

Dr.Babasaheb Ambedkar Open University



DAA **DIPLOMA IN ADVANCE** **ACCOUNTING**

Block

1

Basics of Accounting

Unit -1

Concepts, Conventions and Principles of Accounting **04**

Unit -2

Accounting Standards **11**

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Unit :1: Concepts, Conventions and Principles of Accounting

Introduction :

Accounts are prepared with the main objective keeping track of the financial transactions of the business, to control the day to day business records and ultimately to know the periodic profit or loss of business or its states of affairs. This objective can be fulfilled only when accounts are maintained regularly and following sound financial principals. There are certain concepts, conventions and principles which must be followed for preparing accounts. Entries are made on the basis of these principles. Further the books of accounts must me made in accordance of certain statutes and on the basis of the generally followed accounting rules and regulations. Accounting is a science and certain principles are to be observed, while maintaining books of accounts. Over a period, firm concepts, conventions and principles have developed according to which accountants do their work and prepare records of the financial transactions and events etc. Such concepts, principles help in overall preparation of financial statements.

Structure of the Chapter :

- 1.1 Objectives**
- 1.2 Need For Accounting Concepts Or Principles**
- 1.3 Dual Aspect Concept**
- 1.4 Entity Concept**
- 1.5 Going Concern Concept**
- 1.6 Cost Concept**
- 1.7 Stable Money Value Concept**
- 1.8 Conservatism Concept**
- 1.9 Materiality Concept**
- 1.10 Disclosure Concept**
- 1.11 Periodicity Concept**
- 1.12 Objectivity Concept**
- 1.13 Accrual Concept**
- 1.14 Matching Concept Or Matching Cost With Revenue**
- 1.15 Consistency Concept**
- 1.16 Exercise**

1.1 Objectives :

By the end of this chapter the student will learn about

- Need for different accounting concepts, principles and conventions
- Understanding of different accounting concepts, principles and conventions

1.2 NEED FOR ACCOUNTING CONCEPTS AND PRINCIPLES:

As we discussed in the introduction paragraph about the main objectives of preparing accounts is to provide wide variety of information related to business to different categories of people like owners, creditors, Government etc. it must be prepared on following certain rules and regulations and using certain generally accepted accounting principals. Now a days, accounting information of certain enterprise is not only useful to the owners of that enterprise only but also it is useful to the outsiders may be creditors, bankers etc.

Outside parties like the creditors, bankers, employees, prospective investors and government are paying attention in the accounts of the enterprise. In order to use the accounts for the purpose of comparison with other similar enterprise, it is necessary that the accounts must be prepared on the basis of generally acceptable

accounting principles, concepts and conventions. Another reason is that the person who prepares the accounts and the person who reads them and makes use of them must take the information contained in accounts in the same sense, then only, it will be meaningful. Both the makers of accounts and the readers of accounts must use the same type of principles for better understanding of accounting data.

Now a days, more and more, business enterprises are run in the form of body corporate, whose owners are the shareholders. Shareholder only make investment of their money into the business but otherwise individually they do not take part in the business but still they are interested in knowing the profits of the business and state of financial affairs of the corporate body. Hence fair preparation and presentation of the accounts is necessary for all types of body corporate.

So, from above discussion, we can say that the needs and uses of different accounting concepts, conventions and principles are very wide in preparation of accounts, considering various categories of users. The regulators like Government, Institute of Chartered Accountants of India & Stock Exchanges provide framework and guidelines for the preparation of accounts. They provide the form of financial statements, way or presentation, mandatory information to be included in the accounts, periodicity of financial statements etc.

Accounting Concepts

A number of principles and concepts are used in accounting, some of which are as follows :

A number of principles and concepts are used in accounting, some of which are as follows :

- (1) Dual Aspect Concept
- (2) Separate Existence or Entity Concept.
- (3) Continuity Concept or Going Concern Concept.
- (4) Cost Concept
- (5) Money Value Concept
- (6) Conservatism Concept
- (7) Materiality
- (8) Full Disclosure
- (9) Periodicity Concept
- (10) Objectivity Concept
- (11) Realization Concept
- (12) Accrual Concept
- (13) Matching Concept
- (14) Consistency Concept
- (15) Substance over legal form

1.3 Dual Aspect Concept

This is a very basic concept of accounting on which, the whole process of accounting is based on. According to this concept, every transaction has two effects : one, debit effect and the other credit effect. There can not be any transaction with only single effects.

When wages are paid we used to get the services of an workers, which shows that sort of gain is received, so wages account is debited. Secondly, cash is paid and cash account gives the benefit, so cash account is credited.

The effect of these double effects is that the total of all sums debited is equal to the total of all sums credited. Hence, if balances of all accounts are found out by preparing trial balance and a list of debit and credit balances is prepared, then the total of debit balances and the total of credit balances will always be equal. If it is not equal then it is presumed that there must be some error in preparation of monetary statement. This is the reason why both sides of balance sheet, asset side and liabilities side should get tally.

1.4 Entity Concept

This concept uses the concept of separation between owners and business only for accounting purpose. According to this concept, it is presumed that the business has distinct identity from its proprietor. On the basis of such concept every person even the real owner of the business is also considered as an outsider in the business.

All the transactions of the business are recorded in the books of the business from the view point of the business and not from the point of view of the owner of the business. One can not make transaction with himself and make entries of it. So, the fact that capital is shown as a liability in the balance-sheet of business, shows that business is separate from its owners. The owner becomes the creditor of business when the brings capital in the business. Legally, there is no difference between money in the business and their personal money. They belong to the one and the same person. Here, only for accounting purpose, it will be presumed that the owner is treated as an outsider of the business and transactions are processed accordingly.

In respect of body corporate, it is easy to make out the limits of. 'accounting entity'; The joint stock body corporate itself has a separate legal entity and it is easy to write accounts of this business entity as a body corporate and different from its shareholders. But, in other types of organizations, like sole proprietor firm, where in fact there is no difference in between owner and the business, just for accounting purpose, it will be presumed that both are different.

1.5 Going Concern Concept

In fact this concept should be treated as an assumption rather than a concept. This accounting concept is based on the assumption that in the absence of any evidence to the contrary, the business operations are to be carried on for a very long period in future. So, there is even no prediction about the closure of the business.

This assumption has special effects on the accounts mainly on assets of the business. It is due to this concept, that the fixed assets are usually stated in balance sheet at cost less depreciation and its market value is not taken into account. If accounts are written on the assumption that business is likely to be closed, then the fixed assets will be shown at market value. This will show the sum that will be realized from assets, if business is to be closed. Moreover, provisions for depreciation are also made on this

assumption. This presumption is not normally required to be disclosed in the books of accounts, when it is followed. But, if it is not followed then it is required to be disclosed the fact that while preparing the accounts the supposition of going concern is not followed.

This concept does not suggest that the business will never be closed or that it will continue indefinitely. It only means that the business will continue for a very long time and the time is uncertain.

1.6 Cost Concept

This concept considers the real cost of the assets or services. According to this concept, in accounting all transactions and events are recorded at their real and monetary cost of acquisition. Moreover, accounting should not be affected by the personal views of the people. It means if the asset or service does not cost anything i.e. no money is paid for its acquisition, then such transactions would not be recorded in the books of accounts. All fixed assets like land, building, goodwill, patent, machinery, furniture etc. are shown at their original cost price.

1.7 Stable Money Value Concept :

According to this concept, only such transactions and events which can be expressed in monetary terms are recorded. In other words, transactions and events on which money value cannot be put will not be recorded in books of account even though the event may be extremely important from transaction may be extremely important for the business.

Moreover, under this assumption it is also presumed that the value of money remains stable and it does not change in any circumstances. It is not affected by inflation in the general economy.

1.8 Conservatism Concept :

According to this concept, considered future losses and do not consider future gains. It suggests that the provisions should be made for all losses and expenses but no credits should be taken for revenues and gains.

Here are some instances of use of conservatism in accounts : Assets like stock and investments are shown at cost or market price whichever is lower, Creating investment fluctuation fund, repairs and renewal reserve etc.

1.9 Materiality Concept

According to this concept all material items should be disclosed and it should be disclosed in such a manner so that the reader can perceived the effects of it. So, all the material items should be disclosed, on the basis of which the reader of the financial statement can make decision regarding investments.

Materiality may be considered from two points of view from quantity point of view and quality point of view. In case of quantity point of view, sum of transaction is considered where as from quality point of view, the effect of transaction is considered irrespective of sum involved. An item is considered as material if it is large or sufficient enough to influence the judgment or decision based on accounting reports.

1.10 Disclosure Concept :

According to this concept all significant transactions should be disclosed so that the reader can perceive the effect of it. It is only on the basis of such full disclosure of the business transactions the readers of the such statement can make an informed decision related to business. The term disclosure, however, does not mean that all and full information should be disclosed but it means that a sufficient and enough disclosure of an information which may be of material interest to all concerned parties.

Where any material change has been made preparation and presentation of financial statement then such, the nature of such change should be clearly indicated, e.g. body corporate has changed the technique from straight line to diminishing balance technique of providing depreciation.

The principle of disclosure is very important so that the Companies Act made enough provisions for the full disclosure of information in the Body corporate Accounts. The contents of the Balance Sheet and Profit & Loss Account of a Body corporate are already prescribed in the Schedule VI, Parts I & II of the Indian Companies Act of 1956.

1.11 Periodicity Concept

According to this concept, accounts are prepared and results are derived for some specific time period which may be one year, six months etc. Unless the accounts are started somewhere or closed somewhere, it will be difficult to know the results of the business of some specific period. Though the business is going to carry on for long or uncertain time span, the financial statement showing profit and loss of business is prepared at some specific periodic intervals. The period is generally one year. A profit and loss account is prepared at the end of every year to know the profit or loss of business, which shows the results of year's trading. A balance sheet is also prepared at the end of each such period (of one year), which shows the financial position of business. Generally a period of one year is selected, because it mainly covers all types of seasons. It may be a calendar year from 1st January to 31st December or a financial year starting from 1st April and ending on 31st March or a Vikram Samvat year from 1st of Kartik Sud to Amas of Aso Vad. Various law suggests use of financial year for the purpose of consideration.

1.12 Objectivity Concept :

According to this concept the transactions, accounts and books must be written and supported by some evidences usually vouchers. If objectivity of accounts is to be maintained, they must be written not according to the personal opinion of some person but they must be supported by some evidences and such evidence must be available for the purpose of verification for an outsider. Such evidences mainly includes vouchers and other evidences e.g. If money is paid to someone, there must be a receipt given by the receiver and an accounting entry must be based on that receipt. In certain cases, it may be possible that the evidence or receipts cannot be obtained from persons concerned for small such transaction, e.g. no vouchers can be received for rickshaw charges. In such cases, the firm will prepare the vouchers and the signature of the person who has paid money is received on it. In easy words, the accounts prepared by the accountants must be on the basis of some supportive evidences.

1.13 Accrual Concept :

According to this concept, transaction should be recorded in books of accounts at the time of its accrual and no waiting should be made for the cash receipts. Accrual Concept is also known as mercantile concept. There are two systems of accounting : One, cash system and the other mercantile system or Accrual, System. In cash system, revenue is recognized only when it is received in cash. It is recorded in books of account, at that time only when money is received. But in accrual system, revenue is recognized when it accrues, 'whether received in cash or not. In cash system, expenses are recorded only when they are paid. Usually, businessmen use mercantile system, in which revenue and expenses are recorded, when they are accrued. According to this concept certain year end adjustments are required to be made while preparing Profit and Loss Account. e.g. revenue due but not received, expenses due but not paid.

1.14 Matching Concept or Matching Cost with Revenue

According to this concept, unless the expenses of the year is matched with the revenues of the year, it won't be possible to know the results of the year. When result of year's trading is to be ascertained, then the expenses incurred in order to earn revenue during that period must be recorded (matched) against it. Thus recording expenses against the revenue of a particular period is called 'matching cost with revenue'. During the certain period, when revenue is recognized as being generated, then the expenses or costs incurred in earning that revenue must be debited to it; so that the net income of that period is ascertained. Only revenue expenses of a particular period can be matched with the revenue income of that period to know the profits or the losses of the period.

1.15 Consistency Concept :

According to this concept, accounting policies and principles used in preparation and presentation of financial statements should be consistently followed. If the same accounting principles and procedure are applied consistently from year to year, then accounting statements would be comparable, e.g. It would be improper to value stock-in-trade according to one technique (say FIFO) in one year and according to another technique (say LIFO) in the next year. If any change in principle or technique becomes necessary then such change made and its effect should be clearly stated so that the readers can perceive its effects. If different techniques and methods are used from time to time, the user will have difficulty in comparing the data of two time span.

1.16 Exercise

1. Write a short note on following:

- a. consistency concept
- b. conservatism concept
- c. dual aspect concept
- d. cost concept
- e. periodicity concept
- f. matching concept

Unit : 2 : Accounting Standards

Introduction :

With the attempt to make the accounting work in standardize form, accounting standards are continuously issued by Institute of Chartered Accountants of India. Most of accounting standards are made compulsory for the body corporates under the Companies Act, 1956. A step further now attempt is made for standardization of accounting work at international level. Various business enterprises present their accounts in their own way. While presenting such accounts, certain point would arise for which the opinions of accountants would differ, e.g. of the depreciation techniques, one body corporate may adopt a Straight Line Technique (SLM) and the other body corporate may adopt Reducing Balance Technique. In case of some body corporates the management may try to conceal some important information or may not fully disclose it, hence no useful conclusions can be drawn there from. If there can be understanding among accountants on national or global level on such debatable points and some specific standards of presentation of accounts are fixed, then such chaos may be avoided and uniformity in the presentation of accounts can be achieved. In India at present there are 29 such accounting standard issued by the Institute of Chartered Accountants of India (ICAI).

Structure of the Chapter:

- 2.1 Objectives**
- 2.2 Concept Of Accounting Standards**
- 2.3 Accounting Standards**
- 2.4 Accounting Standard-1 (As 1*) Disclosure Of Accounting Policies**
- 2.5 Accounting Standard - 2 (As 2) Valuation Of Inventories**
- 2.6 Accounting Standard - 3 (As 3) Cash Flow Statements**
- 2.7 ACCOUNTING STANDARD - 4 (AS 4) CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE**
- 2.8 Accounting Standard - 5 (As 5) Net Profit Or Loss For The Period, Prior Period Items And Changes In Accounting Policies**
- 2.9 Accounting Standard - 6 (As 6) Depreciation Accounting**
- 2.10 As - 7 Accounting For Construction Contracts**
- 2.11 Accountings Standard - 9 (As 9) Revenue Recognition**
- 2.12 Accounting Standard (As 10) : Accounting For Fixed Assets**
- 2.13 Accounting Standard 11: Accounting For The Effects Of Changes In Foreign Exchange Rates**
- 2.14 Accounting Standards (As) – 12 Government Grants**
- 2.15 Accounting Standards –13 : Accounting For Investments**
- 2.16 Accounting Standard (As) – 14 Amalgamation**
- 2.17 Accounting Standard - 15 Accounting For Retirement Benefits In The Financial Statements Of Employers**
- 2.18 Accounting Standard (As 16) – Borrowing Costs**
- 2.19 Exercise**

Source of data: The Institute of Chartered Accountants of India is the sole authority to publish Accounting Standards and it has published various Accounting Standards till date, out of which some of such Accounting Standards are reproduced below.

2.1 Objectives:

By the end of the chapter the student will learn about

- Concept of accounting standards
- Various Accounting Standards

2.2 Concept Of Accounting Standards:

The Indian Accounting standards are issued by the Institute of Chartered Accountant of India, regarding the various issues relating to preparation and presentation of financial statements. Accounting Standards are the uniform rules for presentation of financial accounting reports.

2.3 Accounting Standards :

The ICAI has published 29 Accounting Standards so far out of which the following standards are involved in the syllabus :

2.4 Accounting Standard-1(As 1) Disclosure Of Accounting Policies

The following is the text of the Accounting Standard (AS) 1 issued in Nov. 1979 by the Accounting Standards Board, the Institute of Chartered Accountants of India on 'Disclosure of Accounting Policies'. The Standard deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements.

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by body corporates listed on a recognized stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

Introduction

This statement deals With the disclosure" of significant accounting policies followed in preparing and presenting financial statements.

The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation 'and presentation of the financial statements. The accounting policies followed differ from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.

The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by law in some cases.

The Institute of Chartered Accountants of India has, in Statements issued by it, recommended the disclosure of certain accounting policies, e.g., translation policies in respect of foreign currency items.

In recent years, a few enterprises in India have adopted the practice of including in their annual reports to shareholders a separate statement of accounting policies followed in preparing and presenting the financial statements.

In general, however, accounting policies are not at present regularly and fully disclosed in all financial statements. Many enterprises include in the Notes on the Accounts, descriptions of some of the significant accounting policies. But the nature and degree of disclosure vary considerably between the body corporate and the non-body corporate sectors and between units in the same sector.

Even among the few enterprises that presently include in their annual reports a separate statement of accounting policies, considerable variation exists. The statement of accounting policies forms part of accounts in some cases while in others it is given as

supplementary information.

The purpose of this Statement is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the technique in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

Explanation

Fundamental Accounting Assumptions :

Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically, stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

The following have been generally accepted as fundamental accounting assumptions :

a. 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 necessity of liquidation or of curtailing materially the scale of the operations.

b. Consistency

It is assumed that accounting policies are consistent from one period to another.

c. Accrual

Revenues and costs are accrued, that is, recognized as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the period to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this Statement.)

Nature of Accounting Policies :

The accounting policies refer to the specific accounting principles and the techniques of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

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

The various statements of the Institute of Chartered Accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternatives particularly in the case of body corporate enterprises. While continuing efforts in this regard in future are likely to reduce the number still further, the availability of alternative accounting principles and techniques of applying those principles is not likely to be eliminated altogether in view of the differing circumstances faced by the enterprises.

