INTRODUCTION

1.1 STANDARDS SETTING PROCESS

ICAI, being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The standard-setting procedure by ASB can be briefly outlined as follows:

- Identification of broad areas by ASB for formulation of AS.
- Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards.
- Consideration of the preliminary draft prepared by the study group by ASB and revision, if any, of the draft on the basis of deliberations.
- Circulation of draft of accounting standard (after revision by ASB) to the Council members and specified outside bodies for comments.
- Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard.
- Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments.
- Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
- Consideration of the final draft of the proposed standard and by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB is done.
- The accounting standard on the relevant subject is then issued by the ICAI.

1.2. APPLICABILITY OF ACCOUNTING STANDARDS

- The institute, not being a legislative body, can enforce compliance with its standards only by its members.
- However, Section 211(3A) of the Companies Act requires companies to present their profit and loss accounts and balance sheets in compliance with the accounting standards.
- Also, the standards cannot override laws and local regulations. Accounting Standards however, do not apply to enterprises **solely** carrying on the activities, which are not of commercial, industrial or business nature.

1.3 <u>Accounting Standard and Income Tax Act</u>

- Guidance Note on Audit u/s 44AB of Income Tax Act, requires all financial statements prepared under mercantile system of accounting to comply with all applicable mandatory accounting standards issued by the Institute.
- It should be noted that the Central Government has notified two accounting standards, viz. AS (IT) 1, Disclosure of Accounting Policies and AS (IT) 2, Disclosure of Prior Period and Extra Ordinary Items and Disclosure of Accounting Policies for the purpose of taxation.

1.4. COMPLIANCE OF ACCOUNTING STANDARDS

Level I Enterprise: satisfying any one or more of the following:-

- Enterprises, whose equity or debt securities are either listed or is in the process to be listed in India or outside India.
- Banks, Insurance Companies and Financial Institutions.
- All commercial, industrial and other business reporting enterprises, having (during the preceding accounting year)
  - total turnover in excess of Rs. 50 crores.
  - total borrowings including public deposits in excess of Rs. 10 crores
- Holding or subsidiary company of any of the above enterprises any time during the year.

Level II Enterprise: not covered under level I enterprise and satisfying any one or more of the following

- All commercial, industrial and other business reporting enterprises, having (during the preceding accounting year)
  - total turnover in excess of Rs. 40 lakhs but less than 50 crores.
  - total borrowings including public deposits in excess of Rs. 1 crores but less than 10 crores.
- Holding or subsidiary company of any of the above enterprises any time during the year.

Level III Enterprise: All the enterprises not covered in above two levels.

Note: Where an enterprise has been covered under an AS, and subsequently, ceases to be so covered, the enterprise will not qualify for exemption, until the enterprise ceases to be covered for **two consecutive years**.

AS 1 : DISCLOSURE OF ACCOUNTING POLICIES

1.1 Applicable to: all enterprises since 1-4-93.
1.2 Deals with: the disclosure of significant accounting policies followed in preparing and presenting financial statements.
1.3 The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.
1.4 Accounting policies adopted for preparing and presentation of financial statements of all enterprises may not be identical, because various matters are not governed by AS or AS provide more than one policy.

1.5 CONSIDERATIONS IN THE SELECTION OF ACCOUNTING POLICIES

1.5.1 <u>Prudence:</u> In view of uncertainty associated with future events, profits are not anticipated, but losses are provided for as a matter of conservatism.
1.5.2 <u>Substance over form</u>: Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. [e.g. The ownership of an asset purchased on hire purchase is not transferred till the payment of the last instalment is made but the asset is shown in the books of the hire purchaser.]

1.5.3 <u>Materiality:</u> Financial statements should disclose all 'material items, i.e. the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. In certain cases quantitative limits of materiality is specified.

