

GN(A) 6 (Issued 1988)

Guidance Note on Accrual Basis of Accounting

Foreword

The controls to which the corporate system is subject to change from time to time. In the past couple of decades, there has been an increasing use of the corporate system for the purpose of converting in to readily transferable form of ownership of large and complex business enterprises. This evolution has brought about changes in company legislation which have led to the creation of new controls, including reconsideration of accounting procedures. As a result of this development, the presentation of fairest possible periodic net income and the financial position has assumed considerable importance not only for the investors but also for the other interest groups such as creditors, government and the general public. These changes have manifested in the form of a recent amendment in the Indian Companies Act, whereby all companies are now required to maintain their accounts on accrual basis of accounting - a basis of accounting which has long been heralded as the most scientific in the accounting literature.

Since the introduction of the relevant Bill in the Parliament, a need was being felt for a document which could provide guidance on the conceptual and practical aspects of accrual basis of accounting. I am indeed happy to note that the Research Committee rose to the occasion and has brought out this Guidance Note on Accrual Basis of Accounting, soon after the enactment of the Amendment Act.

I am confident that this Guidance Note will be useful to our members in industry and in practice, as well as to those who are otherwise concerned.

September 16, 1988

S.K.Dasgupta
President

Preface

The Companies (Amendment) Act, 1988, amended section 209 of the Companies Act, 1956, requiring all companies to maintain their accounts on accrual basis of accounting. Thus, by placing this basis of accounting on the statute book, the law has recognised that proper income measurement, which represents true economic performance of an entity, can be achieved if efforts and accomplishments of an enterprise are matched - the prime objective of accrual basis of accounting. However, prior to the enactment of the said amendment, as well as subsequent to that also, some misgivings about the application of this basis of accounting have been expressed in certain quarters. It was therefore imperative that some guidance was required for proper understanding of the concept of accrual and its applicability in practice. The Institute of Chartered Accountants of India being the premier accounting body in the country, assumed this responsibility through its Research Committee. The result is this Guidance Note on Accrual Basis of Accounting.

The Guidance Note at the outset explains the concept of accrual as a basis of accounting, particularly, in comparison with the cash basis of accounting. It also deals generally with the matters of recognition of revenue and expenses, assets and liabilities. A section of the Guidance Note is devoted to the concept of materiality vis-a-vis accrual basis of accounting. It also provides guidance to the auditor in case a company has not maintained its accounts on accrual basis. Finally, in the Appendix, illustrations highlighting application of the principles explained in the Guidance Note to certain important commercial situations have been included.

I am indeed indebted to Shri P.N. Shah, past President of the Institute and a member of this Research Committee, who spared his invaluable time in giving this Guidance Note its final shape and form. I am also grateful to other members of the Research Committee for extending full support in bringing out this Guidance Note in a short time.

I hope this Guidance Note will prove to be of immense help to our members in industry as well as to those in practice in discharging their responsibilities.

September 16, 1988

A. H. Dalal
Chairman
Research Committee

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1. INTRODUCTION

1.1 Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. “Accrual” is one of the fundamental accounting assumptions. Para 27 of the Accounting Standard on Disclosure of Accounting Policies (AS-1), issued by the Institute of Chartered Accountants of India (ICAI), provides that if fundamental accounting assumptions, viz., going concern, consistency and accrual are not followed, the fact should be disclosed.

1.2 There are three bases of accounting in use, viz., (i) accrual (ii) cash and (iii) hybrid. The Companies (Amendment) Act, 1988, has amended section 209 of the Companies Act, 1956, with effect from 15th June, 1988, making it obligatory on all companies to maintain their accounts on accrual basis and according to the double entry system of accounting. In view of this amendment all companies will now be required to keep their accounts on accrual basis of accounting, in respect of any accounting year closing on or after 15th June, 1988.

1.3 This guidance note is issued by the Research Committee of the ICAI providing guidance in respect of maintenance of accounts on the accrual basis of accounting.

2. ACCRUAL BASIS OF ACCOUNTING

2.1 The term “Accrual” has been explained in the Accounting Standard on Disclosure of Accounting Policies (AS-1), as under:

“Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate”.

2.2 The Guidance Note on Terms Used in Financial Statements, issued by the Accounting Standards Board of the ICAI, explains ‘Accrual Basis of Accounting’ as under:

“The method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts in the period in which they accrue. The ‘Accrual Basis of Accounting’ includes considerations relating to deferrals, allocations, depreciation and amortisation. This basis is also referred to as ‘Mercantile Basis of Accounting’.”

2.3 Accrual basis of accounting, thus, attempts to record the financial effects of the transactions, events, and circumstances of an enterprises in the period in which they occur rather than recording them in the period(s) in which cash is received or paid by the enterprise. It recognises that the buying, producing, selling and other economic events that affect enterprise's performance often do not coincide with the cash receipts and payments of the period. The goal of accrual basis of accounting is to relate the accomplishments (measured in the form of revenue) and the efforts (measured in terms of cost) so that reported net income measures an enterprise's performance during a period instead of merely listing its cash receipts and payments. Apart from income measurement, accrual basis of accounting recognises assets, liabilities or components of revenues and expenses for amounts received or paid in cash in past, and amounts expected to be received or paid in cash in the future.