Areas in Which Differing Accounting Policies are Encountered

The following are examples of the areas in which different accounting policies may be adopted by different enterprises.

- Techniques of depreciation, depletion and amortization
- Treatment of expenditure during construction
- Conversion or translation of foreign currency items
- Valuation of inventories
- Treatment of goodwill
- Valuation of investments -
- Treatment of retirement benefits ,
- Recognition of profit on long-term contracts
- Valuation of fixed assets
- Treatment of contingent liabilities.

The above list of examples is not intended to be exhaustive.

Considerations in the Selection of Accounting Policies :

The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended on that date.

For this purpose, the major considerations governing the selection and application of accounting policies are :

a. Prudence

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 sum cannot be determined with certainty and represents only a best estimate in the light of available information.

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.

c. Materiality

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.

Disclosure of Accounting Policies

To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

Such disclosure should form part of the financial statements.

It would be helpful to the reader of financial statements if they are all disclosed as such in one place instead of being scattered over several statements, schedules and notes.

Examples of matters in respect of which disclosure of accounting policies adopted will be required are contained in here. This list of examples is not, however,

intended to be exhaustive.

Any change in an accounting policy which has a material effect should be disclosed. The sum by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such sum is not ascertainable, wholly or in part, 'the fact should be indicated. If a change is made in the accounting policies which -has no material effect on the financial statements for the current period but which 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.

Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

Accounting Standard

All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.

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 sum by which any item in the financial statement is affected by such change should also be disclosed to the extent ascertainable. Where such sum is not ascertainable, wholly or in part, the fact should be indicated.

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.

2.5 Accounting Standard - 2 (As 2) Valuation Of Inventories

The following is the text of the Accounting Standard (AS) 2 issued by the Council of the Institute of Chartered Accountants of India on 'Valuation of Inventories'. The Standard deals with the principles of valuing inventories for financial statements.

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by body corporates listed on a recognized stock exchange and other large commercial, industrial and business enterprises In the public and private sectors.

During' the period the standard is recommendatory, it is the intention that the technique/s of inventory valuation may, as far as possible and practicable, be brought in line with the standard.

Therefore, during the aforesaid period, an auditor in discharging his duties under the Manufacturing and Other Body corporates (Auditor's Report) Order, 1975 issued under Section 227(4A) of the Companies Act 1956, would, while recognizing the importance of the standard, be free to accept other techniques of inventory valuation if they have been consistently followed and if he considers them as being fair and proper and in accordance with the normally accepted accounting principles.

Introduction

Inventories generally constitute the second largest item after fixed assets, in the financial statements, particularly of manufacturing organizations. The value attached to inventories can materially affect the operating results and the financial position. However, different bases of valuing inventories are used by different businesses and even by different undertakings within the same trade or industry.

In formulating the statement, recognition has been given to current practices of inventory valuation and the statement seeks to narrow the differences therein and to ensure adequate disclosure in the financial statements.

This statement does not deal with the technique of ascertaining the quantities on hand and is confined to principles to be considered in computing the value of inventories.

The statement applies to financial statements prepared on historical cost basis. Different considerations would be involved for statements prepared on other bases.

This statement applies to valuation of all inventories except inventories of the following to which special considerations apply :

- (i) Plantations, forestry, agricultural commodities and livestock
- (ii) Extractive industries such as mining, quarrying etc
- (iii) Work-in-progress under long-term contracts, such as engineering, real estate development and construction projects
- (iv) Shares, debentures and other securities held as stock-in-trade
- (v) Immovable properties
- (vi) Loose tools.

Definitions :

The following terms are used in the statement with the meanings specified :

Inventories mean tangible property held

- (i) for sale in the ordinary course of business, or
- (ii) in the process of production for such sale, or
- (iii) for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares.

Historical Cost represents an appropriate combination of the

- (a) cost of purchase;
- (b) cost of conversion; and
- (c) other costs incurred in the normal course of business in bringing the inventories up to their present location and condition.

Cost of Purchase consists of the purchase price including duties and taxes, freight inwards and other expenditure directly attributable to acquisition, less trade discounts, rebates, duty drawbacks and subsidies, in the year in which they are accounted, whether immediate or deferred, in respect of such purchase.

Cost of Conversion consists of

- (i) costs which are specifically attributable to units of production i.e. direct labour, direct expenses and sub-contracted work; and
- (ii) production overheads, ascertained in accordance with either the direct costing or absorption costing technique.

Production overheads exclude expenses which relate to general administration, finance, selling and distribution.

Direct Costing is the technique whereby the cost of inventories is determined to as so include the appropriate share of variable costs only, all fixed costs being charged against revenue in the period in which they are incurred.

Absorption Costing is the technique whereby the cost of inventories is determined so as to include the appropriate share of both variable and fixed costs, the latter being allocated on the basis of normal level of production.

Variable Costs are those costs of production which vary directly, or nearly directly, with the volume of production.

Fixed Costs are those costs of production which by their very nature remain relatively unaffected in a defined period of time by variations in the volume of production.

Net Realizable Value is the actual/estimated selling price in the ordinary course of business, less cost of completion and cost necessarily to be incurred in order to make the sale.

Explanation

Historical Cost as the Basis of Inventory Valuation :

Inventories are held in the expectation of deriving revenue directly or indirectly from their sale or use. In order to determine the results of a business for a given period, it is necessary to carry forward the cost related to inventories until the inventories are sold or consumed. However, if there is no reasonable expectation that net realizable value would cover the cost incurred (as a result, for example, of deterioration, obsolescence or change in demand), it is necessary that cost which cannot be recovered should be charged against the revenue of the current period. Therefore, inventories are normally stated at the lower of historical cost and net realizable value.

Determination of Historical Cost:

Cost Formula used :

Several different formulae with widely different effects are in current use for the purpose of assigning costs, including the following :

- (a) First in first out (FIFO)
- (b) Average cost
- (c) Last in first out (LIFO)
- (d) Base stock
- (e) Specific identification
- (f) Standard cost
- (g) Adjusted selling price (also called retail inventory technique) (h) Latest purchase price.

FIFO, average cost, LIFO, base stock and specific identification formulae use costs that have been incurred by the enterprise at one time or another. Latest purchase price formula uses costs that may not have been incurred for the specific item in inventory and is therefore not based on historical cost.

The base stock formula proceeds on the assumption that a minimum quantity of inventory (base stock) must be held at all times in order to carry on business. Inventories up to this quantity are stated at the cost at which the base stock was acquired. Inventories in excess of the base stock are dealt with on some other basis e.g. any one of the above mentioned formulae. The base stock formula requires a clear existence of the

circumstance that a minimum level of inventory must be held at all times and therefore has a limited application. Most enterprises customarily maintain certain minimum stock level at all times but that is not by itself a justification for use of base stock technique because there must exist clear circumstances to permit use of base stock technique.

The specific identification formula attributes specific costs to identified goods that have been bought or manufactured and are segregated for a specific purpose.

Adjusted selling price (also called retail inventory formula) is used 'widely in retail business or in businesses where the inventory comprises items the individual costs of which are not readily ascertainable.' The historical cost of inventory is estimated by calculating it in the first instance at selling price -and then deducting an sum equal to the estimated gross margin of profit on such stocks. The calculation of the estimated gross margin of profit may be made for individual items or groups of items or by departments, as may be appropriate to the circumstances. This formula is also used by some manufacturing organizations for valuing the inventory of finished products held against forward sale contracts.

Standard cost formula is often used to arrive at historical cost for the purpose of inventory valuation. The use of standard cost for determining the cost of inventories requires that standards are realistic, are reviewed regularly and, where necessary, revised in the light of current conditions and that there exists a proper system of pro-rating significant variances between the cost of sales and the inventories.

Cost of Conversion :

Cost of conversion includes direct labour, direct expenses and production overheads and can be segregated into fixed costs and variable costs. The two main techniques of dealing with fixed costs are direct costing and absorption costing. There is substantial support for use of either of these techniques of inventory valuation.

In applying the absorption costing technique, regard should be had to the normal level of production. The normal level of production depends on the facts of each case having regard to such factors as available capacity of the plant, production achieved in the earlier years and in the current year.

Costs other than production overheads are sometimes incurred in bringing inventories to their present location and condition, for example, expenditure incurred in designing products for specific customers. On the other hand, selling and distribution expenses, general administration overheads, research and development costs and interest are usually considered not to relate to putting the inventories in their present location and condition. They are, therefore, excluded from determining the valuation of inventories.

Valuation of Inventories Below Historical Cost :

The historical cost of inventories may at times not be realized e.g., if their selling prices have significantly declined, or if they become wholly or partially obsolete, or if the quantity of inventories is so large that it is unlikely to be sold/utilized within, the normal turnover period and there exists a genuine risk of physical deterioration, obsolescence or loss or disposal. In such, circumstances, it "becomes necessary to write down the inventory to 'net realizable value', in accordance with the principle of conservatism which requires that current assets should not be carried in the financial statements in excess of sums expected to be realized in the ordinary course of business.

Comparison of the historical-cost and the net realizable value can be made separately in

respect of each item of inventory, or for groups of similar, (or interchangeable) items. However, to compare the aggregate of the net realizable value of all dissimilar and non-interchangeable items in a class of business, or all the inventories of an enterprise on an overall basis, with the aggregate of the cost of all those items is not prudent because it sums to setting off loss against unrealized profit.

Normal quantity of materials and other supplies held for use in production are not written down below historical cost if the finished goods are expected to be sold at or above historical cost.

Inventory of maintenance supplies and consumable stores is ordinarily valued at cost. In appropriate circumstances, this is valued at below cost.

Inventory of by-products is valued at lower of cost and net realizable value. Where cost of the by-product cannot be separately determined, it is valued at net realizable value. Inventory of non-reusable waste is also valued at net realizable value. Inventory of reusable waste is valued on the following basis :

- (i) Where facilities (either in-house or external) exist for reprocessing pf such wastes, and such facilities are being used for reprocessing, the stock of waste is valued at the raw material cost less reprocessing cost,
- (ii) Where reprocessing facilities are not available, the inventory is valued at 'net realizable value'.

In computing the cost of purchase of raw materials consumed and the cost of conversion, the value of by-products and/or-waste is deducted.

Inventories are normally classified in the financial statements as under :

- (i) Raw materials and components
- (ii) Work-in-process
- (iii) Finished goods
- (iv) Stores and spares.

Accounting Standard

For the purpose of comparing historical cost with net realizable value, each item in the inventory may be dealt with separately, or similar items may be dealt with as a group.

The historical cost of inventories should normally be determined by using 'FIFO', 'average cost' or 'LIFO' formulae.

The 'specific identification' technique may be used for inventories of items that are not ordinarily interchangeable, or for goods manufactured and earmarked for a specific purpose.

The 'adjusted selling price' may be used in retail business or in businesses where the inventory comprises items the individual costs of which are not readily ascertainable.

The 'standard cost' technique of valuing inventories may be used if the results approximate consistently the results that would be obtained.

The 'base stock' technique may be used in exceptional circumstances only.

The historical cost of manufactured inventories may be arrived at on the basis of either direct costing or absorption costing. Where absorption costing has been used, the allocation of fixed costs to inventories should be based on the normal level of

production.

Overheads other than production overheads should be involved as part of the inventory cost only to the extent that they clearly relate to putting the inventories in their present location and condition.

I Inventory of consumable stores and maintenance supplies should ordinarily be valued at cost. In appropriate circumstances, however, this may be valued at below cost.

Inventory of by-products should be valued at lower of cost and net realizable value. Where cost of the by-product cannot be separately determined, it should be valued at net realizable value.

Inventory of reusable waste should be valued at raw material cost less reprocessing cost where facilities for reprocessing exist.

Inventory of non-reusable waste or inventory of reusable waste for which facilities for reprocessing do not exist should be valued at net realizable value.

The accounting policy adopted for valuation of inventories, including the cost formulae used, should be disclosed in the financial statements. Where the base stock technique is used, the difference between the value at which it is carried and the value by applying the technique at which stock in excess of the base stock is valued should be disclosed.

Consistency is generally accepted as a fundamental accounting assumption. Therefore, any change in the accounting policy relating to inventories (including the basis of comparison of historical cost with net realizable value and the cost formulae used) 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 policy which has a material effect in the current period, the sum by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such sum is not ascertainable, wholly or in part, the fact should be indicated.

2.6 Accounting Standard - 3 (As 3) Cash Flow Statements

The following is the text of the revised Accounting Standard (AS) 3, 'Cash Flow Statements', issued by the Council of the Institute of Chartered Accountants of India. This Standard supersedes Accounting Standard (AS) 3, 'Changes in Financial Position', issued in June, 1981.

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by body corporates listed on a recognized stock exchange and other commercial, industrial and business enterprises in the public and private sectors.

Objective

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assets the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

The Statement deals with the provision of information about the historical

changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

Scope

An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.

As revised and published in *The Chartered Accountant*, March 1997. The Standard was originally issued in June 1981 and was titled 'Changes in Financial Position'.

Users of an enterprise's financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise's activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial enterprise. Enterprises need cash for essentially the same reasons, however different their, principal revenue producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors.

Benefits of Cash Flow Information :

A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the sums and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

Historical cash flow information is often used as an indicator of the sum, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

Definitions :

The following terms are used in this Statement with the meanings specified :

Cash comprises cash on hand and demand deposits with batiks.

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

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

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

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

Financing activities are activities that result in changes in the size and

composition of the owners' capital (including preference share capital in the case of a body corporate) and borrowings of the enterprise.

Cash and Cash Equivalents

Cash equivalents are held for the purpose of meeting short-term cash commitments- rather than for investment or other purposes. For an investment to qualify as cash equivalent, it must be readily convertible to a known sum of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when -it has a short maturity of, say, three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a body corporate acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the body corporate to repay the sum at maturity).

Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Presentation of a Cash Flow Statement :

The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

An enterprise presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the sum of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

A single transaction may include cash flows that are classified differently. For example, when the installment paid in respect of fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

Operating Activities :

The sum of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are :

- (a) cash receipts from the sale of goods and the rendering of services;
- (b) cash receipts from royalties, fees, commissions and other revenue;
- (c) cash payments to suppliers for goods- and services;
- (d) cash payments to and on behalf of employees;

- (e) cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
- (f) cash payments or refunds of revenue taxes unless they can be specifically identified with financing and investing activities; and
- (g) cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is involved in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

Investing Activities :

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future revenue and cash flows. Examples of cash flows arising from investing activities are :

- (a) cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalized research and development costs and self-constructed fixed assets;
- (b) cash receipts from disposal of fixed assets (including intangibles);
- (c) cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- (d) cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- (e) cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
- (f) cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);
- (g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
- (h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Financing Activities :

The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are :

- (a) cash proceeds from issuing shares or other similar instruments;
- (b) cash proceeds from issuing debentures, loans, notes, bonds and other short or long-term borrowings; and
- (c) cash repayments of sums borrowed.

Reporting Cash Flows from Operating Activities :

An enterprise should report cash flows from operating activities using either :

- (a) *the direct technique, whereby major classes of gross cash receipts and gross cash payments are disclosed; or*
- (b) *the indirect technique, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of revenue or expense associated with investing or financing cash flows.*

The direct technique provides information which may be useful in estimating future cash flows and which is not available under the indirect technique and is, therefore, considered more appropriate than the indirect technique. Under the direct technique, information about major classes of gross cash receipts and gross cash payments may be obtained either :

- (a) from the accounting records of the enterprise; or
- (b) by adjusting sales, cost of sales (interest and similar revenue and interest expense and(similar charges for a financial enterprise) and other items in the statement of profit and loss for :
 - (i) changes during the period in inventories and operating receivables and payables;
 - (ii), other non-cash items; and
 - (iii) other items for which the cash effects are investing or financing cash flows.

Under the indirect technique, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of :

- (a) changes during the period in inventories and operating receivables and payables;
- (b) non-cash items such as depreciation, provisions, deferred taxes, and unrealized foreign exchange gains and losses; and
- (c) all other items for which the cash effects are investing or financing cash

flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect technique by showing the operating revenues and expenses excluding non-cash items disclosed in the statement of profit and loss and the change during the period in inventories and operating receivables and payables.

Reporting Cash Flows from Investing and Financing Activities

An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows describe, are reported on a net basis.

Reporting Cash Flows on a Net Basis :

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 sums are large, and the maturities are short.*

examples of cash receipts and payments referred to in paragraph 22(a) are :

- (a) the acceptance and repayment of demand deposits by a bank;
- (b) funds held for customers by an investment enterprise; and
- (c) rents collected on behalf of, and paid over to, the owners of properties.

Examples of cash receipts and payments referred to in paragraph 22(b) are advances made for, and the repayment of :

- (a) principal sums relating to credit and customers;
- (b) the purchase and sale of investments; and
- (c) other short-term borrowings, for example, those which have a maturity period of three months or less.

Cash flows arising from each of the following activities of a financial 'enterprise may be reported on a net basis :

- (a) *cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;*
- (b) *the placement of deposits with and withdrawal of deposits from other financial enterprises; and*
- (c) *cash advances and loans made to customers and the repayment of those advances and loans.*

Cash flows arising from transactions in a foreign currency should be recorded in an enterprise's reporting currency by applying to the foreign currency sum the exchange rate between the reporting currency and the foreign currency at the date of the cash flow. A rate that approximates the actual rate may be used if the result is substantially the same as would arise if the rates at the dates of the cash flows were used. 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.

Cash flows denominated in foreign currency are reported in a manner consistent with Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates. This permits the use of an exchange rate that approximates the actual rate. For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions.

Unrealized gains and losses arising from changes in foreign exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This sum is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end-of-period exchange rates.

Extraordinary Items :

The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed.

