

Accounting Standards

An introduction

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Financial reporting

- ◆ **Reliable and transparent financial reporting is particularly important in an evolving business environment and is also fundamental to the well-being of capital markets**
- ◆ **Though financial reporting cannot forecast the strengths and weaknesses of the economy, the financial statements and related information MD&A can provide useful information that allows users to make informed decisions and facilitates continued efficient functioning of capital markets**

Role of GAAP in Quality Financial Reporting

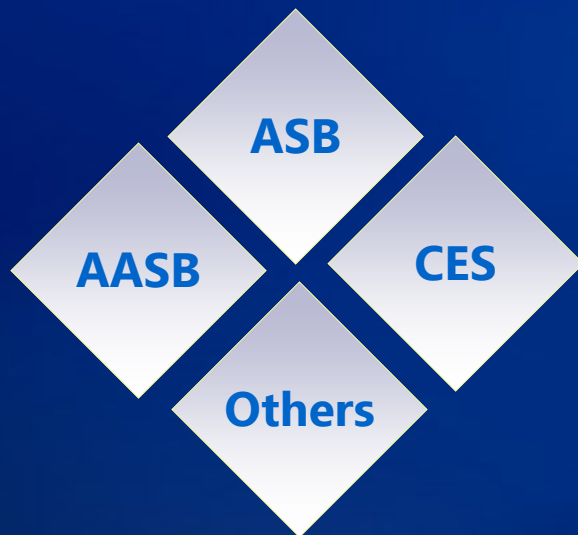
◆ A Framework is necessary to:

- Understand the information needs of users
- Define acceptable form and content
- Establish principles for measurement
- Enhance consistency to facilitate comparability
- Provide disclosures for improved transparency

◆ Continuous monitoring and improvements are necessary to reflect changes in economic and other conditions.

Accounting Standards setting

Standard setting bodies



Reviews accounting standards and makes recommendations to Central Government for notification of standards

Standard setting - history

- ◆ ICAI first took up the task of laying down standards of accounting in India in 1977
 - ▬ accounting standards issued by the ICAI were however mandatory only for its members
- ◆ Companies (Amendment) Act, 1999 gave recognition to accounting standards thereby making it mandatory for companies
 - ▬ Standards to be formulated by ASB/ICAI Council
 - ▬ Standards to be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards (NACAS)
 - ▬ Pending notification of standards by NACAS, standards issued by the ICAI are required to be followed

NACAS-National Advisory Committee on Accounting Standards

- ◆ Completed the review of all the standards of accounting issued by the ICAI till date and has finalised and submitted its recommendations on the same to the Government for notification under the Companies Act, 1956
 - 29 accounting standards have been recommended by NACAS and prescribed by the Central Government
 - necessary exemptions and relaxations to Small and Medium Companies have been recommended

ICAI - Big leap in financial reporting

	Before 2000	In and after 2000	Total
Accounting Standards (AS)	15	17	32*

* Revisions	
Accounting standards	2

Indian GAAP is being modified on a continuous basis

The Accounting Standards

- ◆ AS 1: Disclosure of Accounting policies
- ◆ AS 2: Valuation of inventories
- ◆ AS 3: Cash Flow Statement
- ◆ AS 4: Contingencies and events occurring after balance sheet date
- ◆ AS 5: Net P/L for the period, Prior period items and Changes in Accounting policies
- ◆ AS 6: Depreciation Accounting
- ◆ AS 7: Construction contracts
- ◆ AS 8: Accounting for Research and Development (withdrn/AS 26)
- ◆ AS 9: Revenue recognition
- ◆ AS 10: Accounting for fixed assets

The Accounting Standards

- ◆ AS 11: The effects of changes in foreign exchange rates
- ◆ AS 12: Accounting for Government Grants
- ◆ AS 13: Accounting for investments
- ◆ AS 14: Accounting for amalgamations
- ◆ AS 15: Employee benefits
- ◆ AS 16: Borrowing costs
- ◆ AS 17: Segment reporting
- ◆ AS 18: Related party disclosure
- ◆ AS 19: Leases
- ◆ AS 20: Earnings per share

The Accounting Standards

- ◆ AS 21: Consolidated accounting statements
- ◆ AS 22: Accounting for taxes on income
- ◆ AS 23: Accounting for investments in associates in consolidated financial statements
- ◆ AS 24: Discontinuing operations
- ◆ AS 25: Interim financial reporting
- ◆ AS 26: Intangible assets
- ◆ AS 27: Financial reporting of interest in joint ventures
- ◆ AS 28: Impairment of assets
- ◆ AS 29: Provisions, contingent liabilities and contingent assets

Applicability

ICAI

ICAI classifies enterprises into **three** categories

- Level I (large),
- Level II (medium) and
- Level III (small)

RULES

The Rules stipulate only **two** categories –

- (i) Small and Medium Sized Company (SMC) which is entitled to certain exemptions and
- (ii) other companies

