AS -1 Disclosure of Accounting Policies

Objective:

- To enhance the user ability to understand the past and extrapolate in to the near future performance of the organizations.
- To provide meaningful comparison between the financial statements of different enterprises.

Scope:

- Applicability : 1-04-1993
- To whom : All enterprises – mandatory

Accounting policy:

a) **Definition:** these are the accounting principles and methods of applying these principles adopted by the enterprise in th preparation and presentation fo financial statements.

b) There is no single list of accounting policies which are applicable to all enterprises, it vary from organization to organization depending upon their diverse and complex economic activities.

c) The choice of appropriate accounting policies in the specific circumstances of each enterprise calls for considerable judgment by the management.

Accounting policy= accounting principle + Methods applying those principles

Examples for Accounting policies

Method of depreciation --- SLM, WDV

Valuation of Invertories --- FIFO, Weighted Average

Selection of accounting policy

A) Major Criteria:

The policy which we select should give the true and fair view of the state of affairs of the enterprise as on the balance sheet date and of the profit or loss for the period ended that date.

B) Secondary Criteria: the following major considerations needs to be considered

a) **Prudence:** provision is made for all known liabilities even though the amount cannot be determined with certainty and represents only a best estimate, where as profits are recognized only when realized through not necessary in cash.

b) **Substance over form:** The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form. **Ex:** Hire Purchase Agreement

c) **Materiality:** Financial statements should disclose all material items and facts which are sufficient enough to influence the decisions of the users of financial statements.

Fundamental accounting assumptions:

The following are the fundamental accounting assumptions underline the preparation and presentation of financial statements. Disclosure is necessary only when they are not followed.

A) Going concern: The enterprise is normally viewed as going concern for the near foreseeable future.

B) Consistency: it means the same accounting policies are followed from one year to another year.

C) Accrual: It means all the financial statements are prepared based on the mercantile system only.

Disclosure of accounting policy:

To ensure proper understanding of financial statements, it is necessary to disclose all significant accounting policies adopted by the enterprise in the preparation and presentation of financial statements. The following points should be considered.

1) All accounting policies should be drafted in clear and concise manner and disclose at one place only.
2) Any change in accounting policy which has material effect in the current financial statements should be disclosed.
3) Even if that change is not having any effect in current financial statements but reasonably expected to have a material effect in later periods the fact of such change should be disclosed in the period in which such change is adopted.
4) The amount by which any item in the current and future financial statements is affected by such change should also be disclosed to the extent ascertainable.
5) Where such amount is not ascertainable, wholly or in part the fact should be disclosed.

QUICK REVISION

Accounting policy= accounting principle + Methods applying those principles

OBJECTIVE

⇩

- Better Understanding
- Meaningful Comparison

of financial statements

FACTORS TO BE CONSIDERED

Fundamental Accounting Assumptions
- Going Concern
- Consistency
- Accrual

Considerations
- Prudence
- Substance Over form
- materiality

Disclosure
a) All significant accounting policies.
b) Changes and material effect there off.
c) Reasons for non disclosure of fundamental accounting overflows

Practical Questions

1) PRIME Ltd is engaged in the business of financial services and is undergoing tight liquidity position, since most of the assets of the company are blocked in various claim/petitions in a Special Court. PRIME Ltd has accepted Inter-Corporate Deposits (ICDs) and is making its best efforts to settle the dues. There were claims at varied rates of interest from lenders from the due date of ICDs to the date of repayment. The company has provided interest, as per the terms of the contract till the due date and a note for non provision of interest from the due date to date of repayment was affected in the financial statements. On account of uncertainties existing regarding the determination of the amount and in the absence of any specific legal obligation at present as per the terms of contracts, the company considers that these claims are in the nature of "claims against the company not acknowledged as debt," and the same has been disclosed by way of a note in the accounts instead of making a provision in the Statement of profits and loss. Comment on the correctness of the treatment for such claims as done by the company.

Solution:

AS 1 "Disclosure of Accounting Policies" recognizes prudence as one of the major considerations governing the selection and application of accounting policies. In view of the uncertainty attached to future events, profits are not anticipated but recognized only when realized though not necessarily in cash. Provision is made 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.

Further, 'accrual' is one of the fundamental accounting assumptions as per AS 1. Irrespective of the terms of the contract, so long as the principal amount of a loan is not repaid, the lender cannot be placed in a disadvantageous position for nonpayment of interest in respect of claim for interest from the due date to date of repayment of loan.

From the aforesaid, it is apparent that the company should provide for the liability (since it is not waived by the lenders) at an amount estimated or on reasonable basis based on facts and circumstances of each case. Non-provision of the interest from the due date to the date of repayment of loan amounts to violation of accrual basis of accounting.

2) Jagannath Ltd. had made a rights issue of shares in 1996. In the offer document to its members, it had projected a surplus of Rs. 40 crores during the accounting year to end on 31st March, 1998. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of Rs. 10 crores. The board in consultation with the managing director, decided on the following :

(i) Value year-end inventory at works cost (Rs. 50 crores) instead of the hitherto method of valuation of inventory at prime cost (Rs. 30 crores).

(ii) Provide depreciation for the year on straight line basis on account of substantial additions in gross block during the year, instead of on the reducing balance method, which was hitherto adopted. As a consequence, the charge for depreciation at Rs. 27 crores is lower than the amount of Rs. 45 crores which would have been provided had the old method been followed, by Rs. 18 cores.

(iii) Not to provide for "after sales expenses" during the warranty period. Till the last year, provision at 2% of sales used to be made under the concept of "matching of costs against revenue" and actual expenses used to be charged against the provision. The board now decided to account for expenses as and when actually incurred. Sales during the year total to Rs. 600 crores.

(iv) Provide for permanent fall in the value of investments - which fall had taken place over the past five years - the provision being Rs. 10 crores. As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 1997-1998

Answer

As per AS 1 "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 later periods 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. Accordingly, the notes on accounts should properly disclose the change and its effect.

Notes on Accounts :

(i) During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost as was the practice till last year. This has been done to take cognisance of the more capital intensive method of production on account of heavy capital expenditure during the year. As a result of this change, the year-end inventory has been valued at Rs. 50 crores and the profit for the year is increased by Rs. 20 crores.

(ii) In view of the heavy capital intensive method of production introduced during the year, the company has decided to change the method of providing depreciation from reducing balance method to straight line method. As a result of this change, depreciation has been provided at Rs. 27 crores which is lower than the charge which would have been made had the old method and the old rates been applied, by Rs. 18 crores. To that extent, the profit for the year is increased.

(iii) So far, the company has been providing 2% of sales for meeting “after sales expenses during the warranty period. With the improved method of production, the probability of defects occurring in the products has reduced considerably. Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for the year is increased by Rs. 12 crores than would have been the case if the old policy were to continue.

(iv) The company has decided to provide Rs. 10 crores for the permanent fall in the value of investments which has taken place over the period of past five years. the provision so made has reduced the profit disclosed in the accounts by Rs. 10 crores.