2.4 The major difference between accrual accounting and accounting based on cash receipts and outlays, is in timing of recognition of revenues, expenses, gains and losses. Cash receipts in a particular period may largely reflect the effects of activities of the enterprise in the earlier periods, while many of the cash outlays may relate to activities and efforts expected in future periods. Thus, an account showing cash receipts and cash outlays of an enterprise for a short period cannot indicate how much of the cash received is return *of* investment and how much is return *on* investment and thus cannot indicate whether or to what extent an enterprise is successful or unsuccessful.

2.5 The following are the essential features of accrual basis of accounting:

- (i) Revenue is recognised as it is earned.
- (ii) Costs are matched either against revenues so recognised or against the relevant time period to determine periodic income, and
- (iii) Costs which are not charged to income are carried forward and are kept under continuous review. Any cost that appears to have lost its utility or its power to generate future revenue is written-off as a loss.

2.6 The above features of accrual basis of accounting are discussed in the following paragraphs.

3. REVENUE RECOGNITION

3.1 The Accounting Standard on “Revenue Recognition” (AS-9) issued by ICAI deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. This standard lays down rules for recognition of revenue arising in the course of the ordinary activities of the enterprise from (i) sale of goods, (ii) rendering of services, and (iii) use of resources of the enterprise by others yielding interest, royalties and dividends.

3.2 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of service or the use of resources of the enterprise by others it would not be unreasonable to expect ultimate collection.

3.3 An essential criterion for the recognition of revenue is that the consideration receivable from the sale of goods, the rendering of services or from the use by others of resources of the enterprise is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

3.4 When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue for the period in which it is properly recognised according to the principles discussed herein.

3.5 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. It is possible that the uncertainty of collection may be either in respect of the entire transaction or a part thereof. For that part in respect of which there is no uncertainty of collection, the revenue is immediately recognised and for the remaining part the recognition of revenue is postponed. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. It is necessary to disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by installments. 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.

3.6 Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 3.7 and 3.8 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection.

3.7 In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

- (i) The seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
- (ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of goods. Thus, when such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

3.8 In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

3.9 The use of resources of the enterprise by others yielding interest, royalties and dividends is recognised when no significant uncertainty as to measurability or collectability exists. The terms interest, royalties and dividends mean -

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

3.10 The revenues from the above sources are recognised on the following basis:

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

- (ii) Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.
- (iii) Dividends from investments in shares accrue when the owner's right to receive payment is established.

Similar considerations would apply where the resources of the enterprise are used by others and yield revenue such as rent.

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

3.12 The accrual basis of accounting necessitates adjustments for income received in advance as well as for outstanding income at the end of the period of accounting since the receipts during the period may not co-incide with what is properly recognisable as income for the period.

4. RULES FOR EXPENSE RECOGNITION

4.1 The Guidance Note on Terms Used in Financial Statements, explains the term 'Expense' as under:

“A cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period”.

4.2 In the accrual basis of accounting, costs are matched either against revenues or against the relevant time period to determine periodic income. Further, costs which are not charged against income of the period are carried forward. If any particular item of cost has lost its utility or its power to generate future revenue the same is written off as an expense or a loss.

4.3 Under accrual basis of accounting, expenses are recognised by the following approaches:

- (i) *Identification with revenue transactions*

Costs directly associated with the revenue recognised during the relevant period (in respect of which whether money has been paid or not) are considered as expenses and are charged to income for the period.

(ii) *Identification with a period of time*

In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time. Such costs are regarded as 'period costs' and are expensed in the relevant period, e.g., salaries, telephone, traveling, depreciation on office building etc. Similarly, the costs the benefits of which do not clearly extend beyond the accounting period are also charged as expenses.

4.4 Expenses relating to a future period are accounted for as prepaid expenses even though they are paid for in the current accounting period. Similarly, expenses of the current year, for which payment has not yet been made (outstanding expenses) are charged to the profit and loss account for the current accounting period.

4.5 The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:

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

4.6 The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 4.5 is not met, unless the possibility of a loss is remote.

5. RECOGNITION OF ASSETS AND LIABILITIES

5.1 As in the case of revenues and expenses which are recognised under the accrual basis of accounting, as they are earned or incurred (and not as money is received or paid), the transactions related to assets and liabilities are recognised as they occur irrespective of the actual receipts or payments.

6. CONCEPT OF MATERIALITY

6.1 Section 209(3) of the Companies Act, 1956, requires that every company has to keep the books of account in such a manner that they give a 'true and fair' view of its state of affairs and that the books are maintained on the accrual basis of accounting.