1.6 <u>ACCOUNTING STANDARD:</u>

1. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.
2. The disclosure of the significant accounting policies should form part of the financial statements and should normally **be disclosed in one place**.
3. **Change in the accounting policies**: which has a material effect in the current period or reasonably expected to have a material effect in later periods should be disclosed.
4. If change has a material effect in the current period, the amount by which any item in the financial statements is affected should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.
5. If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

AS 2 : VALUATION OF INVENTORIES

2.1 Applicability: to all enterprises since 1-4-1999 [originally issued in june-1981]

2.2 Deals with: accounting for inventories **other than**:

- **a.** WIP in construction contracts (AS – 7)
- **b.** WIP in the ordinary course of business of service providers;
- **c.** Shares, debentures and other financial instruments held as stock-in-trade; and
- **d.** Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at NRV in accordance with well established practices in those industries.

2.3 DEFINITIONS:

2.3.1 INVENTORIES: Inventories are assets:

- a. held for sale in the **ordinary course** of business; [i.e. finished goods]
- b. in the process of production for such sale; [i.e. WIP]
- c. in the form of materials or supplies to be consumed in the production process or in the rendering of services. [i.e. Raw Material]

* Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; [dealt in AS -10]

2.3.2 Net realisable value = estimated selling price - estimated costs of completion - estimated costs to make the sale.

2.4 Measurement of Inventories: at lower of cost and net realizable value.

2.4.1 Cost of Inventories = *costs of purchase + costs of conversion + other costs incurred in bringing the inventories to their present location and condition.*

- **a. Costs of Purchase =** purchase price + duties and taxes (other than subsequently recoverable) + freight inwards + other expenditure directly attributable to the acquisition – Trade discounts – rebates – duty drawbacks etc.
- **b. Costs of Conversion =** direct cost of production + allocation of fixed and variable production overheads

  Fixed production overheads: indirect costs of production that **remain relatively constant** regardless of the volume of production. Fixed production overhead should be allocated based on

  → FOH per unit at normal rate [If actual production < normal capacity]

  → FOH per unit at actual rate [If actual production > normal capacity]

  Variable production overheads: indirect costs of production that **vary directly, or nearly directly**, with the volume of production. [to be allocated on actual basis]

  Joint products or by-products: if costs of conversion of each product not separately identifiable, then cost is allocated between the products on a rational and consistent basis. [The allocation may be based, for example, on the relative sales value either at the separation stage or at completion stage.

  When by-products (or scrap or waste materials) are immaterial: their NRV (of by-product) is deducted from the cost of the main product.
- **c. Other Costs: to be include** only to the extent that they are incurred in bringing the inventories to their present location and condition. e.g. costs of designing products for specific customers. [borrowing costs usually not to form part of cost of inventories]

Note: when an enterprise purchases inventories on deferred settlement terms and the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing. [since 1-4-11]

2.4.2 Exclusions from the Cost of Inventories: the followings are to be excluded from cost of inventory:-

- a. abnormal amounts of wasted materials, labour, or other production costs;
- b. storage costs, unless necessary in the production process prior to a further production stage;
- c. administrative overheads
- d. selling and distribution costs.

2.5 COST FORMULA: Following are the various suggested cost formulae:-
Where items are not interchangeable: [Specific Identification Method**]:** where each unit of stock along with their associated cost can be separately identified.[e.g. ship building, machinery building]
Where are interchangeable: *FIFO (First In First Out) or Weighted Average Price*

2.6 Other techniques of cost measurement

a. Instead of actual, **the standard costs** may be taken as cost, provided standards fairly approximate the actual. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.
b. In retail business, [**a retail method**] cost of inventory is determined by reducing sale value of unsold stock by appropriate average percentage of gross margin.

2.7 NET REALISABLE VALUE (NRV): the inventory is written down to NRV because the cost of inventories may not be recoverable due to:

- Inventory is damaged;
- Inventory is wholly or partially obsolete;
- selling prices of inventory have declined;
- estimated costs of completion or estimated costs to make sale have increased.

2.8 Note:

- Inventories are usually written down to NRV on an item-by- item basis. In some circumstances, however, it may be appropriate to group similar or related items. [items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line.]
- The followings are to be taken into consideration for Estimation of NRV:
  - ✓ reliable evidence available at the time of making estimates.
  - ✓ fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.
  - ✓ the purpose for which the inventory is held.
- materials and other supplies held for use in the production of inventories are not written down below cost if the selling price of finished product containing the material exceeds the cost of the finished product.
- An assessment is made of net realisable value as at each balance sheet date

2.9 DISCLOSURE

i. The financial statements should disclose:
- The accounting policies adopted in measuring inventories, including the cost formula used;

  and
- The total carrying amount of inventories and its classification appropriate to the enterprise.

ii. Carrying amounts and changes in them during an accounting period for each class of inventory, e.g. raw materials, components, work-in-progress, finished stock, stores, spares and loose tools.

2.10 ACCOUNTING STANDARDS INTERPRETATION (ASI) 2:
ACCOUNTING FOR MACHINERY SPARES [AS-2 and AS-10]

Machinery spares which are not specific to a particular item of fixed asset but can be used **generally** for various items of fixed assets should be treated as inventories for the purpose of AS 2. Such machinery spares should be charged to the statement of profit and loss as and when issued for consumption in the ordinary course of operations.

2.11 AS-2 and International Accounting Standard (IAS)-2: both are similar.

AS 3 :CASH FLOW STATEMENTS

3.1 Mandatory to: Level III enterprises (since 1-4-2004)

Note: Where an enterprise has been covered and subsequently, ceases to be so covered, the enterprise will not qualify for exemption, until the enterprise ceases to be covered for two consecutive years.

3.2 Deals with: information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement.

3.3 Accounting Standard :

- An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.
- The cash flow statement should report cash flows during the period classified by **operating, investing and financing activities.**
  - ✓ **Reporting Cash Flows from Operating Activities:** direct or indirect method
  - ✓ **Reporting Cash Flows from Investing and Financing Activities:** *major classes of gross cash receipts and gross cash payments arising from investing and financing activities should be disclosed.*

Note: Non-cash Transactions: are to be excluded from cash flow statement

3.4 Definitions

Cash: comprises cash on hand and **demand deposits** with banks.

Cash equivalents: short term, highly liquid investments readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows: inflows and outflows of cash and cash equivalents.

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

Investing activities: the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing activities: activities that result in changes in the size and composition of the owners' capital and borrowings of the enterprise.

3.5 Other

3.5.1 Reporting Cash Flows on a Net Basis: [i.e. inflow – outflow]: Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

a. cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise; and
b. cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

3.5.2 Foreign Currency Cash Flows:

a. To be recorded in reporting currency using exchange rate at the date of the cash flow (or a rate that approximates the actual rate).
b. The effect of changes in exchange rates on cash and cash equivalents held in a foreign currency should be reported as a separate part of the reconciliation of the changes in cash and cash equivalents during the period.

3.5.3 Extraordinary Items: should be classified as operating, investing or financing activities as appropriate and separately disclosed.

3.5.4 Interest and Dividends: to be disclosed separately.

In case of financial enterprises: cash flows arising from interest paid and interest received and dividends received → operating activities

In other cases: cash flows arising from interest or dividend paid→ financing activities
interest and dividends received → investing activities.

3.5.5 Taxes on Income: to be separately disclosed and should be classified as operating activities unless specifically identifiable with financing and investing activities.

3.5.6 Acquisitions and Disposals of Subsidiaries and Other Business Units: should be presented separately and classified as investing activities.

3.6 Disclosure:

- the **components** of cash and cash equivalents and a **reconciliation** of the amounts in cash flow statement with the equivalent items reported in the balance sheet.
- *the amount of significant cash and cash equivalent balances held by the enterprise that are **not available for use** by it.*

AS 4: CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

4.1 Mandatory to: all enterprises (since 1-4-1998)

4.2 Deals with: treatment in financial statements of events occurring after the balance sheet date.

4.3 Events occurring after the balance sheet date: significant events, (favourable or unfavourable), that occur between the **balance sheet date** and the date on which the financial statements are approved by the BODs in the case of a company, or, by the corresponding approving authority in the case of any other entity.

4.4 Accounting Standard:

4.4.1 Assets and liabilities should be adjusted if

- Such events provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or
- that indicate that the fundamental accounting assumption of going concern is not appropriate.

4.4.2 Disclosure in the report of the approving authority*****: if such events represent material changes and commitments affecting the financial position of the enterprise. (but condition was not existing on the balance sheet date)

* following information should be provided in disclosure:

a. the nature of the event;

b. an estimate of the financial effect, or a statement that such an estimate cannot be made.

4.5 Note: Dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted.

AS 5: NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES

Applicability: all enterprises (since 1-4-1996) for

- Presenting P&L from ordinary activities, extraordinary items & prior period items in P&L a/c; and
- accounting for changes in accounting estimates, and
- disclosure of changes in accounting policies.

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.

S. no.	Item	Meaning	Treatment
(i)	Ordinary	activities undertaken by an enterprise as part of its business and related activities arising due to these activities.	➢ If these are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.
(ii)	Ordinary but exceptional	activities but are of exceptional size, nature or incidence	Disclose separately in P&L.
(iii)	Extra-ordinary	Arisen from event or transaction that are clearly distinct from the ordinary activities, and not expected to recur frequently or regularly.	➢ The extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. ➢ The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.
(iv)	Prior period items	arise, in the current period as a result of errors or omissions in the preparation of financial statements of one or more prior periods	➢ the disclosure should be such as to clearly show the effects of such items ➢ [it is normally taken as **a item of net profit** of current year or may not be taken]
(v)	**Changes in accounting policies:** should be made only if ➢ the adoption of a different accounting policy 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 presentation of the financial statements of the enterprise.		➢ Material effect in the current period - disclose the effect separately. ➢ If material effect in the current period is not ascertainable- disclose the fact. ➢ If material effect on the following to the current period- disclose the fact.
(vi)	Changes in accounting estimates.		➢ The effect of a change in accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate. ➢ The nature and amount of change in 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.

Note: sometimes it is difficult to distinguish between change in accounting policy and change in accounting estimate. In such cases the change is treated as change in accounting estimate, with appropriate disclosure.

AS 6: DEPRECIATION ACCOUNTING

6.1 Mandatory to: all enterprises (since 1-4-1995)

6.2 Deals with: depreciation accounting and applies to all depreciable assets, except the following:

i. forests, plantations and similar regenerative natural resources;
ii. wasting assets [mines, queries, oil-wells, oilfields etc.]
iii. expenditure on research and development;
iv. goodwill;
v. live stock.
vi. land (however if it has a limited useful life then applicable)

6.3 Depreciation: a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion **(**passing) of time or obsolescence through technology and market changes.

- **Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset**.
- Depreciation includes amortisation of assets whose useful life is predetermined.

6.4 Depreciable amount = historical cost (or amount substituted for historical cost) – estimated residual value.

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

6.5 AMOUNT OF DEPRECIATION

- Depreciation is based on the following three factors:
  - (i) Historical cost (or amount substituted for the historical cost)
  - (ii) Expected useful life of the depreciable asset; and
  - (iii) Estimated residual value of the depreciable asset.
- quantum of depreciation to be provided in an accounting period involves the exercise of judgment by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review.
- Depreciation is charged in each year irrespective of an increase in the market value.

6.6 BASIS FOR COMPUTATION OF DEPRECIATION

- When the statute governing an enterprise provide basis for computation of the depreciation:-
  - If management's estimate for useful life is shorter than that envisaged under the statute, use higher rate of depreciation
  - If the management's estimate for useful life is longer than that envisaged under the statute, lower depreciation rate can be applied only in accordance with requirements of the statute.
- In case change in the historical cost due to change in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors:- revised unamortised depreciable amount and residual useful life of the asset.
- In case **revaluation** (change in estimates): revalued amount and on the estimated remaining useful lives.
- In case revision of estimated useful life: unamortised depreciable amount and revised remaining useful life.

6.7 Depreciable assets: which

- are expected to be used during more than one accounting period; and
- have a limited useful life; and
- are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

6.8 Useful life [is shorter than physical life**]:** may be in period of use or number of production units

1. The useful life should be estimated after considering the following factors:
   - expected physical wear and tear;
   - obsolescence;
   - legal or other limits on the use of the asset.
2. The useful life may be reviewed periodically.

6.9 HISTORICAL COST: money outlay in connection with acquisition of depreciable assets, installation and commissioning as well as for additions to or improvement thereof.
It may undergo subsequent changes arising as a result of increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

6.10 Determination of residual value: [normally a difficult matter]

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

6.11 METHODS OF DEPRECIATION

- Those most commonly employed methods: straight line method and the reducing balance method.
- The management of a business selects the most appropriate method(s) based on various important factors e.g., (i) type of asset, (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business.
- A combination of more than one method is sometimes used.
- In case depreciable assets not have material value, depreciation is often allocated fully in the accounting period of acquisition.

6.12 CHANGE IN METHOD OF DEPRECIATION

- The depreciation method selected should be applied consistently from period to period.
- A change in method should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.
- **In case change in the method of depreciation: depreciation should be recalculated in accordance with the new method from the date of the asset coming into use.**
- The deficiency or surplus arising from retrospective recomputation of depreciation should be adjusted in the accounts in the year in which the method of depreciation is changed, and it is charged or credited to P&L A/c as per the case
- Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

6.13 Any addition or extension (of a capital nature) to an existing asset:-

- If becomes an integral part of the existing asset:- should be depreciated over the remaining useful life of that asset. [may also be provided at the rate applied to the existing asset.]
- If the addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of:- depreciation should be provided independently on the basis of an estimate of its own useful life.

6.14 If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.

6.15 **disclosures:-**

- the historical cost (or amount substituted for historical cost) of each class of depreciable assets;
- total depreciation for the period for each class of assets;
- the related accumulated depreciation.
- depreciation methods used; depreciation rates or the useful lives of the assets, if different from the principal rates specified in the statute.
- In case the revaluation has a material effect on the amount of depreciation, the same is disclosed separately in the year in which revaluation is carried out.
- A change in the method of depreciation is treated as a change in an accounting policy and is disclosed accordingly.

AS 7: CONSTRUCTION CONTRACTS

Applicability: to all enterprises (since 01-04-02)
Deals with: the accounting treatment of revenue and costs associated with construction contracts.

7.3 Definitions

7.3.1 A construction contract: a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

7.3.2 A fixed price contract: in this the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

7.3.4 A cost plus contract: in this the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

7.4 Construction contracts include:
(a) contracts for the rendering of services directly relatable to the construction of the asset [e.g. services of project managers and architects]; and
(b) contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

7.5 Combining and Segmenting Construction Contracts

7.5.1 **contract for construction of a number of assets** (treated as single contract): but the construction of each asset should be treated as a separate construction contract when:

a. separate proposals have been submitted for each asset;
b. each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; **and**
c. the costs and revenues of each asset can be identified.

7.5.2 **A group of contracts**, (with a single customer or several customers) should be treated as a single construction contract when:

a. the group of contracts is negotiated as a single package;
b. the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; **and**
c. the contracts are performed concurrently or in a continuous sequence.

7.5.3 **construction of an additional asset**: should be treated as a separate construction contract when:

a. the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
b. the price of the asset is negotiated without regard to the original contract price.