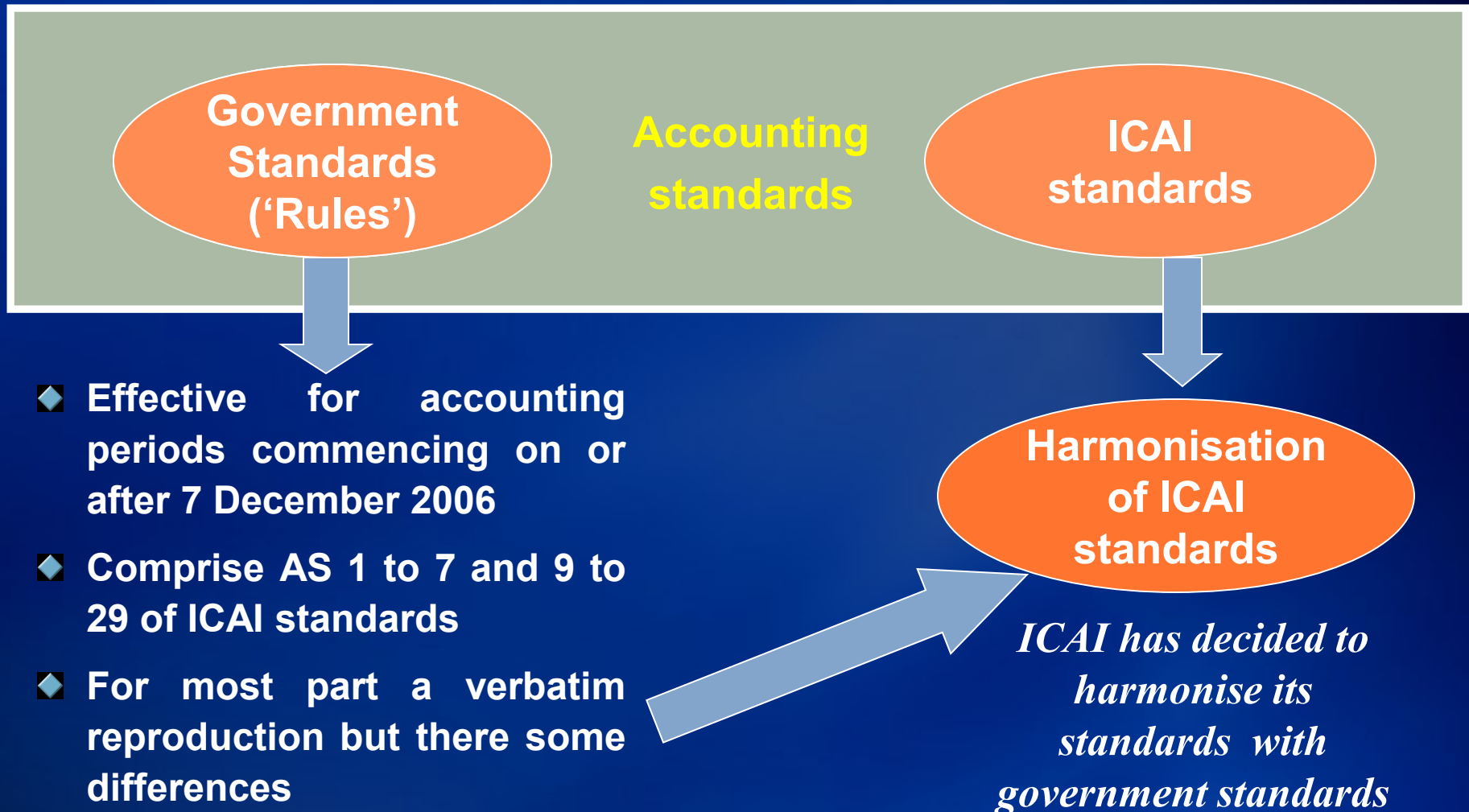
Unlike ICAI, no distinction between small and medium companies

The prescribed standards are mandatory for all companies except as exempted/relaxed for SMCs.

SMC means a company –

- 1 Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India
- 2 Which is not a bank, financial institution or insurance company
- 3 Whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year
- 4 Which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the **immediately preceding accounting year** and
- 5 Which is not a holding or subsidiary company of a company which is not a small and medium-sized company

Harmonisation of accounting standards



Harmonisation of the standards issued by ICAI with those notified by Central Government

Harmonisation with regard to applicability of Accounting Standards to various levels of entities

ICAI to continue with three levels – Level I, II and III (Two levels in Rules)

- **Level I to reflect the same criteria as ‘Other than SMCs’ as per Government standards with inclusion of cooperative banks**
- **Level II to include all SMCs and non-corporates as per specified criteria**
- **Level III to include non-corporates only not covered above**

AS 1- Disclosure of Accounting Policies

- ◆ **Disclose all significant accounting policies at one place as part of the financial statements**
- ◆ **Any change in accounting policy, having a material effect in the current period or expected to have a material effect in later periods needs to be disclosed**
- ◆ **Fundamental accounting assumptions: Going concern, Consistency and Accrual**

AS 2 - Valuation of Inventories

- ◆ Valued at lower of cost or net realisable value
- ◆ Cost usually determined on a FIFO, weighted average or specific identification
- ◆ Cost to include all duties, taxes etc.
- ◆ Production overheads to be included
- ◆ Disclose accounting policy (including cost formulae)

AS 3 – Cash Flow Statement

- ◆ **Direct and indirect methods**
- ◆ **Report cash flows during the accounting period**
- ◆ **Report cash flows classified by operating, investing and financing activities**
- ◆ **Disclose components of cash and cash equivalents**

AS 4 - Contingencies and Events Occurring after the Balance Sheet Date

Contingencies

- ◆ Contingency is a condition or situation, the ultimate outcome of which (g/l) will be known only on the occurrence or non occurrence of one or more future events.
- ◆ Provision/disclosure of existence, nature and quantum of contingent loss based on degree of probability of occurrence
- ◆ No accounting for contingent asset

Events occurring after the balance sheet date

- ◆ Make adjustments if events provide additional evidence relating to conditions existing at the balance sheet date or indicate that the going concern assumption is not appropriate
- ◆ Disclose nature of event and impact

AS 5 - Net Profit or Loss for the Period, Prior Period and Extraordinary Items and Changes in Accounting Policies

Net profit or loss

- ◆ Comprises profit or loss from ordinary activities and extraordinary items
- ◆ Disclose nature and amount of extraordinary items separately
- ◆ Disclose large items of income and expense within profit or loss from ordinary activities

Prior period items

- ◆ Are errors or omissions
- ◆ Included in determination of net profit or loss

Changes in accounting policies

- ◆ Only if required by statute or considered more appropriate
- ◆ Disclose impact and adjustments, if material

AS 6 - Depreciation Accounting

- ◆ Allocate depreciable amount on a systematic basis over the useful life of the asset
- ◆ Apply method consistently
- ◆ For change in method, recalculate depreciation retrospectively
- ◆ For revision in useful lives, amortize unamortised amounts over remaining useful lives
- ◆ Revaluation
- ◆ Disclosures- historical cost
 - total depreciation for the current period
 - accumulated depreciation
 - method
 - rates, if different from the Companies Act

AS 9 - Revenue Recognition

Recognise revenue only when

- ◆ amount is ascertainable
 - ◆ it is not unreasonable to collect ultimate collection
- and

Sale of goods

- ◆ property in goods or significant risks or rewards of ownership transferred to the buyer

Sale of services

- ◆ performance of services
 - completed service contract method
 - proportionate completion method

AS 9 - Revenue Recognition (continued)

Others

Interest: time proportion basis

Royalties: accrual basis as per agreed terms

Dividends: right to receive established

Case study – Bill and hold

- ◆ **Company A offers its customers financial incentives to write purchase orders before they actually need the goods. Since many customers wish to take advantage of these inducements but cannot burden their warehouses with out-of-season merchandise, Company A offers to hold the goods for the customers until they request delivery. In most cases Company A pays the cost of storage, shipment and insurance on the goods.**

Question

- ◆ **May Company A recognise the revenue in the current financial year for the sale of the goods?**

Case study – Presentation of turnover

A Ltd has a turnover of INR 500,000 on which an excise duty of INR 50,000 has been paid. How should the turnover be disclosed in the financial statements?

Option 1: Net turnover of INR 450,000 (500,000 – 50,000) should be disclosed on the face of the profit and loss account. Disclosure of the excise duty paid is disclosed in the schedules to the financial statements.

Option 2: On the face of the P/L Account

Turnover (gross)	500,000
Less: Excise Duty	50,000
Turnover (net)	450,000

AS 13 - Accounting for Investments

◆ Classification of investments

- Long term
- Current

◆ Carrying value

- Long term valued at cost less diminution in value , other than temporary
- Current valued at lower of cost and market value

◆ Several disclosures required under schedule VI.

AS 15 – Employee benefits-Four broad areas

Short-term employee benefits

Wages, salaries, paid annual leave, profit-sharing and bonuses (payable in 12 months) & non-monetary benefits for current employees

Long-term employee benefits

Long-service leave, long-term disability benefits, profit-sharing, bonuses and deferred compensation (if not payable within 12 months of end of the period)

Post-employment benefits

Gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care

Termination benefits

VRS

As 18 - Related party transactions

Related party relationship

- ◆ Ability to control or exercise significant influence over financial/operating decisions
- ◆ Both enterprises need to comply with disclosure requirements

Related party transaction...

Transfer of resources or obligations between related parties, regardless of whether or not a price is charged

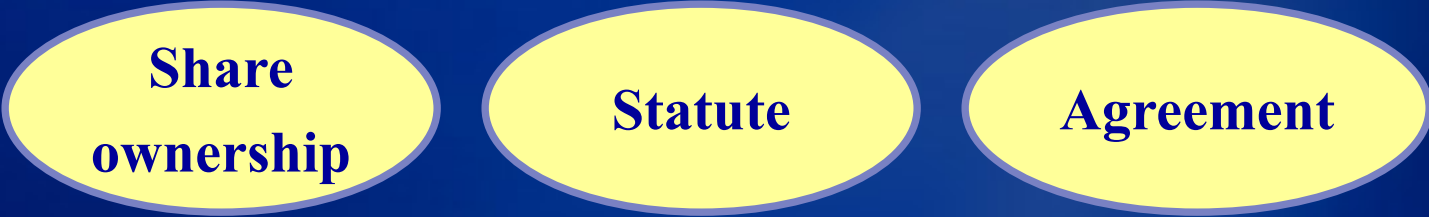
Control

- ◆ Ownership, directly or indirectly, of more than one half of the voting power
 - ◆ Control of composition of governing body (board of directors in the case of a company)
 - ◆ A substantial interest in voting power (20% or more) and power under statute/agreement to direct financial and/or operating policies of the enterprise
-

Significant influence

- ◆ Participation in financial and/or operating policy decisions but not control

- ◆ May be gained by



Share
ownership

Statute

Agreement

- ◆ Assumed to exist in case of holding of 20% or more voting power **directly or indirectly**. This assumption is however rebuttable

Relationships covered

- ◆ Control by another enterprise (parent)
 - ◆ Control of another enterprise (subsidiary)
 - ◆ Under common control (fellow subsidiary)
- } Control through one or more intermediaries i.e. subsidiaries
- ◆ Associates/joint ventures
 - ◆ Investor in respect of which the enterprise is an associate
 - ◆ Co-venturer
 - ◆ Individuals owning, directly or indirectly, voting power that gives them control or significant influence ('major owners') and their relatives (spouse, children, parents, brother, sister)
 - ◆ Key management personnel and their relatives
 - ◆ Enterprises over which major owners, key management personnel or their relatives are able to exercise significant influence

Excludes non –executive directors

Not considered related parties

-  Two companies simply because they have a director in common
-  A single customer, supplier, franchiser, distributor or general agent
-  Providers of finance, trade unions, public utilities, government departments and government agencies in the course of their normal dealing

Examples of related party transactions

- ✓ **Purchases or sales of goods or fixed assets**
- ✓ **Rendering or receiving of services**
- ✓ **Agency arrangements**
- ✓ **Leasing or hire purchase arrangements**
- ✓ **Transfer of research and development**
- ✓ **License agreements**
- ✓ **Finance (including loans and equity contributions in cash/kind)**
- ✓ **Guarantee and collaterals**
- ✓ **Management contracts including for deputation of employees.**

AS 18 – case study

If a parent owns along with its subsidiary more than one-half of the voting power in an enterprise, whether that enterprise will be considered as a related party of the parent?

For instance, A Limited owns 60 per cent of the voting power of B Limited, which in turn owns 40 per cent of the voting interest in C Limited. Further, A Limited also directly owns 15 per cent of the voting interest in C Limited. As a result of the holding structure, A Limited has an economic interest in C Limited of 39 per cent (15 per cent plus 60 per cent of 40 per cent). Would A Limited be deemed to have control over C Limited, or would it only be considered as exercising significant influence?

AS 18 – Solution

A Limited would be considered to have control over C Limited. The definition of control, contained in paragraph 10 of the statement, includes ownership, directly or indirectly, of more than one-half of the voting power of another enterprise. As A Limited is a majority shareholder in B Limited it has control over it. Further, as A Limited and B Limited, together are majority shareholders in C Limited, A Limited has indirect control over it. Accordingly, A Limited has the ability to control C Limited, indirectly, via the share ownership in B Limited, apart from its individual shareholding in C Limited.

AS 18 – Case study

Would ownership of less than 20 per cent of voting power in an enterprise along with representation on the board of directors result in a control relationship?

For example, AB Limited acquires a 12 per cent voting power in LM Limited. AB Limited being the single largest shareholder of LM Limited appoints the chairman and one other member of the Board of Directors of LM Limited (out of a total of 12 directors). These nominees of AB Limited are not directors of AB Limited. By virtue of its representation on the board (through two nominees) of LM Limited, AB limited participates in the financial and operating policy decisions of the enterprise taken at the board meetings. Would AB Limited be considered as exercising control over LM Limited?

AS 18 – Solution

- ◆ **AB Limited's relationship with LM Limited is not one of control as per paragraph 10 of the Statement as it does not:**
 - own, directly or indirectly, more than one half of the voting power of LM Limited, or
 - control the composition of the board of directors of LM Limited, or
 - hold a substantial interest in voting power in LM Limited (over 20 per cent) and the power to direct the financial and/or operating policies of LM Limited.
- ◆ **However, the standard includes “associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture” as a related party relationship.**
- ◆ **In the given example, there is no agreement or statute, which gives AB Limited any power to exert significant influence. However, by virtue of its ownership of voting power to the extent of 12 per cent and being the single largest shareholder, AB Limited participates in the financial and operating policy decisions of LM Limited, Therefore, in this case it is clearly demonstrated that AB Limited has significant influence over LM Limited. Accordingly, LM Limited is a related party of AB Limited.**

AS 19, Leases - Classification

The overriding principle

Substance over form

The key question

Have substantially all risks and rewards of ownership of the leased asset been transferred to the lessee ?

Timing of classification

At the inception of the lease

Finance lease

- ◆ Lease that transfers substantially all of the risks and rewards to the lessee



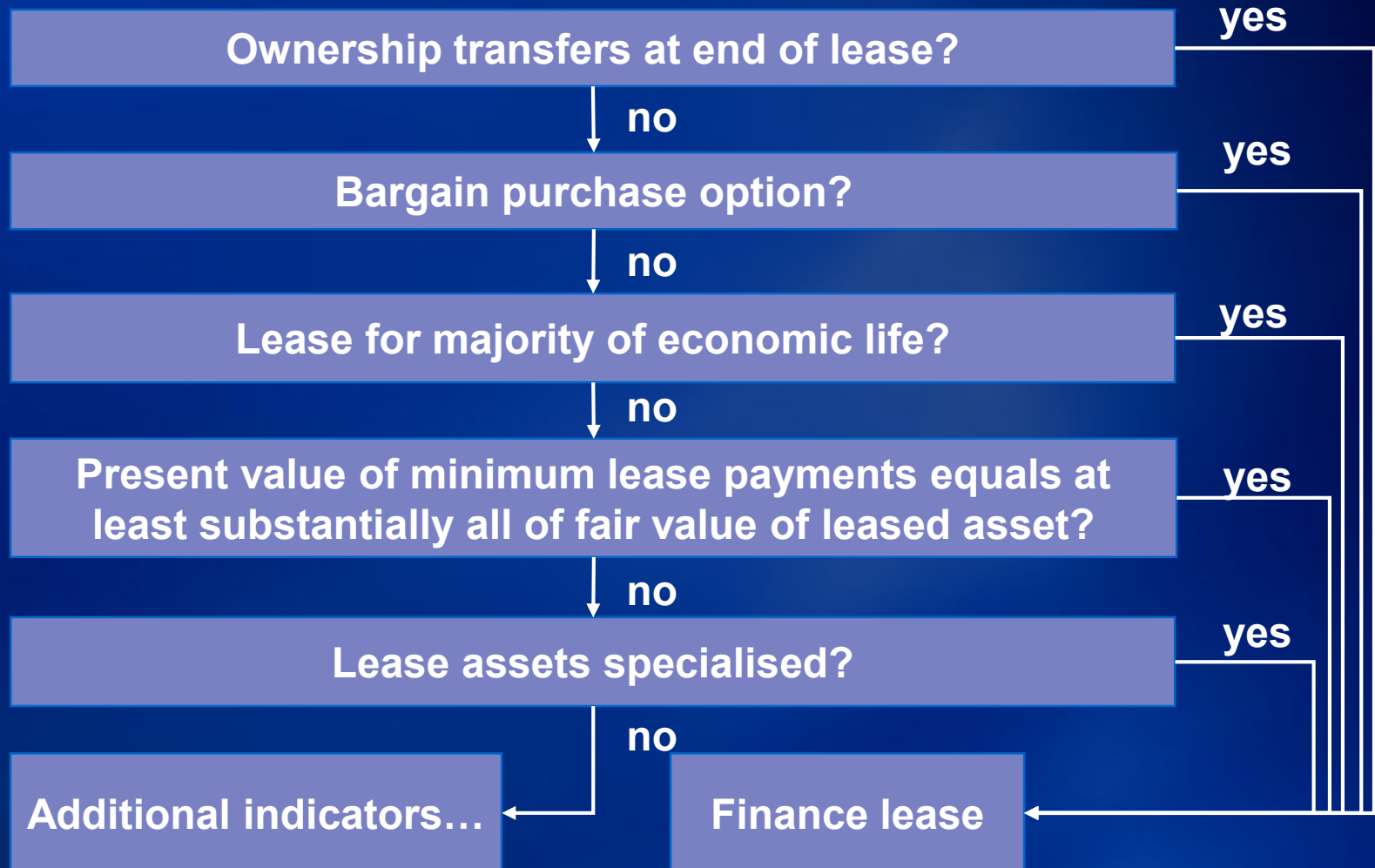
¹ i.e. derecognise leased asset, but not necessarily immediate recognition of gains/losses

Operating lease

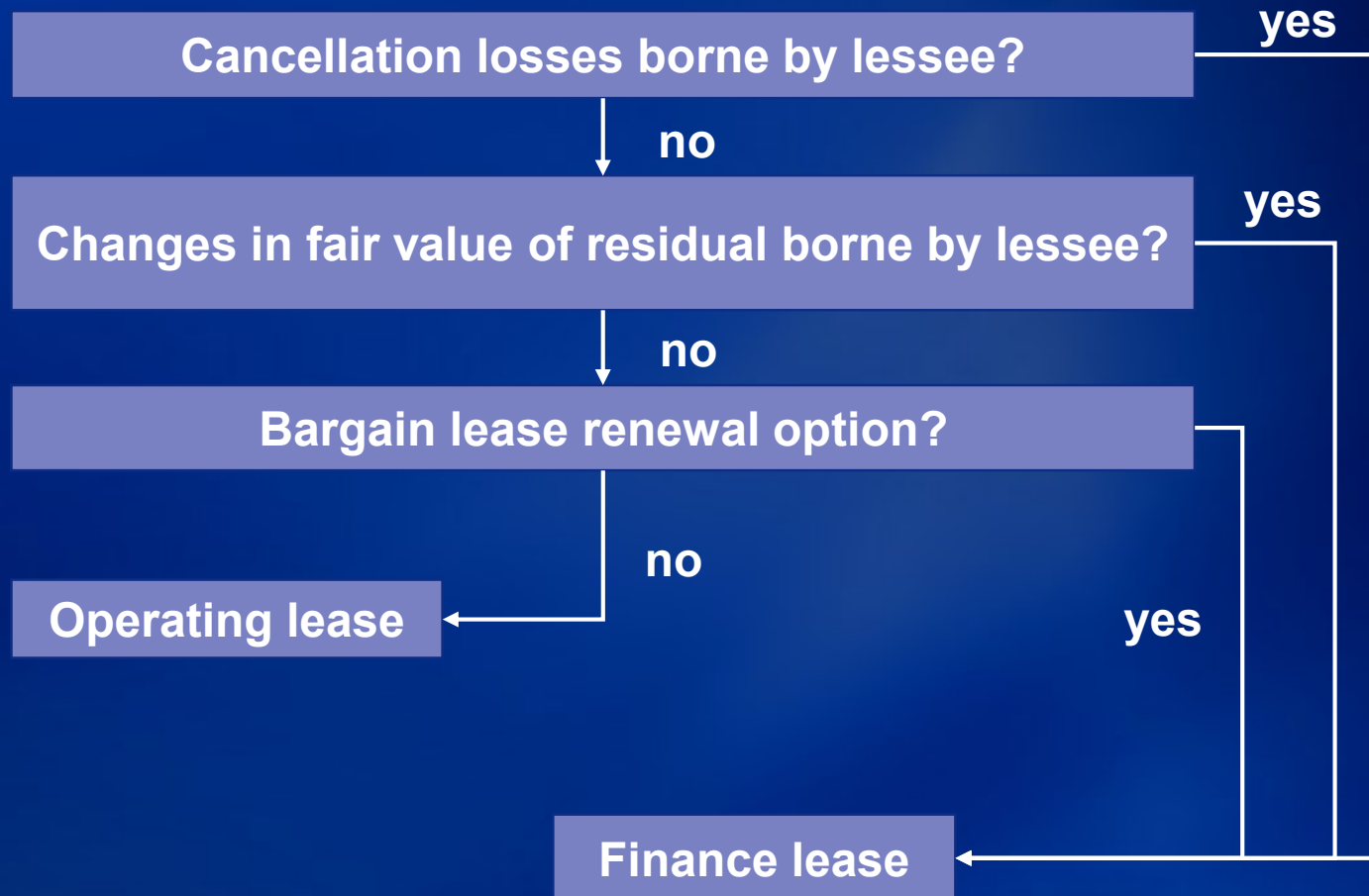
- ◆ Lease that does not transfer substantially all of the risks and rewards to the lessee



Indicators of a finance lease



More indicators of a finance lease



Operating lease-accounting

	Lessee	Lessor
Balance sheet	Prepaid/accrued lease rental payable	• Leased asset • Accrued/deferred lease rental receivable
Income statement	Lease rental expense	• Depreciation expense • Lease rental income

Operating lease - Example

◆ Example

- On 1 January 20X5, X signs a 5-year lease for equipment
- The cost of the equipment was 30,000
- Total lease payments are 20,000 (4,000/year)
- Unguaranteed residual value is 15,000
- Economic life of equipment is 10 years

◆ Questions

- Why is this an operating lease?
- What are the journal entries to be recorded at 1 January 20X5 and 31 December 20X5?

Operating lease - Solution (lessee)

No entry at 1 January 20X5

At 31 December 20X5:

Dr Rental expense	4,000	
Cr Cash or accrued lease rental payable		4,000

Operating lease - Solution (lessor)

At 1 January 20X5:

Dr Leased asset	30,000	
Cr Cash or creditor		30,000

At 31 December 20X5:

Dr Depreciation expense	3,000	
Cr Leased asset		3,000
Dr Cash or accrued lease rental	4,000	
Cr Lease rental income		4,000

AS 19, Leasing- Rent free period

- ◆ Larkspur leases a warehouse from Novato Properties on 1 January 2006. The non cancellable lease term is 10 years and the rent varies during the term of the lease.
- ◆ For years 1 through 5, Larkspur will pay INR 5,000 per month and for years 6 through 10, rent increases to INR 6,000 per month.
- ◆ As an incentive to sign a ten year lease agreement, Novato has given Larkspur the first 3 months of the contract rent-free.
- ◆ What is the annual rent expense recognized by Larkspur in 2006?

AS 19, Leasing-straight lining

- ◆ Rent for 3 months: zero.
- ◆ Rent for next 9 + 48 (57) months @ Rs 5000 pm equals Rs 285,000
- ◆ Rent for next 60 months @ Rs 6000 pm equals Rs 360,000
- ◆ Total rent earned in 10 years equals Rs 645,000
- ◆ Therefore rental income per annum is Rs 64,500

AS 25, Interim financial reporting

Interim period – discrete vs integral

Under the integral approach an interim period is treated as part of the financial year whereas under the discrete approach each interim period is considered as a discrete and a separate accounting period almost like a full fiscal year.

AS 25 takes a primarily discrete approach and by requiring an enterprise to apply the same accounting policies in its interim financial statements as in its annual financial statements seems to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period.

AS 25, Interim financial reporting

- ◆ **Depreciation will be based on the assets owned at the end of each interim period and not on the basis of planned capital expenditure for the entire year**
- ◆ **Cost benefiting two or more interim periods – e.g. major annual repairs - is charged in the interim period in which it is incurred instead of each interim period being charged an appropriate amount**
- ◆ **Inventory loss from a decline in market price that is expected to be restored before the end of the financial year - both decline and reversal recognised in different interim periods as against no recognition of loss**

AS 25, Interim financial reporting

Changes in accounting policy

A change in accounting policy is reflected by restating the financial statements of prior interim periods of the current financial year

This principle ensures that a single accounting policy is applied to a particular class of transaction throughout the entire financial year and any changes during the financial year is appropriately disclosed

AS 25, Interim financial reporting

Annual income tax rate - illustration

- ◆ An enterprise has tax loss carry forward of Rs 100 lakhs
- ◆ It earns Rs 100 lakhs in the first quarter of the current year and expects to earn Rs 100 lakhs in each of the three remaining quarters
- ◆ Excluding the loss carry forward, the average annual income tax rate is expected to be 40 per cent

What should be the amount of tax expense for the first quarter?

AS 25, Interim financial reporting - challenges

Annual income tax rate - illustration

- ◆ Estimated payment of the annual tax on Rs. 400 lakhs of earnings for the current year would be Rs. 120 lakhs $\{(Rs. 400 \text{ lakhs} - Rs. 100 \text{ lakhs}) \times 40\%\}$
- ◆ Considering the loss carried forward, the estimated average annual income tax rate would be 30% $\{(Rs. 120 \text{ lakhs} / Rs. 400 \text{ lakhs}) \times 100\}$
- ◆ This average annual income tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows:

<i>Qtr1</i>	<i>Qtr 2</i>	<i>Qtr 3</i>	<i>Qtr 3</i>	<i>Annual</i>
<i>30.00</i>	<i>30.00</i>	<i>30.00</i>	<i>30.00</i>	<i>120.00</i>

AS 26 - Intangible Asset

- ◆ ‘Intangible asset’ is “an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes”
- ◆ An asset is a resource controlled by an enterprise from which future economic benefits are expected to flow to the enterprise

Examples of expenditure to be expensed

◆ Expenditure on research

◆ Start-up costs other than

- Expenditure which can be capitalised as per AS 10
- Share/debenture issue expenses
- Discount on shares/debentures (Preliminary expenses other than the above are to be expensed)

◆ Expenditure on training activities

◆ Expenditure on advertising/promotional activities

◆ Expenditure on relocation/re-organisation

◆ Expenditure initially recognised as expense in previous annual/interim financial reports cannot later be recognised as part of cost of an intangible asset

Are these intangible assets?

- Purchase of computer software as an integral part of the related hardware. The software is essential to the running of the computer controlled machine
- Non compete fee paid to the seller of the business
- Cost of training relating to specialized activities where the employees are under a legal duty to maintain confidentiality and serve the company for the next five years
- Expenses incurred on building market share/retaining customers
- Cost of maintaining customer relationship resulting in an agreement whereby the customer is bound to purchase company's products for the next 5 years at stipulated prices

AS 28 – Impairment of assets

- ◆ **Traditionally, current assets (as also current investments) have been valued at lower of cost and realisable value**
 - ▬ Inventories, provision for debtors considered doubtful of recovery, bills receivable, loans and advances, and current investments

- ◆ **However, fixed assets have been carried at historical cost (or revalued amounts) less accumulated depreciation**
 - ▬ Barring exceptions (namely, assets retired from active use and held for disposal), the amount likely to be recovered from a fixed asset was not considered for purposes of its balance sheet valuation

Concept of impairment

- ◆ **An asset is tested for impairment if there is a trigger event**
- ◆ **To perform the test of impairment, the asset's recoverable amount is estimated. 'Recoverable amount' is the higher of the following two amounts:**
 - ▬ The asset's net selling price
 - ▬ The asset's value in use, i.e., the present value of estimated future cash flows expected to arise from the continuing use of the asset and from its disposal at the end of its useful life
- ◆ **If the amount likely to be recovered from future use/sale of a fixed asset is lower than its book value, the shortfall ('impairment') should be provided for**

AS 29 - Provisions and contingent liabilities

There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.	There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources	There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.
A provision is recognised	No provision is recognised	No provision is recognised
Disclosures are required for the provision	Disclosures are required for the contingent liability	No disclosure is required

Recognition criteria – asset, liability or contingency?

Asset	Virtually certain	Recognise
Contingent asset	Probable	Disclose in report of approving authority
	Possible	Do not disclose
	Remote	Do not disclose
Estimated Liability	Probable	Recognise as provision
	Possible	Disclose as contingent liability
	Remote	Do not disclose

Provision - Examples

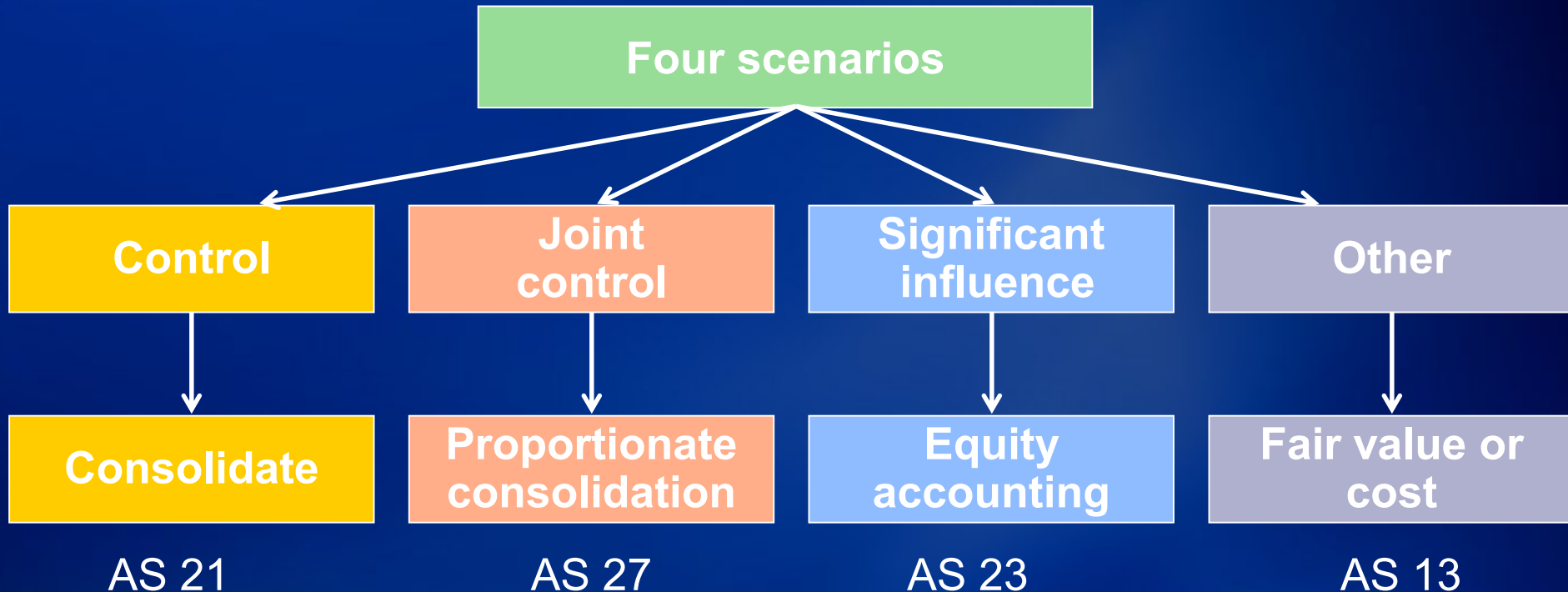
An offshore oilfield where its licensing agreement requires removal of the oil rig at end of production and restore seabed. 90% of the costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10% arise through the extraction of oil

At the balance sheet date, the rig has been constructed but no oil has been extracted

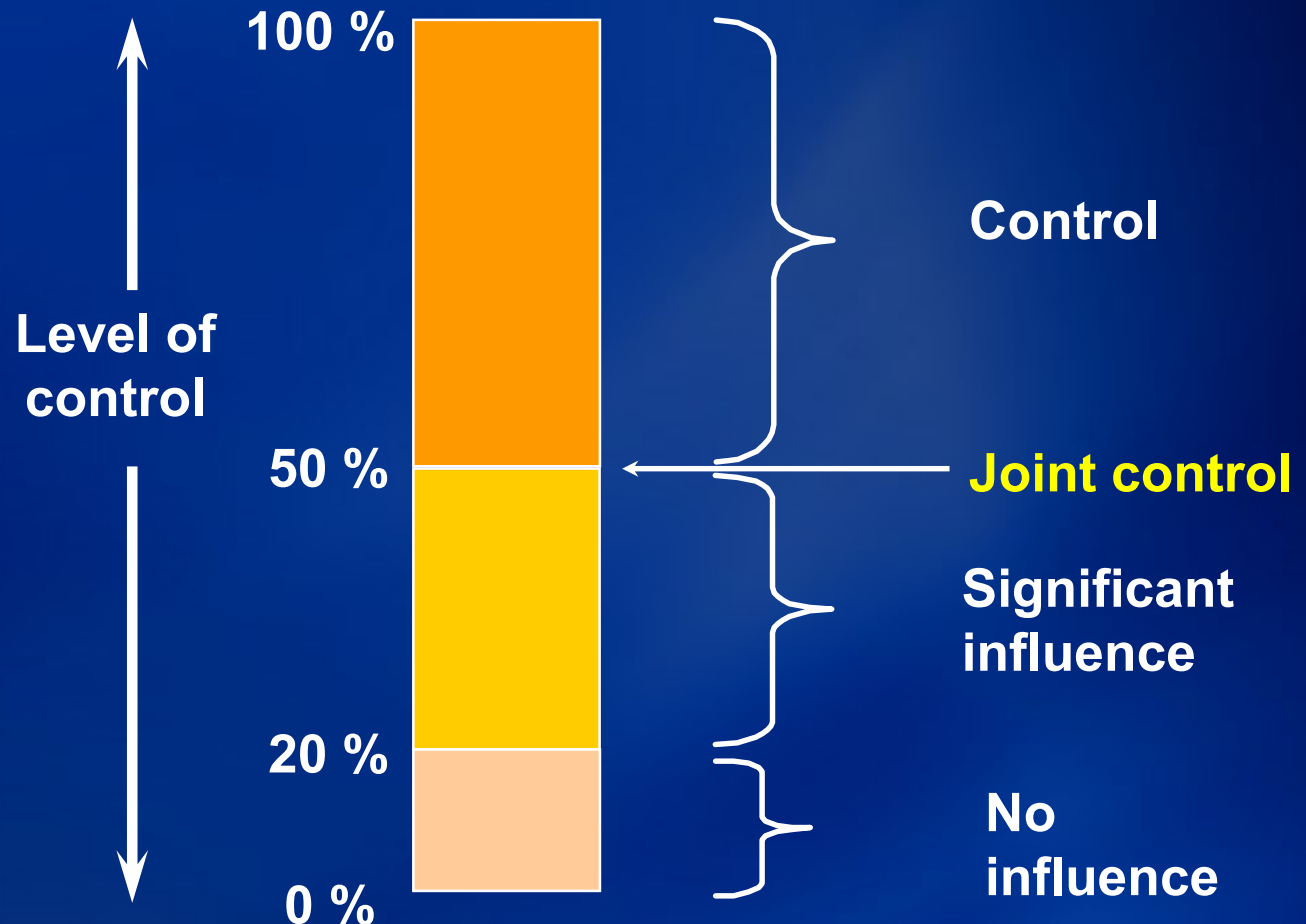
Provision - Examples

- ◆ Construction of oil rig is an **obligating event**. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil
- ◆ An **outflow of resources embodying economic benefits** in settlement is probable
- ◆ A provision is recognised for the **best estimate of 90%** of the costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of oil rig. The 10% of costs that arise through extraction of oil are recognised as a liability when the oil is extracted

Consolidated financial statements



Levels of control of an investment



Thank you

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