The cash flows associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the cash flow statement, to enable users to understand their nature and effect on the present and future cash flows of the enterprise. These disclosures are in addition to the separate disclosures of the nature and sum of extraordinary items required by Accounting Standard (AS) 5. Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Interest and Dividends :

Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

The total sum of interest paid during the period is disclosed in the cash flow statement whether it has been recognized as an expense in the statement of profit and loss or capitalized in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

Interest paid and interest and dividends received are usually classified as operating cash flows for a financial enterprise. However, there is no consensus on the classification of these cash flows for other enterprises. Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of net profit or loss. However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash flows and investing cash flows respectively, because they are cost of obtaining financial resources or returns on investments.

Some argue that dividends paid may be classified as a component of cash flows

from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows. However, it is considered more appropriate that dividends paid should be classified as cash flows from financing activities because they are cost of obtaining financial resources.

Taxes on Revenue :

Cash flows arising from taxes on revenue should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Taxes on revenue arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a cash flow statement. While tax expenses may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transactions. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flow are allocated over more than one class of activity, the total sum of taxes paid is disclosed.

Investments in Subsidiaries, Associates and Joint Ventures :

When accounting for an investment in an associate or a subsidiary or a joint venture, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee/joint venture, for example, cash flows relating to dividends and advances.

Acquisition and Disposals of Subsidiaries and other Business Units :

The aggregate cash flows arising from acquisition and from disposals of subsidiaries or other business units should be presented separately and classified as investing activities.

An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following :

- (a) *the total purchase or disposal consideration; and*
- (b) *the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.*

The separate presentation of the cash flow effects of acquisitions and disposals of subsidiaries and other business units as single line items helps to distinguish those cash flows from other cash flows. The cash flow effects of disposals are not deducted from those of acquisitions.

Non-cash Transactions :

Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an enterprise. The exclusion of non-cash transactions from the cash flow statement is consistent with

objective of a cash flow statement as these items do not involve cash flows in the current period.

Examples of non-cash transactions are :

- (a) the acquisition of assets by assuming directly related liabilities;
- (b) the acquisition of an enterprise by means of issue of shares; and
- (c) the conversion of debt to equity.

Components of Cash and Cash Equivalents :

An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the sums in its cash flow statement with the equivalent items reported in the balance sheet.

In view of the variety of cash management practices, an enterprise discloses the policy which it adopts in determining the composition of cash and cash equivalents.

The effect of any change in the policy for determining components of cash and cash equivalents is reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Other Disclosures :

An enterprise should disclose, together with a commentary by management, the sum of significant cash and cash equivalent balances held by the enterprise that are not available for use by it.

There are various circumstances in which cash and cash equivalent balances held by an enterprise are not available for use by it. Examples include cash and cash equivalent balances held by a branch of the enterprise that operates in a country where exchange controls or other legal restrictions apply as a result of which the balances are not available for use by the enterprise.

Additional information may be relevant to users in understanding the financial position and liquidity of an enterprise. Disclosure of this information, together with a commentary by management, is encouraged and may include:

- (a) the sum of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and
- (b) the aggregate sum of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity.

The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the enterprise is investing adequately in the maintenance of its operating capacity. An enterprise that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

2.7 ACCOUNTING STANDARD - 4 (AS 4) CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

The following is the text of the revised Accounting Standard (AS) 4,

'Contingencies and Events Occurring after the Balance Sheet Date', issued by the Council of the Institute of Chartered Accountants of India.

This revised standard comes into effect in respect of accounting periods commencing on or after 1-4-1995 and is mandatory in nature. It is clarified that in respect of accounting periods commencing on a date prior to 1-4-1995, Accounting Standard 4 as originally issued in November 1982 (and subsequently made mandatory) applies.

Introduction

This Statement deals with the treatment in financial statements of

- (a) contingencies, and
- (b) events occurring after the balance sheet date.

The following subjects, which may result in contingencies, are excluded from the scope of this Statement in view of special considerations applicable to them :

- (a) liabilities of life assurance and general insurance enterprises arising from policies issued;
- (b) obligations under retirement benefit plans; and
- (c) commitments arising from long-term lease contracts.

Definitions :

The following terms are used in this Statement with the meanings specified :

A *contingency* is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the

As revised and published in *The Chartered Accountant*, April 1995. The Standard was originally issued in November 1982.

occurrence, or non-occurrence, of one or more uncertain future events.

Events occurring after the balance sheet date are those significant events, both favorable and unfavorable, that occur between the balance 'sheet date and the date on which the financial statements are approved _ by the Board of Directors in the case of a body corporate, and, by the corresponding approving authority in the case of any other entity. Two types of events can be identified :

- (a) those which provide further evidence of conditions that existed at 'the balance sheet date; and
- (b) those which are indicative of conditions that arose subsequent to the balance sheet date.

Explanation

Contingencies :

The term "contingencies" used in this Statement is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.

Estimates are required for determining the sums to be stated in the financial

statements for many on-going and recurring activities of an enterprise. One must, however, distinguish between an event which is certain and one which is uncertain. The fact that an estimate is involved does not, of itself, create the type of uncertainty which characterizes a contingency. For example, the fact that estimates of useful life are used to determine depreciation, does not make depreciation a contingency; the eventual expiry of the useful life of the asset is not uncertain. Also, sums owed for services received are not contingencies as defined, even though the sums may have been estimated, as there is nothing uncertain about the fact that these obligations have been incurred.

The uncertainty relating to future events can be expressed by a range of outcomes. This range may be presented as quantified probabilities, but in most circumstances, this suggests a level of precision that is not supported by the available information. The possible outcomes can, therefore, usually be generally described except where reasonable quantification is practicable.

The estimates of the outcome and of the financial effect of contingencies are determined by the judgment of the management of the enterprise. This judgment is based on consideration of information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

Accounting Treatment of Contingent Losses :

The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result, in a loss to the enterprise, then it is prudent to provide for that loss in the 'financial statements.

The estimation of the sum of a contingent loss to be provided for in the financial statements may be based on information referred.

If there is conflicting or insufficient evidence for estimating the sum of a contingent loss, then disclosure is made of the existence and nature of the contingency.

A potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the sum of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists. Suitable disclosure regarding the nature and gross sum of the contingent liability is also made.

The existence and sum of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.

Provisions for contingencies are not made in respect of general or unspecified business risks since they do not relate to conditions or situations existing at the balance sheet date.

Accounting Treatment of Contingent Gains :

Contingent gains are not recognized in financial statements since their recognition may result in the recognition of revenue which may never be realized. However, when the realization of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

Determination of the Sums at which Contingencies are involved in Financial Statements :

The sum at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are approved. Events occurring after the balance sheet date that indicate that an asset may have been impaired, or that a liability may have existed, at the balance sheet date are, therefore, taken into account in identifying contingencies and in determining the sums at which such contingencies are involved in financial statements.

In some cases, each contingency can be separately identified, and the special circumstances of each situation considered in the determination of the sum of the contingency. A substantial legal claim against the enterprise may represent such a contingency. Among the factors taken into account by management in evaluating such a contingency are the progress of the claim at the date on which the financial statements are approved, the opinions, wherever necessary, of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations.

If the uncertainties which created a contingency in respect of an individual transaction are common to a large number of similar transactions, then the sum of the contingency need not be individually determined, but may be based on the group of similar transactions. An example of such contingencies may be the estimated uncollectible portion of accounts receivable. Another example of such contingencies may be the warranties for products sold. These costs are usually incurred frequently and experience provides a means by which the sum of the liability or loss can be estimated with reasonable precision although the particular transactions that may result in a liability or a loss are not identified. Provision for these costs results in their recognition in the same accounting period in which the related transactions took place.

Events Occurring after the Balance Sheet Date :

Events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.

Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the sums relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not normally relate to the condition of the investments at the balance sheet date, but reflect circumstances which have occurred in the following period.

Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make

proper evaluations and decisions.

There are events which, although they take place after the balance sheet date, are, sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the sum of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements.

Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the balance sheet date (e.g., destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements.

Disclosure :

The disclosure requirements herein referred to apply only in respect of those contingencies or events which affect the financial position to a material extent.

If a contingent loss is not provided for, its nature and an estimate of its financial effect are generally disclosed by way of note unless the possibility of a loss is remote. If a reliable estimate of the financial effect cannot be made, this fact is disclosed.

When the events occurring after the balance sheet date are disclosed in the report of the approving authority, the information given comprises the nature of the events and an estimate of their financial effects or a statement that such an estimate cannot be made.

Accounting Standard

Contingencies :

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

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

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

Contingent gains should not be recognized in the financial statements.

Events Occurring after the Balance Sheet Date :

Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of sum relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

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.

Disclosure should be made in the report of the approving authority of those events

occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise.

Disclosure :

If disclosure of contingencies is required by this Statement, the following information should be provided :

- (a) *the nature of the contingency;*
- (b) *the uncertainties which may affect the future outcome;*
- (c) *an estimate of the financial effect, or a statement that such an estimate cannot be made.*

If disclosure of events occurring after the balance sheet date in the report of the approving authority is required by this Statement, the following information should be provided :

- (a) *the nature of the event;*
- (b) *an estimate of the financial effect, or a statement that such an estimate cannot be made.*

2.8 Accounting Standard - 5 (AS 5) Net Profit Or Loss For The Period, Prior Period Items And Changes In Accounting Policies

The following is the text of the revised Accounting Standard (AS) 5, 'Net -Profit or Loss for the Period, -Prior- Period Items and Changes in Accounting Policies', issued by the Council of the Institute of Chartered Accountants of India.

This revised standard comes into effect in respect of accounting periods commencing on or after 1-4-1996 and is mandatory in nature. It is clarified that in respect of accounting periods commencing on a date prior to 1-4-1996, Accounting Standard 5 as originally issued in November, 1982 (and subsequently made mandatory) will apply.

Objective :

The objective of this Statement is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Statement requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

Scope :

This Statement should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.

This Statement deals with, among other matters, the disclosure of certain items

of net profit or loss for the period. These disclosures are made in addition to any other disclosures required by other Accounting Standards.

This Statement does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Definitions

The following terms are used in this Statement with the meanings specified :

Ordinary activities: are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.

Extraordinary items are revenue or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. Prior period items are revenue or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Accounting policies are the specific accounting principles and the techniques of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Net Profit Or Loss For The Period

All items of revenue and expense which are recognized in a period should be involved in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

Normally, all items of revenue and expense which are recognized in a period are involved in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates.

The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss :

(a) profit or loss from ordinary activities; and

(b) extraordinary items. Extraordinary Items :

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 sum 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.

Virtually all items of revenue and expense involved in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item.

Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as

a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

Examples of events or transactions that generally give rise to extraordinary items for most enterprises are :

- attachment of property of the enterprise; or
- an earthquake.

Profit or Loss from Ordinary Activities :

When items of revenue and expense within profit or loss from ordinary activities 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 sum of such items should be disclosed separately.

Although the items of revenue and expense described in paragraph 12 are not extraordinary items, the nature and sum of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Disclosure of such information is sometimes made in the notes to the financial statements.

Circumstances which may give rise to the separate disclosure of items of revenue and expense in accordance with paragraph 12 include :

- (a) the write-down of inventories to net realizable value as well as the reversal of such write-downs;
- (b) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;
- (c) disposals of items of fixed assets;
- (d) disposals of long-term investments;
- (e) legislative changes having retrospective application;
- (f) litigation settlements; and
- (g) other reversals of provisions.

Prior Period Items :

The nature and sum of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

The term 'prior period items', as defined in this Statement, refers only to revenue or expenses which arise 'in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods are determined in the current period, e.g., arrears payable to workers as a result of revision of wages with retrospective effect during the current period.

Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight.

Prior period items are generally infrequent in nature and can be distinguished

from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, revenue or expense recognized on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

Prior period items are normally involved in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

Changes in Accounting Estimates :

As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. Estimates may be required, for example, of bad debts, inventory obsolescence or the useful lives of depreciable assets. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

Sometimes, it is difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

The effect of a change in an accounting estimate should be involved in the determination of net profit or loss in :

- (a) *the period of the change, if the change affects the period only; or*
- (b) *the period of the change and future periods, if the change affects both.*

A change in an accounting estimate may affect the current period only or both the current period and future periods. For example, a change in the estimate of the sum of bad debts is recognized immediately and therefore affects only the current period. However, a change in the estimated useful life of a depreciable asset affects the depreciation in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognized as revenue or expense in the current period. The effect, if any, on future periods, is recognized in future periods.

The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously involved in the profit or loss from ordinary activities is involved in that component of net profit or loss. The effect of a change in an accounting estimate that was previously involved as an extraordinary item is reported as an extraordinary item.

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

disclosed.

Changes In Accounting Policies

Users need to be able to compare the financial statements of an enterprise over a period of time in order to identify trends in its financial position, performance and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

A change in an accounting policy 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.

A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise.

The following are not changes in accounting policies :

- (a) the adoption of an accounting policy for events or transactions that differ in 'substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement; and
- (b) the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

Any change in an accounting policy which has a material effect should be disclosed. 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 such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which 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.

2.9 Accounting Standard - 6 (As 6) Depreciation Accounting

The following is the text of the revised Accounting Standard (AS) 6, 'Depreciation Accounting', issued by the Council of the Institute of Chartered Accountants of India.

Introduction

This Statement deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply :

- (i) forests, plantations and similar regenerative natural resources;
- (ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;
- (iii) expenditure on research and development;
- (iv) goodwill;

(v) live stock.

This statement also does not apply to land unless it has a limited useful life for the enterprise.

Different accounting policies for depreciation are adopted by different enterprises. Disclosure of accounting policies for depreciation followed by an enterprise is necessary to appreciate the view presented in the financial statements of the enterprise.

Definitions :

The following terms are used in this Statement with the meaning specified :

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable sum in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose useful life is predetermined.

Revised in August 1994. This revised Accounting Standard is mandatory in respect of accounts for periods commencing on or after 1-4-1995.

Depreciable assets are assets which

- (i) are expected to be used during more than one accounting period;
- and
- (ii) have a limited useful life; and
- (iii) 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.

Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

Depreciable sum of a depreciable asset is its historical cost, or other sum substituted for historical cost in the financial statements, less the estimated residual value.

Explanation

Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable sum, irrespective of an increase in the market value of the assets.

Assessment of depreciation and the sum to be charged in respect thereof in an accounting period are usually based on the following three factors :

- (i) historical cost or other sum substituted for the historical cost of the depreciable asset when the asset has been revalued;
- (ii) expected useful life of the depreciable asset; and
- (iii) estimated residual value of the depreciable asset.

Historical cost of a depreciable asset represents its money outlay or its equivalent in

connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof. The historical cost of a depreciable asset 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.

The useful life of a depreciable asset is shorter than its physical life and is:

- (i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;
- (ii) directly governed by extraction or consumption;

This statement does not deal with the treatment of the revaluation difference which may arise when historical costs are substituted by revaluations.

- (iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and
- (iv) reduced by obsolescence arising from such factors as :
 - (a) technological changes;
 - (b) improvement in production techniques;
 - (c) change in market demand for the product or service output of the asset; or
 - (d) legal or other restrictions.

Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.

Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful "life

Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value 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 realizable 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.

The 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. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortized depreciable sum of the asset is charged to revenue over the revised remaining useful life.

There are several techniques of allocating depreciation over the useful life of the

assets. Those most commonly employed in industrial and commercial enterprises are the straightline technique and the reducing balance technique. The management of a business selects the most appropriate technique(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 technique is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired.

The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.

Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, is disclosed separately.

The technique of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one technique of providing depreciation to another is made only if the adoption of the new technique 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. When such a change in the technique of depreciation is made, depreciation is recalculated in accordance with the new technique from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new technique is adjusted in the accounts in the year in which the technique of depreciation is changed. In case the change in the technique results in deficiency in depreciation in respect of past years, the deficiency is charged in the statement of profit and loss. In case the change in the technique results in surplus, the surplus is credited to the statement of profit and loss. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

Where the historical cost of an asset has undergone a change due to circumstances specified in above, the depreciation on the revised unamortized depreciable sum is provided prospectively over the residual useful life of the asset.

Disclosure :

The depreciation techniques used, the total depreciation for the period for each class of assets, the gross sum of each class of depreciable assets and the related accumulated depreciation are disclosed in the financial statements alongwith the disclosure of other accounting policies. The depreciation rates or the useful lives of the assets are disclosed only if they are different from the principal rates specified in, the statute governing the enterprise.

In case the depreciable assets are revalued, the provision for depreciation is based on the revalued sum on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect on the sum of depreciation, the same is disclosed separately in the year in which revaluation is carried out.

A change in the technique of depreciation is treated as a change in an accounting policy and is disclosed accordingly.

Accounting Standard

The depreciable sum of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

The depreciation technique selected should be applied consistently from period to period. A change from one technique of providing depreciation to another should be made only if the adoption of the new technique 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. When such a change in the technique of depreciation is made, depreciation should be recalculated in accordance with the new technique from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new technique should be adjusted in the accounts in the year in which the technique of depreciation is changed. In case the change in the technique results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the technique results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

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

- (i) expected physical wear and tear;
- (ii) obsolescence;
- (iii) legal or other limits on the use of the asset.

The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortized depreciable sum should be charged over the revised remaining useful life.

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

Where the historical cost of a depreciable asset has undergone a change due to increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors, the depreciation on the revised unamortized depreciable sum should be provided prospectively over the residual useful life of the asset.

Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued sum and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the sum of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.

If any depreciable asset is disposed of, discarded, demolished or destroyed, the

net surplus or deficiency, if material, should be disclosed separately.

The following information should be disclosed in the financial statements :

- (i) the historical cost or other sum substituted for historical cost of each class of depreciable assets;
- (ii) total depreciation for the period for each class of asset; and
- (iii) the related accumulated depreciation.

The following information should also be disclosed in the financial statements along with the disclosure of other accounting policies :

- (i) depreciation techniques used; and
- (ii) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

2.10 As – 7 Accounting For Construction Contracts

The following is the text of the Accounting Standard 7(AS-7) issued by the Institute of Chartered Accountants of India on "Accounting for Construction Contracts". The Standard deals with accounting for construction contracts in the financial statements of contractors.

In the initial years, this Accounting Standard will be recommendatory in character. During this period, this standard is recommended for use by body corporates listed on a recognized stock exchange and other large commercial, industrial and business enterprise in the public and private sectors.

Introduction

This Statement deals with accounting for construction contracts in the financial statements of enterprises undertaking such contracts (hereafter referred to as 'Contractors'). The Statement also applies to enterprises undertaking construction activities of the type dealt with in this Statement not as contractors but on their own accounts as a venture of a commercial nature where the enterprise has entered into agreements for sale.

The feature which characterizes a construction contract dealt with in this Statement is the fact that the date at which the contract is secured and the date when the contract activity is completed fall into different accounting periods. The specific duration of the contract performance is not used as a distinguishing feature of a construction contract. Accounting for such contracts is essentially a process of measuring the results of relatively long-term events and allocating those results to relatively short-term accounting periods.

For the purposes of this Statement a construction contract is a contract for the construction of an asset or of a combination of assets which together constitute a single project. Examples of activity covered by such contracts include the construction of bridges, dams, ships, buildings and complex pieces of equipment.

extent that they are directly related to a contract for the construction of an asset. Examples of such service contracts are contracts for the services of project managers and architects and for technical engineering services related to the construction of an asset.

Explanation

The principle problem relating to accounting for construction contracts is the allocation of revenues and related costs to accounting periods over the duration of the contract.

Types of Construction Contracts

Construction contracts are formulated in a variety of ways but generally fall into two basic types :

- (i) fixed price contracts – the contractor agrees to a fixed contract price or rate, in some cases subject to cost escalation clauses;
- (ii) Cost plus contracts – the contractor is reimbursed for allowable or otherwise defined costs, and is also allowed a percentage of these of this Statement.

Accounting Treatment of Construction Contract Costs and Revenues

Two techniques of accounting for contracts commonly followed by contractors are the percentage of completion technique and the completed contract technique.

Under the percentage of completion technique, revenue is recognized as the contract activity progresses based on the stage of completion reached. The costs incurred in reaching the stage of completion are matched with this revenue, resulting in the reporting of results which can be attributed to the proportion of work completed. Although (as per the principle of 'prudence') revenue is recognized only when realized, under this technique, the revenue is recognized as the activity progresses even though in certain circumstances it may not be realized.

Under the completed contract technique, revenue is recognized only when the contract is completed or substantially completed; that is, when only minor work is expected other than warranty obligation. Costs and progress payments received are accumulated during the course of the contract but revenue is not recognized until the contract activity is substantially completed.

Under both techniques, provision is made for losses for the stage of completion reached on the contract. In addition, provision is usually made for losses on the remainder of the contract.

It may be necessary for accounting purposes to combine contracts made with a single customer or to combine contracts made with several customers if the contracts are negotiated as a package or if the contracts are for a single project. Conversely, if a contract covers a number of projects and if the costs and revenues of such individual projects can be identified within the terms of the overall contract, each such project may be treated as equivalent to a separate contract.

Costs to be Accumulated for Construction Contracts

Costs attributable to a contract are identified with reference to the period that commences with the securing of the contract and closes when the contract is completed.

Costs not specially attributable to any contract incurred by the contractor before a contract is secured are usually treated as expenses of the period in which they are incurred. However, if costs attributable to securing the contract can be separately identified and either the contract has been secured or there is a clear indication that the contract will be obtained the costs are sometimes treated as applicable to the contract and are deferred. As a practical measure, costs directly identifiable with a contract are sometimes deferred until it is clear whether the contract has been secured or not.

Costs attributable to a contract include expected warranty costs. Warranty costs are provided for when such costs can be reasonably estimated.

Costs incurred by a contractor can be divided into :

- (i) Costs that related directly to a specific contract;
- (ii) Costs that can be attributed to the contract activity in general and can be allocated to specific contracts;
- (iii) Costs that relate to the activities of the contractor generally, or that relate to contract activity but cannot be related to specific contracts.

Examples of costs that relate directly to a specific contract include :

- (i) site labour costs, including supervision;
- (ii) materials used for project construction;
- (iii) depreciation of plant and equipment required for a contract;
- (iv) cost of moving plant and equipment to and from site.

Examples of costs that can be attributed to the contract activity in general and can be allocated to specific contracts include :

- (i) insurance;
- (ii) design and technical assistance;
- (iii) construction overheads.

Examples of costs that related to the activities of the contractor generally or that relate to contract activity but cannot be related to specific contracts, include;

- (i) general administration and selling costs;
- (ii) finance costs;
- (iii) research and development costs;
- (iv) depreciation of plant and equipment that cannot be allocated to a particular contract.

Costs referred to in above, are usually excluded from the accumulated contract costs because they do no relate to reaching the present stage of completion of a specific contract. However, in some circumstance general administrative expenses, development costs and finance costs are specifically attributable to a particular contract and are

sometimes involved as part of accumulated contract costs.
Basic for Recognizing Revenue on Construction Contracts

Percentage Of Completion Technique

Under the percentage of completion technique, the amount of revenue recognized is determined by reference to the stage of completion of the contract activity at the end of each accounting period. The advantage of this technique of accounting for contract revenue is that it reflects revenue in the accounting period during which activity is undertaken to earn such revenue.

The stage of completion used to determine revenue to be recognized in the financial statements is measured in an appropriate manner. For this purpose no special weightage should be given to a single factor; instead, all relevant factors should be taken into consideration; for example, the proportion that costs incurred to date bear to the estimated total costs of the contract, by the surveys which measure work performed and completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the stage of completion and therefore, cannot usually be treated as equivalent to revenue earned.

If the percentage of completion technique is applied by calculating the proportion that costs to date bear to the latest estimated total costs of the contract, adjustments are made to include only those costs that reflect work performed. Examples of items which may need adjustment include :

- (i) the costs of material that have been purchased for the contract but have not been installed or used during contract performance; and
- (ii) payments to subcontractors to the extent they do not reflect the sum of work performed under the subcontract.

The application of the percentage of completion technique is subject to a risk of error in making estimates. For this reason, profit is not recognized in the financial statements unless the outcome of the contract can be reliably estimated. If the outcome cannot be reliably estimated, the percentage of completion technique is not used.

While recognizing the profit under this technique, an appropriate allowance for future unforeseeable factors which may affect the ultimate quantum of profit is generally made on either a specific or a percentage basis.

In the case of fixed price contracts, the condition which will usually provide this degree of reliability are :

- (i) total contract revenues to be received can be reliably estimated,
- (ii) both the costs to complete the contract and the stage of contract performance completed at the reporting date can be reasonably estimated, and
- (iii) the costs attributable to the contract can be clearly identified so that actual experience can be compared with prior estimates.

Normally, the profit is not recognized in fixed price contracts unless the work on a contract has progressed to a reasonable extent. Ordinarily this is not considered as having been satisfied unless 20 to 25% of the work is completed. In the case of cost plus contracts, the conditions which usually provide this degree of reliability are :

Completed contract technique

The principal advantage of the completed contract technique is that it is based on results as determined when the contract is completed or substantially completed rather than on estimates which may require subsequent adjustment as a result of unforeseen costs and possible losses. The risk of recognizing profits that may not have been earned is therefore, minimized.

The principal disadvantage of the completed contract technique is that periodic reported revenue does not reflect the level of activity on contracts during the period. For example, when a few large contracts are completed in one accounting period but no contracts have been completed in the previous period or are to be completed in the subsequent period the level of reported revenue can be erratic although the level of activity on contracts may have been relatively constant throughout. Even when numerous contracts are regularly completed in each accounting period, and reported revenue may appear to reflect the level of activity on contracts, there is a continuous lag between the time when work is performed and the related revenue is recognized.

Selection of Technique

The selection of a technique of accounting for a construction contract depends on considerations discussed earlier. The contractor may use both techniques simultaneously for different contracts depending upon circumstances.

When a contractor uses a particular technique of accounting for a contract, then in respect of all other contracts that meet similar criteria, the same techniques is used.

The techniques of accounting used by the contractor and the criteria adopted in selecting the techniques/s represent an accounting policy.

Change in Accounting Policy

When there is a change in the accounting policy used for construction contracts, there is disclosure of the effect of the change and its sum. If the contractor changes from the percentage of completion technique to the completed contract technique, it is sometimes not possible to quantify the full effect of the change in the current accounting period. In such cases, there is disclosure of at least the sum of attributable profits reported in prior years, in respect of contracts in progress at the beginning of the accounting period.

Provision for Foreseeable Losses

When current estimates of total contract costs and revenues indicate a loss, provision is made for the entire loss on the contract irrespective of the sum of work done and the technique of accounting followed. In some circumstances, the foreseeable losses may

exceed the costs of work done to date. Provision is nevertheless made for the entire loss on the contract.

When a contract is of such magnitude that it can be expected to absorb a considerable part of the capacity of the enterprise for a substantial period, indirect costs to be incurred during the period of the completion of the contract are sometimes considered to be directly attributable to the contract and involved in the calculation of the provision for loss on the contract.

If a provision for loss is required, the sum of such provision is usually determined irrespective of :

- (i) whether or not work has commenced on the contract; and
- (ii) the stage of completion of contract activity; and
- (iii) the sum of profits expected to arise on other unrelated contracts.

The determination of a future loss on a contract may be subject to high degree of uncertainty. In some of these cases, it is possible to provide for the future loss and in other cases only the existence of a contingent loss is disclosed.

Claims and Variations Arising Under Construction Contracts

Sums due in respect of claims made by the contractor and of variations in contract work approved by the customer are recognized as revenue in the financial statements only in circumstances when, and only to the extent that, the contractor has evidence of the final acceptability of the sum of the claim or variation.

Claims or penalties payable by the contractor arising out of delays in completion or from other causes are provided for in full in the financial statements as costs attributable to the contract. Claims in the nature of contingency are treated as indicated in Accounting Standard 4 on "contingencies and Events Occurring After the Balance Sheet Date."

Progress Payments, Advances and Retentions

Progress payments and advances received from customers in respect of construction contracts in relation to the work performed thereon are disclosed in financial statements either as a liability or shown as a deduction from the sum of contract-work-in progress.

In case progress payments and advances received from customers in respect of construction contracts are not in relation to the work performed thereon, these are shown as a liability.

Sums retained by customers until the satisfaction of conditions specified in the contract for release of such sums are either recognized in financial statements as receivables or alternatively indicated by way of a note.

Accounting Standard

In accounting for construction contracts in financial statements, either the

percentage of completion technique or the completed contract technique may be used. When a contractor uses a particular technique of accounting for a contract, then the same technique should be adopted for all other contracts which meet similar criteria.

The percentage of completion technique can be used if the outcome of the contract can be reliably estimated.

In the case of fixed price contracts, this degree of reliability would be provided if the following conditions are satisfied :

- (i) total contract revenues to be received can be reliably estimated.
- (ii) Both the costs to complete the contract and the stage of contract performance completed at the reporting date can be reasonably estimated; and
- (iii) The costs attributable to the contract can be clearly identified so that actual experience can be compared with prior estimates.

Profit in the case of fixed price contracts, normally should not be recognized unless the work on a contract has progressed to reasonable extent.

In the case of cost plus contracts, this degree of reliability would be provided only if both the following conditions are satisfied :

- (i) costs attributable to the contract can be clearly identified; and
- (ii) costs other than those that are specifically reimbursable under the contract can be reliably estimated.

While recognizing the profit under percentage of completion technique, an appropriate allowance for future unforeseeable factors should be made on either a specific or a percentage basis.

The costs involved in the sum at which construction contract work is stated should comprise those costs that relate directly to a specific contract and those that are attributable to the contract activity in general and can be allocated to specific contracts.

Left foreseeable loss on the entire contract should be provided for in the financial statements irrespective of the sum of work done and the technique of accounting followed.

Disclosure.

There should be disclosure in the financial statement of :

- (i) the sum of construction work-in-progress;
- (ii) progress payments received and advances and retentions on account of contracts involved in construction work-in-progress; and
- (iii) the sum receivable in respect of revenue accrued under cost plus contracts not involved in construction work-in-progress.

If both the percentage of completion technique and the completed contract technique are simultaneously used by the contract, the sum of contract work described in (I) above should be analyzed to disclose separately the sums

attributable to contracts accounted for under each technique.

Disclosure of changes in an accounting policy used for construction contracts should be made in the financial statements giving the effect of the change and its sum. However, if a contractor changes from the percentage of completion technique to the completed contract technique for contracts in progress at the beginning of the year, it may not be possible to quantify the effect of the change. In such cases, disclosure should be made of the sum of attributable profits reported in prior years in respect of contracts in progress at the beginning of the accounting period.

2.11 Accountings Standard - 9 (As 9) Revenue Recognition

The following is the text of the Accounting Standard (AS) 9 issued by the, Institute of Chartered Accountants of India on 'Revenue Recognition'.

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by body corporates' listed on a recognized stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

Introduction

This Statement deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Statement is concerned with the recognition of revenue arising in the Bourse of the ordinary activities of the enterprise from

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

This Statement does not deal with the following aspects of revenue recognition to which special considerations apply:

- Revenue arising from construction contracts
- Revenue arising from hire-purchase, lease agreements;
- Revenue arising from government grants and other similar subsidies;
- Revenue of insurance body corporates arising from insurance contracts.

Examples of items not involved within the definition of "revenue" for the purpose of this Statement are :

- Realized gains resulting from the disposal of, and unrealized gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;
- Unrealized holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;
- Realized or unrealized gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;
- Realized gains resulting from the discharge of an obligation at less than its carrying sum;

Issued in November 1985.

(v) Unrealized gains resulting from the restatement of the carrying sum of an obligation.

Definitions

The following terms are used "in this Statement with the meanings specified:

Revenue, is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the sum of commission and not the gross inflow of cash, receivables or other consideration.

Completed service contract technique is a technique of accounting which recognizes revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed.

Proportionate completion technique is a technique of accounting which recognizes revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract.

Explanation

Revenue recognition is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of an enterprise. The sum 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 sum, or its associated costs, these uncertainties may influence the timing of revenue recognition.

Sale of Goods :

A key criterion for determining when to recognize revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognized at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes.

At certain stages in specific industries, such, as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realizable value. Such sums, while not revenue as defined in this Statement, are sometimes recognized in the statement of profit and loss and appropriately described.

Rendering of Services :

Revenue from service transactions is usually recognized as the service is performed, either by the proportionate completion technique or by the completed service contract technique.

- (i) *Proportionate completion technique* - Performance consists of the execution of more than one act. Revenue is recognized proportionately by reference to the performance of each act. The revenue recognized under this technique would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognized on a straight line basis over the specific period unless there is evidence that some other technique better represents the pattern of performance.
- (ii) *Completed service contract technique* - Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract technique is relevant to these patterns of performance and accordingly revenue is recognized when the sole or final act takes place and the service become chargeable.

The Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

The use by others of such enterprise resources gives rise to :

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

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

Royalties accrue in accordance with the terms of the relevant agreement and are usually recognized on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognize revenue on some other systematic and rational basis.

Dividends from investments in shares are not recognized in the statement of profit and loss until a right to receive payment is established.

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

Effect of Uncertainties on Revenue Recognition :

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

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. In such cases, it may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognized 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 sum of revenue originally recorded.

An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by ' others of enterprise resources is reasonably determinable. When, such 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 recognized.

Accounting Standard

Revenue from sales or service transactions should be recognized when the requirements as to performance set out, are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

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 sum of the consideration that will be derived from the sale of the goods.

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

Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognized when no significant uncertainty as to measurability or collectability exists. These revenues are recognized on the following bases :

- (i) Interest :** on a time proportion basis taking into account the sum outstanding and the rate applicable.
- (ii) Royalties :** on an accrual basis in accordance with the terms of the relevant agreement.
- (iii) Dividends from :** when the owner's right to receive payment is investments in shares : established. Disclosure :

In addition to the disclosures required by Accounting Standard 1 on 'Disclosure of Accounting Policies' (AS 1), enterprise should also disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

Appendix

This appendix is illustrative only and does not form part of the accounting standard set forth in this Statement. The purpose of the appendix is to illustrate the application of the Standard to a number of commercial situations in an endeavour to assist in clarifying application of the Standard.

Sale of Goods

Delivery is delayed at buyer's request and buyer takes title and accepts billing

Revenue should be recognized 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 recognized rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

Delivered subject to conditions

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

Revenue should normally not be recognized 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 recognize 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 antennae).

(b) *on approval*

Revenue should not be recognized 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 recognize the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may sum 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 recognized until the goods are sold to a third party.

(e) *cash on delivery sales*

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

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 recognized until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognized when a significant deposit is received.

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 recognized until goods are manufactured, identified and ready for delivery to the buyer by the third party.

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 recognized as revenue.

Sales to intermediate parties i.e. where goods are sold to distributors, dealers or others for resale :

Revenue from such sales can generally be recognized 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.

Subscriptions for publications :

Revenue received or billed should be deferred and recognized 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.

Installment sales :

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

Trade, discounts and volume rebates :

Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and . volume, rebates given should be deducted in determining revenue. B. Rendering of Services :

Installation Fees :

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

Advertising and insurance agency commissions :

Revenue should be recognized when the service is completed. For advertising agencies, media commissions will normally be recognized 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 recognized when the project is completed. Insurance agency commission should be recognized on the effective commencement or renewal dates of the related policies.

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 sum 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 recognized when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognized over the life of the loan or facility having regard to the sum of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

Admission fees :

Revenue from artistic performances, banquets and other special events should be recognized 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.

Tuition fees :

Revenue should be recognized over the period of instruction.

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 recognized when received. If the membership fee entitles the member to services or publications to be provided during the year, it should be recognized on a systematic and rational basis having regard to the timing and nature of all services provided.

2.12 Accounting Standard (As 10) : Accounting For Fixed Assets

The following is the text of the Accounting Standard 110(AS 10) issued by the Institute of Chartered Accountants of India on "Accounting for fixed assets".

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by body corporates listed on a recognized stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

Introduction

Financial statements disclose certain information relating to fixed assets. In many enterprises these assets are grouped into various categories, such as land and buildings, plant and machinery, vehicles, furniture and fittings, goodwill, patents, trademarks and designs. This Statement deals with accounting for such fixed assets except as described below.

This statement does not deal with the specialized aspects of accounting for fixed assets that arise under a comprehensive system reflecting the effects of changing prices but applies to financial statements prepared on historical cost basis.

This statement does not deal with accounting for the following items to which special consideration apply:

- i. Forests, plantations and similar regenerative natural resources;
- ii. Wasting assets including mineral rights, expenditure on the exploration for sand extraction minerals, oil, natural gas and similar non-regenerative resources;
- iii. Expenditure on real estate development; and
- iv. Livestock

This statement does not cover the allocation of the depreciable sum of fixed assets to future periods since this subject is dealt with in Accounting Standard 6 on "Depreciation Accounting".

This statement does not deal with the treatment of Government grants and subsidies, and assets under leasing rights. It makes only a brief reference to the capitalization of borrowing costs and assets acquired in an amalgamation or merger. These subjects require more extensive consideration than can be given within the statement.

Definitions

The following terms are used in this Statement with their meanings specified:

Fixed asset is 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.

Fair market value is 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.

Gross book value of a fixed asset is its historical cost or other sum substituted for historical cost in the books of account or financial statements. When this sum is shown net of accumulated depreciation, it is termed as **net book value**.

Explanation

Fixed assets often comprise a significant portion of the total assets of an enterprise and therefore, are important in the presentation of financial position.

Furthermore, the determination of whether expenditure represents an asset or an expense can have a material effect on an enterprise's reported results or operations.

Identification of fixed Assets

The definition gives criteria for determining whether items are to be classified as fixed assets. Judgment is required in applying the criteria to specific circumstances or specific types of enterprises. It may be appropriate to aggregate individually insignificant items, and to apply the criteria to the aggregate value. An enterprise may decide to expense an items which could otherwise have been involved as fixed assets, because the sum of the expenditure is not material.

Stand-by equipment and servicing equipment are normally capitalized. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed assets and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.

In certain circumstances, the accounting for an item of fixed asset may be improved if the total expenditure thereon is allocated to its component parts, provided they are in practice separable, and estimates are made of the useful lives of these components. For example, rather than treat an aircraft and its engines as one unit, it may be better to treat the engines as a separate unit if it is likely that their useful life is shorter than that of the aircraft as a whole.

Components of Cost

The cost of an item of fixed assets comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:

- i. site preparation;
- ii. initial delivery and handling costs;
- iii. installation cost, such as special foundations for plant; and
- iv. professional fees, for example fees of architects and engineers.

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.

Financing costs relating to deferred credits or to borrowed funds attributable to construction or acquisition of fixed assets for the period up to the completion of construction or acquisition of fixed assets are also sometimes involved in the gross book value of the asset to which they relate. However, financing costs (including interest) on fixed assets purchased on a deferred credit basis or on monies borrowed for construction or acquisition of fixed assets are not capitalized to the extent that such costs relate to periods after such assets are ready to be put to use.

Administrating and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction, may be involved or to the acquisition of a fixed asset or bringing it to its working condition, may be involved as part of the cost of the construction project or as a 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 as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production i.e. production intended for sale or captive consumption, is not capitalized and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period.

If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement. However, the expenditure incurred during this period is also sometimes treated as deferred revenue expenditure to be amortized over a period not exceeding 3 to 5 years after the commencement of commercial production.

Self-Constructed Fixed Assets

In arriving at the gross book value of self-construction fixed assets, the same principles apply as those described. Involved in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.

Non-monetary Consideration

When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the considerate given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. An alternative accruing treatment that is sometimes used for an exchange of assets, particularly when the assets exchanged are similar, is to record the asset acquired at the net book value of asset given up. In each case an adjustment is made for any balancing receipt or payment of cash or other consideration.

Improvements and Repairs

Frequently, it is difficult to determine whether subsequent expenditure related to fixed assets represents improvements that ought to be added to the gross book value or requires that ought to be charged to the profit and loss statement. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is involved in the gross book value, e.g. an increasing capacity.

The cost of an addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is usually added to its

gross book value. Any addition or extension which has a separate identity and is capable of being used after the existing asset is disposed of is accounted for separately.

Sum Substituted for Historical Cost

Sometimes financial statements that are otherwise prepared on a historical cost basis include part or all of fixed assets at evaluation in substitution for historical costs and depreciations calculated accordingly. Such financial statements are to be distinguished from financial statements prepared on a basis intended to reflect comprehensively the effects of changing prices.

A commonly accepted and preferred technique of restating fixed assets is by appraisal, normally undertaken by competent valuers. Other techniques sometimes used are indexation and reference to current prices which when applied are cross checked periodically by appraisal technique.

The revalued sums of fixed assets are presented in financial statements, either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued sum or by restating the net book value by adding therein the net increase on account of revaluation. An upward revaluation does not provide a basis for crediting to the profit and loss statement the accumulated depreciation existing at the date of revaluation.

Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the different categories of fixed assets. In such cases, it is necessary to disclose the gross book value involved on each basis.

Selective revaluation of assets can lead to unrepresentative sums being reported in financial statements. Accordingly, when reevaluations do not cover all the assets of a given class, it is appropriate that the selection of assets to be revalued be made on a systematic basis. For example, an enterprise may revalue a whole class of assets within a unit.

It is not appropriate for the revaluation of class of assets to result in the net book value of that class being greater than the recoverable sum of the assets of the class.

An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. LEFT decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is involved in revaluation reserve, it is sometimes charged against that earlier increase. It sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to profit and loss statement in which case the increase is credited to profit and loss statement to the extent that it offsets the previously recorded decrease.

Retirements and Disposals

An item of fixed asset is eliminated from the financial statement on disposal.

Items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realizable value and are shown separately in the financial statements. Any expected loss is recognized immediately in the profit and loss statement.

In historical financial statements, gains or losses arising on disposal are generally recognized in the profit and loss statement.

On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that 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, it is charged directly to that account. The sum standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve.

Valuation of Fixed Assets in Special Cases

In the case of fixed assets acquired on hire purchase terms, although, legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.

Where an enterprise owns fixed assets jointly with others (otherwise than as a partner in a firm), the extent of its share in such assets and the proportion in the original costs, accumulated depreciation and written down value are stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.

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 values.

Fixed Assets of Special Types

Good will in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable either in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over the excess is termed as goodwill. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.

As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

Patents are normally acquired in two ways: (i) by purchase, in which case patents are valued at the purchase cost including incidental expenses, stamps duty, etc. and (ii) by development within the enterprise, in which case identifiable costs incurred in

developing the patents are capitalized. Patent are normally written off over their legal terms of validity or over their working life whichever is shorter.

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

- i. relating to manufacturing processes; and
- ii. relating to plans, designs and drawings of buildings or plant and machinery.

Know-how related to plans, designs and drawings of buildings or plant and machinery is capitalized under the relevant asset heads. In such case depreciation is calculated on the total cost of those assets, including the cost of the know-how capitalized. Know-how related to manufacturing processes is usually expenses in the year in which it is incurred.

Where the sum paid for know-how is a composite sum in respect of both the types mentioned, such consideration is apportioned amongst them on a reasonable basis.

Where the consideration for the supply of know-how is a series of recurring annual payments as royalties, technical assistance fees, contribution to research, etc. such payments are charged to the profit and loss statement each year.

Disclosure

Certain specific disclosures on accounting for fixed assets are already required by Accounting Standard 1 on "Disclosure of Accounting Policies" and Accounting Standard 6 on "Depreciation Accounting".

Further disclosure that are sometimes made in financial statements include:

- i. gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;
- ii. expenditure incurred on account of fixed assets in the course of construction or acquisition; and
- iii. revalued sums substituted for historical costs of fixed assets, the technique adopted to compute the revalued sums, the nature of any indices used, the year of any appraisal made, and whether an external value was involved, in case where fixed assets are stated at revalued sums.

Accounting Standard

The items determined in accordance with the definition of this statement should be include under fixed assets in financial statements.

The gross book value of a fixed asset should be either historical cost or a revaluation computed in accordance with this Standard. The technique of accounting for fixed assets involved at historical cost as set out.; the technique of accounting for revalued assets as set out.

The cost of a fixed asset should comprise its purchase price and any attributable costs of bringing the asset to its working condition for its intended use. Financing costs relating to deferred credits or to borrowed funds attributable to construction or acquisition of fixed assets for the period up to the completion of construction or acquisition of fixed assets should also be involved in the gross book value of the asset to which they relate. However, the financing costs (including interest) on fixed assets purchased on fixed asset should not be capitalized to the extent that such costs relate to periods after such assets are ready to be put to use.

The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.

When a fixed asset is acquired in exchange or in part exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up. Adjusted for any balancing payment or receipt of cash or other consideration. For these purposes fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident. Fixed asset acquired in exchange for shares or other securities in the enterprise should be recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance.

Material items retired from active use and held for disposal should be stated at the lower of their net book value and net realizable value and shown separately in the financial statements.

Fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal.

Losses arising from the retirement or gains or losses arising from disposal of fixed asset which is carried at cost should be recognized in the profit and loss statement.

When a fixed asset is revalued in financial statements, an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. This basis should be disclosed.

The revaluation in financial statements of a class of assets should not result in the net book value of that class being greater than the recoverable sum of assets of that class.

When a fixed asset is revalued upwards, any accumulated depreciation existing at the date of the revaluation should not be credited to the profit and loss statements.

An increase in net book value arising on revaluation of fixed assets should be credited directly to owner's interest under the head of revaluation reserve, except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement., it may be

credited to the profit and loss statement. A decrease in net book value arising on revaluation of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilized, it may be charged directly to that account.

On disposal of a previously revalued items of fixed asset, the difference between net disposal proceeds and the net book value should be charged or credited to the profit and loss statement except that to the extent that 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, it may be charged directly to that account.

Fixed assets acquired on hire purchase terms should be recorded at their cash value, which, if not readily available, should be calculated by assuming an appropriated rate of interest. They should be shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.

In the case of fixed assets owned by the enterprise jointly with others, the extent of the enterprise's shares in such assets, and the proportion of the original cost, accumulated depreciation and written down value should be stated in the balance sheet. Alternatively, the pro rate cost of such jointly owned assets may be grouped together with similar fully owned assets with an appropriate disclosure thereof.

Where several fixed assets are purchased for a consolidated price, the consideration should be apportioned to the various assets on a fair basis as determined by competent values.

Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess should be termed as "goodwill".

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

Sum paid for know-how for the plans, layout and designs of buildings and/or design of the machinery should be capitalized under the relevant asset heads, such as, buildings, plant and machinery etc. Depreciation should be calculated on the total cost of those assets, including the cost of the know-how capitalized. Where the sum paid for know how is a composite sum in respect of both the manufacturing process as well as plans, drawings and designs for buildings, plant and machinery etc., the management should apportion such consideration into two parts on a reasonable basis.

Disclosure

The following information should be disclosed in the financial statements:

- i. gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;
- ii. expenditure incurred on account of fixed assets in the course of construction or acquisition; and
- revalued sum substituted for historical costs of fixed assets, the technique adopted to compute the revalued sums, the nature of indices used, the year of any appraisal made and whether an external valuer was involved, in case where fixed assets are stated at revalued sums.

2.13 Accounting Standards 11 : Accounting For The Effects Of Changes In Foreign Exchange Rates

(In this Accounting Standard, the standard portions have been set in bold italic type. These should be read in the context of the background material which has been set in normal type, and in the context of the 'Preface to the Statements of Accounting Standards'.)

The following is the text of Accounting Standard (AS 11) 11, 'Accounting for the Effects of Changes in Foreign Exchange Rates', issued by the Council of the Institute of Chartered Accountants of India.

This Standard will come into effect in respect of accounting periods commencing on or after 1-4-1995 and will be mandatory in nature.

Objective

An enterprise may have transactions in foreign currencies or it may have foreign branches. Foreign currency transactions should be expressed in the enterprise's reporting currency and the financial statements of foreign branches should be translated into the enterprise's reporting currency in order to include them in the financial statements of the enterprise.

The principal issues in accounting for foreign currency transactions and foreign branches are to decide which exchange rate to use and how to recognize in the financial statements the financial effect of changes in exchange rates.

Scope

This Statement should be applied by an enterprise:

- i. in accounting for transactions in foreign currencies; and
- ii. in translating the financial statements of foreign branches for inclusion in the financial statements of the enterprise.

Definitions

The following terms are used in this Statement with the meanings specified:

Reporting currency is the currency used in presenting the financial statements.

Foreign currency is a currency other than the reporting currency of an enterprise.

Exchange rate is the ratio for exchange of two currencies as applicable to the realization of a specific asset or the payment of a specific liability or the recording of a specific transaction or a group of inter-related transactions.

Average rate is the mean of the exchange rates in force during a period.

Forward rate is the exchange rate established by the terms of an agreement for exchange of two currencies at a specified future date.

Closing rate is the exchange rate at the balance sheet date.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable sums of money e.g., cash receivables, payables.

Non-monetary items are assets and liabilities other than monetary items e.g. fixed assets, inventories, investments in equity shares.

Settlement date is the date at which receivable is due to be collected or a payables due to be paid.

Recoverable sum is the sum which the enterprise expects to recover from the future use of an asset, including its residual value on disposal.

Foreign Currency Transactions

Exchange Rate

A multiplicity of foreign exchange rate is possible in a given situation. In such a case, the term 'exchange rate' refers to the rate, which is applicable to the particular transaction.

The term 'exchange rate' is defined in this statement with reference to a specific asset, liability or transaction or a group of inter-related if, by virtue of being set off against one another or otherwise, they affect the net sum of reporting currency that will be available on, or required for, the settlement of those transaction. Although the exchange rates applicable to realization and disbursements in a foreign currency may be different, an enterprise may, where legally permissible, partly use the receivable to settle the payables directly, in which case the payable and receivable are reported at the exchange rate as applicable to the net sum of receivable or payable. Further, where realizations are deposited into, and disbursements made out of a foreign currency bank account, all the transactions during a period (e.g. a month) are reported at a rate that approximates the actual rate during that period. However, where transactions cannot be considered inter-related as stated above, by set-off or otherwise, the receivables and payables are reported at the rates applicable to the respective sums even where these are receivable from, or payable to, the same foreign party.

Recording Transactions on Initial Recognition

A transaction in a foreign currency should be recorded in the reporting currency by applying to the foreign currency sum the exchange rate between the reporting currency and the foreign currency at the date of the transaction, except as stated in para 4 above in respect of inter-related transactions.

A transaction in a foreign currency is recorded in the financial records of an enterprise as at the date on which the transaction occurs, normally using the exchange rate at that date. This exchange rate is often referred to as the spot rate. For practical reason, a rate that approximates the actual rate is often used, for example, an average rate for all transactions during the week or month in which the transactions occur. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Reporting Effects of Changes in Exchange Rates Subsequent to Initial Recognition

At each balance sheet date:

- i. monetary items denominated in a foreign currency (e.g. foreign currency notes, balances in bank account denominated in a foreign currency, and receivables, payables and loans denominated in a foreign currency) should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the sum in reporting currency that is likely to be realized from, or require to disburse, foreign currency monetary item at the balance sheet date, e.g. where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the sum which is likely to be realized from, or required to disburse, such item at the balance sheet date;
- ii. non-cemetery items other than fixed assets, which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction;
- iii. non-monetary items other than fixed assets, which are carried in terms of fair value or other similar valuation, e.g. net realizable value, denominated in a foreign currency should be reported using the exchange rates that existed when the values are determined (e.g. if the fair value is determined as on the balance sheet date, the exchange rate on the balance sheet date may be used); and
- iv. The currency sum of fixed assets should be adjusted as stated in paragraphs 10 and 11 below.

Recognition of Exchange Difference

Exchange differences arising on foreign currency transactions should be recognized as revenue or as expense in the period in which they arise.

Exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets, which are carried in terms of historical cost, should be adjusted in the carrying sum of the respective fixed assets. The carrying sum of such fixed assets should, to the extent not already so adjusted or otherwise account for, also be adjusted to account for any increase or decrease in the liability of the enterprise, as expressed in the reporting currency by applying the closing rate, for making payment towards the whole or

a part of the cost of the assets or for repayment of the whole or a part of the cost of the assets or for repayment of the whole or a part of the monies borrowed by the enterprise from any person, directly or indirectly, in foreign currency specifically of the purpose of acquiring those assets.

The carrying sum of fixed assets which are carried in terms of revalued sums should also be adjusted in the manner decried in paragraph 10 above. However, such adjustment should not result in the net book value of a class of revalued fixed assets exceeding the recoverable sum of assets of that class, the remaining sum of the increase in liability, if any, being debited to the revaluation reserve, or to the profit and loss statement in inadequacy or absence of the revaluation reserve.

An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from foreign currency transaction. When the transaction is settled within the same accounting period as that in which is occurred, the entire exchange difference arises in that period.

However, when the transaction is not settled in the same accounting period as that in which it occurred, the exchange difference arises over more than one accounting period.

Forward Exchange Contracts

An enterprise may enter into a forward exchange contract, or another financial instrument that is in substances a forward exchange contract, to establish the sum of the reporting currency required or available at the settlement date of a transaction. The difference between the forward rate and the exchange rate at the date of the transact should be recognized as revenue or expanses over the life of the contract, except in respect of liabilities incurred for acquiring fixed assets in which case, such difference should be adjusted in the carrying sum of the respective fixed assets.

The difference between the foreword rate and the exchange rate at the inception of a forward exchange contract is recognized as revenue or expense over the life of the contract. The only exceptions in respect of forward exchange contracts related to liabilities in foreign currency incurred for acquisition of fixed assets.

Any profit or loss arising on cancellation or renewal of a forward exchange contract should be recognized as revenue or as expense for the period, except in case of a forward exchange contract relating to liabilities incurred for acquiring fixed assets, in which case, such profit or loss should be adjusted in the carrying sum of the respective fixed assets.

Depreciation

Where the carrying sum of a depreciable asset has under gone a change, the depreciation on the revised unamortized depreciable sum should be provided in accordance with Accounting Standard (AS) 6, Depreciation Accounting.

The need for foreign currency translation arises in respect of the financial statements of foreign branches of the parent enterprise.

Revenue items, except opening and closing inventories and depreciation, should be translated into reporting currency of the reporting enterprise at average rate. In appropriate circumstances, weighted average rate may be applied, e.g., where the revenue or expanses are not earned or incurred evenly during the accounting period (such as in the case of seasonal business) or where there are exceptionally wide fluctuations in exchange rate during the accounting period. Opening and closing inventories should be translated at the rates prevalent at the commencement and close respectively of the accounting period. Depreciation should be translated at the rates used by the translation of the value of the assets on which depreciation is calculated.

Monetary items should be translated using the closing rate. However, in circumstances where the closing rate does not reflect with reasonable accuracy the sum in reporting currency that is likely to be realized from, or required to disburse, the foreign currency item at the balance sheet date, a rate that reflects approximately the likely realization or disbursement as aforesaid should be used.

Non-monetary items other than inventories and fixed assets should be translated using the exchange rate at the date of the transaction.

Fixed assets should be translated using the exchange rate at the date of the transaction. Where there has been an increase or decrease in the liability of the enterprise, as expressed in Indian rupees by applying the closing rate, for making payment towards the whole or a part of the cost of a fixed asset or for repayment of the whole or a part of monies borrowed by the enterprise from any person, directly or indirectly, in foreign currency specifically for the purpose of acquiring a fixed asset, the sum by which the liability is so increased or reduced during the year, should be added to, or reduced from, the historical cost of the fixed cost concerned.

Balance in 'head office account', whether debit or credit, should be reported at the sum of the balance in the 'branch account' in the books of the head office after adjusting for unreasoned transactions.

The net exchange difference resulting from the translation of items in the financial statements of a foreign branch should be recognized as revenue or as expense for the period, exempt to the extent adjusted in the carrying sum of the related fixed assets in accordance with specified above.

Contingent liabilities should be translated into the reporting currency of the enterprise at the closing rate. The translation of contingent liabilities does not result in any exchange difference as defined in this Statement.

Disclosures

An enterprise should disclose:

- i. the sum of exchange differences involved in the net profit or loss for the period;
- ii. the sum of exchange differences adjusted in the carrying sum of fixed assets during the accounting period; and

- iii. the sum of exchange differences in respect of forward exchange contracts to be recognized in the profit or loss for one or more subsequent accounting periods, as required.

Disclosure is also encouraged of an enterprise's foreign currency risk management policy.

Clarification on AS 11

Applicability of Accounting Standard 11, Accounting for the Effect of Changes in Foreign Exchange Rates to Authorized Foreign Exchange Dealers

Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange rates, as revised in 1995, deals with accounting for foreign currency transactions and translation of financial statements of foreign branches. It is hereby clarified that the above Standard is not applicable to forward exchange transactions which are entered into by authorized foreign exchange dealers, in view of the fact that the nature of such transactions has certain special features which need to be addressed specifically. The Standard shall, however, apply to translation of financial statement of foreign branches of the foreign exchange dealers.

2.14 Accounting Standards (As) – 12 Government Grants

The following is the text of the Accounting Standard (AS) 12 issued by the Council of the Institute of Chartered Accountants of India on 'Accounting for Government Grade'.

The Standard comes into effect retrospect of accounting periods commencing on or after 1.4.1992 and will be recommendatory in nature for an initial period of two years. Accordingly, the Guidance Note on 'Accounting for Capital Based Grants' issued by the Institute in 1981 shall stand withdrawn from this date. This Standard will become mandatory in respect of accounts for periods commencing on or after 1.4.1994.

Introduction

This Statement deals with accounting for government grants. Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, etc

This Statement does not deal with :

- i. The special problems arising in accounting for government grants in financial statement reflecting the effects of changing prices of in supplementary information of a similarly nature;
- ii. Government assistance other than in the form of government grants; and
- iii. Government participation in the ownership of the enterprise.

Definitions

The following terms are used in this Statement with the meaning specified;

Government refers to government, government agencies and similar bodies whether local, national or international.

Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Explanation

The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grants has been receive, an appropriate technique of accounting therefore is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period.

The facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

Accounting Treatment of Government Grants

Capital Approach versus Revenue Approach

Two broad approaches may be followed for the accounting treatment of government grants : the 'capital approach', under which a grant is treated as part of shareholder" funds, and the "revenue approach' under which a grant is taken to revenue over one or more periods.

Those in support of the 'capital approach' argue as follows:

- i. Many government grants are in the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayments is ordinarily expected in the case of such grants. These should, therefore, be credited directly to shareholders' funds.
- ii. It is inappropriate to recognize government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs.

Arguments in support of the revenue approach' are as follows:

- i. Government grants are rarely gratuitous. The enterprise earns them through compliance with their conditions and meeting the envisaged obligation. They should therefore be taken to revenue and matched with the associated costs which the grant is intended to compensate.
- ii. As revenue tax and other taxes are charges against revenue it is logical to deal also with government grants, which are an extension of fiscal policies, in the profit and loss statement.
- iii. In case grants are credited to shareholders' funds, no correlation is done between the accounting treatment of the grant and the accounting treatment of the expenditure to which the grant relates.

It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Revenue approach may be more appropriate in the case of other grants.

It is fundamental to the 'revenue approach' that government grants be recognized in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs. Revenue recognition of government grants on a receipts basis is not in accordance with the accrual accounting assumption.

In most cases, the periods over which an enterprise recognizes the costs or expenses related to a government grants are readily ascertainable and thus grants in cognition of specific expenses are taken to revenue in the same period as the relevant expense.

Recognition of Government Grants

Government grants available to the enterprise are considered for inclusion in accounts:

- i. where there is reasonable assurance that the enterprise will comply with the conditions attached to them ; and
- ii. where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

Mere receipt of a grant is not necessarily a conclusive evidence that conditions attaching to the grant have been or will be fulfilled.

An appropriate sum in respect of such earned benefits, estimated on a prudent basis, is credited to revenue for the year even though the actual sum of such benefits may be finally settled and received after the end of the relevant accounting period.

A contingency related to a government grant, arising after the grant has been recognized, is treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring after the Balance Sheet Date.

In certain circumstances, a government grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure. Such grants may be confined to an individual enterprises and may not be available to a whole class of enterprises. These circumstances may warrant taking the grant to revenue in the period in which the enterprise qualifies to receive it, as an extraordinary item if appropriate.

Government grants may become receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such a grant is recognized in the revenue statement of the period in which it becomes receivable, as an extraordinary item if appropriate.

Non- monetary Government Grants

Government grants may take the forms of non-monetary assets, such as land or other

resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value.

Presentation of Grants Related to Specific Fixed Assets

Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Two techniques of presentation in financial statements of grants (or the appropriate portion of grants) related to specific fixed assets are regarded as acceptable alternatives.

Under one technique, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognized in the profit and loss statement over the useful life of a depreciation asset by way of a reduced depreciation charge.

Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

Under the other technique, grants related to depreciable assets are treated as deferred revenue which is recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to revenue is usually made over the periods and in the proportions in which depreciation on related assets is charged. Grants related to non-depreciable assets are credit to capital reserve under the technique as there is usually no charge to revenue in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to revenue over the same period over which the cost of meeting such obligations is charged to revenue. The deferred revenue is suitably disclosed in the balance sheet pending its apportionment to profit and loss account. For example, in the case of a body corporate, it is shown after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description e.g. 'Deferred government grants'.

The purchase of assets and the receipt of related grants can cause major movements in assets, such movements are often disclosed as separate items in the statement of changes in financial position regardless of whether or to the grant is deducted from the related assets for the purpose of balance sheet presentation.

Presentation of Grants Related to Revenue

Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Revenue'. Alternatively, they are deducted in reporting the related expense.

Supporters of the first technique claim that it is inappropriate to net revenues and expense items and that separation of the grant from the expenses facilitates comparison with other expenses not affected by a grant. For the second technique, it is argued that the expenses might well not have been incurred by the enterprise if the grant had not

been available and presentation of the expenses without of setting the grant may therefore be misleading.

Presentation of Grants of the Nature of Promoters' Contribution

Where the government grants are of the nature of promoters' contribution i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, Central Investment Subsidy Scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred revenue.

Refund of government grants

Government grants sometimes become refundable because certain contribution are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item.

The sum refundable in respect of a government grant related to revenue is applied first against any unamortized deferred credit remaining in respect of the grant. To the extent that the sum refundable exceeds any such deferred credit, or where no deferred credit exists, the sum is charged immediately to profit and loss statement.

The sum refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred revenue balance, as appropriate, by the sum refundable. In the first alternative, i.e. where the book value of the assets increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.

Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant sum recoverable by the government is reduced from the capital reserve.

Disclosure

The following disclosures are appropriate:

- i. the accounting policy adopted for government grants, including the techniques of presentation in the financial statement;
- ii. the nature and extent of government grants recognized in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

Accounting Standard

Government grants should not be recognized until there is reasonable assurance that (i) the enterprise will comply with the conditions attached to them and (ii) the grants will be received.

Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the assets, the asset should be shown in the

balance sheet at a nominal value. Alternatively, government grants related to depreciable fixed assets may be treated as deferred revenue to which should be recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e. such grants should be allocated to revenue over the periods and in the proportions in which depreciation on those assets is charged. Grants related to non-depreciable assets should be credited to capital reserve under this technique. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant should be credited to revenue over the same period over which the cost of meeting such obligations is charged to revenue. The deferred revenue balance should be separately disclosed in the financial statements.

Government grants related to revenue should be recognized on a systematic basis in the profit and loss statement over the periods necessary to match them with related costs which they are intended to compensate. Such grants should either be shown separately under 'other revenue' or deducted in reporting the related expenses.

Government grants of the nature of promoters' contribution should be credited to capital reserve and treated as a part of shareholders' funds.

Government grants in the form of non-monetary assets, given at a concessional rate, should be accounted for on the basis of their acquisition cost. In case a non-monetary asset is given free of cost, it should be recorded at a nominal value.

Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related cost, should be recognized and disclosed in the profit and loss statement of the period in which they are receivable, as an extraordinary item if appropriate.

A contingency related to a government grant, arising after the grant has been recognized, should be treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.

Government grants that become refundable should be accounted for as an extraordinary item.

The sum refundable in respect of a grant related to revenue should be applied first against any unamortized deferred credit remaining in respect of the grant. To the extent that the sum refundable exceeds any such deferred credit, or where no deferred credit exists, the sum should be charged to profit and loss statement. The sum refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred revenue balance, as appropriate, by the sum refundable. In the first alternative, i.e. where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

Government grants in the nature of promoters' contribution that become refundable should be reduced from the capital reserve.

Disclosure

The following should be disclosed:

- i. the accounting policy adopted for government grants, including the techniques of presentation in the financial statements;
- ii. the nature and extent of government grants recognized in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

2.15 Accounting Standards –13 : Accounting For Investments

Introduction

This statement deals with accounting for investments in the financial statements of enterprises and related disclosure requirements.

This statement does not deal with :

- (a) the bases for recognition of interest, dividends and rentals earned on investments which are covered by Accounting Standard 9 or Revenue Recognition;
- (b) operating or finance leases;
- (c) Mutual funds and/or the related asset management body corporates, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956.

Definitions

The following terms are used in this Statement with the meanings assigned:

Investments are assets held by an enterprise for earning revenue by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not 'investments'.

A current investment is an investment that is by its nature readily releasable and is intended to be held for not more than one year from the date on which such investments is made.

A long-term investment is an investment other than a current investment. An investment in property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

Fair value is the sum for which an asset could be exchanged between a knowledgeable willing buyer and a knowledgeable willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realizable value provides an evidence of fair value.

Market value is the sum obtainable from the sale of an investment in a market, net of expenses necessarily to be incurred on or before disposal.

Explanation

Forms of Investments

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.

Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while other exist in a physical form (e.g., buildings). The nature of an investment may be that of a debt, other than a short or long-term loan or a trade debt, representing a monetary sum owing to the holder and usually bearing interest, alternatively, it may be a stake in the results and net assets of an enterprise such as an equity share. Most investments represent financial rights, but some are tangible, such as certain investments in land or buildings.

For some investments, an active market exists from which a market value can be established. For such investments, market value generally provides the best evidence of fair value. For other investments an active market does not exist and other means are used to determine fair value.

Classification of Investments

Enterprises present financial statements that classify fixed assets, investments and current assets into separate categories. Investments are classified as Long Term Investment and Current Investments. Current investments are in the nature of current assets, although the common practice may be to include them in investments.

Investments other than current investments are classified as long-term investments, even though may be readily marketable.

Cost of Investments

The cost of an investment includes acquisition charges such as brokerage, fees and duties.

If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost is the fair value of the securities issued (which, in appropriate cases, may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued.

If an investment is acquired in exchange or parts exchange, for another asset, the acquisition cost of the investment is determined by reference to the fair value of the asset given up. It may be appropriate to consider the fair value of the investment acquired if it

is more clearly evident.

Interest dividend and rentals receivables in connection with an investment are generally regarded as revenue, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of revenue. For example, when unpaid interest has accrued before the acquisition of an interest-bearing investment and is therefore involved in the price paid for the investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion is deducted from cost. When dividends on equity are declared from pre-acquisitions profits, a similar treatment may apply. If it is difficult to make such an allocation except on an arbitrary basis the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

When rights shares offered is subscribed for, the cost of the rights shares is added to the carrying sum of the original holdings. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right basis and the market value of they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying sum of such investments to the market value.

Carrying Sum of Investments

Current Investments

The carrying sum for current investments is the lower of cost and fair value. In respect of investments for which an active market exists, market value generally provides the best evidence of fair value. The valuation of current investments at lower of cost and fair value provides a prudent technique of determining the carrying sum to be stated in the balance sheet.

Valuation of current investments on overall (or global) basis is not considered appropriate. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not with each individual investments, and accordingly the investments may be carried at the lower of cost and fair value computed category wise (i.e. equity shares preference shares convertible debentures, etc.) However the more prudent and appropriate technique is to carry investment individually at the lower of cost and fair value.

For current investment, any reduction to fair value and any reversals of such reductions are involved in the profit and loss statement.

Long-term Investments

Long -term investments are usually carried at cost. However when there is a decline, other than temporary, in the value of a long-term investment, the carrying sum is reduced to recognize the decline. Indicators of the value of an investment are obtained by reference to its market value, the investor's assets and results and the expected cash flows from the investment. The type and extent of the investor's stake in the investor are also taken into account. Restrictions on disposal by the investor may affect the value

attributed to the investment.

Long-term investments are usually of individual importance to the investing enterprise. The carrying sum of long-term investments is therefore determined on an individual investment basis.

Where there is a decline, other than temporary, in the carrying sums of long-term investments the resultant reduction in the carrying sum is charged to the profit and loss statement. The reduction in carrying sum is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

Investment Properties

The cost of any shares in co-operative society or a body corporate, the holding of which is directly related to the right to hold the investment property, is added to the carrying sum of the investment property.

Disposal of Investments

On disposal of an investment the difference between the carrying sum and the disposal proceeds net of expenses is recognized in the profit and loss statement.

When disposing of a part of the holding of an individual investment the carrying sum to be allocated to that part is to be determined on the basis of the average carrying sum of the total holding of the investment.

Reclassification of Investments

Where, long-term investments are reclassified as current investments; transfers are made at the lower of cost and carrying sum at the date of transfer.

Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

Disclosure

The following disclosures in financial statements in relations to investments are appropriate :

- (a) the accounting policies for the determination of carrying sum of investments;
- (b) the sums involved in profit and loss statement for :
 - (i) interest, dividends (showing separately dividends from subsidiary body corporates), and rentals on investments showing separately such revenue from long-term and current investments Gross revenue should be stated, the sum of revenue tax deducted at source being involved under Advance Taxes Paid;
 - (ii) profits and losses on disposal of current investments and changes in carrying sum of such investments;
 - (iii) profits and losses on disposal of long-term investments and changes in the

carrying sum of such investments;

- (c) significant restrictions on the right of ownership, reliability of investments or the remittance of revenue and proceeds of disposal;
- (d) the aggregate sum of quoted and unquoted investments, giving the aggregate market value of quoted investments;
- (e) Other disclosures a specially required by the relevant statute governing the enterprise.

Accounting Standard

Classification of Investments

An enterprise should disclose current investments and long-term investments distinctly in its financial statements.

Further classification of current and long-term investments should be as specified in the statute governing the enterprise. In the absence of a statutory requirement, such further classification should disclose, where applicable, investments in :

- (a) Government or Trust securities;
- (b) Shares, debentures or bonds;
- (c) Investment properties; and
- (d) Other – specifying nature.

Cost of Investments

The cost of an investment should include acquisition charges such as brokerage fees and duties.

If an investment is acquired, or partly acquired, by the issue of shares or other securities the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

Investment Properties

An enterprise holding investment properties should account for them as long-term investments.

Carrying Sum of Investments

Investments classified as current investments should be carried in the financial

statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.

Investments classified as long-term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognize a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Any reduction in the carrying sum and any reversals of such reductions should be charged or credited to the profit and loss statement.

Disposal of Investments

On disposal of an investment the difference between the carrying sum and net disposal proceeds should be charged or credited to the profit and loss statement.

Disclosure

The following information should be disclosed in the financial statements :

- (a) the accounting policies for determination of carrying sum of investments; and
- (b) the sums involved in profit and loss statement for :
 - (i) Interest dividends (showing separately dividends from subsidiary body corporates) and rentals on investments showing separately such revenue from long-term and current investments. Gross revenue should be stated the sum of revenue tax deducted at source being involved under Advance Taxes Paid :
 - (ii) profits and losses on disposal of current investments and changes in the carrying sum of such investments; and
 - (iii) profits and losses on disposal of long term investments and changes in the carrying sum of such investments;
- (c) significant restrictions on the right of ownership, reliability of investments or the remittance of revenue and proceeds of disposal;
- (d) the aggregate sum of quoted and unquoted investments, giving the aggregate market value of quoted investments;
- (e) Other disclosures as specifically required by the relevant statute governing the enterprise.

2.16 Accounting Standard (As) – 14 Amalgamation

The following is the text of Accounting Standard (AS) 14, Accounting for Amalgamations, issued by the council for the Institute of Chartered Accountants of India.

This standard will come into effect in respect of accounting periods commencing on or after 1-4-1995 and will mandatory in natures. The Guidance Note on Accounting

Treatment of Reserves in Amalgamations issued by the Institute in, 1983 will stand withdrawn from the aforesaid date.

Introduction

This statement deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This statement is directed principally to body corporates although some of its requirements also apply to financial statements of other enterprises.

This statement does not deal with cases of acquisitions which arise when there is a purchase by one body corporate (referred to as the acquiring body corporate) of the whole or part of the shares, or the whole or part of the assets, of another body corporate (referred to as the acquired body corporate) in consideration for payments in cash or by issued of shares or other securities in the acquiring body corporate or partly in one form and partly in the other. The distinguishing feature of an acquisition is that the acquired body corporate is not dissolved and its separate entity continues to exist.

Definitions

The following terms are used in this statement with the meanings specified :

- (a) Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956, or any other statute which may be applicable to body corporates.
- (b) Transferor body corporate means the body corporate which an amalgamated into another body corporate.
- (c) Transferee Body corporate means the body corporate into which a transferor body corporate is amalgamated.
- (d) Reserve means the portion of earnings receipts or other surplus of an enterprise (Whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.
- (e) Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions :
 - (i) All the assets and liabilities of the transferor body corporate become, after amalgamation, the assets and liabilities of the transferee body corporate.
 - (ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor body corporate (other than the equity shares already held therein, immediately before the amalgamation, by the transferee body corporate or its subsidiaries or their nominees) become equity shareholders of the transferee body corporate by virtue of the amalgamation.

- (iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor body corporate who agree to become equity shareholders of the transferee body corporate is discharged by the transferee body corporate wholly by the issue of equity shares in the transferee body corporate, except that cash may be paid in respect of any fractional shares.
- (iv) The business of the transferor body corporate is intended to be carried on, after amalgamation, by the transferee body corporate.
- (v) No adjustment is intended to be made to the book values of the assets and liabilities of the Transferor Body corporate when they are in body corporate in the financial statements of the Transferee Body corporate except to ensure uniformity of accounting policies.
- (f) Amalgamation in the nature of purchase is an amalgamation, which does not satisfy any or more of the conditions specified in sub-paragraph (e) above.
- (g) Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the Transferee Body corporate to the shareholders of the Transferor Body corporate.
- (h) Fair value is the sum for which an asset could be exchanged between a knowledgeable willing buyer and a knowledgeable willing seller in an arm's length transaction.
 - (i) Pooling of interests is a technique of accounting for amalgamations the object of which is to account for the amalgamations as if the separate businesses of the amalgamating body corporates were intended to be continued by the transferee body corporate. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating body corporates.

Explanation

Types of Amalgamations

Generally speaking amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating body corporates but also of the shareholder's interests and of the businesses of these body corporates? Such amalgamations are amalgamations which are in the nature of 'merger' and the accounting treatment of such amalgamations should ensure that the resultant figures of assets, liabilities, capital and reserves more or less represent the sum of the relevant figures of the amalgamating body corporates. In the second category are those amalgamations which are in effect a mode by which one body corporate acquires another body corporate and as a consequence, the shareholders of the body corporate which is acquired normally do not continue to have a proportionate share in the quite of the combined body corporate or the business of the body corporate which is acquired is not intended to be continued. Such amalgamations are

amalgamations in the nature of 'purchase'.

An amalgamation is classified as an 'amalgamation in the nature of merger' when all the conditions listed above are satisfied. There are, however differing views regarding the nature of any further conditions that may apply. Some believe that in addition to an exchange of equity shares it is necessary that the shareholders of the transferor body corporate obtain a substantial share in the transferee body corporate even to the extent that it should not be possible to identify any one party as dominant therein. This belief is based in part on the view that the exchange of control of one body corporate for an insignificant share in a larger body corporate does not sum to a mutual sharing or risks and benefits.

Others believe that the substance of an amalgamation in the nature of merger is evidenced by meeting certain criteria regarding the relationship of the parties, such as the former independence of the amalgamating body corporates, the manner of their amalgamation, the absence of planned transactions that would undermine the effect of the amalgamation, and the continuing participation by the management of the transferor body corporate in the management of the transferee body corporate after the amalgamation.

Techniques of Accounting for Amalgamations

There are two main techniques of accounting for Amalgamations :

- (a.) the pooling of interests technique; and
- (b) The purchase technique.

The use of the pooling of interest technique is confined to circumstances which meet the criteria referred for an Amalgamation in the nature of merger.

The object of the purchase technique is to account for the Amalgamation by applying the same principles as are applied in the normal purchase of assets. The technique is used in accounting for Amalgamations in the nature of purchase.

The Pooling of Interests Technique

Under the pooling of interest's technique, the assets, liabilities and reserves of the transferor body corporate are recorded by the transferee body corporate at their existing carrying sums

If at the time of the Amalgamation, the transferor and the transferee body corporates have conflicting accounting policies, Amalgamations uniform set of accounting policies is adopted following the Amalgamations. The effects on the financial statements of any changes in accounting policies are reported in accordance with Accounting Standard (AS) 5, 'Prior Period and Extraordinary Items and Changes in Accounting Policies'.

Under the purchase technique the Transferee Body corporate accounts for the Amalgamation either by incorporating the assets and liabilities at their existing carrying sums or by allocating the consideration to individual identifiable assets and liabilities of

the transferor body corporate on the basis of their fair value at the date of Amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor body corporate.

Where assets and liabilities are restated on the basis of their fair values, the determination of fair values may be influenced by the intentions of the Transferee Body corporate. For example, the Transferee Body corporate may have Amalgamations specialized use for an asset, which is not available to other potential buyers. The transferee body corporate may intend to effect changes in the activities of the transferor body corporate which necessitate the creation of specific provisions for the expected costs, e.g. planned employee termination and plant relocation costs.

Consideration

The consideration for the Amalgamation may consist of securities, cash or other assets. In determining the value of the consideration, an assessment is made of the fair value of its elements. Amalgamation variety of techniques is applied in arriving at fair value. For example, when the consideration includes securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

Many Amalgamations recognize that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of Amalgamation, it is involved in the calculation of the consideration. In all other cases, the adjustment is recognized as soon as the sum is determinable [see. Accounting Standard (AS) 4 Contingencies and Event Occurring after the Balance Sheet Date].

Treatment of Reserves on Amalgamation

If the amalgamation is an 'amalgamations in the nature of merger'. The identify of the reserves is preserved and they appear in the financial statements of the transferee body corporate in the same form in which they appeared in the financial statements of the transferor body corporate. Thus, for example, the General Reserve of the Transferor Body corporate becomes the General Reserve of the Transferee Body corporate, the Capital Reserve of the Transferor Body corporate becomes the Capital Reserve of the Transferee Body corporate and the Revaluation Reserve of the Transferor Body corporate becomes the Revaluation Reserve of the Transferee Body corporate. As a result of preserving the identify, reserves which are available for distribution as dividend before the amalgamations would also be available for distribution as dividend after the Amalgamations. The difference between the sum recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the sum of share capital of the Transferor Body corporate is adjusted in reserves in the financial statements of the Transferee Body corporate.

If the amalgamation is an 'amalgamation in the nature of purchase', the identify of the reserves, other than the statutory reserves death with, is not preserved. The sum of the consideration is deducted from the value of the net assets of the transferor body corporate

acquired by the transferee body corporate. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and dealt with in the manner stated. If the result of the computation is positive, the difference is credited to Capital Reserve.

Certain reserves may have been created by the Transferor Body corporate pursuant to the requirements of, or to avail of the benefit under the Revenue-tax Act 1961; for examples, Development Allowance Reserve, or Investment Allowance Reserve. The Act requires that the identify of the reserves should be preserved for Amalgamations specified period. Likewise, certain other reserves may have been created in the financial statements of the Transferor Body corporate in terms of the requirements of other statutes. Though, normally in an amalgamation in the nature of purchase, the identify of reserves is not preserved, an exception is made in respect of reserves of the aforesaid nature (referred to hereinafter as 'statutory reserves') and such reserves retain their identify in the financial statements of the transferee body corporate in the same form in which they appeared in the financial statement of the transferor body corporate, so long as their identify is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the Transferee Body corporate are complied. In such cases, the statutory reserves are recorded in the financial statements of the transferee body corporate by Amalgamations corresponding debit to Amalgamations suitable account head (e.g. 'Amalgamations Adjustment Account') which is disclosed as part of "miscellaneous expenditure" or other similar category in the balance sheet. When the identify of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

Treatment of Goodwill arising on Amalgamation

Goodwill arising on arising on amalgamation represents Amalgamations payment made in anticipation of future revenue and it is appropriate to treat it as an asset to be amortized to revenue on Amalgamations systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is however, made on Amalgamations prudent basis. Accordingly it is considered appropriate to amortize goodwill over Amalgamations period not exceeding five years unless Amalgamations somewhat longer period can be justified.

Factors which may be considered in estimating the useful life of goodwill arising on Amalgamation include :

The foreseeable life of the business or industry;

The effects of product obsolescence, in demand and other economic factors;

The service life expectancies of key individuals or groups of employees;

Expected actions by competitors or potential competitors; and

Legal, regulatory or contractual provisions affecting the useful life.

Balance of Profit and Loss Account

In the case of an 'amalgamation in the nature of merger', the balance of the Profit and Loss Account appearing in the financial statements of the transferor body corporate is aggregated with the corresponding balance appearing in the financial statements of the transferee body corporate. Alternatively, it is transferred to the General Reserve, if any.

In the case of an 'amalgamation in the nature of purchase'. The balance of the Profit and Loss Account appearing in the financial statements of the transferor body corporate, whether debit or credit, loses its identify.

Treatment of Reserves Specified in Amalgamations Scheme of Amalgamation

The scheme of amalgamation sanctioned under the provisions of the Companies Act, 1956, or any other statute may prescribe the treatment to be given to the reserves of the Transferor Body corporate after its amalgamation. Where the treatment is so prescribed, the same is followed.

Disclosure

For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation :

- (a.) names and general natures of business of amalgamating body corporates;
- (b) Effective date of amalgamation for accounting purposes;
- (c) the technique of accounting used to reflect the amalgamation; and
- (d) Particulars of the schemes sanctioned under Amalgamations statute.

For amalgamations accounted for under the pooling of interests technique, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation :

- (a.) description and number of share issued, together with the percentage of each body corporate's equity shares exchanged to effect the amalgamation;
- (b) The sum of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

For amalgamations accounted for under the purchase techniques, the following additional disclosures are considered appropriate in the first statement following the amalgamation :

- (a.) consideration for the amalgamation and Amalgamations description of the consideration paid or continentally payable; and
- (b) The sum of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period

of amortization of any good-will arising on amalgamation.

Amalgamation after the Balance Sheet Date

When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure I made in accordance with AS 4, 'Contingencies and Events Occurring after the Balance Sheet Date'. But the amalgamation is not in body corporate in the financial statements. In certain circumstances the amalgamation may also provide additional information affecting the financial statements themselves, for instance by allowing the going concern assumption to be maintained.

Accounting Standard

An amalgamation may be either :

- (a.) an amalgamation in the nature of merger, or
- (b) An amalgamation in the nature of purchase.

An amalgamation should be considered to be an amalgamation in the nature of merger when all the following conditions are satisfied :

- (j) All the assets and liabilities of the transferor body corporate become, after amalgamation the assets and liabilities of the transferee body corporate.
- (ii) Shareholders holding not less than 90 % of the face value of the equity shares of the transferor body corporate (other than the equity shares already held therein, immediately before the amalgamation, by the transferee body corporate or its subsidiaries or their nominees) become equity shareholders of the transferee body corporate by virtue of the amalgamation.
- (iv) The consideration for the amalgamation receivable by those equity shareholders of the transferor body corporate who agree to become equity shareholders of the transferee body corporate is discharged by the transferee body corporate wholly by the issue of equity shares in the transferee body corporate except that cash may be paid in respect of any fractional shares.
- (v) The business of the Transferor Body corporate is intended to be carried on, after the amalgamation, by the transferee body corporate.
- (vi) No adjustments is intended to be made to the book value of the assets and liabilities of the transferor body corporate when they are in body corporate in the financial statements of the transferee body corporate except to ensure uniformity of accounting policies.

An Amalgamation should be considered to be an amalgamation in the nature of purchase when any one or more the conditions specified is not satisfied.

When an amalgamation is considered to be an amalgamation in the nature of merger it

should be accounted for under the pooling of interests technique described.

When an amalgamation is considered to be an amalgamation in the nature of purchase it should be accounted for under the purchase technique described.

The Pooling of Interests Technique

In preparing the transferee body corporate's financial statements, the assets, liabilities and reserves (whether capital or revenue or arising on revaluation) of the transferor body corporate should be recorded at their existing carrying sums and in the same form as at the date of the amalgamation. The balance of the Profit and Loss Account of the Transferor Body corporate should be aggregated with the corresponding balance of the Transferee Body corporate or transferred to the General Reserve, if any.

If, at the time of the amalgamation, the transferor and the transferee body corporates have conflicting accounting policies, Amalgamations uniform set of accounting policies hold be adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies should be reported in accordance with Accounting Standard (AS) 5 'Prior Period and Extraordinary Items and Changes in Accounting Policies'.

The difference between the sum recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the sum of share capital of the Transferor Body corporate should be adjusted in reserves.

In preparing the transferee body corporate's financial statement, the assets and liabilities of the transferor body corporate should be in body corporate at their existing carrying sums or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserve (whether capital or revenue or arising on revaluation) of the transferor body corporate, other than the statutory reserves, should not be involved in the financial statements of the transferee body corporate except as stated.

Any excess of the sum of the consideration over the value of the net assets of the Transferor Body corporate acquired by the Transferee Body corporate should be recognized in the transferee body corporate's financial statements as goodwill arising on amalgamation. If the sum of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.

The goodwill arising amalgamations should be amortized to revenue on Amalgamations systematic basis over its useful life. The amortization period should not exceed five years unless Amalgamations somewhat longer period can be justified

Here the requirements of the relevant statute for recording the statutory reserves in the books of the Transferee Body corporate are complied with, statutory reserves of the Transferor Body corporate should be recorded in the financial statements of the Transferee Body corporate. The corresponding debit should be recorded in the financial statements of the Transferee Body corporate. The corresponding debit should be given to as suitable account head (e.g. 'Amalgamation Adjustment Account') which should be disclosed as part of "miscellaneous expenditure" or other similar category in the balance

sheet. When the identify of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid accounts should be reversed.

The consideration for the amalgamation should include any non-cash element at fair value. In case of issue of securities the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets the fair value may be determined by reference to the market value of the asset given up. Where the market value of the asset given up cannot b reliably assessed, such assets may be valued at their respective net book values.

Where the scheme of amalgamation provides for an adjustment to the consideration contingent on one or more future events the sums of the additional payments should be involved in the consideration if payment is probable and a reasonable estimate of the sum can be made. In all other cases the adjustment should be recognized as soon as the sum is determinable [See Accounting Standard (AS) 4 Contingencies and Events Occurring after the Balance Sheet Date].

Treatment of Reserves Specified in a Scheme of Amalgamation

Where the scheme of amalgamation sanctioned under a statue prescribes the treatment to be given to the reserves of the transferor body corporate after amalgamation, the same should be followed.

Disclosure

For all amalgamations, the following disclosures should be made in the first financial statements following the amalgamation:

- (a) names and general nature of business of the amalgamating body corporates;
- (b) effective date of amalgamation for accounting purposes;
- (c) the technique of accounting used to reflect the amalgamation; and
- (d) Particulars of the scheme sanctioned under a statute.

For amalgamations accounted for under the pooling of interest's techniques, the following additional disclosures should be made in the first financial statements following the amalgamation:

- (a) description and number of shares issued together with the percentage of each body corporate's equity shares exchanged to effect the amalgamation; and
- (b) The sum of any difference between the consideration and the value of net identifiable asset acquired and the treatment thereof.

For amalgamations accounted for under the purchase technique, the following additional disclosures should be made in the first financial statements following

the amalgamations:

- (a.) consideration for the amalgamations and amalgamations description of the consideration paid or contingently payable; and
- (c) The sum of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortization of any goodwill arising on amalgamation.

Amalgamation after the Balance Sheet Date

When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation disclosure should be made in accordance with AS-4 'Contingencies and Events occurring after the Balance Sheet Date'. But the amalgamation should not be in body corporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance by allowing the going concern assumption to be maintained.

2.17 Accounting Standard - 15 Accounting For Retirement Benefits In The Financial Statements Of Employers

The following is the text of Accounting Standard (AS) 15 'Accounting for Retirement Benefits in the Financial Statements of Employer's, issued by the Council of the Institute of Chartered Accounts of India.

The Standard will come into effect in respect of accounting periods commencing on or after 1-4-1995 and will be mandatory in nature. The 'Statement on the Treatment of Retirement Gratuity in Accounts issued by the Institute will stand withdrawn from the aforesaid date.

Introduction

This Statement deals with accounting for retirement benefits in the financial statements of employers.

Retirement benefits usually consist of :

- (a.) Provident fund
- (b) Superannuating / pension
- (c) Gratuity
- (d) Leave enactment benefit on retirement
- (e) Post-retirement health and welfare schemes
- (f) Other retirement benefits.

The Statement applies to retirement benefits in the form of provident funds, superannuating/ pension and gratuity provided by an employer to employees, whether in pursuance of requirements of any law or otherwise. It also applies to retirement benefits in the form of leave enactment benefit, health and welfare schemes and other retirement benefits, if the predominant characteristics of these benefits are the same as those of provident fund, superannuation/pension or gratuity benefit, i.e. if such amalgamations retirement benefit is in the nature of either amalgamations defined contribution scheme or amalgamations defined benefit scheme as described in this Statement. This Statement does not apply to those retirement benefits for which the employer's obligation cannot be reasonably estimated, e.g. ad hoc ex-gratia payments made to employees on retirement.

Definitions.

The following terms are used in this Statement with the meanings specified :

Retirement benefit schemes are arrangements to provide provident fund, superannuating or pension gratuity, or other benefits to employees on leaving service or retiring or, after an employee's death, to his or her dependents.

Defined contribution schemes are retirement benefit schemes under which sums to be paid amalgamations as retirement benefits are determined by contributions to amalgamations fund together with earning thereon.

Defined benefit schemes are retirement benefit schemes under which sums to be paid as retirement benefit is determinable usually by reference to employee's earning and / or years of service.

Actuary means an amalgamation actuary within the meaning of Sub-Section (1) of Section (2) of the Insurance Act 1938.

Actuarial valuation is the process used by an actuary to estimate the present value of benefits to be paid under amalgamations retirement benefit scheme and the present values of the scheme assets and, sometimes, of future contributions.

Pay-as-you-go is a technique of recognizing the cost of retirement benefits only at the time payments are made to employees on, or after, their retirement.

Explanation

Retirement benefit schemes are normally significant elements of an employer's remuneration package for employees. It is therefore, important that retirement benefits are properly accounted for and that appropriate disclosures in respect hereof are made in the financial statement of an employer.

Provident fund benefit normally involves either creation of amalgamations separate trust to which contributions of both employees and employer are made periodically or remittance of such contributions to the employees provident fund, administered by the Central Government.

Superannuation/pension benefit (hereinafter referred to as 'superannuation benefit') is basically of two types.

(a.) The first type of benefit is known as defined contribution scheme. Under this type of benefit the employer makes amalgamations contribution once amalgamations year (or more frequently in some cases) towards amalgamations separately created trust funds or to amalgamations scheme administered by an insurer. These contributions earn interest and the accumulated balance of contributions and interest is used to pay the retirement benefit to the employee. Superannuation amalgamations available under defined contribution scheme has relevance to only total of accumulated contributions and interest and bears no relationship, what so defined contribution scheme for superannuating/ pension is in most respects similar to the provident fund, so far as the accounting treatment is concerned. It also presupposes payment of contributions every year, either in amalgamations year or more frequently.

(b) The second types of superannuation scheme is the defined benefit scheme. Under this scheme, the benefit payable to the employee is determined with reference to factors such as percentage of final salary (e.g. the average of one three or five years' salary) number of years of service and the grade of the employee. The contribution required to finance such scheme is actuarially determined and is generally expressed as percentage of salary for the entire group of employees covered by the scheme. For defined benefit superannuation/pension scheme, trust fund can be created or an arrangement can be negotiated with an insurer so that the annual contributions calculated actuarially can be made each year. In such amalgamations the employer as and when an employee leaves would pay case benefits to employees on entitlement would be paid by the trust fund or by the insurer. Alternatively, the superannuating benefit can be paid by the employer as and when an employee leaves.

Gratuity benefit is in the nature of a defined benefit. The employer as and when an employee leaves can pay gratuity. Alternatively, a trust fund can be created, or an arrangement can be negotiated with an insurer so that the annual contributions calculated actuarially can be made each year. Benefits to employees on entitlement would in such a case be paid by the trust fund or by the insurer.

In certain cases, a retirement benefit scheme may stipulate the basis of contributions on which the benefits are determined and because of this, may appear to be a defined contribution scheme. However, the provisions of the scheme may also result in the employer being responsible for specified benefits or a specified level of benefits. In this case, the schemes, is, in substance, a defined benefit scheme and should be accounted for accordingly.

While provident fund schemes are generally contributory schemes from the point of view of employees, gratuity schemes are non-contributory. The superannuating schemes, on the other hand, can be contributory or non-contributory.

Defined benefit schemes, especially those that promise benefits related to remuneration at or near retirement present significant difficulties in the determination of periodic charge to the statement of profit and loss. The extent of

an employer's obligation under such schemes is usually uncertain and requires future conditions and events, which are largely outside the employer's control.

As a result of various factors that frequently enter into the computation of retirement benefits under defined benefit schemes and the length of the period over which the benefits are earned, allocation problems arise in determining how the costs of the retirement benefits should be recognized in the financial statements of the employer. Furthermore, long-term uncertainties may give rise to adjustment of estimates of earlier years that can be very significant in relation to current service cost.

The cost of retirement benefits to an employer results receiving services from the employees who are entitle to receive such benefits. Consequently, the cost of retirement benefits is accounted for in the period during which these services are rendered. Accounting for retirement benefit cost only when employees retire or receive benefits payment (i.e. per pay-as-you-go technique) does not achieve the objective of allocation of those costs the periods in which the services were rendered.

Funding

When there is separate retirement benefit fund, it is sometimes assumed that the sum paid by an employer to the fund during an accounting period provides an appropriate charge to the statement of profit and loss. While, in many cases, the sum funded may provided a reasonable approximation of the sum to be charged to the statement of profit and loss, there is a vital distinction between the periodic funding of retirement benefits and the allocation of the cost of providing these benefits.

The objective of funding is to make available sum to meet future obligations for the payment of retirement benefits. Funding is a financing procedure and in determining the periodical sum to be funded, the employer may be influenced by such factors as the availability of money and tax considerations.

On the other hand, the objective of accounting for the cost of a retirement benefit scheme is to ensure that the cost of benefits is allocate dot accounting periods on a systematic basis related to the receipt of the employees services.

Accounting

In respect of retirement benefits in the form of provident fund and other defined contribution schemes, the contribution payable by the employer for a year is charged to the statement of profit and loss for the year. Thus, besides the sum of contribution paid, a shortfall of the sum of contribution paid compared to the sum payable for the year is also charged to the statement of profit and loss for the year. On the other hand, if contribution paid is in excess of the sum payable for the year, the excess is treated as a pre-payment.

In respect of gratuity benefit and other defined benefit schemes, the accounting treatment depends on the type of arrangement which the employer has chose to make:

- (i) If the employer has chose to make payment for retirement out of his own funds,

an appropriate charges to the statement of profit and loss for the year is made through a provision for the accruing liability. The accruing liability is calculated according to actuarial valuation. However, many enterprises which employ only a few persons do not calculate the accrued liability by using actuarial techniques. They calculate the accrued liability by reference to some other rational technique e.g. a technique based on the assumption that such benefits are payable to all employees at the end of the accounting year.

- (ii) In case the liability for retirement benefits is funded through creation of trust, the cost incurred for the year is determined actuarially. Many employers undertake such valuations every year while others undertake them less frequently, usually once in every three years. If actuarial valuations are conducted every year, the annual accrual of retirement benefits cost can be easily determined. If, however, the actuarial valuations are not conducted annually, the actuary's report specifies the contribution to be made by the employer on annual basis for the inter-valuation period. This annual contribution (which is in addition to the contribution that may be required to finance unfunded past services cost) reflects proper accrual of retirement benefit cost for each of the years during the inter-valuation period and is charged to the statement of profit and loss for each such year. Where the contribution paid during a year is lower than the sum required to be contributed during the year to meet the accrued liability as certified by the actuary, the excess is treated as a pre-payment
- (iii) In case the liability for retirement benefits is funded through a scheme administered by an insurer, it is usually considered necessary to obtain an actuarial certificate or a confirmation from the insurer that the contribution payable to the insurer is the appropriate accrual of the liability for the year. Where the contribution paid during a year is lower than the sum required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the shortfall is charged to the statement of profit and loss for the year. Where the contribution paid during a year is in excess of the sum required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the excess is treated as a pre-payment.

Actuarial Principles

A number of actuarial valuation techniques have been developed by the actuarial profession to estimate employer's obligations under defined benefit schemes. While these techniques are primarily designed to calculate funding requirements, they are also frequently used to determine retirement benefit costs for accounting purposes.

The actuarial technique selected for determining accrual of liability and the assumptions made can have a significant effect on the expense to be recorded in each accounting period. Therefore, in carrying out a periodical valuation, an actuary chooses a suitable valuation technique and, in consultation with the employer, makes appropriate assumptions about the variable elements affecting the computations.

The assumptions relate to the expected inflow from future contributions and from investments as well as to the expected outgo for benefits. The uncertainty inherent in

projecting future trends in rates of inflation, salary levels and earnings on investments are taken into consideration by the actuary in the actuarial valuations by using a set of compatible assumptions. Usually, these projections are extended until the expected date of death of the last pensioner in case of a superannuation scheme, expected date of death etc. of the beneficiary in case of family pension, and expected service in case of gratuity and are, accordingly, long-term.

Past Service Cost and Review of Actuarial Assumptions

An actuarially determined past service cost arises on the introduction of a retirement benefit scheme for existing employees or on the making of improvements to an existing scheme, etc. This cost gives employees credit for benefits for services rendered before the occurrence of one or more of these events.

Views differ as to how to account for this cost. One view is that this cost should be recognized as soon as it has been determined. Others believe that the entitlement giving rise to past service cost is in return for services to be rendered by employees in future and therefore, this cost ought to be allocated over the period during which the services are to be rendered.

In making an actuarial valuation, the actuary may sometimes effect a change in the actuarial technique used or in the assumption adopted for determining the retirement benefit costs. Any alterations in the retirement benefit cost so arising are charged or credited to the statement of profit and loss for the year or, alternatively, spread over a period not more than the expected remaining working lives of the participating employees. A change in the actuarial technique used for determining the retirement benefit costs constitutes a change in an accounting policy and is disclosed accordingly.

Retired Employees

When a retirement benefit scheme for retired employees is amended, due to inflation or for other reasons, to provide additional benefits to retired employees, any additional cost are charged to the statement of profit and loss of the year.

Disclosures

In view of the diversity of practices used for accounting of retirement benefit costs, adequate disclosure of technique followed in accounting for them is essential for an understanding of the significance of such cost to an employer.

Retirement benefit cost are sometimes disclosed separately for statutory compliance. In other cases, they are considered to be an element of employee remuneration and their separate disclosure is not usually made.

Accounting Standard

In respect of retirement benefits in the form of provident fund and other defined contribution scheme, the contribution payable by the employer for a year should be charged to the statement of profit and loss for the year. Thus, besides the sum of contribution paid, a shortfall of the sum of contribution paid compared to the sum

payable for the year should also be charged to the statement of profit and loss for the year. On the other hand, if contribution paid is in excess of the sum payable for the year, the excess should be treated as a pre-payment.

In respect of gratuity benefit and other defined benefit schemes, the accounting treatment will depend on the type of arrangement which the employer has chosen to make.

- (i) If the employer has chosen to make payment for retirement benefits out of his own funds, an appropriate charge to the statement of profit and loss for the year should be made through a provision for the accruing liability. The accruing liability should be calculated according to actuarial valuation. However, those enterprises which employ only a few persons may calculate the accrued liability by reference to any other rational technique e.g., a technique based on the assumption that such benefits are payable to all employees at the end of the accounting year.
- (ii) In case the liability for retirement benefits is funded through creation of a trust the cost incurred for the year should be determined actuarially. Such actuarial valuation should normally be conducted at least once in every three years. However, where the actuarial valuation are not conducted annually, the actuary's report should specify the contributions to be made by the employer on annual basis during the inter-valuation period. This annual contribution (which is in addition to the contribution that may be required to finance unfounded past services cost) reflects proper accrual of retirement benefit cost for each of the year during the inter-valuation period and should be charged to the statement of profit and loss for each such year. Where the contribution paid during a year is lower than the sum required to be contributed during the year to meet the accrued liability as certified by the actuary, the shortfall should be charged to the statement of profit and loss for the year. Where the contribution paid during a year is in excess of the sum required to be contributed during the year to meet the accrued liability as certified by the actuary, the excess should be treated as a pre-payment.
- (iii) In case the liability for retirement benefits is funded through a scheme administered by an insurer, an actuarial certificate or a confirmation form the insurer should be obtained that the contribution payable to the insure is the appropriate accrual of the liability for the year. Where the contribution paid during a year is lower than the sum required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the shortfall should be charged to the statement of profit and loss for the year. Where the contribution paid during a year is in excess of the sum required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the excess should be treated as a pre-payment.

Any alterations in the retirement benefit costs arising from:

- (a) Introduction of a retirement benefit scheme for existing employees or making of improvements to an existing scheme, or

(b) Changes in the actuarial technique used or assumptions adopted, should be charged or credited to the statement 5 (AS 5), "Prior Period and Extraordinary Items and Change in Accounting Policies". Additionally, a change in the actuarial technique used should be treated as a change in an accounting policy and disclosed in accordance with Accounting Standard (AS) 5, "Prior Period and Extraordinary Items and Changes in Accounting Policies".

When a retirement benefit scheme is amended with the result that additional benefits are provided to retired employees, the cost of the additional benefits should be accounted for in accordance with.

Disclosures

The financial statement should disclose the technique by which retirement benefits costs for the period have been determined. In case the costs related to gratuity and other defined benefit schemes are based on an actuarial valuation, the financial statements should also disclose whether the actuarial was made at the end of the period or at an earlier date. In the latter case, the date of the actuarial valuation should be specified and the technique by which the accrual for the period has been determined should also be briefly described, if the same is not based on the report of the actuary.

2.18 Accounting Standard (As 16) – Borrowing Costs

Borrowing Costs

(In this Accounting Standard, the standard portions have been set in **bold** type. These should be read in the context of the background material which has been set in normal type, and in the context of the 'Preface to the Statements of Accounting Standards').

The following is the text of Accounting Standard (AS) 16, 'Borrowing Costs', issued by the Council of the Institute of Chartered Accountants of India. This Standard comes into effect in respect of accounting periods commencing on or after 1-4-2000 and is mandatory in nature.

Objective

The objective of this Statement is to prescribe the accounting treatment for borrowing costs.

Scope

This Statement should be applied in accounting for borrowing costs.

2. This Statement does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

Definitions

The following terms are used in this Statement with the meanings specified:

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Borrowing costs may include:

- (a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;
- (b) amortization of discounts or premiums relating to borrowings;
- (c) amortization of ancillary costs incurred in connection with the arrangement of borrowings;
- (d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and
- (e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Recognition

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. The sum of borrowing costs eligible for capitalization should be determined in accordance with this Statement. Other borrowing costs should be recognized as an expense in the period in which they are incurred.

Borrowing costs are capitalized as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognized as an expense in the period in which they are incurred.

Borrowing Costs Eligible for Capitalization

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an enterprise is coordinated centrally or when a range of debt instruments are used to

borrow funds at varying rates of interest and such borrowings are not readily identifiable with a specific qualifying asset. As a result, the determination of the sum of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is often difficult and the exercise of judgment is required.

To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the sum of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any revenue on the temporary investment of those borrowings.

The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the sum of borrowing costs eligible for capitalization during a period, any revenue earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the sum of borrowing costs eligible for capitalization should be determined by applying a capitalization rate to the expenditure on that asset. The capitalization rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The sum of borrowing costs capitalized during a period should not exceed the sum of borrowing costs incurred during that period.

Excess of the Carrying Sum of the Qualifying Asset over Recoverable Sum

When the carrying sum or the expected ultimate cost of the qualifying asset exceeds its recoverable sum or net realizable value, the carrying sum is written down or written off in accordance with the requirements of other Accounting Standards. In certain circumstances, the sum of the write-down or write-off is written back in accordance with those other Accounting Standards.

Commencement of Capitalization

The capitalization of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

- (a) Expenditure for the acquisition, construction or production of a qualifying asset is being incurred;
- (b) borrowing costs are being incurred; and
- (c) activities that are necessary to prepare the asset for its intended use or sale are in progress.

Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset (see Accounting Standard 12, Accounting for Government

Grants). The average carrying sum of the asset during a period, including borrowing costs previously capitalized, is normally a reasonable approximation of the expenditure to which the capitalization rate is applied in that period.

The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalized during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalization.

Suspension of Capitalization

Capitalization of borrowing costs should be suspended during extended periods in which active development is interrupted.

Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalization. However, capitalization of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalization of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalization continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Cessation of Capitalization

Capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalization of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

Disclosure

The financial statements should disclose:

- (a) the accounting policy adopted for borrowing costs; and
- (b) the sum of borrowing costs capitalized during the period.

2.19 Exercise:

1. Explain the concept of accounting standards?
2. State the usefulness and scope of accounting standards?
3. Write a note on AS-1?
4. Write a note on AS-9?
5. Write a note on AS-6?
6. Write a note on AS-7?
7. Write a note on AS-16?



