ACCOUNTING STANDARD – 1

DISCLOSURE OF ACCOUNTING POLICIES

Purpose: APPLICABLE TO ALL ENTERPRISES
- To facilitate better understanding of financial statements. - To facilitate meaningful comparison between financial statements of different enterprises. - The standard also requires disclosure of changes in accounting policies such that the users can compare financial statements of same enterprise for different accounting periods.

Accounting Policies ***(Vary from enterprise to enterprise)***	- Specific Accounting Principles. - Methods of applying those principles adopted by the enterprise. - In **preparation** & **presentation** of Financial Statements.
Areas Covered (Examples)	- Valuation of Inventories, - Valuation of Investments, - Valuation of Fixed Assets. - Methods of Depreciation etc. - Treatment of Goodwill. - Treatment of retirement benefits. - Treatment of Contingent Liabilities
Consideration in Selection of Accounting Policies	**Primary Consideration** The financial statements prepared & presented on the basis of such accounting policies should represent a **true and fair** view of the state of affairs of the enterprise. **Secondary Consideration** - **PRUDENCE**, - The enterprise should not anticipate profits but should provide for all possible losses. Provision should be created for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

	E.g. Valuing inventory at lower of cost and net realisable value. *E.g. Suppose a company is facing a damage suit. No provision for damages should be recognised by a charge against profit, unless the probability of losing the suit is more than the probability of not losing it.* ⌗ **SUBSTANCE OVER FORM**, - The accounting treatment should be governed by their substance and financial reality and not merely by their legal form. ⌗ **MATERIALITY**, - 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. *E.g. Any item under which the expenses exceed 1 per cent of total revenue of the company or Rs. 100,000, whichever is higher, are shown as a separate and distinct item against appropriate account head in the Profit & Loss Account and are not combined with any other item shown under 'Miscellaneous Expenses'. (Revised Schedule VI of Companies Act, 1956).*
Fundamental Accounting Assumptions (FAA)- GCA	⌗ **GOING CONCERN** - The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has **neither the intention nor the necessary of liquidation** or of curtailing materially the scale of the operations. ⌗ **CONSISTENCY** - It is assumed that accounting policies are consistent from one period to another. The consistency improves comparability of financial statements through time. and ⌗ **ACCRUAL** - Revenues and costs are accrued, i.e., recognized when 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. *Section 209(3)(b) of the Companies Act makes it mandatory for companies to maintain accounts on accrual basis only*. ***These are not specifically stated in the financial statements. Their acceptance and usage is assumed.***

Disclosure	⌘ **All significant accounting policies** adopted in the preparation and presentation of financial statements should be **disclosed**. ⌘ The disclosure should **form part of the financial statements** and **usually at "one place"**. ⌘ Any change in the accounting policies which has a **material effect in the current period** should be disclosed along with amount of effect. ⌘ If **the fundamental accounting assumptions are not followed**, the fact should be disclosed.
Changes in Accounting Policies	⌘ Any change in the accounting policies which has a **material effect in the current period** should be disclosed along with amount of effect. ⌘ If the **amount is not ascertainable** (whether wholly or in part), the fact should be disclosed. ⌘ If there is any **material effect in later period**, the fact should be disclosed.

Notes: Disclosure of Accounting Policies or of its Changes therein ***cannot be a remedy of a wrong or in appropriate treatment of the item*** in the accounts.

P.1(a): One Accounting Policy for all – Is it possible?

Ans: It is not possible to have a single list of accounting policies for all.

The management should choose accounting policy in such a manner, financial statements shall present a "True and Fair View" picture.

P.1(b): Differing Circumstances, Differ Accounting Policies?

Ans: There is no single list of accounting policies which are applicable to all circumstances.

The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable.

The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise.

P.2: When is the Change in Accounting Policy recommended?

Ans: A Change in the Accounting Policy should be made only if adoption of different Accounting Policy is required

- By ***Statute***, or
- For ***Compliance with an AS***, or
- If it is considered that the ***change would result in more appropriate presentation of financial statements***.

P.3: What are the disclosure requirements as to Changes in Accounting Policies?

Ans:

Case	What is to be disclosed?
When the change has material effect in current period	1. The **nature** of change. 2. **Financial effect** of change on items to the period extent ascertainable. 3. Where the **amount is not ascertainable** in wholly or part, **then indicate this fact**.
When the change has material effect in later period(s).	1. The **nature** of change. 2. The **fact that changes** in accounting policies has an effect in later period.

P.4: What are the disclosure requirements as to Fundamental Accounting Assumptions (FAA)?

Ans:

Case	What is to be disclosed?
If All FAA **are** followed.	**No specific disclosure** is required.
If any of FAA is not followed	The **fact** that accounting assumption is not followed **must be disclosed.**

P.5: Zen Ltd. has sold its building for Rs. 10 crores to KRN Ltd. Zen handed over the possession of building to KRN Ltd. The book value of the building is Rs. 5 crores. However, till the end of the financial year, the legal and registration formalities have not been completed. For this reason the company doesn't want to recognize the sale and want to show the amount received as an advance. As an auditor of the company, comment upon the company's intention.

Ans: As per AS-1, Transaction and other events should be measured and presented in accordance with their substance and economic reality and not merely by its form.