7.6 Contract Revenue: Contract revenue should comprise:

a. the initial amount of revenue agreed in the contract; and
b. variations in contract work, claims and incentive payments [if can be measured reliably] to the extent that it is probable that they will result in revenue; and

7.7 Contract Costs: Contract costs should comprise:

a. costs directly relatable to the specific contract; [material, labour etc.]
b. costs attributable to contract activity **in general** and can be allocated to the contract [insurance of machinery used in many projects, borrowing cost(A.S.-16)]; and
c. such other costs as specifically chargeable to the customer under the terms of the contract.

Note:

- costs may be reduced by any incidental income (not included in contract revenue), e.g. income from sale of surplus materials and the disposal of plant and equipment at the end of the contract.
- Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract; e.g. selling cost, depreciation on idle plant.
- Cost includes cost incurred in securing the contract if they can be separately identified and measured reliably and it is **probable that the contract will be obtained**.
- When costs incurred in securing a contract are recognised as an expense, they are not included in contract costs when the contract is obtained.

7.8 Recognition of Contract Revenue and Expenses

When the outcome of a construction contract can be **estimated reliably (**percentage of completion method**)**, contract revenue and contract costs should be recognised as revenue and expenses respectively by reference to the **stage of completion*** of the contract activity at the reporting date.

Note:

- *Under this method, contract revenue and cost are recognised as revenue and expenses in the accounting periods in which the work is performed.
- Costs incurred in advance related to future activity on the contract, shall be recognised as an asset (Contract WIP) provided it is probable that they will be recovered.
- In case an uncertainty arisen about the collectability of revenue already recognized, such uncertain amount is recognised as an expense rather than as an adjustment in revenue.
- determination of stage of completion: the followings are the methods for it:
  (a) the proportion of (costs incurred / total cost)
  (b) surveys of work performed; or
  (c) completion of a physical proportion of the contract work.
  Progress payments and advances received from customers may not necessarily reflect the work performed.
- ***in case, the outcome of a construction contract cannot be estimated reliably:***
  (a) revenue should be recognised only to the extent of costs incurred that are expected to be recovered; and
  (b) contract costs should be recognised as an expense in the period in which they are incurred.
- ***When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.***

7.9 When outcome of construction contract can be estimated reliably:-

7.9.1 In the case of a fixed price contract:-:

(a) total contract revenue can be measured reliably;
(b) it is probable that the economic benefits associated with the contract will flow to the enterprise;
(c) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
(d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

7.9.2 In the case of a cost plus contract:-

(a) it is probable that the economic benefits associated with the contract will flow to the enterprise;
(b) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

7.10 Disclosure

An enterprise should disclose:

a. the amount of contract revenue recognised as revenue in the period;
b. the methods used to determine the contract revenue recognized in the period; and
c. the methods used to determine the stage of completion of contracts in progress.

An enterprise should disclose the following for **contracts in progress at the reporting date:**

a. the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;
b. the amount of advances received; and
c. the amount of retentions.

41. An enterprise should present:

a. the gross amount due from customers for contract work as an asset; and
b. the gross amount due to customers for contract work as a liability.

AS 9: REVENUE RECOGNITION

8.1 Applicability: to all enterprises (since 01-04-93)
8.2 Deals with: the bases for recognition of revenue
8.3 Not dealt: revenue arising from:

- (i) construction contracts;
- (ii) Hire-purchase, lease agreements;
- (iii) Government grants and other similar subsidies;
- (iv) insurance contracts to insurance companies.

Note: for the above, special consideration is applied.

8.4 Revenue: the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from

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

Note:

- In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.
- Followings will **not be included** within the definition of "revenue" for the purpose of AS-9:
  - (i) Realised gains from disposal (or unrealized gains from holding) of non-current assets;
  - (ii) Unrealised holding gains from the change in value of current assets;
  - (iii) natural increases in herds (animals) and agricultural and forest products;
  - (iv) Realised or unrealised gains from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;
  - **(v)** Realised gains from the discharge of an obligation; and
  - (vi) Unrealised gains from the restatement of an obligation.

