheet Date

Types of "Events occurring after the balance sheet date."

i) Events which provide further evidence for the estimation of amounts relating to conditions that existed at the balance sheet date.

Example:

Information regarding In May that a debtor was insolvent as on March 31 (the date of the balance sheet) and only 25 paise for every rupee would be realised from his estate.

Accounting Standard 4

Contingencies and Events Occurring after the Balance Sheet Date

ii) Events which are indicative of conditions that arose subsequent to the balance sheet date. These events do not relate to conditions existing at the balance sheet date.

Example:

Decline in market value of investments after the balance sheet date.



Accounting Standard 4

Contingencies and Events Occurring after the Balance Sheet Date

Requirements as per ESAAR, 1985

1. Material contingent liabilities should be disclosed as on the balance sheet
2. As per ESSAR, events occurring after the balance sheet date are events or transactions occurring after the date of balance sheet and before the date of the auditors' report.



Accounting Standard 4

Contingencies and Events Occurring after the Balance Sheet Date

Shortcomings of ESAAR

The definition of the term 'events occurring after the balance sheet date', is not appropriate since, it may not be possible for the management to incorporate the effect of/disclose the events that occur after the balance sheet date on which financial statements are approved, i.e., upto the date of auditors' report as required in ESAAR.

Accounting Standard 5

Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

AS 5 deals with disclosure in the profit and loss account of:

- i) Significant items arising in the course of ordinary activities of the enterprise;
- ii) Extraordinary items;
- iii) Prior period items;
- iv) Changes in accounting estimates; and
- v) Changes in accounting policies

Accounting Standard 5

Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

Salient Features and Principal Requirements:

1. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.
2. The following components of the net profit or loss for a period should be disclosed on the face of the profit and loss account:
 - a) profit or loss from ordinary activities; and
 - b) extraordinary items.

Accounting Standard 5

Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

Extraordinary items are

“income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.”

Accounting Standard 5

Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

Prior Period Items are

“income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.”

Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

Accounting estimates:

Accounting estimates (for example, useful lives of depreciable assets, provision for bad and doubtful debts) made in one accounting period may need revision in a subsequent period in the light of changes in the circumstances on which estimates were based, or as a result of new information, more experience or subsequent developments.

Accounting Standard 5

Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

Accounting Standard 5

Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

Changes in Accounting Policy:

A change in an accounting policy should be made only if :-

- The adoption of a different accounting policy is required
 - i) by statute; or
 - ii) for compliance with an accounting standard; or
- It is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise

Accounting Standard 5

Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

- A change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such changes if material, should be shown in the financial statements of the period in which such change is made.
- Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated.
- If a change made in an accounting policy has not material effect on the financial statement for the current period but is reasonably expected to have material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Accounting Standard 5

Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

Shortcomings of ESAAR:

- ESAAR does not prescribe the circumstances in which any accounting policy, once adopted, can be changed. Evidently, an accounting policy once adopted can't be changed even if the circumstances so warrant.
- The terms 'extraordinary items and 'prior period revenues and costs' have been used in ESAAR but their meaning has not been clarified. Further, as per ESAAR, 'prior period revenues and costs' include 'change in accounting estimates', whereas these terms have different connotations in GAAPs.



Accounting Standard 6

Depreciation Accounting

Salient Features:

- The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.
- The depreciation method selected should be applied consistently from period to period.
- A change from one method of providing depreciation to another should be made if the adoption of 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.



Accounting Standard 6

Depreciation Accounting

The useful life of a depreciable asset should be estimated on considering the following factors:

- ❑ expected physical wear or tear
- ❑ obsolescence
- ❑ legal or other limits on the use of the asset

Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. Alternatively, depreciation on such addition or extension may be provided at the rate applied to the existing asset.



Accounting Standard 6

Depreciation Accounting

Where the historical cost of a depreciable asset has undergone a change, depreciation should be provided on the revised unamortised depreciable amount prospectively over the residual life of the asset.

- Where a depreciable asset is revalued, provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful life of the asset.
- Where a depreciable asset is disposed of, scrapped, retired, etc. the net surplus or deficiency, if material, should be disclosed separately.