Advice – Hence, the company's intention is not correct. Zen Ltd. should recognize the sale and should not treat the amount received as an advance.

P.6: Why the Prudence Concepts in Selection of accounting policies is exercised?

Ans: The exercise of prudence in selection of accounting policies ensure that

1. Profits are not overstated,
2. Losses are not understated,
3. Assets are not overstated and
4. Liabilities are not understated.

The prudence however does not permit creation of hidden reserve by understating profits and assets or by overstating liabilities and losses.

P.7: KRN Ltd. wants to change the method from FIFO to weighted average formula for ascertaining cost of inventory. If the closing inventory by FIFO is Rs. 2 lakh and that by weighted average formula is Rs. 1.8 lakh, State your opinion?

Ans: The change in accounting policy pulls down profit and value of inventory by Rs. 20,000. The company may disclose the change in accounting policy in the following manner:

'The company values its inventory at lower of cost and net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost.

In the present year, the company has changed to weighted average formula, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced profit and value of inventory by Rs. 20,000'.

A change in accounting policy is to be disclosed if the change is reasonably expected to have material effect in future accounting periods, even if the change has no material effect in the current accounting period. An enterprise has to disclose changes in accounting policies in the year of change only.

P.8 When can a company change its accounting policy? (M-2007)

Ans: A change in accounting policy should be made in the following conditions:

(i) If the change is required by some statute or for compliance with an Accounting Standard.

(ii) Change would result in more appropriate presentation of the financial statement.

Change in accounting policy may have a material effect on the items of financial statements. For example, if depreciation method is changed from straight-line method to written-down value method, or if cost formula used for inventory valuation is changed from weighted average to FIFO, or if interest is capitalized which was earlier not in practice, or if proportionate amount of interest is changed to inventory which was earlier not the practice, all these may increase or decrease the net profit.

Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts. Therefore, it is necessary to quantify the effect of change on financial statement items like assets, liabilities, profit / loss.

P.9 What is meant by accounting estimate? Give two examples for accounting estimate. (N-2007)

Ans: As a result of the uncertainties in business activities, many financial statement items cannot be measured with precision but can only be estimated. These are called accounting estimates.

Therefore, the management makes various estimates and assumptions of assets, liabilities, incomes and expenses as on the date of preparation of financial statements. This process of estimation involves judgements based on the latest information available.

Examples of estimation in some fields are:
(i) Estimation of useful life of depreciable assets.
(ii) Estimation of provision to be made for bad and doubtful debts.

P.10 Mention six areas in which different accounting policies are followed by companies. (N-2007)

Ans: Following are the examples of the areas in which different accounting policies may be adopted by different enterprises:

(i) Methods of depreciation, depletion and amortisation.
(ii) Treatment of expenditure during construction.
(iii) Valuation of inventories.
(iv) Treatment of goodwill.
(v) Valuation of investments.
(vi) Valuation of fixed assets.

P.11 List the criteria to be applied for rating an enterprise as Level-I enterprise for the purpose of compliance of Accounting Standards in India. (N-2007)

Ans: Following are the criteria for classifying an enterprise as Level -I enterprise:

1. Enterprises, whose equity or debt securities are listed or is in the process of being listed in India.
2. Banks (including co-operative banks), Insurance companies and Financial Institutions.
3. All commercial, industrial and other business reporting enterprises whose turnover during the previous year is in excess of Rs.50 crores. Here turnover does not include 'other income'.
4. All commercial, industrial and other business reporting enterprises whose total borrowings including public deposits during the accounting year exceeds Rs.10 crores.
5. Holding and subsidiary companies of any of the above enterprises at any time during the accounting year.

CASE STUDIES – DISCLOSURE OF CHANGES IN ACCOUNTING POLICIES

Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in a later period should be disclosed.

In the case of a change in accounting policies, which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

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A simple disclosure that an accounting policy has been changed is not of much use for a reader of a financial statement. The effect of change should therefore be disclosed wherever ascertainable. Suppose a company has switched over to weighted average formula for ascertaining cost of inventory, from the earlier practice of using FIFO. If the closing inventory by FIFO is ` 2 lakh and that by weighted average formula is ` 1.8 lakh, the change in accounting policy pulls down profit and value of inventory by ` 20,000. The company may disclose the change in accounting policy in the following manner:

'The company values its inventory at lower of cost and net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year the company has changed to weighted average formula, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced profit and value of inventory by ` 20,000'. A change in accounting policy is to be disclosed if the change is reasonably expected to have material effect in future accounting periods, even if the change has no material effect in the current accounting period.

The above requirement ensures that all important changes in accounting policies are actually disclosed. Suppose a company makes provision for warranty claims based on estimated costs of materials and labour. The company changed the policy in 2010-11 to include overheads in estimating costs for servicing warranty claims. If value of warranty sales in 2010-11 is not significant, the change in policy will not have any material effect on financial statements of 2010-11. Yet, the company must disclose the change in accounting policy in 2010-11 because the change can affect future accounting periods when value of warranty sales may rise to a significant level. If the disclosure is not made in 2010-11, then no disclosure in future years will be required. This is because an enterprise has to disclose changes in accounting policies in the year of change only.

IMPORTANT NOTES

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