8.5 Key Criterion for Recognition of Revenue:
Revenue recognition is mainly concerned with the timing of recognition of revenue. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

8.5.1 In case of Sale of Goods:

- property in the goods has been transferred to the buyer for a consideration, Or significant risks and rewards of ownership has been transferred to the buyer; and
- seller retains no effective control of ownership of the goods transferred; and
- no significant uncertainty exists regarding the amount of the consideration.

Note: Where stock (like agricultural products) is valued at NRV due to forward contract, and sale has not been taken place, such amount of NRV is sometimes recognized as revenue. (while it is not revenue as per this statement)

8.5.2 in case of Rendering of Services: when the service is performed and no significant uncertainty exists regarding the amount of the consideration.
Performance is measured either:

- **Completed service contract method**: recognises revenue only when the rendering of services under a contract is completed or substantially completed, or
- **Proportionate completion method:** recognises revenue proportionately with the degree of completion of services under a contract. The revenue recognised should be determined on the basis of contract value, associated costs, number of acts or other suitable basis.

8.5.3 In case of Use by Others of Enterprise Resources Yielding Interest, Royalties and

- (i) **Interest:** on the **time proportion basis** determined by the amount outstanding and the rate applicable.
- **(ii) Royalties:** on accrual basis in accordance with the **terms of the relevant agreement**.
- **(iii) Dividends:** when a right to receive payment is established.

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

8.6 Effect of Uncertainties on Revenue Recognition

- In case of postponing of revenue recognition due to uncertainty in ultimate collection of revenue, it should be recognised only when it is reasonably certain that the **ultimate collection will be made**.
- If consideration is not determinable within reasonable limits, the recognition of revenue is postponed.
- When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.
- **When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.**

8.7 Disclosure: circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

For some commercial situation and revenue recognition, read the appendix to the AS-9.

AS 10: ACCOUNTING FOR FIXED ASSETS

10.1 Applicability: to all enterprises (since 01-04-93)

10.2 Deals with: deals with accounting for fixed assets except the followings:

(i) forests, plantations and similar regenerative natural resources;
(ii) wasting assets [mines, queries, oil-wells, oilfields etc.]
(iii) expenditure on real estate development; and
(iv) Livestock.

10.3 Definitions

10.3.1 Fixed asset: an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

10.3.2 Fair market value: the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at **arm's length** who are fully informed and are not under any compulsion to transact.

10.3.3 Gross book value: historical cost or amount substituted for historical cost in the books of account of financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

10.4 Identification of Fixed Assets

- An enterprise may decide to expense an item which could otherwise have been included as fixed asset, because the amount of the expenditure is not material.
- Stand-by equipment and servicing equipment are normally capitalised.
- Machinery spares are usually charged to the P&L a/c when consumed. But when they can be used only in connection with an item of fixed asset and their use is expected to be irregular- their cost should be allocated over a period not exceeding the useful life of the principal item.
- if a single asset consists a number of components which are in practice separable, and estimates are made of the useful lives of these components:- such components may be accounted for as separate fixed assets for improving the accounting. [aircraft and its engines]

10.5 Components of Historical Cost

	purchase price
Add:	import duties and other non-refundable taxes
Add:	any directly attributable cost of bringing the asset to its working condition for its **intended use**;
less:	any trade discounts and rebates

Note:

- The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar factors.
- Borrowing costs (for period up to assets are **ready to be put to use**) are added to the cost of a fixed asset.
- Administration and other general overhead if specifically attributable to the acquisition of a fixed asset may be included as part of the cost of the fixed asset..
- The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalized.
- Expenditures during the period from the date of ready to be put to use to actual date of put to use, are charged to the P&L a/c. However, sometimes treated as deferred revenue expenditure to be amortised over a period not exceeding 3 to 5 years.

10.5.1 Self-constructed Fixed Assets

- costs of construction directly relatable to the specific asset and
- costs attributable to the construction activity in general to be allocated to the specific asset.
- Any internal profits are eliminated in arriving at such costs.

10.5.2 Assets acquired for Non-monetary Consideration

- **For shares or other securities <u>in the enterprise</u>:** usually recorded at its FMV, or the FMV of the securities issued, whichever is more clearly evident.
- **For other assets:** cost is usually determined by reference to the FMV of the consideration given or the FMV of the asset acquired, whichever is more clearly evident.
- An alternative accounting treatment: to record the asset acquired at the net book value of the asset given up. And an adjustment is made for any balancing receipt or payment of cash or other consideration.

10.6 Amount Substituted for Historical Cost [Revaluation]

10.6.1 method of restating fixed assets:

- Appraisal [मूल्य निर्धारण], normally undertaken by competent valuers.
- indexation and reference to current prices [to be crossed checked periodically by appraisal method]

Note:

- Preferably all the assets of a class should be revalued because selective revaluation of assets can lead to unrepresentative amounts being reported in financial statements.
- When revaluations is made on selective basis, selection of assets for revaluation should be made on a systematic basis. E.g.: whole class of assets **within a unit**.
- The Net Book Value of a class of assets (after Revaluation) should not exceed the recoverable amount of the assets of that class.

10.6.2 Presentation of revalued amount: either by

- Restating both the gross book value and accumulated depreciation; or
- Restating the net book value

10.6.3 Accounting Treatment of revaluation:

An upward revaluation → credit to Revaluation Reserve and not credit to P&L a/c
(Revaluation Reserve is not available for distribution)

A Downward Revaluation → charge to P&L a/c

In case of further revaluation:

- If **upward revaluation and previously downward revaluation**: (may be) credit to the P&L a/c to the extent that it offsets the previously recorded decrease in the P&L a/c.
- If **downward revaluation and previously upward revaluation**: (may be) charged to against earlier increase, which was included in Revaluation Reserve.

10.7 Valuation of Fixed Assets in Special Cases

10.7.1 Fixed assets acquired on hire purchase terms: to be recorded at their cash value. Such assets are shown in the balance sheet with an appropriate narration.

10.7.2 Jointly held (not under partnership in a firm) fixed assets:

- proportionate original cost, accumulated depreciation and WDV are stated in the balance sheet.
- Alternatively, the pro rata cost of such assets is grouped together with similar fully owned assets.
- Details of such jointly owned assets are indicated separately in the fixed assets register.

10.7.3 Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers.

10.8 Improvements and Repairs

Expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.

An addition or extension to an existing asset which is of a capital nature:

- If becomes an integral part of the existing asset:- usually added to its gross book value
- If the addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of:- is accounted for separately.

10.9 Retirements and Disposals:

10.9.1 Disposal: An item of fixed asset is eliminated from the financial statements on disposal, and loss/ gains arising on disposal are generally recognized in P&L a/c.

10.9.2 Retirement: Fixed assets retired from active use and held for disposal are stated at the lower of their net book value and NRV and are shown separately in the financial statements. Any expected loss is recognised immediately.

10.9.3 Disposal of a previously revalued fixed asset: Loss should be charged to the Revaluation Reserve to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilized.

10.10 Fixed Assets of Special Types

10.10.1 Goodwill: generally recorded only when some consideration in money or money's worth has been paid for it. However it is written off over a period.

10.10.2 Patents: *The direct costs incurred in developing the patents should be capitalised and written off over their legal term of validity or over their working life, whichever is shorter***.**

10.10.3 Know-how: generally recorded only when some consideration in money or money's worth has been paid for it. Know-how is generally of two types:

- Relating to manufacturing processes: usually expensed in the year in which it is incurred;
- Relating to plans, designs and drawings of buildings or plant and machinery: capitalised under the relevant asset heads.

10.11 Disclosure

- Gross and net book values at beginning and end showing additions, disposals etc.
- Expenditure incurred on fixed assets under construction or acquisition; and
- Revalued amounts, the method adopted for revaluation, the nature of any indices used, the year of any appraisal made, and whether an external valuer was involved.