6.2 The concept of 'true and fair' view also recognises that the concept of materiality must be given due importance in the preparation and presentation of financial statements. As explained in para 17 of Accounting Standard on 'Disclosure of Accounting Policies' (AS-1), financial statements should disclose all "material" items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements.

6.3 The accrual basis of accounting does not necessarily imply that detailed calculations are required to be made in respect of even the smallest and immaterial amounts of revenue and expenditure and co-relate the same on the basis of the principle of accrual. For example, it may not be improper to write off a small calculator costing Rs. 100 even though it is expected to be used for more than one year.

7. CHANGE IN THE BASIS OF ACCOUNTING

7.1 When an enterprise which was earlier following cash basis of accounting for all or any of its transactions, changes over to the accrual basis of accounting, the effect of the change should be ascertained with reference to the transactions of the previous accounting periods also, to the extent such transactions have an impact on the current financial position of the enterprise. The fact of such change should be disclosed in the financial statements. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made to reflect the effect of such change. Where the effect of the change is not ascertainable, wholly or in part, the fact should be indicated. If the change has no material effect on the financial statements for the current period but is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

8. AUTHORITATIVE PRONOUNCEMENTS OF THE INSTITUTE VIS-A-VIS ACCRUAL ACCOUNTING

8.1 The Council of the ICAI and its various committees have issued various Guidance Notes, Statements and Accounting Standards. The accounting treatments contained in these documents are primarily based on accrual accounting. Thus, adoption of accounting treatments recommended in these documents would ensure that a company has followed accrual basis of accounting. The Appendix to this guidance note contains some special circumstances of recognition of revenue and expenses as dealt with in the aforesaid documents issued by the Institute. The Appendix also contains illustrations of situations where due to uncertainty of collection, revenue recognition may be postponed.

9. AUDITOR'S RESPONSIBILITY

9.1 Where a company has maintained its books of account in a manner that all material transactions are accounted for on accrual basis as discussed above, the auditor should state in his report that, as far as this aspect is concerned, the company has maintained proper books of account as required by law. Where a company has not maintained its books of account in a manner that all material transactions are accounted for on accrual basis as discussed above, the auditor will have to qualify his report or give a negative opinion with regard to the following assertions:

- (a) Whether proper books of account as required by law have been kept by the company.
- (b) Whether the accounts give the information required by this Act in the manner so required and give a true and fair view of:
 - (i) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and
 - (ii) in the case of the profit and loss account, of the profit or loss for its financial year.

Appendix

This Appendix is illustrative only. The purpose of the Appendix is to illustrate the application of the Guidance Note on Accrual Basis of Accounting to some of the important commercial situations.

REVENUE RECOGNITION

1. Sale of Goods

- (i) *Delivery is delayed at buyer's request and buyer takes title and accepts billing*

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

- (ii) *Delivered subject to conditions*

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

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

- (b) *on approval*

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

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

Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of “money back if not completely satisfied” it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment, in which case it should be treated as indicated below.

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

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

(e) Cash on delivery sales

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

(iii) Sales where the purchaser makes a series of installment payments to the seller, and the seller delivers the goods only when the final payment is received

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

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

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

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

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

- (vi) *Sales to intermediate parties i.e. where goods are sold to distributors, dealers or others for resale*

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

- (vii) *Subscriptions for publications*

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

- (viii) *Installments sales*

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

2. Rendering of Services

- (i) *Installation fees*

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

- (ii) *Advertising and Insurance Agency Commissions*

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

(iii) *Financial service commissions*

A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made, or added to a loan or other account and settled in stages. The recognition of such revenue should, therefore, have regard to:

- (a) Whether the service has been provided “once and for all” or is on a “continuing” basis;
- (b) the incidence of the costs relating to the service;
- (c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

(iv) *Admission fees*

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

(v) *Entrance and membership fees*

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

3. Uncertainty of collection

In respect of the following items of revenue, if the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved :

- (i) Claim for escalation of price under a contract.
- (ii) Export incentives due from the Government or any statutory authority.
- (iii) Drawback claims, cash subsidies, benefits of Import Licenses etc. received from the Government or any statutory authority.
- (iv) Interest due or receivable on loans or other dues when the recovery of the amount is in dispute or is doubtful.
- (v) Insurance claim in respect of loss of goods or loss of profits, when the amount receivable is not certain or capable of being determined.

4. Construction contracts

In accounting for construction contracts in financial statements either the percentage of completion method or the completed contract method¹ may be used. When a contractor uses a particular method of accounting for a contract, then the same method should be adopted for all other contracts which meet similar criteria.

LIABILITY FOR EXPENDITURE

Gratuity

Under accrual basis of accounting it is necessary to provide for accruing liability in each accounting period.

¹ Accounting Standard (AS) 7, 'Construction Contracts' (revised) issued by the Institute of Chartered Accountants of India, permits the use of only percentage of completion method for accounting for construction contracts. AS 7 (revised) comes into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature.