LOVELY PROFESSIONAL UNIVERSITY

CONTEMPORARY ACCOUNTING

Edited By

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SYLLABUS

Contemporary Accounting

Objectives: The course will enable the students to identify and analyze the developments of contemporary and emerging accounting issues. The students will be able to adapt and apply strategic tools developed from the discipline of accounting in different decision-making environments. They will be able to analyze the implications of applying recent accounting and business techniques and approaches in a variety of management decision settings.

Sr. No.	Description
1.	**Accounting Standards:** meaning, nature and rationale.
2.	Price-level accounting; meaning and scope, major drawbacks of historical cost system, utility and applications.
3.	**Environmental Accounting:** methodology, objectives and observations.
4.	**Economic Value Added (EVA):** concept, approaches to computation, applications and shortcomings.
5.	**Social Reporting:** meaning, nature, need and models of social disclosure.
6.	**Human Resource Accounting:** meaning, nature and scope and approaches.
7.	**Corporate Reporting:** concept of disclosure in relation to publish accounts, issues and recent trends in corporate reporting, IFRS and its relevance.
8.	**The financial reporting framework:** the contribution and limitations of financial statements in meeting the needs of users' and capital markets; the applications, strengths and weaknesses of an accounting framework; critical evaluation of principles and practices; Forensic Accounting.

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Unit 1: Accounting Standards

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Objectives

After studying this unit, you will be able to:

- Describe the meaning of accounting standards
- Discuss the nature and rationale of accounting standards
- Understand the process of accounting standards setting

Introduction

Financial statements summarise the end-result business activities of an enterprise during an accounting period in monetary term. Business activities are varied. It is strenuous task to present the facts intelligibly, in a summarised form, and yet with minimum loss of information. In order that the methods and principles adopted by various reporting enterprises are coherent, not misleading – and to the extent possible are uniform and comparable – standards are evolved.

Did u know? **What are standards?**

The term standards denote a discipline, which provides both guidelines and yardsticks for evaluations. As guidelines, they provide uniform practices and common techniques. As yardsticks, standards are used in comparative analysis involving more than one subject matter.

1.1 Meaning of Accounting Standards

Accounting standard is an authoritative pronouncement of code of practice of the regulatory accountancy body to be observed and applied in the preparation and presentation of financial

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statements. World over, professional bodies of accountants have the authority and the obligation to prescribe "Accounting Standards". International Accounting Standards (IASs) are pronounced by the International Accounting Standards Committee (IASC). The IASC was set up in 1973, with headquarters in London (UK).

In India, the Institute of Chartered Accountants of India (ICAI) had established in 1977 the Accounting Standards Board (ASB). The composition of ASB includes (i) elected (ii) ex-officio and (iii) co-opted members of the Institute, nominees of RBI, FICCI, Assocham, ICSI, ICWAI and special invitees from UGC, ICWAI, and SEBI, IDBI and IIM.

ASB is entrusted with the responsibility of formulating standards on significant accounting matters, keeping in view (a) international developments as also (b) legal requirements in India. According to the preface to the Statement on Accounting Standards issued by the ICAI, Accounting Standards will be issued by the ASB constituted for the purpose of harmonising the different and diverse accounting policies and practices in use in India and propagating the Accounting Standards and persuading the concerned enterprise to adopt them in the preparation and presentation of financial statement.

Self Assessment

Fill in the blanks:

1. Accounting standard is an authoritative pronouncement of code of practice of the regulatory accountancy body to be observed and applied in the preparation and presentation of ……..
2. The IASC was set up in …….., with headquarters in London (UK).
3. In India, the Institute of Chartered Accountants of India (ICAI) had established in ……. the Accounting Standards Board (ASB).
4. ASB is entrusted with the responsibility of formulating standards on significant accounting matters, keeping in view (a) international developments as also (b) …….in India.
5. The term …….. denote a discipline, which provides both guidelines and yardsticks for evaluations.

1.2 Nature and Rationale of Accounting Standards

Accounting Standards are formulated with a view to harmonise different accounting policies and practices in use in a country. The objective of Accounting Standards is, therefore, to reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises with a view to provide meaningful information to various users of financial statements to enable them to make informed economic decisions.

The following points discuss the nature of accounting standards for the perspective of key acts and organisations:

1.2.1 Accounting Standards and Companies Act

The specific provisions of the Companies Act include,

1. ***Section 211 (form and contents of Balance Sheet and Profit & Loss Account)***
   - *(3A):* Every profit and loss account, balance sheet of the company shall comply with the accounting standards.

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- *(3B):* Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely:
  - (i) the deviation from the accounting standards
  - (ii) the reasons for such deviation, and
  - (iii) the financial effect, if any, arising due to such deviation
- *(3c):* For the purpose of this section, the "expression, accounting standards", means the standards of accounting recommended by the Institute of Chartered Accountants of India, constituted under the Chartered Accountants Act, 1949 (38 of 1949), as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under Sub-section (1) of Section 210 A:

Provided that the standards of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards as are prescribed by the Central Government under this sub-section.

2. ***Section 217 (2AA) (i): Compliance with Accounting Standards***

The Board's report shall also include a Director's Responsibility Statement, indicating therein that in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures.

According to the sec 217(2AA) the statement should indicate:

(i) that in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(ii) that the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit or loss of the company for that period;

(iii) that the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(iv) that the directors had prepared the annual accounts on a going concern basis.

3. ***Section 227 (3) (d): Powers and Duties of Auditors***

The auditor's report shall also state –

Whether, in his opinion, the profit and loss account and balance sheet complied with the accounting standards referred to in Subsection (3c) of Section 211.

The members discharging attest functions are bound by regulations and should examine whether the standards complied with in the presentation of financial statements covered by audit. In the event of deviation, adequate disclosures are to be made. For those occupying managerial positions, exercising control functions in the area of finance and accounts, compliance with standards is a legal requirement as well.

1.2.2 Accounting Standards and Income Tax Act, 1961

There appears to be no link and harmony between the Accounting Standards issued by the ICAI and the tax laws and procedure for calculation of taxable income of corporate assesses. The

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Accounting Standards are applicable to the preparation of general-purpose financial statements where the taxable income is calculated on the basis of tax treatment of different items. The tax treatment is primarily guided by the fiscal considerations and other principles of taxations.

There are several areas where tax treatment of an item and the relevant accounting standards are significantly different and therefore there is marked difference in the reported profit and taxable income. Some of the areas where significant differences can be noted are: revenue recognition principle, computation of depreciation, accounting for construction contracts, treatment of research and development expenses and other intangibles, treatment of borrowing costs, leases, etc.

For example, in case of Finance Lease, the asset is to be shown in the balance sheet of the lessee and he can charge depreciation on this asset. However, under the Income Tax Act, 1961, the assets under finance lease are to be shown in the balance sheet of the lessor (being the real owner) and the depreciation deduction is available to the lessor.

There is a need for harmonising the accounting treatment and tax treatment of several items. In doing so, the principle of accounting as well as the principles of taxation, both required to be taken care of it.

Caution The Finance Act, 1995 has conferred powers on the Central Government to prescribe accounting standards for tax purposes. These Tax Accounting Standards (may be called TAS) are to be followed by any class of assesses or in respect of any class of income. So far, the Central Government has notified two TAS. These are:

1. ***TAS – 1:*** relating to Disclosure of Accounting Policies
2. ***TAS – 2:*** relating to Disclosure of Prior period and Extraordinary items and Changes in Accounting Policies.

These TAS are to be followed by the assesses using mercantile systems of accounting both corporates in as well as non-corporates.

1.2.3 Accounting Standards and Non-commercial Organisations

The Preface to Accounting Standards provides that the Accounting Standards shall apply to commercial, industrial and business enterprises in preparation of general-purpose financial statements issued to the public by such enterprises. So, these Accounting Standards are not applicable to charitable organisations and co-operative societies. However, if the charitable organisations and co-operative societies are engaged in any type of commercial activity, then the Accounting Standards shall apply to their financial statements. The ICAI has clarified that even if a part of the activities of these enterprises are commercial in nature, then the Accounting Standards shall apply to all the activities of the enterprise.

Self Assessment

State true or false:

6. Accounting Standards are formulated with a view to harmonise different accounting policies and practices in use in a country.
7. The Finance Act, 1999 has conferred powers on the Central Government to prescribe accounting standards for tax purposes.
8. TAS – 1 is related to Disclosure of Accounting Policies.

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9. The tax treatment is primarily guided by the fiscal considerations and other principles of taxations.
10. The ICAI has clarified that even if a part of the activities of charitable organisations and co-operation societies enterprises are commercial in nature, then the Accounting Standards shall apply to all the activities of the enterprise.

1.3 Accounting Standards Setting in India

The Institute of Chartered Accountants of India (ICAI) being a member body of the IASC, constituted the Accounting Standards Board (ASB) on 21st April, 1977, with a view to harmonise the diverse accounting policies and practices in use in India. After allowing the adoption of liberalisation and globalisation as the corner stones of Indian economic policies in early '90s, and the growing concern about the need of effective corporate governance in case 90s, the Accounting Standards have increasingly assumed importance. While formulating accounting standards, the ASB takes into consideration the applicable laws, customs, usages and business environment prevailing in the country. The ASB also gives due consideration to International Financial Reporting Standards (IFRSs)/International Accounting Standards (IASs) issued by IASB and tries to integrate them, to the extent possible, in the light of conditions and practices prevailing in India.

1.3.1 Accounting Standards Setting Process

The accounting standard setting, by its very nature, involves reaching an optimal balance of the requirements of financial information for various interest-groups having a stake in financial reporting. With a view to reach consensus, to the extent possible, as to the requirements of the relevant interest-groups and thereby bringing about general acceptance of the Accounting Standards among such groups, considerable research, consultations and discussions with the representatives of the relevant interest-groups at different stages of standard formulation become necessary. The standard-setting procedure of the ASB, as briefly outlined below, is designed in such a way so as to ensure such consultation and discussions:

1. Identification of the broad areas by the ASB for formulating the Accounting Standards.
2. Constitution of the study groups by the ASB for preparing the preliminary drafts of the proposed Accounting Standards.
3. Consideration of the preliminary draft prepared by the study group by the ASB and revision, if any, of the draft on the basis of deliberations at the ASB.
4. Circulation of the draft, so revised, among the Council members of the ICAI and 12 other specified. Outside bodies such as Standing Conference of Public Enterprises (SCOPE), Indian Banks' Association, Confederation of Indian Industry (CII), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C& AG), and Department of Company Affairs, for comments.
5. Meeting with the representatives of specified outside bodies to ascertain their views on the draft of the proposed Accounting Standard.
6. Finalization of the Exposure Draft of the proposed Accounting Standard on the basis of comments received and discussion with the representatives of specified outside bodies.
7. Issuance of the Exposure Draft inviting public comments.
8. Consideration of the comments received on the Exposure Draft and finalization of the draft Accounting Standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.

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9. Consideration of the draft Accounting Standard by the Council of the Institute, and if found necessary, modification of the draft in consultation with the ASB.
10. The Accounting Standard is issued under the authority of the Council.

1.3.2 Accounting Standards in India

The Institute of Chartered Accountants of India has issued the following accounting standards:

Accounting Standards (AS)	Title of the Accounting Standards
AS – 1	Disclosure of Accounting Policies
AS – 2 (Revised)	Valuation of Inventories
AS – 3 (Revised)	Cash Flow Statements
AS – 4 (Revised)	Contingencies and Events Occurring after the Balance Sheet Date
AS – 5 (Revised)	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS – 6 (Revised)	Depreciation Accounting
AS – 7 (Revised)	Accounting for Construction Contracts
AS – 9	Revenue Recognition
AS – 10	Accounting for Fixed Assets
AS – 11 (Revised 2003)	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	Accounting for Retirement Benefits in the Financial Statements of Employers
AS – 16	Borrowing Costs
AS – 17	Segment Reporting
AS – 18	Related Patty Disclosures
AS – 19	Leases
AS – 20	Earnings Per Share
AS – 21	Consolidated Financial Statements
AS – 22	Accounting for Taxes on Income
AS – 23	Accounting for Investment 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 & Contingent Assets
AS 30	Financial Instruments: Recognition and Measurement and Limited Revisions to AS 2, AS 11 (revised 2003), AS 21, AS 23, AS 26, AS 27, AS 28 and AS 29
AS 31	Financial Instruments: Presentation
AS 32	Financial Instruments: Disclosures, and limited revision to Accounting Standard (AS) 19, Leases

The given below is the brief expiation of accounting standards in India:

1. ***AS-1 – Disclosure of Accounting policies:*** Within the overall allowed framework of different accounting standards and provisions of different statutes, a company is free to formulate

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its own accounting policies. Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

AS-1 lays down the following requirements:

(a) All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed in one place as a part of financial statements.

(b) Any change in the accounting policies which has a material impact in the current period or which is expected to have a material effect in later periods should be disclosed and the amount by which any item in the financial statements is affected by such change should also be quantified and disclosed to the extent ascertainable. When such amount is not ascertainable, the fact should be mentioned.

(c) If any of the fundamental accounting assumptions (viz., going concern, consistency and accrual) is not followed, the fact should be disclosed.

2. ***AS-2 – Valuation of Inventories:*** Inventories include:

(a) Raw materials and components

(b) Work-in-process

(c) Finished goods

(d) Stores and spares

Inventories should be valued at lower of historical cost and net realisable value. For the purpose of comparing historical cost with net realisable value, each item in the inventory should be dealt with separately or similar items may be dealt with as a group.

However, the above principle of inventory valuation is not applicable in cases of:

(a) *Consumable stores and supplies:* Should be ordinarily valued at cost.

(b) *By-products:* Where cost of by-product cannot be separately determined, it should be valued at net realisable value.

(c) *Reusable waste:* Should be valued at raw material cost less processing cost.

(d) *Non-reusable waste:* Should be valued at net realisable value.

3. ***AS-3 – Cash Flow Statement:*** The Companies Act, 1956 does not require corporate entities to prepare and present cash flow statement as part of financial statements. However, listing agreement of different stock exchanges require corporate entities to submit cash flow statement to the respective stock exchanges. Thus, listed companies are bound to prepare cash flow statement.

The cash flow statement should clearly show cash flows from three distinct activities:

(a) cash flows from operating activities

(b) cash flows from investing activities

(c) cash flows from financing activities

4. ***AS-4 – Contingencies and events occurring after the balance Sheet date:*** Contingencies are conditions or situations, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence or non-occurrence, of one or more uncertain future events. Estimates are required for determining the amount to be stated in financial statements for many items, e.g., depreciation, provision for doubtful debts, provision for taxation, etc. However, the fact that the items have been estimated does not make the items contingencies.

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Contingencies are of two types – contingent loss and contingent gain. The amount of a contingent loss should be provided for by way of a change 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 amount of the resulting loss can be made. [Para 10 of AS-4.]

5. ***AS-5 – Net profit or loss for the periods, prior period items and changes in accounting policies:*** The net profit or loss for a given accounting period comprises essentially of two items – (a) profit or loss from Ordinary activities and (b) extraordinary items. Ordinary activities are undertaken by a business entity as part of its business and include such related activities in which the entity engages. Extraordinary items are income 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.

Both profit or loss from ordinary activities and extraordinary items are to be disclosed on the face of profit and loss statement. It may be noted here that virtually all items of income and expenses included in the determination of net profit or loss arise in the course of ordinary activities of the enterprise. Therefore, occurrence of extraordinary items is a rarity. In most of the cases, only losses arising out of natural calamity can be considered as an extraordinary item.

Prior Period Items

(a) The nature and amount 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.

(b) The term 'prior period items', as defined in this Statement, refers only to income 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.

Changes in Accounting Policies

On the other hand, a change in an accounting policy should be made only if the adoption of the new 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 financial statements of the enterprise.

6. ***AS-6 – Statements of accounting standards revised – 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.

(a) 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.

Notes

(b) 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.

7. ***AS-7 – Accounting for construction contracts:*** Construction Contracts (Revised proved reserves contracts) are basically of two types:

   (a) *Fixed price contracts:* the contractor gets a fixed price or rate.

   (b) *Cost plus contracts:* the contractor is reimbursed for allowable costs plus a fee is paid to the contractor.

   Para 2 of AS-7 defines construction contract as a "contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or independent in terms of their design, technology and function or their ultimate purpose or use". Construction contracts also include services rendered by project managers and architects which are directly related to the construction of asset.

8. ***AS-8 – Accounting for research and development:*** Research is an original and planned investigation to gain new scientific or technical knowledge, whereas development is the utilisation of research results to produce new or substantially improved materials, devices, products, processes, etc., prior to the commencement of commercial production.

   Thus, the sequence can be shown as below:

Step 1	Step 2	Step 3
Research	Development	Commercial Production

   If, after step 1, no viable outcome is found, steps 2 and 3 are not undertaken. Similarly, if step 2 does not result in any positive outcome, step 3 is not initiated. Thus, the use of each step depends on the result of the preceding step. However, in India, we do not distinguish between costs incurred for research and development. We use the phrase 'costs of research and development.'

9. ***AS-9 – revenue recognition:*** Para 4.1 of AS-9 states "Revenue is the gross inflow of cash, receivable or other consideration arising in the course of 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." Thus, revenue from ordinary activities may arise under three situations:

   (a) by sale of goods;

   (b) by rendering of services; and

   (c) by allowing others to use enterprise resources yielding interest, royalties and dividends.

   Revenue recognition is concerned with the timing of recognition of revenue in the profit and loss statement.

10. ***AS-10 – Accounting for fixed assets:*** The following is the text of the Accounting Standard 10 (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, this standard is recommended for use by companies listed on a recognised stock

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exchange and other large commercial, industrial and business enterprises in the public and private sectors.

(a) Financial statements disclose certain information relating to fixed assets. In many enterprises these assets are grouped into various categories, such as land, 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 in paragraphs 2 to 5 below.

(b) This statement does not deal with the specialised 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.

(c) This statement does not deal with accounting for the following items to which special considerations apply:

(i) forests, plantations and similar regenerative natural resources;

(ii) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources;

(iii) expenditure on real estate development; and

(iv) livestock.

Expenditure on individual items of fixed assets used to develop or maintain the activities covered in (i) to (iv) above, but separable from those activities, are to be accounted for in accordance with this statement.

(d) This statement does not cover the allocation of the depreciable amount of fixed assets to future periods since this subject is dealt with in Accounting Standard 6 on 'Depreciation Accounting'.

(e) 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 to assets acquired in an amalgamation or merger. These subjects require more extensive consideration than can be given within this Statement.

11. ***AS-11 – The effects of changes in foreign exchange rates:*** This standard was revised in 2003 and is made mandatory with effect from 1st April 2004. Originally, this accounting standard was titled "Accounting for the effects of changes in foreign exchange rates". AS-11 discusses how to recognize the financial effect of changes in foreign exchange rates in the financial statements of the reporting entity. Two currencies are involved in determining an exchange rate–foreign currency and reporting currency. The reporting currency for business entities in India is INR (Indian Rupee) and hence the foreign currency is any currency other than INR. AS-11 is applicable in accounting for foreign currency transactions and in translating the financial statements of foreign operations. Thus, accounting for transaction exposure and translation exposure in foreign currency is dealt with in AS-11.

12. ***AS-12 – Accounting for government grants:*** Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions.

Para 13 of AS-12 states that "Government grants should not be recognised until there is reasonable assurance that (i) the enterprise will comply with the conditions attached to them, and (ii) the grants will be received."

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Government grants can essentially be of four types:

(a) Grants related to specific fixed assets.

(b) Grants related to revenue items.

(c) Grants in the nature of promoters' contribution.

(d) Grants as compensation for expense or losses incurred in a previous accounting period.

13. ***AS-13 – Accounting for investments:*** There are two types of investment—current and long-term. These two follow different valuation principles. Current investments are valued at lower of cost and fair value, whereas long-term investments are valued mainly at cost. Reclassification of current investments into long-term investments and vice versa is allowed. Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer. Where current investments are reclassified as long-term investments, transfers are made at the lower of cost and fair value at the date of transfer.

14. ***AS-14 – Accounting for amalgamations:*** Para 43 of AS-14 states "For all amalgamation, the following disclosures should be made in the first financial statements following the amalgamation:

(a) names and general nature of business of the amalgamating companies;

(b) effective date of amalgamation for accounting purposes;

(c) the method of accounting used to reflect the amalgamation; and

(d) Particulars of the scheme sanctioned under a statute."

15. ***AS-15 – Accounting for retirement benefits in the financial statements of employers:*** Retirement benefits usually consist of:

(a) Provident fund

(b) Superannuation (pension)

(c) Gratuity

(d) Leave encashment benefit on retirement

(e) Post-retirement health and welfare schemes

(f) other benefits.

Accounting for retirement benefits depends on the nature of the benefit schemes. Retirement benefit schemes are classified into two broad categories: (a) defined contribution schemes; and (b) defined benefit schemes. In case of the former, only the contribution of the employer (as well as that of employee, if any) is certain and the ultimate benefits, which would accrue to the employees, would depend on the prevailing interest rates and other market factors. The benefits under the defined contribution schemes are in no way related to the factors like, employees salary at the time of retirement, number of years of service rendered, etc. The obligation of the employer in these schemes is limited to periodic and timely contribution to the funds/trust managing the schemes. Whereas, in case of defined benefit schemes, the benefits are linked to certain defined criteria and are determinable usually by reference to employee's earnings and/or years of service. The employer, in these schemes, has to ensure that retiring employees get these defined benefits as per entitlements. Provident fund is an example of a benefit under defined contribution scheme. Pension and gratuity benefits are examples of defined benefit schemes.

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16. ***AS-16 – Borrowing costs:*** Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds. Examples of borrowing costs include: interest and commitment charges on borrowings; amortisation of discounts or premiums relating to borrowings; finance charges under finance lease; exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to interest costs.

    Borrowing costs incurred in connection with acquisition, construction or production of a fixed asset should be capitalised till the date the asset is ready for commercial use. All other borrowing costs are to be expensed in the year in which they are incurred. Borrowing costs incurred to buy inventories (which are held for a short period of time) are not to be added to the cost of inventories. But borrowing costs incurred to acquire long-term strategic investments can be capitalised with the cost of acquisition.

17. ***AS-17 – Segment reporting:*** This standard suggests that a business entity should provide important financial information on each reportable segment separately. A reportable segment is a business segment or a geographical segment. Para 5 of AS-17 defines a business segment as "a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments." The same paragraph also defines a geographical segment as "a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments."

    A business segment or geographical segment should be identified as a reportable segment if one or more of the following conditions are satisfied (Para 27 of AS-17):

    (a) its revenue from sales to external customers and from transactions with other segments is equal to or more than 10% of total revenue of the firm; or

    (b) its segment result (profit or loss) is equal to or more than 10% of combined result of all segments in profit or combined results of all segments in loss, whichever is greater in absolute amount; or

    (c) its segment assets are 10% or more of the total assets of all segments.

    Thus, there are three criteria to select a reportable segment – sales basis, profits/loss basis and asset basis.

18. ***AS-18 – Related party disclosures:*** This accounting standard requires that a company reports all transactions entered into with the related parties. Paragraph 10 of AS-18 defines related parties as "parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions." Sometimes it may so happen that related parties enter into certain transactions with such terms and conditions as are not available to unrelated parties. Such favourable terms to related parties might affect the profitability of the firm.

    Related parties disclosures include the following (Para 23 of AS-18):

    (a) the name of the transacting related party;

    (b) a description of the relationship between the parties and of the nature of transactions;

    (c) volume of the transactions either as an amount or as an appropriate proportion;

    (d) the amount or appropriate proportions of outstanding items relating to related parties at the balance sheet date;

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(e) amounts written off or written back in the period in respect of debts due from or to related parties; and

(f) any other matter.

19. ***AS-19 – Leases:*** There are broadly two types of lease transactions- finance lease and operating lease. In case of finance lease, the lessee should recognise the lease as an asset and a liability in the Balance sheet. Hence, lessee claims depreciation too. The lessor has to recognise assets given under finance lease in its balance sheet as receivables. In case of operating lease, the lessor shows the asset given on lease as its asset in the balance sheet and claims depreciation. However, Income Tax laws in India still allows tax benefit on depreciation to the lessor for assets under finance lease. Hence, there is a contradiction between the accounting treatment of finance lease suggested in AS-19 and the provisions of Income Tax Act.

20. ***AS-20 – Earning per share:*** The traditional method of calculating has been done away with. AS-20 prescribes that the profit available for equity shareholders should be divided by weighted average number of shares instead of closing number of shares.

For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto for the period. All items of income and expense which are recognised in a period, including tax expense and extraordinary items are included in the determination of the net profit or loss for the period unless an Accounting Standard requires or permits otherwise. The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period. The weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or lesser number of shares outstanding at any time. It is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighting factor. The time-weighting factor is the number of days for which the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

21. ***AS-21 – Consolidated financial statements:*** A holding company is now required (although not legally mandatory) to prepare consolidated financial statements, under certain circumstances, portraying the financial performance of the group in addition to its individual and separate financial statements.

Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, other statements and explanatory material that form an integral part thereof. Consolidated cash flow statement is presented in case a parent presents its own cash flow statement. The consolidated financial statements are presented, to the extent possible, in the same format as that adopted by the parent for its separate financial statements.

Users of the financial statements of a parent are usually concerned with, and need to be informed about, the financial position and results of operations of not only the enterprise itself but also of the group as a whole. This need is served by providing the users:

(a) separate financial statements of the parent; and

(b) consolidated financial statements, which present financial information about the group as that of a single enterprise without regard to the legal boundaries of the separate legal entities

Notes

In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line by line basis by adding together like items of assets, liabilities, income and expenses.

22. ***AS-22 – Accounting for taxes on income:*** The accounting for taxes on income, before the introduction of AS-22, in India was a rudimentary one where the provision for tax was estimated only on the basis of current tax liability, thereby completely ignoring the deferred tax liability. This treatment was quite contrary to the practices followed globally. AS-22 attempted to reduce this gap. AS-22 demands that taxes on income should be accounted for following the matching principle. Matching of such taxes against revenue for a period poses problem because tax is levied on taxable income and taxable income can be significantly different from accounting income. Such differences arise because taxable income is based on tax laws and accounting income is determined using provisions in the Companies Act, 1956 and in certain cases as laid down in the listing requirements of stock exchanges.

23. ***AS-23 – Accounting for investment in associates in consolidated financial statements:*** This standard comes into force only when a holding company prepares consolidated financial statements. An unlisted holding company is not required to prepare consolidated financial statements. In that case, AS-23 is not applicable for such an unlisted company even if it has an associate. Also, it may be noted that even where a listed holding company prepares and presents consolidated financial statements, AS-23 is not applicable for separate financial statements of the same holding company. Where AS-23 is not applicable, the company should follow AS-13 in presenting its investment in associates in the separate Balance sheet.

    An associate is an enterprise in which the investor has significant influence (generally evidenced by holding of equity interest between 20%-50%) and which is neither a subsidiary nor a joint venture of the investor. AS-23 provides that the investment in associates should be accounted for in consolidated financial statements using the equity method.

24. ***AS-24 – Discontinuing operations:*** This standard is mandatory with effect from 1st April 2004 for all listed companies and business entities having annual turnover in excess of Rs 50 crores. For all other enterprises, AS-24 will become mandatory with effect from 1st April 2005. This standard requires separate reporting of discontinuing operations from continuing operations so that users of financial statements may make proper forecast of the entity's future cash flows/earnings from continuing operations. Para 3 of AS-24 defines a discontinuing operation as a component of an enterprise:

    (a) that the enterprise, pursuant to a single plan, is:

        (i) disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or

        (ii) disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or

        (iii) terminating through abandonment; and

    (b) that represents a separate major line of business or geographical area of operations; and

    (c) that can be distinguished operationally and for financial reporting purposes.

    Thus, a discontinuing operation must be a separate line of business which is under a plan of disposal or abandonment.

Notes

25. ***AS-25 – Interim financial reporting:*** This standard is applicable only when a business entity is required to present interim financial reports. For example, SEBI requires listed companies to prepare and publish quarterly financial results. In such cases, AS-25 should be followed in deciding the form and content of interim financial reporting.

    Para 9 of AS-25 states that "an interim financial report should include, at a minimum, the following components:

    (a) condensed balance sheet;

    (b) condensed statement of profit and loss;

    (c) condensed cash flow statement; and

    (d) selected explanatory notes"

    An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements. Thus, inventory valuation and depreciation policies followed for interim financial statements should be same as those followed for annual financial statements.

26. ***AS-26 – Intangible assets:*** An 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" (Para 6 of AS-26). Common examples of intangible assets include patents, copyright, computer software, customer list, franchises, brands, etc. Goodwill is a special type of intangible asset in the sense that it is not separable. The definition of an intangible asset as mentioned in Para 6 of AS-26 requires that the asset must be separately identifiable. In that sense, Goodwill is not an intangible asset as it cannot be bought or sold separately.

    An intangible asset can be recognised in the balance sheet as an asset only if two conditions are satisfied:

    (a) it is probable that future economic benefits out of use of the asset will flow to the enterprise; and

    (b) the cost of the asset can be reliably estimated.

    If both the above conditions are not satisfied, the amount incurred should be fully written off. Goodwill can be recognised as an asset only when money or money's worth is paid for its acquisition. Internally generated Goodwill cannot be recognised as an asset. Similarly, internally generated brands, customer list, publishing titles cannot be recognised as intangible assets.

27. ***AS-27 – Financial reporting of interests in joint ventures:*** A joint venture is a business run by two or more parties. It can take the shape of a partnership or it can also be an incorporated venture. The criterion that one applies to determine whether a business is a joint venture is to look for a contractual agreement (known as Joint venture agreement). Joint ventures can be of three types:

    (a) Jointly controlled operations;

    (b) Jointly controlled assets; and

    (c) Jointly controlled entities.

28. ***AS-28 – Impairment of assets:*** Impairment denotes loss in value. An asset is deemed impaired when its carrying amount (i.e., depreciated value) exceeds its recoverable amount. The difference is called impairment loss. The impairment loss should be recognised as an expense in the statement of profit and loss immediately. This standard attempts to present

Notes

the assets in the balance sheet in their recoverable amount, where it is lower than the carrying amount. Hence, the standard follows a conservative approach in the sense that it does not suggest carrying an asset at its recoverable amount when it is higher than the carrying amount. Thus, AS-28 attempts to take some care of the criticism of historical cost accounting.

29. ***AS-29 – Provisions, contingent liabilities and contingent assets:*** This is a mandatory accounting standard effective from 1st April, 2004. The standard seeks to make a distinction between provisions and contingencies and suggest recognition and disclosure requirements for these items. At the outset, it should be made clear that provisions (e.g., provision for tax) are different from outstanding liabilities (e.g., salary payable). In the case of the former, the amount is based on estimation, whereas in case of the latter, the liability is certain and hence no estimation is involved. Para 10 of AS-29 defines the term 'provision' as below:

"A provision is a liability which can be measured only by using a substantial degree of estimation".

Task Academy Ltd. purchased a computer for ₹ 1,50,000 to be paid in 2 installments of ₹ 1,00,000 and ₹ 50,000 payable on 1-12-2003 and 31-01-2004 respectively. The acquisition of asset at ₹ 1,50,000 was duly recorded and the supplier was shown as a creditor for ₹ 50,000 in the balance sheet as on 31-12-2003. The account of the creditor, however, was settled by paying ₹ 49,000 only on 31-01-04. The rebate of ₹ 1,000 has been considered as income of the year 2004. Comment.

Hint: See AS-9 for Revenue Recognition

Self Assessment

Multiple Choice Questions:

11. Revenue reorganization is recorded under which Accounting Standard:

    (a) AS 2 (b) AS 5

    (c) AS 9 (d) AS 6

12. Earning per Share is recorded under which Accounting Standard:

    (a) AS 2 (b) AS 20

    (c) AS 6 (d) AS 9

13. Going concern is the part of which accounting principle under GAAP:

    (a) Basic assumptions (b) Basic principles

    (c) Modifying principles (d) None of the above

14. AS-20 prescribes that the profit available for equity shareholders should be divided by……number of shares.

    (a) Weighted (b) Closing

    (c) Total (d) Opening

Notes

15. The Institute of Chartered Accountants of India (ICAI) being a member body of the IASC, constituted the Accounting Standards Board (ASB) on 21st April,……..

    (a) 1999 (b) 1977

    (c) 1956 (d) 1966

1.4 Summary

- The term standards denote a discipline, which provides both guidelines and yardsticks for evaluations.
- Accounting standard is an authoritative pronouncement of code of practice of the regulatory accountancy body to be observed and applied in the preparation and presentation of financial statements.
- In India, the Institute of Chartered Accountants of India (ICAI) had established in 1977 the Accounting Standards Board (ASB).
- Accounting Standards will be issued by the ASB constituted for the purpose of harmonising the different and diverse accounting policies and practices in use in India and propagating the Accounting Standards and persuading the concerned enterprise to adopt them in the preparation and presentation of financial statement.
- Accounting Standards are formulated with a view to harmonise different accounting policies and practices in use in a country.
- The Accounting Standards are applicable to the preparation of general-purpose financial statements where the taxable income is calculated on the basis of tax treatment of different items.
- The Preface to Accounting Standards provides that the Accounting Standards shall apply to commercial, industrial and business enterprises in preparation of general-purpose financial statements issued to the public by such enterprises.
- The accounting standard setting, by its very nature, involves reaching an optimal balance of the requirements of financial information for various interest-groups having a stake in financial reporting.

1.5 Keywords

Accounting Standards: These are norms and guidelines to prepare the financial statements. In India these are framed by ICAI.

Disclosure of accounting policies: Giving the information of methods to prepare the accounts.

Inventories: It includes work-in-progress, materials and finished goods.

1.6 Review Questions

1. PQR Ltd. shows its inventory at cost in the financial statements. In the current year, the realizable value of a portion of inventory has gone down below the cost of goods. Comment.
2. H Ltd. manufactures furniture items as per specific order of the customer. Raw material is purchased as per the order specification. Which method of valuation of stock of raw materials or finished goods be adopted by the company and why?

Notes

3. Accounting Standards are formulated with a view to harmonise different accounting policies and practices in use in a country. Discuss.
4. An enterprise has in its stock, 10,000 bags of cement purchased at a cost of ₹ 180 per bag. The terms of trade are that the cement is delivered at the buyer's door, and the cost of delivery of ₹ 10 per bag is paid by the seller. The selling price of cement is ₹187 per bag. Find out the value of closing stock.
5. In respect of a particular type of asset, the rate of depreciation as per WDV method under the Income Tax Act, 1961 is higher than the rate prescribed in Schedule XIV to the Companies Act, 1956. At what rate the depreciation be charged?
6. XYZ Ltd. purchased an asset costing ₹10,00,000 a few years ago. It provided depreciation on WDV method and at present the carrying cost of the asset is ₹3,50,000. It is now felt that the depreciation should have been provided as per SL method, amounting to total ₹7,00,000. The remaining useful life of the asset is estimated at the 3 years. Explain the treatment in the light of AS-6 given that the above figures do no include depreciation for the current year.
7. PQR Ltd. charges depreciation on its plant and machinery @ 20% WDV. In the current year, a new machine has been acquired, which will work as a part of the existing plant. However, the life of this machine is expected to be only 4 years. So, the company wants to charge depreciation as per 4 year SL method on this machine. Is it allowed as per AS 6?
8. The carrying amount of a machine in the balance sheet is ₹ 1,50,000 (original cost ₹ 2,30,000). It has been revalued for ₹ 1,80,000, the accounting treatment of gain of ₹ 30,000 is:
   (a) Taken to Profit and Loss A/c or
   (b) Taken to Revaluation Reserve A/c or
   (c) Adjusted against the depreciation for the asset of the current year
9. PQR Ltd. purchased a machine for ₹ 1,50,000 a few years ago. It was revalued two years ago by adding ₹ 75,000 to the carrying cost and the revaluation reserve. The present carrying amount of the asset is ₹ 95,000. It has been sold for ₹ 1,05,000 now. Find out the amount of profit on sale to be recognised in the Profit & Loss A/c.
10. The net written down value of an asset is ₹ 8,50,000 as on 1-1-04. During the year 2004, the asset has been discarded as it has been found to be of no use to the firm. The annual depreciation charge of this asset for the year 2004 is ₹ 1,30,000. However, on 31.12.2004, the net realisable value of the discarded asset has been estimated to be ₹ 3,50,000 only. Show the presentation of this asset in the financial statements for the year 2004.

Answers: Self Assessment

1. Financial statements
2. 1973
3. 1977
4. Legal requirements
5. Standards
6. True
7. False
8. True

Notes

9. True
10. True
11. (c)
12. (b)
13. (a)
14. (a)
15. (b)

1.7 Further Readings

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

Sudhindra Bhat, *Financial Management*, New Delhi, Excel Books, 2008.

Van Horne, J.C. and Wachowicz, Jr, J.M., *Fundamentals of Financial Management*, New Delhi, Prentice Hall of India Pvt. Ltd., 1996, p. 2.

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Unit 2: Price Level Accounting

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Objectives

After studying this unit, you will be able to:

- Define price level accounting
- Describe the scope of price level accounting
- Identify the major drawbacks of historical cost system
- Describe the utility and applications of inflation accounting

Introduction

The basic objective of accounting is the preparation of financial statements in a way that the income statement should disclose the true profit or loss made by the business during a particular period while the balance sheet must show a true and fair view of the financial position of the business on a particular date. Financial statements are prepared in monetary units, i.e., rupees, in our country. They can serve very well the basic objective if the value of such monetary units remains stable. This is possible only when there is stability in the price levels. However, it has been our experience that over a period of time, the prices have not remained stable. There have been inflationary as well as deflationary tendencies. The inflationary tendencies have been more frequent and since 1931 they have been dominating economies of all the countries of the world. It is increasingly being accepted that in spite of all fiscal, monetary and fiscal measures, these tendencies are likely to stay and it seems unlikely that we will return to an era of stable prices in the near future.

2.1 Meaning and Scope

In view of the above, it has been increasingly felt that the accountant will be failing in his duties if he continues to remain contented with the time honoured and traditional system of accounting

Notes

by historical cost. He should move with the time and evolve a suitable system of accounting to deal with the changing price levels.

Price level accounting may, therefore, be defined as that technique of accounting by which the financial statements are restated to reflect changes in the general price level. Such changes, as stated earlier, may be either inflationary or deflationary. Of course, inflation has come to stay and, therefore, price level accounting is more concerned with inflationary tendencies.

Did u know? **What is historical accounting system?**

Under historical accounting system, accounts are prepared without regard to changes in the price levels.

2.2 Inflation Accounting

Inflation accounting is a term describing a range of accounting systems designed to correct problems arising from historical cost accounting in the presence of inflation. Inflation accounting is used in countries experiencing high inflation or hyperinflation. For example, in countries experiencing hyperinflation the International Accounting Standards Board requires corporate financial statements to be adjusted for changes in purchasing power using a price index.

"Inflation accounting is a system for accounting that purports to record as a built in mechanism of all economic events in terms of current cost".

According to author "Inflation accounting is an accounting technique that aims to record business transactions at current values and to neutralise the impact of changes in the price on the business transaction".

"Inflation accounting is a system of accounting just like historical accounting. The difference lies in the process of matching cost against revenue. In historical accounting cost represents 'historical cost' whereas in inflation accounting cost represents the cost prevailing at the date of sale or at the reporting time".

The distinctive features of inflation accounting are as follows:

- The recording procedure is automatic
- The unit of measurement is not assumed to be stable
- It considers all elements of the financial statements and is not concerned only with fixed assets or closing stock
- Realisation principles are not followed rigidly, particularly, when recording long-term loans and fixed assets at the current value

Self Assessment

State true or false:

1. Price level accounting may be defined as that technique of accounting by which the financial statements are restated to reflect changes in the general price level.
2. Under historical accounting system, accounts are prepared without regard to changes in the price levels.
3. Conventional accounting is a system for accounting that purports to record as a built in mechanism of all economic events in terms of current cost.

Notes

4. In historical accounting cost represents 'historical cost' whereas in inflation accounting cost represents the cost prevailing at the date of sale or at the reporting time".
5. Historical accounting is used in countries experiencing high inflation or hyperinflation.

2.3 Major Drawbacks of Historical Cost System

Under a historical cost-based system of accounting, inflation leads to two basic problems. First, many of the historical numbers appearing on financial statements are not economically relevant because prices have changed since they were incurred.

Second, since the numbers on financial statements represent dollars expended at different points of time and, in turn, embody different amounts of purchasing power, they are simply not additive.

Financial statements that are prepared according to the conventional or historical cost accounting system, therefore, do not reflect current economic realities, in case of historical accounting system; accounts are prepared without regard to changes in the price levels. The assets are shown at the values they were purchased less any depreciation on such values. As a matter of fact their values might have gone up on account of the inflationary tendencies. Similarly, the sales are recorded at the current market prices while the inventories are recorded at the prices at which they were purchased. It may be possible that goods sold may comprise those items that might have been purchased in earlier years when the prices were lower than the current year. Thus, neither the balance sheet nor the income statement shows the correct operating and financial position of the business.

"In most countries, primary financial statements are prepared on the historical cost basis of accounting without regard either to changes in the general level of prices or to increases in specific prices of assets held, except to the extent that property, plant and equipment and investments may be revalued."

Ignoring general price level changes in financial reporting creates distortions in financial statements such as

- reported profits may exceed the earnings that could be distributed to shareholders without impairing the company's ongoing operations
- the asset values for inventory, equipment and plant do not reflect their economic value to the business
- future earnings are not easily projected from historical earnings
- the impact of price changes on monetary assets and liabilities is not clear
- future capital needs are difficult to forecast and may lead to increased leverage, which increases the business's risk
- when real economic performance is distorted, these distortions lead to social and political consequences that damage businesses (examples: poor tax policies and public misconceptions regarding corporate behaviour).

Thus assumption of a stable monetary unit does not hold good in the present times as a result the practical utility of financial statements gets diminished. Inflation accounting is the technique of such accounting methods as are designed to mirror the impact of rising prices on economic magnitudes through the adoption of inflation adjusted accounts.

Notes

Notes Limitations of historical cost-based accounting

1. Historical cost based accounting no doubt works very well under the conditions of stable prices. However, under the conditions of inflation or deflation, it suffers from a major limitation.
2. It is well known that the purchasing power of rupee has been persistently shrinking since later fifties, and more alarmingly since early seventies.
3. On the contrary, historical cost-based accounting fails to recognize the impact of this shrinkage. It records transactions represented by rupees of varying purchasing power.
4. Historical cost-based accounting overstates the profit by undercharging depreciation and materials cost Depreciation is undercharged since it is based on the historical cost of fixed assets instead of their current cost.
5. Historical cost-based accounting reflects assets at their historical cost instead of current cost. It results in understatement of the net worth of an enterprise.
6. Historical cost-based accounting thus fails to serve the primary purpose of the financial statements. It presents a distorted view of the profitability by overstating it and of intrinsic worth by understating it.
7. Fixed asset values shown in balance sheets are unrealistic, as fixed assets are recorded at the cost of acquisition. Whereas replacement cost in periods of rising prices goes up.
8. Depreciation based on historical cost is inadequate as a measure of the value of the asset used.

Thus there is a need to take into account the changes in the purchasing power of money while preparing the financial statements.

Self Assessment

Fill in the blanks:

6. Depreciation based on …….is inadequate as a measure of the value of the asset used.
7. Historical cost-based accounting reflects assets at their historical cost instead of ……...
8. Under historical accounting system the sales are recorded at the ……. prices.

2.4 Methods of Accounting for Changing Prices

The following are the key methods of accounting for price level changes:

1. Current Purchasing Power method
2. Current Cost Accounting method
3. Hybrid method

2.4.1 Current Purchasing Power (CPP) Method

Under this method, all items in the financial statements are to be restated for changes in the general price level.

Notes

CIMA Terminology defines current purchasing power accounting as follows:

"Inflation accounting is a method of accounting for inflation in which the values of the non-monetary items in the historical cost accounts are adjusted using a general price index to show the change in the general purchasing power of money. The current purchasing power balance sheet shows the effect of financial capital maintenance".

The following steps are followed in order to convert the historical cost based financial statements into the financial statements based on current costs using the current purchasing power method.

- Calculation of Conversion Factor and Mid-Point Conversion Factor
- Calculation of the Gain or Loss on Monetary Items
- Calculation of Cost of Sales and Inventory at Current Prices
- Calculation of Profits
- Construction of Balance Sheet.

Calculation of Conversion Factor and Mid-Point Conversion Factor:

1. ***Conversion Factor:*** As the financial statements prepared on historical cost accounting basis are to be restated considering the current prices, the value of assets in historical cost accounts are multiplied by the conversion factor.

Caution Conversion factor is calculated as under:

Conversion Factor = Price index at the date of conversion / Price index at the date the item arose.

Example: Layman Brothers purchased machinery on 1.1.2008 for a sum of ₹6,60,000. The retail price index on that date stood at 150. You are required to restate the value of the machinery according to CPP method on 31st December, 2008 when the price index stood at 200.

Solution:

Conversion Factor = Price index at the date of conversion/Price index at the date of item arose.

= 200/150 = 4/3

Value of machinery on 31st December, 2008 after conversion.

= Existing value × Conversion factor

= 6,60,000 × 4/3

= ₹ 8,80,000

Mid-point Conversion Factor: For translating the transactions to current prices occurring throughout the period, conversion factor cannot be used. In such cases, the mid-point conversion factor is used. Normally the mid-point conversion factor is given. In case the same is not given, it can be calculated by taking the average of the index that is at the beginning of the year and at the end of the year. Thus, it is the average index of the period. Transactions such as purchases, sales and payment of expenses are converted using the mid-point conversion factor.

Calculation of Gain or Loss of Monetary Items

Notes

Once the conversion factor and mid-point conversion factor are known, the next step is to calculate gain or loss on monetary items.

Did u know? **What are the monetary and non-monetary items?**

Monetary items are those items that are fixed by contract or otherwise remain fixed irrespective of any change in the general price level. Monetary items can either be monetary assets or monetary liabilities. Examples of monetary items are cash, debtors, creditors, outstanding expenses, and loan.

Value of non-monetary assets cannot be stated in fixed monetary amounts as they change with the changes in the price level. The examples of non-monetary items include land, building, plant, machinery, inventory of fixed goods and equity shares.

Example: Compute the net monetary result of Mohan Company Ltd. as at 31st December 2008 from the following particulars:

	1.1.2008 ₹	31.12.2008 ₹
Cash	500	1,000
Book Debts	2,000	2,500
Creditors	1,500	2,000
Loan	2,000	2,000
Retail Price Index Numbers are as follows:		
January 1, 2008	200	
December 31, 2008	300	
Average for the year	240	

Solution:

Calculation of conversion factors:

Conversion factor for items as on 1.1.2008: 300/200 = 1.5

Mid-term conversion factor for items arising during 2008: 300/240 = 1.25

Calculation of the increase or decrease in monetary assets/liabilities during 2008

	as on 1.1.2008	as on 31.12.2008	Increase during 2008
(a) Monetary assets	2,500	3,500	1,000
(b) Monetary liabilities	3,500	4,000	500

Statement showing the net monetary result on account of price level changes

(i)	Monetary liabilities as on 1.1.2008 should have gone up with increase in price indices (₹ 3,500x1.5)	5,250	
(ii)	Increase in monetary liabilities during 2008 which should have gone up with increase in price indices (500 x 1.25)	625	
	Monetary liabilities on 31.12.2008 should have stood at:	5,875	

Contd...

Notes

However, the liabilities on 31.12.2008 stood at	4.000	
Gain on holding of monetary liabilities		1,875
(iii) Monetary assets as on 1.1.2008 should have gone up with increase in price indices (₹ 2,500x1.5)	3,750	
(iv) Increase in monetary assets during 2008 should have gone up with increase in price indices (₹ 1,000 x 1.25)	1,250	
Monetary assets on 31.12.2008 should have stood at	5,000	
However, the monetary assets on 31.12.2008 stood at	3.500	
Loss on holding monetary assets		(-) 1.500
Net gain on monetary items		375

Cost of Sales and Inventories

The cost of sales and value of inventories depend upon the cost flow assumptions, i.e., first in, first out (FIFO) or 'last in, first out' (LIFO). According to the 'first in, first out' method, inventories first purchased are taken to be first issued to production or sold to customers; while according to "last in, first out" method inventories purchased in the last are taken to have been first issued to production or sold to customers. While restating the figures under CPP Method, it would be appropriate to keep in mind the cost flow assumptions, since they affect both the cost of sales and closing inventory as shown below:

1. ***First in First out (FIFO) Method:*** If this method is followed the composition of cost of sales and inventory will be as under:
   - *Cost of sales:* Cost of sales will comprise of the total opening stock and current purchases less closing stock.
   - *Closing inventory:* The composition of closing stock will normally include current purchases only. However in cases where total sales are even less than the opening stock a part of the opening stock may also be the part of closing stock.
2. ***Last in First out (LIFO) Method:*** If this method is followed the composition of cost of sales and inventory will be as detailed below:
   - *Cost of Sales:* Under LIFO method the cost of sales will normally comprise of current purchases only. However, if the purchases of the current year are less than the cost of sales, then a part of opening stock may also become a part of cost of sales.
   - *Closing stock:* Closing stock in this case shall comprise of the purchases made in the previous year or even of earlier years.

   Indices to be used for conversion under Current Purchasing Method

   In order to convert the historical cost based financial statements to the financial statements prepared considering the current purchasing power method the indices are used:

Current purchases	Average index of the year
Opening stock	Index at the beginning of the year
Purchases of previous year(s)	Relevant index

Notes

Example: From the following details ascertain (a) Cost of Sales and (b) Closing Inventory as per CPP Method when the firm is following FIFO Method:

	Historical	Price
	₹	Index
Opening stock on 1-1-2008	4,000	80
Purchases during 2008	20,000	125
Closing stock (out of purchases made in the last quarter)	3,000	120
Index No on 31st December, 2008		140

Solution:

Cost of Sales and Closing Inventory (FIFO)

Particulars	Historical cost basis	Conversion factor	Converted amount under CPP
Opening inventory	4,000	140/80	7,000
Add: Purchases	20,000	140/125	22,400
Total	24,000		29,400
Less: Closing inventory (b)	3,000	140/120	3,500
Cost of goods sold (a)	21,000		25,900

Determination of Profits and Preparing Balance Sheet

For determining the profits under the current purchasing power method, any of the following two methods can be used:

1. ***Net Change Method:*** Under this method, profit is the change in equity over the period. Thus, both the opening balance sheet and the closing balance sheet are converted to reflect the changes in price level and any increase in equity is taken as profit and any reduction in equity is taken as loss. It may be worthwhile to mention here that while converting the figures of the opening balance sheet both monetary and non-monetary items except equity are to be converted and while converting the closing balance sheet, only non-monetary items are converted as they already are reported at current values. Monetary items are not to be converted. Thus, this method is based on the normal accounting principal that profit is the change in the equity during the accounting period.

2. ***Conversion or Restatement of Income Statement Method:*** Under the second method, all items of profit or loss account are converted. Sales and operating expenses are converted using the average index. The index to be used for conversion of cost of sales and inventory will depend upon the method used for valuation of inventory, i.e., LIFO or FIFO as discussed above. Fixed assets are converted on the basis of the indices prevailing on the dates they were purchased. The same principle applies for charging depreciation on them. Taxes and dividend paid are to be converted using the indices of the date on which they were paid. Gain on account of monetary items should be calculated and stated separately in the restated income statement.

Notes

Example: Following is the comparative balance sheet of ABC Ltd. as on 31st December 2007 and 2008:

Comparative Balance Sheet

	2007 (₹)	2008 (₹)
Assets		
Cash and receivables	2,00,000	2,60,000
Inventories (FIFO method)	1,50,000	1,30,000
Land	40,000	40,000
Equipment	2,10,000	2,70,000
Less: Accumulated depreciation	(Nil)	(24,000)
	6,00,000	6,76,000
Liabilities and Capital		
Current liabilities	80,000	90,000
Long-term liabilities	1,00,000	1,16,000
Equity share capital (₹ 10)	1,40,000	1,40,000
Share premium	2,80,000	2,80,000
Reserves and surplus	(Nil)	50,000
Total	**6,00,000**	**6,76,000**

The income statement of the company for the year 2008 disclosed the following information:

Income Statement
For the year ending 31st Dec. 2008

Particulars	(₹)	(₹)
Net Sales		**8,00,000**
Less: Cost of goods sold:		
Opening Inventories (FIFO)	1,50,000	
Purchases (Net)	5,00,000	
Cost of goods available for sale	6,50,000	
Less: Closing inventory (FIFO)	1,30,000	5,20,000
Gross Profit		**2,80,000**
Less: Operating expenses (excluding depreciation)	96000	
Depreciation	24000	120000
Profit before tax		1,60,000
Less: Income Tax		70,000
Profit after tax		90,000
Less: Dividend paid		40,000
Retained earnings		50,000

Equipment costing ₹60,000 was acquired on July 1, 2008 when the general price index was 157.5. The amount of depreciation has been calculated as follows:

	₹
10% on ₹ 2,10,000	21,000
5% on ₹ 60,000 (Rate being 10% p.a.)	3,000
	24,000

Notes

Sales, purchases, operating expenses (excluding depreciation) took place evenly throughout the year. Inventories are priced according to first in, first out method. Goods in closing inventories were acquired evenly throughout the year. The dividend of ₹40,000 was declared and paid at the end of 2008. Income tax accrued throughout the year.

You are required to recast the above statement taking into account the price level adjustments under CPP Method. The general price indices are as follows:

At the end of year 2007 (and beginning of the year 2008)	150
Average for the year 2008	157.5
At the end of the year 2008	163.8

Solution:

It will be necessary to compute conversion factor for restating the figures under CPP Method.

Conversion factors For items to which Price Index at the	163.8/150 = 1.092
beginning of 2008 is applicable, For items to which Average Index is applicable	163.8/157.5 =1040

For Items to which Price Index at the end of 2008 is applicable = 163.8/163.8 = 1

ABC Limited
Income Statement
For the year ending 31st Dec, 2008

	As per historical cost basis (₹)	Conversion factor	Restated under CPP Method (₹)
Sales (1)	8,00,000	1.040	8,32,000
Cost of goods sold:			
Opening inventory	1,50,000	1.092	1,63,800
Add: Purchases	5,00,000	1.040	5,20,000
Cost of goods available for sale	6,50,000		6,83,800
Less: Closing inventory (Out of current purchases)	1,30,000	1.040	1,35,200
Cost of goods sold (2)	5,20,000		5,48,600
Gross profit (l)-(2)= 3	2,80,000		2,83,400
Operating expenses (excluding depreciation)	96,000	1.040	99,840
Depreciation	24,000	21,000 × 1.092 = 22,932	26,052
		3,000 × 1.040 = 3,120	
Total operating expenses (4)	1,20,000		1,25,892
Net profit before "general price level gain or			

Contd...

Notes

loss"(3)-(4)	1,60,000		1,57,508
General price-level loss (see statement below)			4,800
Net profit after general price level loss			1,52,708
Less: Income tax	70,000	1.040	72,800
Net Profit	90,000		79,908
Less: Dividend paid	40,000	1.000	40,000
Retained earnings at the end of 2008	50,000		39,908

Computation of General Price-Level Gain or Loss
For the year ending 31st Dec., 2008

	(₹)	(₹)		(₹)
Net monetary items as on 1-1-2008				
Cash and Receivables		2,00,000		
Less: Current Liabilities	80,000			
Long-term Liabilities	1,00,000	1,80,000		
		20,000	1.092	21,840
Add: Source of Net monetary items during 2008:				
Sales		8,00,000	1.040	8,32,000
Total Sources (1)		8,20,000		8,53,840
Uses of net monetary items during 2008				
Purchases		5,00,000	1.040	5,20,000
Operating expenses (excluding depreciation)		96,000	1.040	99,840
Income tax		70,000	1.040	72,800
Dividends paid		40,000	1.000	40,000
Purchases of equipments		60,000	1.040	62,400
Total Uses (2)		7,66,000		7,95,040
Net monetary items as should have been if there were no general Price level gain or loss (l)-(2)				58,800
Net monetary items actually existing as on 31st Dec., 2008				
Cash and Receivables		2,60,000		
Less: Current Liabilities	90,000			
Long-term Liabilities	1,16,000	2,06,000		54,000
General price-level loss during 2008 (58,800-54,000)				4,800

Notes

Working Notes:

1. Monetary items at the end of 2008 have not been adjusted since they are already standing at current values at the end of that year.
2. The amount of retained earnings has been taken from the Income Statement as adjusted according to CPP Method.
3. In the preceding pages, the net profit of the business has been determined by restating all items in CPP terms. In case it is desired to determine the net profit after tax for the year 2008 according to 'net change method', this can be done with the help of comparative balance sheet restated in CPP terms as shown on page 3.175. Net profit for 2008 will be the excess of Reserves in 2008 over that in 2007 as stated in CPP terms, as shown below:

	₹
Assets in CPP terms as on 31-12-2008	7,04,548
Add: Dividends paid on 31-12-91	40,000
	7,44,548
Less: Liabilities in CPP terms as on 31-12-2008	6,64,640
Reserves as on 31-12-2008	79,908
Less: Reserves as on 1-12-2008	(Nil)
Net profit for 2008 (after tax but before dividends)	79,908

ABC Limited
Comparative Balance Sheet

	As on 31st Dec. 2007			As on 31st Dec. 2008		
	Historical Cost basis	**Conversion factor**	**CPP Method rolled forward to end of 2008**	**Historical Cost basis**	**Conversion factor**	**CPP Method**
Assets						
Cash and Receivables	2,00,000	1.092	2,18,400	2,60,000	Note 1	2,60,000
Inventories	1,50,000	1.092	1,63,800	1,30,000	1.040	1,35,200
Land	40,000	1.092	43,680	40,000	1.092	43,680
Equipment	2,10,000	1.092	2,29,320	2,70,000	1.092	2,91,720
Less: Accumulated depreciation	Nil		Nil	(24,000)	(21,000x1.092)	(26,052)
					(3,000x1.040)	
	6,00,000		6,55,200	6,76,000		7,04,548
Liabilities & Share Capital						
Current Liabilities	80,000	1.092	87,360	90,000	Note 1	90,000
Long-term Liabilities	1,00,000	1.092	1,09,200	1,16,000	Note 1	1,16,000
Equity Share Capital (₹ 10 shares)	1,40,000	1.092	1,52,20080	1,40,000	1.092	1,52,20080
Share Premium	2,80,000	1.092	3,05,760	2,80,000	1.092	3,05,760
Retained Earnings	Nil		Nil	50,000	Note 2	39,908
	6,00,000		6,55,200	6,76,000		7,04,548

Notes

2.4.2 Current Cost Accounting Method (CCA) Method

This method attempts to measure the effect of individual rates of price changes on all assets and liabilities, i.e., stocks, plant and machinery, investments, loan, creditors and so on. It recognises that there may be great differences in the rates of inflation of various items and by using specific indices for items or groups of items the method attempts to match the current cost of assets used against current income generated by them in more meaningful manner. The chief objective of this method is to ensure that operating capital is maintained at the current price level. Assets are valued at current cost, considering specific price index of the relevant asset and not general price index as is used in the Current Purchasing Power Method. Profits under this approach are computed on the basis of what the cost would have been on the date of sale rather than actual cost.

Notes **Features of CCA method**

The main features of the CCA method are as follows:

- ***Meaning:*** The method requires each item of financial statements to be restated in terms of the current value of the item. No cognisance is taken of changes in the general purchasing power of money. Assets are shown in terms of what such assets would currently cost.
- ***Objectives:*** The method seeks to ensure that adequate provision/adjustments are made for the maintenance and replacement of the operating assets of the company, at least at the minimum physical levels at which the enterprise can operate efficiently, not only for the year under the review but also for the future.
- ***Adjustments/provisions:*** In order to achieve the objectives stated above, the following adjustments/provisions are usually made.
- ***Revaluation Adjustment:*** The fixed assets are shown at their "value to the business" and not at their depreciated original cost. "Value to the business" means the amount that the company would lose, if it were deprived of the assets.
- ***Net current replacement value:*** This refers to the money now required to buy a new asset of the same type as an existing one less an amount of depreciation that recognises the fact that the true replacement of the asset would not be a new asset, but an asset that has the same remaining useful life as the existing asset.

The following is the process of converting the historical cost based financial statements into the financial statements prepared taking into account inflation factor using the current cost accounting method:

(a) Valuation of Fixed Assets

(b) Depreciation Adjustment

(c) Cost of Sales Adjustment

(d) Monetary Working Capital Adjustment

(e) Gearing Adjustment.

Valuation of Fixed Assets

Notes

The fixed assets in the balance sheet are valued at their value to the business, which is defined as the amount the company will lose if it were deprived of these assets. The value of an asset to the business could be either of the following:

(a) Replacement Cost Value

(b) Net Realisable Value

(c) Economic Value.

1. ***Replacement Cost:*** It refers to the money now required to buy a new asset of the type similar to the existing asset. The amount of depreciation has also got to be deducted from the same considering the fact that the true replacement of the asset would not be a new, asset but an asset that has the same remaining useful life as the existing asset.

Example: Suppose a machine was purchased five years ago with an estimated total useful life of 10 years for ₹ 60,000. The value of the machine in the books would stand at ₹ 30,000, assuming no scrap value. We further assume the same machine today costs ₹ 1,00,000 in the market. The value of this machine now will be shown in the books as ₹ 50,000 (₹ 1,00,000 less depreciation for five years assuming no scrap value).

2. ***Net realisable value:*** This is the value which is represented by the net cash proceeds if the existing asset is sold now.

3. ***Economic value:*** It refers to the discounted (present) value of the net income that will be earned from using the existing assets during the remaining life of the asset. Thus, it is the net present value of the future anticipated net income that the asset is likely to generate. A close examination of the asset values discussed above indicates that the replacement cost value is the purchasing value, net realisable value is the sale value and the economic value is the holding value.

Example: TATA firm purchased machinery for a sum of ₹10 lakhs, on January 1, 2005. It had an expected life of 10 years without any scrap value. The price indices for the asset were as follows:

January 1, 2005	100
January 1, 2008	160
December 31, 2008	175

You are required to value the machinery on January 1, 2008 and December 31, 2008, both according to Historical Cost Accounting System and Current Cost Accounting System, charging depreciation on 'straight line basis.

Solution:

Statement Showing the Value of Machinery

Particulars	January 1, 2008		December 31, 2008	
	Historical Cost (₹)	Current Cost (₹)	Historical Cost (₹)	Current Cost (₹)
Cost	10,00,000	16,00,000	10,00,000	17,50,000
Depreciation (3 Yrs/4 Yrs)	3,00,000	4,80,000	4,00,000	7,00,000
	7,00,000	11,20,000	6,00,000	10,50,000

Notes

The balance sheet as on 31st December 2008 as prepared under CCA would show the machinery at ₹ 10,50,000 as compared to ₹ 6 lakhs under HCA. The excess of ₹ 4,50,000 will be put to "Current Cost Accounting Reserve".

In case the company desires to show the machinery at current costs as on 31st December 2008, in place of the historical cost, the increase of ₹ 7,50,000 in the value of machinery would be debited to Machinery Account and credited to Current Cost Accounting Reserve. The increase in depreciation amount of ₹ 4,00,000 will be charged to Current Cost Accounting Reserve and credited to the Machinery Account. Thus, the net increase in the value of machinery would be ₹ 3,50,000 and Current Cost Accounting Reserve would also stand at ₹ 3,50,000.

Depreciation Adjustment

The charge to the profit and loss account for depreciation should be equal to the value of the fixed assets consumed during the period. When the fixed assets are valued on the basis of their net current replacement cost the charge should be based on such cost. A suitable "depreciation adjustment" is, therefore, required in historical cost profit to determine the current cost profit.

Depreciation Adjustment may be ascertained according to any of the following two bases:

(i) ***On the basis of total replacement cost of the asset*:** According to this method "Depreciation Adjustment" may be computed as follows:

Required Depreciation Provision for the accounting period as per CCA	
Less: Depreciation charged for the accounting period as per HCA	
Depreciation Adjustment	

Example: On the basis of figures of previous example, the amount of depreciation adjustment to be made in the accounts of 2008 will be ascertained as follows:

Depreciation at 10% on Current Cost of ₹ 17,50,000	1,75,000
Less: Depreciation charged for 2008 as per HCA	1,00,000
Depreciation Adjustment	75,000

(ii) ***On the basis of Average Current Cost of Assets:*** The depreciation adjustment in the above illustration has been made by reference to the current cost of the asset on the balance sheet date. However, strictly speaking, this should be done on the basis of the average current cost of the asset during the year. The average current cost may be ascertained as follows:

(Current Cost of the asset in the beginning of the year) + (Current Cost of the asset at the end of the year) / 2

Alternatively, depreciation for the current year may be ascertained as follows:

Depreciation for the full period (say, a year) on current cost of the asset in the beginning of the accounting period	
Add: Depreciation for half the period (say, six months) on increase in the current costs during the year presuming that such increase was gradual	
Less: Depreciation charged as per HCA	
Depreciation Adjustment	

The following entry will be passed for depreciation adjustment

Profit & Loss Account	Dr.
To Current Cost Accounting Reserve	

Notes

Example: KSBS Ltd. had the following fixed assets on 31-12-2008:

Assets	Cost (₹)	Depreciation (₹)	Net (₹)
Land	30,000		30,000
Building	80,000	24,000	56,000
Plant	2,60,000	96,000	1,64,000
	3,70,000	1,20,000	2,50,000

Plant includes ₹60,000 installed on 1-1-2008, depreciation was charged at 5% on building, 10% on plant according to straight line method. The replacement cost indices are as follows:

Assets	On the date of Acquisition	As on 1-1-2008	As on 31-12-2008
Land	100	250	300
Building	100	200	220
Plant	100	180	225

You are required to show how the balance sheet items will be affected by the changes according to CCA method.

Solution:

Two items of the balance sheet, which will be affected under the CCA System are Fixed Assets and Current Cost Accounting Reserve.

(i) ***Fixed Assets:***

Assets	Current Cost (₹)	Depreciation on Current Cost (₹)	Net (₹)
Land	90,000	—	90,000
Building	1,76,000	52,800	1,23,200
Plant & Machinery	5,25,000	2,10,000	3,15,000
	7,91,000	2,62,000	5,28,200

(ii) ***Current Cost Accounting Reserve:***

Particulars	₹
Increase in the cost fixed assets (7,91,000-3,70,000)	4,21,000
Less: Increase in depreciation (2,62,800-1,20,000)	1,42,800
	2,78,200
Add: Depreciation Adjustment [Working Note]	25,650
	3,03,850

Working Notes:

(a)	Computation of Current Costs:		
	Land: 30,000 × 300/100		90,000
	Building: 80,000 × 220/100		1,76,000
	Plant: as on 1-1-2008: 2,00,000 × 225/100	4,50,000	
	Addition during the year. 60,000 × 225/180	75,000	5,25,000
			7,91,000

Contd...

Notes

(b)	Computation of Depreciation, till date:		
	Building: 24,000 × 220/100		52,800
	Plant: as on 1-1-2008: 90,000* × 225/100	2,02,500	
	Addition during the year: 60,000 × 225/180	7,500	2,10,000
			2,62,800
(c)	Depreciation Adjustment:		
(i)	Building: Current cost on 1-1-2008	1,60,000*	
	Increase during year	16,000	
	Depreciation @5% on		
	1,60,000 for full year		8,000
	on 16,000 for half year		400
	or 5% on (1,60,000 + 1,76,000) / 2		8,400
	Already charged in account-5% on 80,000		4,000
	Adjustment required		4,400
(ii)	Plant & Machinery: Current Cost on 1-1-2008	3,60,000	
	Increase in 192008	90,000	
	Addition (on 1-1-2008)	60,000	

Particulars		₹
Increase in value of the addition	15,000	
Depreciation @ 10% on ₹ 3,60,000 for full year		36,000
₹ 90,000 for half year		4,500
₹ 60,000 for half year		6,000
₹15,000 for half year		750
Or 10% on (420000 + 525000)/2		47,250
Already charged in accounts		26,000
Adjustment required		21^250
Total Depreciation adjustment required: (i) + (ii)		25,650

*Depreciation on the additional plant purchased during the year would be ₹6,000. On the balance it would be ₹90,000.

Cost of Sales Adjustment

The Current Cost Accounting method is based on the important principle that current cost must be matched against current revenue for determining the true operating profit or loss. The amount of sales requires no adjustment as it is already at current rate.

Items that enter into the computation of cost of sales have to be taken at the present value that is required to replace them, if consumed or sold. The difference in values is termed as cost of sales adjustment that is debited (in case of inflation) before deriving operating profit. As the value of closing stock will also show a higher value the same will be credited to the Current Cost Accounting Reserve.

Example: From the following information calculate the Cost of Sales under Historical and Current Cost Accounting Systems.

Notes

Opening Stock of raw materials on 1.1.2008	
(100 tonnes @ ₹ 20 per tonne)	₹ 2,000
Purchases during 2008	Nil
Materials consumed during 2008	80 tones
Price of raw materials on Jan. 1, 2008	₹ 25 per tonne
Average price during 2008	₹ 30 per tonne
Price of raw materials on Dec. 31, 2008	₹ 35 per tonne

Solution:

Historical Cost Accounting System	(₹)
Cost of sales (80 tonnes x ₹ 20)	1,600
Closing stock (20 tonnes x ₹ 20)	400
Current cost accounting system	
Cost of sales (80 tonnes x ₹ 30)	2,400
Closing stock (20 tonnes x ₹ 35)	700

The increase in stock of ₹300 in CCA method over historical cost basis will be credited to Current Cost Accounting Reserve. The closing stock in the balance sheet will be shown at ₹700. The cost of Sales Adjustment amounting to ₹800 (i.e. ₹2,400 – ₹1,600) will be charged to Profit and Loss Account and credited to Current Cost Accounting Reserve.

Monetary Working Capital Adjustment

The cost of sales adjustment only takes into account the impact of inflation on stock consumption. Apart from it, an organisation requires additional resources to meet working capital requirements due to the increase in prices. This extra amount of required working capital is known as additional monetary working capital.

The additional net monetary working capital required is purely on account of increase in price levels and not on account of increase in scale of operations. Monetary working capital normally means aggregate of trade receivables, pre-payments and trade bills receivables less trade creditors, and trade bills payables and accruals. An adjustment has to be made in respect of monetary working capital while determining current cost operating profit. This adjustment should present the amount of additional (reduced in case of deflation) finance needed for monetary working capital as a result of changes in the input prices of goods and services used and financed by the business.

Example: From the following information, as per historical cost accounting method, compute the monetary working capital adjustment under current cost accounting method:

	Jan. 1, 2008	**Dec. 31, 2008**
Accounts receivable	2,000	3,600
Accounts payable	1,100	1,840
Monetary working capital	900	1,760
Price Index for materials	200	230
Price index for finished goods	150	180

Solution:

In order to determine Monetary Working Capital Adjustment, it will be necessary first to find out the amount of increase in monetary working capital on account of increase in volume of

Notes

business. This should be done by eliminating the effects of change in price levels in the amounts of receivables and payables. The amounts of receivables and payables have been compared for this purpose by adjusting their figures on the basis of average price indices as shown below:

	Jan. 1, 2008 ₹		Dec. 31, 2008 ₹
(a) Accounts receivable			
2,000 × 165/150	2,200	3,600 × 165/180	3,300
(b) Accounts payable			
1,100 × 215/200	1,183	1,840 × 215/230	1,720
(c) Monetary Working			
Capital [(a) - (b)]			1,580

The increase in monetary working capital on account of increase in volume of business is ₹563 (i.e., ₹1,580 – ₹1,017). However, the actual increase in monetary working capital as shown by Historical Cost Accounting method comes to ₹ 860 (i.e. ₹1,760 – ₹900). The excess of ₹ 297 (i.e. ₹ 860 – ₹563) representing excess working capital required is Monetary Working Capital Adjustment. The amount would be charged to Profit and Loss Account and credited to Current Cost Accounting Reserve.

Gearing Adjustment

The profits as calculated after taking into account the foregoing adjustments, i.e., depreciation adjustment, cost of sales adjustment and monetary working capital adjustment reflect the true amount of profits from operations known as current cost operating profit. This operating profit belongs to those who bring in the operating capital for the business. It is also known that almost all organisations obtain part of their operating capital by loans or other monetary obligations. These loans and monetary obligations are unaffected by changes in price levels. Therefore a part of the adjustments in respect of depreciation adjustment, cost of sales adjustment and monetary working capital adjustment is ascribable to the loan funds or borrowings.

Thus the net adjustment of the above three factors may be reduced by the proportion to the borrowings in the capital structure. This adjustment is known as gearing adjustment. If there are no borrowed funds then this adjustment is not required.

To sum up, gearing adjustment is necessary because a part of the net operating assets are financed by borrowings, which are to be repaid in the same monetary amount irrespective of changes in prices. Equity, debts and preference shareholders provide funds. For debt, a fixed amount has to be paid and thus the gearing adjustment is required.

Gearing Adjustment = (Opening adjustment x Average Borrowings) / (Average Borrowings + Average Equity)

The gearing adjustment in fact reduces the impact of depreciation, cost of sales and monetary working capital adjustments.

Example: From the data below, calculate the gearing adjustment required under Current Cost Accounting Method:

	Opening (₹)	Closing (₹)
Convertible Debentures	100	120

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Notes

Bank Overdraft	60	80
Cash	10	30
Paid-up Share Capital	150	200
Reserves	50	80
Cost of Sales Adjustment	20	
Monetary Working Capital Adjustment	15	
Depreciation Adjustment	5	
Total of Adjustment	40	-

Solution:

Calculation of Net Borrowings: **(₹)**

	Opening	Closing
Convertible Debentures	100	120
Bank Overdraft	60	80
Total Borrowings	160	200
Less: Cash (as this does not enter into MWCA)	10	30
Net Borrowings	T50	170
Calculation of Shareholders' Funds:		
Paid-up Share Capital	150	200
Reserves	50	80
Shareholders' Funds	200	280

Average Net borrowing = 15 + 170 / 2

or B = ₹ 160

Average Shareholders Interest = 200 + 280 / 2

S = ₹ 240

Gearing Adjustment = B / B+S

= 160/160 +240

As total of all the Adjustments = 40 (given)

= 160/400 x 40

= ₹16

Task A firm purchased machinery for a sum of ₹1 lakh on January 1, 2002. It has an expected life of 10 years without any scrap value. The price indices for the asset were as follows:

January 1, 2002	100
January 1, 2008	160
December 31, 2008	175

Contd...

Notes

You are required to value the machinery on January 1, 2008 and December 31, 2008, both according to historical cost accounting system and current cost accounting system, charging depreciation on straight-line basis. Also, find the amount that needs to be adjusted for depreciation in year 2008.

Hint:	(1)	WDV on 1.1.2008	(2)	WDV on 31.12.2008
		Historical Cost - 70000		Historical Cost - 60000
		Current Cost - 112000		Current Cost - 105000

2.4.3 Hybrid Method

This method is a compromise between the Current Purchasing Power and Current Cost Accounting methods. Under this method, fixed assets and inventories are valued at specific indices—Current Cost Accounting. In addition to this, purchasing power gains and losses in respect of monetary items are also considered, which otherwise are ignored in Current Cost Accounting. Those who advocate this method argue that by combining the two methods, the advantages of both the methods can be obtained. But the critics of this method state that its acceptance may prove difficult because of theoretical objections. In addition, the method may be a victim of the disadvantages of both the methods.

Self Assessment

Fill in the blanks:

9. ……..= Price index at the date of conversion / Price index at the date the item arose.
10. ……items are those items that are fixed by contract or otherwise remain fixed irrespective of any change in the general price level.
11. According to the…….method, inventories first purchased are taken to be first issued to production or sold to customers.
12. Under …….method, fixed assets and inventories are valued at specific indices.

2.5 Utility and Applications

The effects of inflation upon a business can briefly be described as distorting its profit performance and valuations of its capital. This, in turn, affects the judgements and decisions of its management, shareholders, investors and the government.

The immediate operating effect of inflation is upon the cash flow of the business entity. That is the ability of the inflowing cash to acquire the depreciated fixed asset in real terms. Assets recorded at historical cost will have a lower real value as the purchasing power of money falls with inflation. On the other hand, liabilities such as loans are recorded in the financial statements at historical cost and that is the amount to be repaid despite the fact that the rupees we repay will have a lower real value than the rupees that were borrowed.

Inflation will also affect the profits of the business. Revenues will be at current prices as they are the price paid today. Costs will be based on historical costs. In real terms, there is no comparison between the both, and the net effect will be overstatement of profits. Depreciation will be based on the historical cost, possibly years ago, and will be understated.

To examine the issue in greater details an attempt is now made to study the distortions that inflation causes in the financial statements based on historical costs and how such distortions affect the quality of information that is available to the users.

Notes

1. The assets that are stated in the balance sheet are reported at values that are much lower than their current replacement values. Due to the understatement of the values, the business is more vulnerable to takeover bids and the shareholders may not realise a fair value for their shares at the time of such takeover.
2. Since the fixed assets are understated in value, the depreciation charged in the Income Statement remains at a low figure. This would distort the current cost data compiled for operational decisions such as pricing, make-or-buy, etc.
3. Another distortion caused is that which arises when the cost of raw materials and components or goods purchased for resale is steadily rising. As the cost concept requires that only the cost of purchase should be charged off to the income statement, the difference between the historical cost and the replacement cost of such items is included in the profits earned. In this way the operating profit also includes a part of holding profits.
4. Assets such as cash and other near-cash assets receivables in periods of inflation lose their real value in terms of purchasing power. Similarly, the real values of monetary liabilities such as creditors and loans outstanding gain their real value in terms of purchasing power but the same does not get reflected in the statements in periods of inflation. The reverse is true in the periods of deflation.
5. The profits and return on investment under historical cost accounting are overstated, as revenue is recorded at increasing price levels and expenses such as depreciation and cost of sales are charged off at the historical cost.
6. The financial statements also reflect a very high growth in sales value, profits, capital additions, etc. The real growth rates of the items can be known only when adjustments are done for the changes in the money value.

From the above, it is clear that accounts that have not been adjusted for the impact of inflation can mislead both internal and external users in respect of decisions that may be taken on the basis of financial statements prepared ignoring the inflation factor.

Applications of Inflation Accounting

In the past few years, the entire world has been experiencing high inflation. Companies have reported very high profits on the one hand but on the other, they have faced real financial difficulties. This is so because in reality, dividends and taxes have been paid out of capital due to overstated figures of profits arrived at by adopting the historical cost concept. Thus, a shift from historical cost concept to inflation accounting is recommended. The major advantages of inflation accounting are as follows:

1. It enables the company to present a more realistic view of its profitability because current revenues are matched with current costs.
2. Depreciation charged on current values of assets in inflation accounting further enables a firm to show accounting profits more nearer to economic profits and replacement of these assets when required become easy.
3. It enables a company to maintain its real capital by avoiding payment of dividends and taxes out of its capital due to inflated profits in historical accounting.
4. The balance sheet reveals a more realistic and true and fair view of the financial position of a concern because the assets are shown at current values and not on distorted values as in historical accounting.
5. When financial statements are presented, adjusted to the price level changes, it makes possible to compare the profitability of two concerns set up at different times.

Notes

6. Investors, employees and the public at large are not misled by inflated book profits because inflation accounting shows more realistic profits. Higher paper profits without adjustment for price level changes cause resentment among workers and they demand higher wages. Also, excessive profits attract new entrepreneurs to enter the business. Inflation accounting helps in avoiding further competition from prospective entrepreneurs.
7. The financial statements prepared by a company adjusted to the price level changes also improve its social image.
8. Inflation accounting also affects the investment market as it helps to establish a realistic price for the shares of a company.

Notes **Disadvantages of Inflation Accounting**

Some people are of the opinion that inflation accounting may create more problems than provide solution to them, because of the following inherent disadvantages of the accounting system considering price level changes:

1. Adjusting accounts to price level changes is a never-ending process. It involves constant changes and alterations in the financial statements.
2. Price level accounting involves many calculations and makes financial statements so complicated and confusing, that it becomes very difficult for a individual of ordinary prudence to understand, analyse and interpret them.
3. The concept of price level accounting appears to have more theoretical importance than practical relevance, because adjusting the accounts to the changes in the price levels may lead to window dressing the accounts due to the element of subjectivity in it. People may adjust the accounts according to the values most suited to them, thereby, making the financial statements inaccurate.
4. Depreciation charged on current values of fixed assets is not acceptable under the Income-tax Act, 1961, and hence adjusting it to price level changes does not serve any practical purposes.
5. During deflation, when the prices are falling, adjustments of accounts to price level changes will mean charging lesser depreciation and overstatement of profits indicating that dividends could be paid from even the capital.

Self Assessment

Fill in the blanks:

13. The immediate operating effect of inflation is upon the ……of the business entity.
14. Assets recorded at historical cost will have a lower real value as the purchasing power of money falls with …….
15. Depreciation charged on current values of fixed assets is not acceptable under the …….

2.6 Summary

- Price level accounting may be defined as that technique of accounting by which the financial statements are restated to reflect changes in the general price level.
- Inflation accounting is a term describing a range of accounting systems designed to correct problems arising from historical cost accounting in the presence of inflation.

Notes

- Financial statements that are prepared according to the conventional or historical cost accounting system, therefore, do not reflect current economic realities, in case of historical accounting system, accounts are prepared without regard to changes in the price levels.
- The following are the key methods of accounting for price level changes:
  - i. Current Purchasing Power method
  - ii. Current Cost Accounting method
  - iii. Hybrid method
- Under CPP method, all items in the financial statements are to be restated for changes in the general price level.
- The Current Cost Accounting (CCA) Method attempts to measure the effect of individual rates of price changes on all assets and liabilities, i.e., stocks, plant and machinery, investments, loan, creditors and so on.
- Hybrid method is a compromise between the Current Purchasing Power and Current Cost Accounting methods.
- The FAS 33 requires companies to compute inflationary effect on profits in two different ways: (i) constant dollar method, and (ii) current cost accounting method.

2.7 Keywords

Economic Value: It refers to the discounted (present) value of the net income that will be earned from using the existing assets during the remaining life of the asset.

Historical Accounting: Under historical accounting system, accounts are prepared without regard to changes in the price levels.

Inflation Accounting: Inflation accounting is a term describing a range of accounting systems designed to correct problems arising from historical cost accounting in the presence of inflation.

Net Realisable Value: This is the value which is represented by the net cash proceeds if the existing asset is sold now.

Price Level Accounting: Price level accounting may be defined as that technique of accounting by which the financial statements are restated to reflect changes in the general price level.

Replacement Cost: It refers to the money now required to buy a new asset of the type similar to the existing asset

2.8 Review Questions

1. Why is it necessary these days to account for price-level changes?
2. Explain the concept of Current Cost Accounting.
3. Explain and illustrate monetary and non-monetary items while accounting for price-level changes?
4. What approaches have generally been recommended for dealing with the problem of changes in the purchasing power of money? Which one is the best? Why? Give reasons in brief.
5. Explain and distinguish between holding gains and operating gains. Give examples.

Notes

6. Explain:
   (a) Monetary Liabilities and Non-monetary Liabilities.
   (b) Cost of Sales Adjustment and Gearing Adjustment.
7. What do you mean by inflation accounting? Enumerate its advantages and disadvantages.
8. "Historical accounting shows unreal profits resulting in distribution of profits out of capital". Offer your observations on the above statement.
9. What is the impact of price level changes on financial statements? What suggestions do you make to disclose the effect of price level changes on the financial statements?
10. Explain with suitable examples the problems of interpretation of financial statements in times of inflation when accounts are scrutinized under the conventional accounting system.

Answers: Self Assessment

1.	True	2.	True
3.	False	4.	True
5.	False	6.	historical cost
7.	current cost	8.	current market
9.	Conversion Factor	10.	Monetary
11.	FIFO	12.	hybrid
13.	cash flow	14.	inflation
15.	Income-tax Act, 1961		

2.9 Further Readings

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

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Unit 3: Environmental Accounting

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Objectives

After studying this unit, you will be able to:

- Describe the methodology of environmental accounting
- State the objectives of environmental accounting
- Identify the key observations of environmental accounting

Introduction

The increasing importance of considering environmental aspects within a company's decisions demands a broader scope in management accounting. Eco-management accounting should enable management to integrate environmental issues into the decision-making process.

—Thomas Orbach and Chrisa Liedtke (1998)

Environmental accounting is defined as the accountants' contribution towards environmental sensitivity in organizations. It gained prominence in the 1990s. The emphasis on the social responsibilities of the accountancy profession is not new, having been led to prominence by the social accounting debate of the 1970s. The social consciousness of the accountancy profession was started to receive its attention. It focused on extending accountability to numerous stakeholders by necessitating disclosure of social information in corporate annual reports.

Caution The accountability function of accounting was believed to be fulfilled by reporting (financial and social) information that stakeholders would find useful in their decision making process.

3.1 Methodology of Environmental Accounting

The preparation of environmental accounting is affected by a number of factors such as the magnitude of the investment required, the objectivity of the data, the ability to compare different kinds of environmental impacts, and the kinds of policy purposes to which they may be applied.

Notes

The following are the key methods used for environmental accounting:

1. ***Natural Resource Accounts***: The natural resource accounts include data on stocks of natural resources and changes in them caused by either natural processes or human use. Such accounts typically cover agricultural land, fisheries, forests, minerals and petroleum, and water. In some countries, the accounts also include monetary data on the value of such resources. But attempts at valuation raise significant technical difficulties. It is fairly easy to track the value of resource flows when the goods are sold in markets, as in the case of timber and fish. Valuing changes in the stocks, however, is more difficult because they could be the result either of a physical change in the resource or of a fluctuation in market price.

2. ***Emissions accounting:*** The concept of emission accounting was developed by the Dutch. The National Accounting Matrix including Environmental Accounts (NAMEA) structures the accounts in a matrix, which identifies pollutant emissions by economic sector. Eurostat, the statistical arm of the European Union, is helping EU members apply this approach as part of its environmental accounting program. The physical data in the NAMEA system are used to assess the impact of different growth strategies on environmental quality. Data can also be separated by type of pollutant emission to understand the impact on domestic, trans-border, or global environments.

Caution If emissions are valued in monetary terms, these values can be used to determine the economic cost of avoiding environmental degradation in the first place, as well as to compare costs and benefits of environmental protection.

3. ***Disaggregation of conventional national accounts:*** Sometimes data in the conventional accounts are taken apart to identify expenditures specifically related to the environment, such as those incurred to prevent or mitigate harm, to buy and install protection equipment, or to pay for charges and subsidies. Over time, revelation of these data makes it possible to observe links between changes in environmental policy and costs of environmental protection, as well as to track the evolution of the environmental protection industry.

4. ***Green GDP:*** Developing a gross domestic product that includes the environment is also a matter of controversy. Most people actively involved in building environmental accounts minimize its importance. Because environmental accounting methods are not standardized, a green GDP can have a different meaning in each project that calculates it, so values are not comparable across countries. Moreover, while a green GDP can draw attention to policy problems it is not useful for figuring out how to resolve them. Nevertheless, most accounting projects that include monetary values do calculate this indicator. Great interest in it exists despite its limitations

Notes **Forms of Environmental Accounting**

1. ***Environmental Management Accounting (EMA):*** Management accounting with particular focus on material and energy flow information and environmental cost information. This type of accounting can be further classified in the following subsystems:

   - *Segment Environmental Accounting:* This is an internal environmental accounting tool to select an investment activity, or a project, related to environmental conservation from among all processes of operations, and to evaluate environmental effects for a certain period.

Contd...

Notes

- *Eco Balance Environmental Accounting:* This is an internal environmental accounting tool to support PDCA for sustainable environmental management activities.
- *Corporate Environmental Accounting:* This is a tool to inform the public of relevant information compiled in accordance with the Environmental Accounting. It should be called as Corporate Environmental Reporting. For this purpose the cost and effect (in quantity and monetary value) of its environmental conservation activities are used.

2. ***Environmental Financial Accounting (EFA):*** Financial accounting with a particular focus on reporting environmental liability costs and other significant environmental costs.
3. ***Environmental National Accounting (ENA):*** National Level Accounting with a particular focus on natural resources stocks & flows, environmental costs and externality costs etc.
4. ***Need of Environmental Accounting at Corporate Level:*** It helps to know whether corporation has been discharging its responsibilities towards environment or not. Basically, a company has to fulfill following environmental responsibilities.
   - Meeting regulatory requirements or exceeding that expectation.
   - Cleaning up pollution that already exists and properly disposing of the hazardous material.
   - Disclosing to the investors both potential and current, the amount and nature of the preventative measures taken by the management (disclosure required if the estimated liability is greater than a certain percent say 10 per cent of the companies net worth).
   - Operating in a way that those environmental damages do not occur.
   - Promoting a company having wide environmental attitude.
   - Control over operational and material efficiency gains driven by the competitive global market.
   - Control over increases in costs for raw materials, waste management and potential liability.

Self Assessment

Fill in the blanks:

1. ……..is defined as the accountants' contribution towards environmental sensitivity in organizations.
2. The ……accounts include data on stocks of natural resources and changes in them caused by either natural processes or human use.
3. …….is a tool to inform the public of relevant information compiled in accordance with the Environmental Accounting.
4. The concept of …… accounting was developed by the Dutch.
5. The National Accounting Matrix including Environmental Accounts (NAMEA) structures the accounts in a matrix, which identifies …….emissions by economic sector.

Notes

3.2 Objectives of Environmental Accounting

Practical developments of environmental accounting saw tremendous growth in research, with various initiatives and proposals being put forward by accountancy bodies and related international organizations. In essence, environmental accounting now plays a vital role in daily commercial undertakings, attempting to ensure that development is not at odds with environmental protection. The potential for accountants to make a significant contribution towards environmental consciousness in organizations has been envisaged through their managerial, auditing and reporting skills. Increasingly, the emphasis has shifted from social accounting in general to a more specific environmental accounting. These days, social accounting has become synonymous with the term Social and Environmental Accounting (SEA), a linkage that places due emphasis on the importance of environmental issues.

Did u know? **What is social reporting?**

Social accountability is about being answerable to the people affected by your actions.

The Environmental Accounting was first considered a new field in accounting in during 1998 by the intergovernmental work group ISAR (United Nations Inter governmental Working Group of Experts on International Standards of Accounting and Reporting). Jointly with this work, ISAR has been coordinating efforts with IAPC (International Auditing Practices Committee) to formalize a group of audit standards for verification of the environmental performance reported on accounting statements. This work group basically emphasised the need for environmental accounting to cover the following basic objectives:

- assistance of professionals in other fields of knowledge
- give the status of the information system of the analyzed company, as regards the preparation of its internal controls to provide its financial accounting with relevant information on environmental aspects
- effective contribution of various external intervenors, as the consulting specialists, certification companies and independent auditors, to grant an independent opinion on specific aspects of the report

Task Discuss the regulatory framework of environmental accounting in India.

Self Assessment

Fill in the blanks:

6. The Environmental Accounting was first considered a new field in accounting in during ……by the intergovernmental work group ISAR.
7. ……. accountability is about being answerable to the people affected by your actions.

3.3 Observations

The following are the key observations for practice of environmental accounting:

There are, in addition, four main observations regarding how useful environmental accounts are for policy:

1. Although some countries are using the environmental accounts quite actively, the accounts are still underutilized, especially in developing countries

Notes

2. No country has truly comprehensive environmental accounts.
3. International comparisons are important, but not yet possible because of differences in methodology, coverage, environmental standards, and other factors.
4. For a country to fully assess its environmental impact, it must have.
   - Accounts for the trans-boundary movement into and out of the country of pollutants via air and water
   - Accounts for its major trading partners to calculate the pollution and material content of products that it imports.

Practices of Environmental in India

1. Very few corporations give adequate information regarding environmental issue. If as per requirement of applicable law they have to prepare and submit any information relevant to environment they do so. The Environment Ministry has issued instruction in this regard to prepare environment statement. It can be observed through their accounts that mainly the following types of information are given:
   - What type of devices installed for pollution control.
   - Steps taken for energy conservation.
   - Steps taken for raw material conservation.
   - Step taken for waste water and production process waste.
   - Step taken for improvement of quality of product and services, process of production, etc.
2. A study was conducted among 80 executives of different industries by Dr. B.B. Padhan and Dr. R.K. Bal which revealed that corporate world is fully aware of the requirements of environmental reporting. They are also aware of the environmental issue. The corporate executives have also expressed their views in favour of environment reporting by the industries.
   - Despite their awareness and consent over environmental reporting by industries is it very poor.
   - It is so inadequate that very little information is found in the annual report.
3. In the words of Jong Seo Choi, research studies have examined the extent to which companies produce social information, of which environmental information would be part. A number of general themes that emerge from this include the following:
   - The proportion of companies disclosing and extent of that disclosure are small and the quantity is low.
   - There is some variety in disclosure over time, between countries and between industries. Social disclosure in general and environmental disclosure in particulars reflects the changing business climate and social, economic and political environment in which they occur.
   - However, the total amount of voluntary disclosure stays fairly constant over time and what changes is the subject addresses in the disclosure.
   - There is a very definite size effects in those larger companies are more likely to disclose than smaller companies.

Notes

- Very little disclosure would qualify as information under any normal criteria and very little of it indeed will contain numbers, financial or otherwise.

4. Environmental reports as contained in the Directors Report of three Indian Companies are as under:

   (i) *Asian Paints (India) Ltd., (1993-94): "Ecology and Safety:* Samples of treated effluents are periodically checked for Compliance with standards"

   (ii) *Goodlass Nerolac Paints Limited (1993-94): "Pollution:* The company regularly monitors measures in force in accordance with the Pollution Control Act for the protection of environment and for ensuring industrial safety. The company carries out improvements regularly to ensure full compliance with the statutory requirements."

   (iii) *Maruti Udyog Limited (1993-94): "Environment:* Modification of the existing effluent treatment plant was undertaken to take care of additional effluents generated due to capacity expansion. Data on non–methane hydrocarbons in Paint Shop and Engine Testing shop, ambient air quality, stack emissions and effluents are being regularly monitored and the parameters are maintained well within prescribed limits. Development of green belt around gas turbine and R&D areas was further augmented by plantation of 3000 additional saplings.

5. It was also revealed that most of the companies disclose the environment information in descriptive manner rather than to financial type i.e. no account is made for the degradation of natural capital when calculating corporate profits.

Notes **Limitations of Environmental Accounting**

EA suffers from various serious limitations as follows:

1. There is no standard accounting method.
2. Comparison between two firms or countries is not possible if method of accounting is different which is quite obvious
3. Input for EA is not easily available because costs and benefits relevant to the environment are not easily measurable.
4. Many business and the Government organizations even large and well managed ones don't adequately track the use of energy and material or the cost of inefficient materials use, waste management and related issue. Many organisations, therefore, significantly underestimate the cost of poor environment performance to their organization.
5. It mainly considers the cost internal to the company and excludes cost to society.
6. EA is a long-term process. Therefore, to draw a conclusion with help of it is not easy.
7. EA cannot work independently. It should be integrated with the financial accounting, which is not easy.

Self Assessment

State true or false:

8. Most of the countries have truly comprehensive environmental accounts.
9. It was also revealed that most of the companies disclose the environment information in descriptive manner rather than to financial type.
10. Very few corporations give adequate information regarding environmental issue.

Notes

3.4 Summary

- Environmental accounting is defined as the accountants' contribution towards environmental sensitivity in organizations.
- The preparation of environmental accounting is affected by a number of factors such as the magnitude of the investment required, the objectivity of the data, the ability to compare different kinds of environmental impacts, and the kinds of policy purposes to which they may be applied.
- The natural resource accounts include data on stocks of natural resources and changes in them caused by either natural processes or human use.
- The concept of emission accounting was developed by the Dutch.
- The National Accounting Matrix including Environmental Accounts (NAMEA) structures the accounts in a matrix, which identifies pollutant emissions by economic sector.
- Sometimes data in the conventional accounts are taken apart to identify expenditures specifically related to the environment, such as those incurred to prevent or mitigate harm, to buy and install protection equipment, or to pay for charges and subsidies.
- Environmental management accounting focuses on material and energy flow information and environmental cost information.
- Environment financial accounting focuses on reporting environmental liability costs and other significant environmental costs.
- National Level Accounting focus on natural resources stocks & flows, environmental costs and externality costs etc.
- Although some countries are using the environmental accounts quite actively, the accounts are still underutilized, especially in developing countries.
- No country has truly comprehensive environmental accounts.
- International comparisons are important, but not yet possible because of differences in methodology, coverage, environmental standards, and other factors.

3.5 Keywords

Environmental Accounting: Environmental accounting is defined as the accountants' contribution towards environmental sensitivity in organizations.

Environmental Financial Accounting (EFA): Financial accounting with a particular focus on reporting environmental liability costs and other significant environmental costs.

Environmental Management Accounting (EMA): Management accounting with particular focus on material and energy flow information and environmental cost information.

Environmental National Accounting (ENA): National Level Accounting with a particular focus on natural resources stocks & flows, environmental costs and externality costs etc.

3.6 Review Questions

1. Identify the meaning and scope of environmental accounting.
2. What are the key methods used for environmental accounting?

Notes

3. How environmental management accounting is different from environmental financial accounting?
4. Is environmental accounting PR exercise? How do you perform environmental accounting and auditing of Fertiliser Company?
5. Identify the key observation of environmental accounting.
6. What are the key drawbacks of environmental accounting?

Answers: Self Assessment

1. Environmental accounting
2. Natural resource
3. Corporate Environmental Accounting
4. Emission
5. Pollutant
6. 1998
7. Social
8. False
9. True
10. True

3.7 Further Readings

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

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Unit 4: Economic Value Added (EVA)

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Objectives

After studying this unit, you will be able to:

- Define EVA
- Illustrate the approaches to compute EVA
- Describe the applications and shortcomings of EVA

Introduction

Economic profit is wealth created above the capital cost of the investment. EVA prevents managers from thinking that the cost of capital is free. In other words, a measure of a company's financial performance based on the residual wealth calculated by deducting cost of capital from its operating profit (adjusted for taxes on a cash basis). The formula for calculating EVA is as follows:

= Net Operating Profit after Taxes (NOPAT) – (Capital * Cost of Capital)

EVA focuses managers on the question, "For any given investment, will the company generate returns above the cost of capital?" Companies that embrace EVA have bonus compensation schemes that reward or punish managers for adding value to or subtracting value from the company. As with any metric, it's hard to link precise EVA returns to a specific technology investment. EVA is ideally suited to publicly traded companies, not private companies, because it deals with the cost of equity for shareholders, as opposed to debt capital.

If a company invests in manufacturing equipment or a warehouse, how much additional profit will be required to pay for it? Managers are intuitively aware of the importance of value creation to their businesses.

Notes

Caution EVA is a management philosophy and performance metric that elevates those goals from intuition to rigorous analysis and ensures that no investment escapes scrutiny.

4.1 Concept of EVA

The New York-based financial advisory Stern Stewart and Co. postulated a concept of economic income in 1990 in the name of 'Economic Value Added' (EVA). EVA is a modified version of residual income concept. EVA has provided financial discipline in many US companies, encouraged managers to act like owners and has boosted shareholders returns and the value of their companies. The company creates shareholder value only if it generates returns in excess of its cost of capital. The excess of returns over cost of capital is simply termed as Economic Value Added (EVA).

Did u know? **What is the role of EVA?**

EVA measures whether the operating profit is sufficient enough to cover cost of capital.

Shareholders must earn sufficient returns for the risk they have taken in investing their money in company's capital. The returns generated by the company for shareholders have to be more than the cost of capital to justify risk taken by the shareholders. If a company's EVA is negative, the firm is destroying shareholders wealth even though it may be reporting positive and growing EPS or return on capital employed EVA is just a way of measuring an operation's real profitability. EVA holds a company accountable for the cost of capital it uses to expand and operate its business and attempt to show whether a company is creating a real value for its shareholders. EVA is a better system than ROI, to encourage growth in new products, new equipment and new manufacturing facilities. EVA measurement also requires a company to be more careful about resource mobilization, resource allocation and investment decisions. It effectively measures the productivity of all factors of production. EVA can be calculated as follows:

$$EVA = NOPAT\ (TCE \times WACC)$$

Where,

NOPAT = Net operating profit after tax

TCE = Total capital employed

WACC = Weighted average cost of capital

The fundamental proposition of EVA is that capital isn't free and its cost must be factored into every benefit analysis or return-on-investment model when an investment in a plant, equipment or a new customer relationship management system is contemplated. Putting a finer point on this concept, EVA targets equity capital as opposed to debt capital. Managers often treat equity capital as free when it's not—shareholders could have invested elsewhere.

Notes **Steps in Implementing EVA**

The implementation of EVA is a 4-step process that includes: (a) Measurement, (b) Management System, (c) Motivation and (d) Mindset.

Contd...

Notes

1. ***Measurement:*** Any company that wishes to implement EVA should institutionalise the process of measuring the metric regularly. This measurement should be carried out after carrying out the prescribed accounting adjustments.
2. ***Management system:*** The company should be willing to align its management system to the EVA process. The EVA-based management system is the basis on which the company should take decisions related the choice of strategy, capital allocation, merger and acquisitions divesting business and goal setting.
3. ***Motivation:*** Companies should decide to implement EVA only if they are prepared to implement the incentive plan that goes with it. An EVA-based incentive system, however, encourages managers to operate in such a way as to maximize the EVA not just of the operations they oversee, but of the company as whole.
4. ***Mindset:*** The effective implementation of EVA necessitates a change in the culture and mindset of the company. All constituents of the organisation need to be taught to focus on the objective of maximising EVA. This singular focus leaves no room for ambiguity and it is also not difficult for employees to know just what actions of theirs will create EVA, and which will destroy it.

Self Assessment

State true or false:

1. EVA is ideally suited to private companies.
2. If a company's EVA is positive, the firm is destroying shareholders wealth.
3. The excess of returns over cost of capital is simply termed as Economic Value Added (EVA).
4. EVA measurement also requires a company to be more careful about resource mobilization, resource allocation and investment decisions.
5. EVA measures whether the operating profit is sufficient enough to cover cost of capital.

4.2 Approaches to Computation of EVA

The pure EVA calculation for the company as a whole is:

Net Operating Profit After Taxes (NOPAT) — Capital Charge (Capital Investment × Cost of Capital)

But purely speaking, there is no net operating profit after taxes (NOPAT) arising out of an IT investment, so the net financial benefits of the IT investment are used as a replacement for NOPAT.

Example: Consider, for instance, a case where the cost-benefit analysis reveals that a ₹ 50,000 IT investment will return ₹8,000 in net quantifiable benefits. The ROI is 16% (₹ 8,000 divided by ₹ 50,000). The cost of capital in the company is 12%. Using the formula above, the EVA in this case is ₹ 2,000.

₹ 8,000 net benefits - (₹ 50,000 capital investment × 12% cost of capital) = ₹ 2,000 EVA

Another way to calculate EVA in this example is to simply deduct the 12% cost of capital from the 16% ROI, then multiply by the investment:

4% × ₹50,000 = ₹ 2,000 EVA

Notes

Caution EVA is always expressed as a rupee amount.

While calculating of NOPAT, the non-operating items like dividend/interest on securities invested outside the business, non-operating expenses, etc., will not be considered. The total capital employed is the sum of shareholders funds as well as loan funds. But this does not include investments outside the business. In determining WACC, cost of debt is taken as cost after tax and the cost of equity is measured on the basis of Capital Asset Pricing Method (CAPM). CAPM is traditionally used by the founders of EVA. Under CAPM, Cost of Equity (Ke) is given by the following:

$$K_e = R_f + b_i (Rm - R_f)$$

Where,

R_f = Risk free return

R_m = Expected market rate of return

b_i = Risk coefficient of particular investment

EVA is expressed in terms of rupee figure and not as a percentage i.e., EVA measures the absolute rupee value of wealth created. EVA calculation removes the distinction between the providers of capital because the total capital employed in the business is taken, whether provided by shareholders or creditors. The EVA figure measures the value added after the claims or expectations of each of the group of capital providers have been met.

EVA calculation involves calculating the three figures NOPAT, TCE and WACC; EVA requires some of the following adjustments for the accounting figures:

4.2.1 Adjustments to 'Net Operating Profit after Tax'

The adjustments suggested for Net Operating Profit after Tax (NOPAT) are as follows:

- The depreciation charge, if excessive, needs adjustments.
- Certain marketing expenses like advertising or sales promotion for a new brand launch are capitalized and amortised over the period during which benefits will be reaped.
- Goodwill of an acquired business, if written off, is capitalized and adjusted in NOPAT and equity.
- Expenses incurred on employee training will provide benefits over a period, so these expenses are to be capitalized.
- Accounting principles allow companies to write-off research and development expenses, but these expenses may not be truly revenue in nature. For successful R&D projects, EVA calculations writes back the R&D expenses and amortises them over a period during which benefits of the successful R&D projects will be reaped. The NOPAT figure calculated from Profit and Loss account is adjusted by adding back the R&D expenses and capitalizing them in the balance sheet. Only these R&D expenses that have no future value are charged to the Income statement.
- During periods of rising prices companies save taxes by adopting the LIFO system of inventory valuation. Under the LIFO method, costs of the recently acquired raw material are charged to the production while the costs of earlier purchases are accumulated in inventory thereby understanding the inventory and the profits. For calculating EVA the LIFO system of valuation is changed to FIFO basis, which is a better basis for estimating

Notes

current replacement costs. NOPAT and Equity are adjusted for this change from LIFO to FIFO by adding the difference between the LIFO and FIFO inventory (or LIFO and FIFO cost of goods sold) to the equity and NOPAT. This way the tax benefits of LIFO are retained.

- Deferred taxes arise due to the difference in timing of recognition of revenues and expenses for financial reporting versus reporting for tax purposes. It is basically the accumulation of the difference between accounting provision of taxes and the tax amount actually paid under the head 'Reserve for deferred taxes'. NOPAT is adjusted for the tax actually paid, instead of the accounting provisions. The reserves for deferred taxes are added to the equity.
- Operating leases are to be capitalized. The net present value of the lease payments is capitalised.
- Restructuring expenses and such other expenses, which will benefit the firm in the long run, are capitalised and written-off over a period.
- Other adjustments like adding back the provision for warranty claims, provisions for bad and doubtful debts are also made. They are accounted for on cash basis. Similarly, other non-cash bookkeeping entries are adjusted and accounted for on cash basis.
- Provision for gratuity and pension should be recognised and provided for properly.

4.2.2 Adjustment to 'Capital Employed'

For calculation of correct EVA, the following adjustments are required to be made for capital employed:

- The capital employed can be calculated through the assets side of the balance sheet or the liability side. From the asset side, capital employed is the current assets less the non-interest bearing current liabilities, i.e., the net working capital plus and net fixed assets.
- From the liabilities side, it is the sum of interest bearing debt (short-term as well as long-term) and net worth less and non-operating assets.
- Use the beginning of the year capital employed for calculating EVA as this was the capital available to the management to earn the returns and it helps in evaluating capital budgeting decisions.
- It is prudent to use the book value figure in the EVA calculations, as this is the amount that has been entrusted to the management to employ in the business. The market value of a firm is the investor's capital and it is not the same as the firm's capital. The capital employed that earns operating profits is the book value of net assets and not the market value of a firm's stock.

4.2.3 Adjustment to 'Cost of Capital'

The third element in EVA calculation is the cost of capital, which is the weighted average of the cost of debt, cost of equity capital and cost of preference capital, if any.

While the cost of debt is the average interest rate paid by the company on its debt, the cost of equity can be found out using the Capital Asset Pricing Model (CAPM) and the cost of preference shares can be taken as the fixed rate of dividend.

Notes

Example: Calculate EVA from the following data for the year ended 31st March 2005:

	(₹ crores)
Average debt	50
Average equity	2760
Profit after tax, before exceptional item	15.4
Interest after taxes	5
Cost of debt (post tax)	7.724
Cost of equity	16.7
Weighted average cost of capital	16.54

Source	Amount (₹ Crores)	Proportion	Cost of capital (%)	Weighted cost of capital
Equity	2,766	0.982	16.70	16.40
Debt	50	0.018	7.72	0.14
Total	2,816	1.000		WACC = 16.54

Cost of Capital Employed (COCE) = 2,816 x 16.54/100 = ₹ 465.77 crores.

	(₹ crores)
Profit after tax, before exceptional items	1,540
Add: Interest, after taxes	5
Net operating profit after tax (NOPAT)	1,540

EVA = NOPAT - COCE = 1,546 - 465.77 = ₹ 1,080.23 crores.

Self Assessment

Fill in the blanks:

6. EVA is always expressed as a …… amount.
7. ……. is traditionally used by the founders of EVA.
8. The EVA figure measures the ……after the claims or expectations of each of the group of capital providers have been met.
9. EVA calculation involves calculating the three figures NOPAT, TCE and ……...

4.3 Applications of EVA

Firms compete with each other for acquiring scarce capital from shareholders. To be able to get the capital, a firm must perform better than those of its competitors. It must earn more than earned by similar risk-seekers. If it can achieve this objective, it has created value for the shareholders and its stock price will command a higher premium in the market. In using the EVA system, employees' focus is on how the capital is being used on the cash flows generated to it. EVA makes managers care about managing assets as well as income, and helps them properly assess the trade-off between the two. EVA forces managers to focus on value creating activities rather than wasting time and energy on playing with the accounting principles. The EVA based bonus system is based on performance of employees and managers. They are rewarded for increasing EVA relative to target, and are penalized for falling short. There is no upper limit of bonus. The incentives of employees and managers increase as they keep on increasing EVA

Notes

relative to target. The EVA target is set for every year on the basis of a standardized acceptable formula. At the beginning of each year, the list of participating employees for the EVA bonus plan is disclosed along with the formula for calculating bonus on the basis of EVA. The formula is so transparent that each eligible employee can calculate his or her bonus without waiting for the authority to announce the same. The success of EVA lies only in its linking with the compensation plan. EVA would be effective only when the corporate decision-makers and even the rank and file officers get bonus linked to improvement in EVA.

4.4 Superiority of EVA

EVA is a superior measure of corporate performance and reflects all the dimensions by which management can increase value. It helps in creation of wealth in the following ways:

- EVA is most directly linked to the creation of shareholder's wealth over time. The term 'maximising value' in the EVA context, means maximising long-term yield on shareholders investment and not just the absolute amount of earnings/profits.
- The mechanism of EVA forces management to expressly recognize is cost of equity in all its decisions from the boardroom to the shop floor. The inclusion of this element in overall cost of capital results into the goal congruence of the managers and owners.
- An EVA financial management system removes all the inconsistencies resulting from the use of different financial measures for different corporate functions under the typical traditional financial management system, as it ties all the functions; for instance:
  - Reviewing a capital budgeting process,
  - Valuing an acquisition,
  - Considering strategic plan alternatives,
  - Assessing performance,
  - Communicating,
  - Rewarding management.

  To one single measure - the effect on shareholder value and thus provides a meaningful target to pursue for both internal and external-oriented decisions.
- EVA compensation system ties management's interest with those of shareholders.
- EVA captures the performance status of corporate system over a broader canvas i.e., to arrive at true profits, cost of borrowed capital as well as cost of equity capital should be deducted from net operating profits. Further, to maximize earnings is not sufficient, at the same time consumption of capital should be minimum optimum under an EVA-based system.
- EVA framework provides a clear perception of underlying economics of a business and enables managers to make better decisions.
- A regular monitoring of EVA emphasises on problem areas of a company and helps managers to take corrective actions.
- It is used to assess the likely impact of competing strategies on shareholder's wealth and thus helps the management to select the one that will best serve shareholders.
- It also fits well with the concept of corporate governance. EVA bonus systems do this by giving employees an ownership stake in improvements in the EVA of their divisions or operations. This causes employees to behave like owners and reduces or eliminates the need for outside interference in decision-making.

Notes

- EVA also helps in brand valuation. The brand equity or value created by a particular business unit for its brand could be equated with the value of wealth that the brand has generated over a period of time.

Task Make a discussion on some other approaches of value addition.

Self Assessment

Fill in the blanks:

10. The success of EVA lies only in its linking with the ..... plan.
11. EVA makes managers care about managing assets as well as income, and helps them properly assess the .....between the two.
12. The mechanism of EVA forces management to expressly recognize is .....in all its decisions from the boardroom to the shop floor.

4.5 Shortcomings of EVA

The EVA concept is criticised for the following reasons:

- EVA ignores inflation and it is biased against new assets. Whenever a new investment is made, capital charge is on the full cost initially, so EVA figure is low. But as the depreciation is written off, the capital charge decreases and hence EVA goes up. This problem existed with measures like ROI.
- Since EVA is measured in rupee terms, it is biased in favour of large, low return business, Large business that have returns only slightly above the cost of capital can have higher EVA than smaller business that earn returns much higher than the costs. This makes EVA a poor metric for comparing businesses.
- In the short run, EVA can be improved by reducing assets faster than the earnings and if this is pursued for long it can lead to problems in the longer run when new improvements to the asset base are mode. This new investment can have a high negative effect of EVA because the asset base would have been reduced to a large extent and improvements will involve will huge investments.

Notes **Suggestions to Improve EVA**

EVA is just a refinement of residual income. Residual income is defined as the difference between profit and the cost of capital. It differs from EVA in the fact that profits and capital employed are book figures i.e., the same appearing in the financial statements. No adjustment to profit and capital employed figures as reported in profit and loss account and balance sheet are made unlike EVA. It can be improved in any of the following ways:

- Increasing NOPAT with the same amount of capital.
- Reducing the capital employed without affecting the earnings i.e., discarding the unproductive assets.
- Investing in those projects that earn a return greater than the cost of capital.

Contd...

Notes

- By reducing the cost of capital, which means employing more debt, as debt is cheaper than equity or preference capital.

The EVA concept is very closely related to the NPV concept. The present value of an investment annual EVA stream is the same as its NPV. NPV analysis is a one-time measure of the value added by an investment. EVA is a continuous annual value added measure.

Self Assessment

Fill in the blanks:

13. EVA ignores …….. and it is biased against new assets.
14. EVA is just a refinement of …….
15. ……..is defined as the difference between profit and the cost of capital.

4.6 Summary

- Economic value added (EVA) is an important form of value addition.
- EVA is ascertained as excess of return over cost of capital.
- EVA measures whether operating profit is sufficient enough to cover cost of capital and how much of EVA is generated to justify risk taken by the shareholders.
- EVA can be improved by increasing returns, by reducing asset base, by reducing cost of capital etc.
- Participation of employees and managers in EVA is a modern concept of compensation system for improving the corporate efficiency and results.
- EVA forces managers to focus on value creating activities rather than wasting time and energy on playing with the accounting principles.
- The EVA based bonus system is based on performance of employees and managers.
- EVA ignores inflation and it is biased against new assets. Whenever a new investment is made, capital charge is on the full cost initially, so EVA figure is low.

4.7 Keywords

Economic Value Added (EVA): EVA is a management philosophy and performance metric that elevates those goals from intuition to rigorous analysis and ensures that no investment escapes scrutiny.

Return on Investment: It is the earning capability of the unit/company on the capital investment.

Total capital employed: The total capital employed is the sum of shareholders funds as well as loan funds.

4.8 Review Questions

1. EVA holds a company accountable for the cost of capital it uses to expand and operate its business and attempt to show whether a company is creating a real value for its shareholders. Discuss.
2. What is Economic Value Added (EVA)? What does EVA show? When will EVA increase?

Notes

3. Illustrate the approaches to compute EVA.
4. EVA calculation involves calculating the three figures NOPAT, TCE and WACC. Discuss.
5. Discuss various aspects of computation of Economic Value Added and its application in business planning and valuation.
6. "EVA is a superior measure of corporate performance and reflects all the dimensions by which management can increase value". Elucidate.
7. What are the key steps of calculating EVA?
8. Make some suggestions to improve EVA.
9. What are the shortcomings of EVA?
10. CAPM is traditionally used by the founders of EVA. Discuss.

Answers: Self Assessment

1.	false	2.	false
3.	true	4.	true
5.	true	6.	rupee
7.	CAPM	8.	value added
9.	WACC	10.	compensation
11.	trade-off	12.	cost of equity
13.	inflation	14.	residual income
15.	Residual income		

4.9 Further Readings

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

Sudhindra Bhat, *Financial Management*, New Delhi, Excel Books, 2008.

Van Horne, J.C. and Wachowicz, Jr, J.M., *Fundamentals of Financial Management*, New Delhi, Prentice Hall of India Pvt. Ltd., 1996, p. 2.

Online links

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Unit 5: Social Reporting

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Objectives
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5.1 Meaning and Nature of Social Reporting
5.2 Need of Social Reporting
5.3 Scope of Social Reporting
5.4 Models of Social Disclosure
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Objectives

After studying this unit, you will be able to:

- Explain the meaning and nature of social reporting
- Identify the need of social reporting
- Describe the models of social disclosure

Introduction

Social reporting is reporting on those activities of an organisation that have an impact on society at large and are not necessarily represented by its traditional financial report.

Aspects included in social reporting include such information disclosed in the annual reports viz., Statement on Human Resource Accounting, Statement of Value Added Report on Foreign Currency Transactions (revealing the balance of payments position) and Accounting for Various Social Objectives. Social and ethical accounting, auditing and reporting is still relatively new in many developing or third world nations, but is gaining acceptance internationally as the primary demonstration of social accountability.

Did u know? **What do you mean by social report?**

A social report is the result of a thorough evaluative process focused on the social impact of a business on its various stakeholders.

5.1 Meaning and Nature of Social Reporting

As discussed above, social reporting measures and reports the social costs and benefits on account of operating activities of a business enterprise. The concept of social reporting is gaining popularity on account of the following factors:

- Increasing awareness of society regarding the contributions the corporate units are making.
- Providing meaningful means of identifying and rewarding business for social contribution.

Notes

- Identifying adverse effects on the environment of the business houses.
- Social reporting improves credibility and reputation of business.
- Transferring cost of social activities to other segments of society.

Social reporting is a rational assessment of and reporting on some meaningful, definable domain of a business enterprises activities that have social impact. This reporting aims at measuring (either in monetary or non-monetary units) adverse and beneficial effects of such activities both on the firms and/or those affected by the firm. Being concerned with the social, human and environmental constraints on organizational behaviour, it measures social costs and benefits. The social reporting information is communicated to social groups both within and outside the firm. Thus social reporting implies the measurement and reporting, internal or external, of information concerning the impact of a business enterprise and its activities on society.

The concept of social responsibility extends beyond the provisions embodied in current law. Essentially, it represents an emerging debate having its roots in political and social theory. While designing the contents to be included in social reporting, due care should be taken to see that it does not conflict with the shareholders' interest. Social reporting presently is being either included in the Annual Reports or finds some reference in the Chairman's Address or the Director's Report. Social reporting format tends to vary from one company to another company as till date no format has been described by any Act in India.

Social Corporate Reporting in India

In India, the Companies Act 1956 deals with the preparation of balance sheet and profit and loss account. The Act requires the auditor to make report under Section 227 to members (shareholders) and express an opinion whether the company's balance sheet ad profit and loss account exhibit true and fair view of the company's state of affairs.

Although, this Act has been amended from time to time, no specific provision has been made requiring companies to provide social responsibility disclosures to their annual reports. The Government of India appointed a Committee under the chairmanship of Justice Rajinder Sachar to consider and report on the changes that are necessary in the form and structure of the Act. The Committee (1978) recommended the inclusion of the following, inter alias, in the directors report:

"Steps taken by the company in various spheres with a view to discharging its social responsibilities towards different segments of the society, quantifying where possible and in monetary terms. The Board should also reports on the future plans of the company towards the discharge of its social responsibilities and duties."

Some Indian companies have made attempts to provide information on their responsibility activities in published annual reports and/or through separate means of disclosure. Some companies prepare social income statements and social balance sheets and report them in their published annual reports.

Notes **List of Social Indicators**

- Quality of Management
- Human Rights
- Environmental Performance

Contd...

Notes

- Health and Safety
- Stakeholder Relationships
- Corporate Social Investment
- Employment Equity
- Products and Services

Self Assessment

Fill in the blanks:

1. …….is reporting on those activities of an organisation that have an impact on society at large and are not necessarily represented by its traditional financial report.
2. The concept of ……..extends beyond the provisions embodied in current law.
3. Social reporting presently is being either included in the Annual Reports or finds some reference in the Chairman's Address or the ……..Report.
4. Social reporting …….. tends to vary from one company to another company as till date no format has been described by any Act in India.
5. A social report is the result of a thorough evaluative process focused on the social impact of a business on all its various …….

5.2 Need of Social Reporting

It has now become important for companies to identify society's changing needs. Only a project that yields economic return while satisfying social priorities should be accepted. Thus, the priorities of the society in today's environment need to be looked at. In addition to this, there has been an increase in the number of ethical investors who believe that they should avoid investing in those companies that are believed to be causing social injury or environmental damage of one type or the other. So social reporting is equally important for both the management and the society.

The following are the key objectives of social reporting:

- To identity, measure and report the net social contribution of an individual firm towards society, this includes not only the costs and benefits of a firm internally but also those arising from external factors affecting the different segments of the society.
- To determine whether the individual firm's strategies and practices are consistent with widely shared social principles of the society.

Example: Discrimination on the basis of caste, creed or sex will not be considered a good practice by the society.

- To make available relevant information about the firm's goals, policies, programmes, performances, use of and contribution to scarce resources etc. Relevant information is that which provides for public accountability and also facilitates public decision-making regarding capital choices and social resources allocation.

Example: Indian companies have to disclose their use and earnings of foreign exchange.

Notes

Notes **Suggestions for Better Social Reporting**

With the changing social and economic realities there is a need for reorienting the accounting system to serve the public interest in the widest context and meaning. In order to witness better social reporting by the business houses the following suggestions are offered:

1. ***Reorienting the Accounting System:*** The accounting system should be designed in a way that incorporates some aspects of social reporting.
2. ***Statutory Provision in the Companies Act, 1956:*** It is suggested that Company Law may be amended in a way to make such disclosures mandatory for the company. It is also suggested that the Sachar Committee Report should be implemented. In addition to it the memorandum of association should contain a clause that states about the social obligations of the company.
3. ***Proper Format for Social Reporting:*** It is suggested that the social reporting format may be devised on the lines of Final Accounts format. This will not only bring about uniformity in reporting, but will also make the reports better understood by the readers. In order to make social reporting more effective and useful, attempts should be made by accountants, accounting bodies, social scientists and accounting researchers to develop a useful and feasible social reporting framework.
4. ***Social Reporting Disclosures be developed:*** It is suggested that like other accounting disclosures, a social reporting disclosure may be developed.
5. ***Social Audit:*** There should be a mandatory requirement on the part of the auditor to make a specific mention in his report about the manner in which social aspects are reported.
6. ***Proper Publication:*** There should be regular publication of the social accounts. This will help to study the comparative social performance of the company. Further, after a certain fixed amount of turnover, the company should be subjected to compulsory annual/periodical social audit.

Self Assessment

Fill in the blanks:

6. Social reporting is equally important for both the …… and the society.
7. There should be regular …….. of the social accounts.
8. Relevant information is that which provides for public accountability and also facilitates public decision-making regarding capital choices and ……..allocation.

5.3 Scope of Social Reporting

The following are the major aspects that are covered in social reporting:

- ***Community Development:*** This includes activities benefiting the general public e.g., food programme, community improvement and financing of health services, etc.
- ***Human Resources:*** This area includes social performance directed towards the well being of employees. For example, training programmes, promotion policies and provision for job enrichment, etc.

Notes

- ***Environmental Contribution:*** Activities directed towards alleviating or preventing environmental deterioration (pollution), i.e., air, water, noise pollution. In addition, efforts made by the organisation in conservation of scarce resources and disposal of waste, etc., are included.
- ***Product or Service Contribution:*** This includes product quality, product safety, etc.

Notes **Limitations of Social Reporting**

Though the importance of social reporting is being recognised by many companies in India, yet its progress is hindered due to the following reasons:

- ***Lack of Clear-cut Definition of Social Reporting:*** Every enterprise adopts different methods for measuring, reporting and evaluation social responsibility, as there is no clear-cut definition and procedure for social reporting even.
- ***Not Mandatory:*** Disclosure of social responsibility information is not presently mandatory.
- ***No Standard Format:*** There are no well-established concepts, conventions, postulate and axioms to guide the social accountant in drafting his accounts and reporting.
- ***Auditing Social Cost and Benefit is an Intricate Function:*** It is highly doubtful if only accountancy scholars would be able to identify, document and audit the many sided social effects of business behaviour and auditing social costs and benefits.
- ***No Cadre of Social Auditors:*** As there is no separate cadre of social auditors, it is not clear how and who will conduct such audit. This has also contributed to its slow progress.
- ***Social Reporting vs. Value Added Statements:*** Some business organisations mix social reporting with value added statements, which to a large extent forfeits the very purpose of social reporting.

Self Assessment

State true or false:

9. Disclosure of social responsibility information is mandatory for all organisations.
10. There are well-established concepts, conventions, postulate and axioms to guide the social accountant in drafting accounts and reporting.
11. Some business organisations mix social reporting with value added statements.
12. Community development includes activities benefiting the general public e.g., food programme, community improvement and financing of health services, etc.

5.4 Models Approaches of Social Disclosure

Social accounting measures and reports the social costs and benefits on account of operating activities of a business enterprise. The following are the key models and approaches used for reporting the social cost benefits:

1. ***Social statement approach:*** According to this approach, two statements are prepared (i) Social Income Statement and (ii) Social Balance Sheet. The Social Income Statement

Notes

provides information according to social benefits and costs to employees, local community and the general public. Social balance sheet portrays social investment of capital nature (i.e. social assets) viz. township, roads, buildings, hospitals, schools, clubs, etc. on the assets side and the organisations equity and social equity on the liabilities side.

2. ***Operating statement approach:*** According to this approach, a firm presents only the positive and negative aspects of social activities as a result of business operations. The positive aspects are broadly termed as social benefits. While negative aspects are termed as social costs.

Caution The difference between social benefits and social costs represent the net social contribution by the firm.

3. ***Narrative approach:*** This is simplest and easiest method for reporting social costs and social benefits information. In case of this approach, disclosure regarding social costs and social benefits is made in a narrative and not in a quantitative form. The firm generally highlights the positive aspects of its social activities.

Notes **Important types of Social Accounts**

1. A report on performance against the stated objectives.
2. An assessment of the impact on the community.
3. The views of stakeholders on our Objectives and Values.
4. A report on environmental performance.
5. A report on how we implement equal opportunities.
6. A report on our compliance with statutory and voluntary quality and procedural standards.

Self Assessment

Fill in the blanks:

13. The …….provides information according to social benefits and costs to employees, local community and the general public.
14. ……..portrays social investment of capital nature (i.e. social assets) viz. township, roads, buildings, hospitals, schools, clubs, etc. on the assets side and the organisations equity and social equity on the liabilities side.
15. In case of narrative approach, disclosure regarding social costs and social benefits is made in a narrative and not in a …….. form.

Task Identify the key Indian companies involved in social reporting.

5.5 Summary

- Social reporting is reporting on those activities of an organisation that have an impact on society at large and are not necessarily represented by its traditional financial report.

Notes

- Social reporting presently is being either included in the Annual Reports or finds some reference in the Chairman's Address or the Director's Report.
- Social reporting format tends to vary from one company to another company as till date no format has been described by any Act in India.
- Social reporting is equally important for both the management and the society.
- Social accounting measures and reports the social costs and benefits on account of operating activities of a business enterprise.
- According to social statement approach, two statements are prepared (i) Social Income Statement and (ii) Social Balance Sheet.
- According to operating statement approach, a firm presents only the positive and negative aspects of social activities as a result of business operations.

5.6 Keywords

Social Balance Sheet: Social balance sheet portrays social investment of capital nature (i.e. social assets) viz. township, roads, buildings, hospitals, schools, clubs, etc. on the assets side and the organisations equity and social equity on the liabilities side.

Social Income Statement: The Social Income Statement provides information according to social benefits and costs to employees, local community and the general public.

Social Reporting: Social reporting measures and reports the social costs and benefits on account of operating activities of a business enterprise.

5.7 Review Questions

1. A social report is the result of a thorough evaluative process focused on the social impact of a business on all its various stakeholders. Give some suggestions to support the statement.
2. The concept of social responsibility extends beyond the provisions embodied in current law. Discuss.
3. Social reporting is equally important for both the management and the society. How?
4. What are the key suggestions for better social reporting?
5. Discuss the scope of social reporting.
6. What are the key accounts prepared under social statement approach?
7. What are the key models of social disclosure?

Answers: Self Assessment

1. Social reporting
2. social responsibility
3. Director's
4. format
5. stakeholders

Notes

6. management
7. publication
8. social resources
9. false
10. false
11. true
12. true
13. Social Income Statement
14. Social balance sheet
15. quantitative

5.8 Further Readings

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

Sudhindra Bhat, *Financial Management*, New Delhi, Excel Books, 2008.

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Unit 6: Human Resource Accounting

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Objectives

After studying this unit, you will be able to:

- Explain the meaning of HRA
- Describe the nature of HRA
- Identify the scope of HRA

Introduction

The past few decades have witnessed a global transition from manufacturing to service-based economies. The fundamental difference between the two lies in the very nature of their assets. In the former, physical assets like plant, machinery, material, etc., are of utmost importance. In contrast, in the latter, knowledge and attitudes of the employees assume greater significance. For instance, in the case of an IT firm, the value of its physical assets is negligible when compared with the value of the knowledge and skills of its personnel. Similarly, in hospitals, academic institutions, consulting firms, etc., the total worth of the organisation depends mainly on the skills of its employees and the services they render. Therefore, the success of these organizations is contingent on the quality of their human resource – their knowledge, skills, competence, motivation and understanding of the organisational culture.

In knowledge-driven economies therefore, it is imperative that the humans be recognised as an integral part of the total worth of an organisation. However, in order to estimate and project the worth of human capital, it is necessary that some method of quantifying the worth of the knowledge, motivation, skills, and contribution of the human element as well as that of the organisational processes, like recruitment, selection, training, etc., which are used to build and support these human aspects, is developed.

Caution Human Resource Accounting (HRA) denotes the process of quantification/ measurement of human resources.

Notes

6.1 Meaning of HRA

In simple words, human resource accounting is the art of, valuing, recording and presenting systematically the worth of human resources in the books of account of an organisation. This definition brings out three important aspects of human resource accounting:

(i) Valuation of human resources.

(ii) Recording the valuation in the books of accounts.

(iii) Disclosure of the information in the financial statements of the business.

The American Accounting Society Committee on human resource accounting defines it as follows:

"Human resource accounting is the process of identifying and measuring data about human resources and communicating this information to interested parties."

Mr. Woodruff Jr. Vice President of R.G. Barry Corporation defines human resources accounting as: "Human resource accounting is an attempt to identify and report investments made in the human resources of an organisation that are presently not accounted for in conventional accounting practice. Basically, it is an information system that tells the management what changes over time are occurring to the human resources of the business."

The American Accounting Association's Committee on Human Resource Accounting (1973) has defined Human Resource Accounting as "the process of identifying and measuring data about human resources and communicating this information to interested parties". HRA, thus, not only involves measurement of all the costs/investments associated with the recruitment, placement, training and development of employees, but also the quantification of the economic value of the people in an organisation.

Flamholtz (1971), too has offered a similar definition for HRA. He defines HRA as "the measurement and reporting of the cost and value of people in organizational resources".

As far as statutory requirements go, the Companies Act, 1956 does not demand furnishing of HRA related information in the financial statements of the companies. The Institute of Chartered Accountants of India too, has not been able to bring any definitive standard or measurement in the reporting of human resources costs. While the chairmen in their AGMs often make qualitative pronouncements regarding the importance of human resources, quantitative information about their contribution is rarely recorded or communicated. There are a few organizations, however, that do recognize the value of their human resources, and furnish the related information in their annual reports.

Example: In India, some of these companies are: Infosys, Bharat Heavy Electricals Ltd (BHEL); Steel Authority of India Ltd. (SAIL), Minerals and Metals Trading Corporation of India Ltd. (MMTC), Southern Petrochemicals Industries Corporation of India (SPIC), Associated Cement Companies Ltd, Madras Refineries Ltd., Hindustan Zinc Ltd., Engineers India Ltd, Oil and Natural Gas Commission (ONGC), Oil India Ltd., Cement Corporation of India Ltd., etc.

Objectives of HRA

The following are the key objectives of HRA:

- To furnish the information for making the decisions at the investors' and managers' level
- To evaluate the return on human investment through the results
- To report the worth of human resources to the organization and society

Notes

Self Assessment

Fill in the blanks:

1. Human Resource Accounting (HRA) denotes the …….. of quantification/measurement of human resources.
2. Human resource accounting is the art of, valuing, recording and …… systematically the worth of human resources in the books of account of an organisation.
3. The ……does not demand furnishing of HRA related information in the financial statements of the companies.

6.2 Nature of HRA

Like any accounting exercise, HRA too depends heavily on the availability of relevant and accurate information. HRA is essentially a tool to facilitate better planning and decision-making based on the information regarding actual HR costs and organisational returns. The kind of data that needs to be managed systematically depends upon the purpose for which HRA is being used by an organisation.

Example: If the purpose is to control the personnel costs, a system of standard costs for personnel recruitment, selection and training has to be developed. It helps in analysing projected and actual costs of manpower and thereby, in taking remedial action, wherever necessary.

Did u know? **What is the role of information on turnover cost?**

Information on turnover costs generates awareness regarding the actual cost of turnover and highlights the need for efforts by the management towards retention of manpower.

Accountability in the management process is often enhanced when information involving an evaluation of managerial effectiveness is generated. Finally, information on the intangibles like intellectual capital/human capital becomes necessary to measure the true worth of the organisation. This information, though unaudited, needs to be communicated to the board and the stockholders.

Notes **Significance of Human Resources Accounting**

Human Resources Accounting provides useful information to the management, financial analysts and employees, as shown below:

1. Human Resources Accounting helps the management in the decision-making process relating to the following matters:
   - Employment, locating and utilisation of human resources.
   - Transfers, promotions, training and retrenchment of human resources.
   - Planning of physical assets vis-à-vis human resources.
   - Evaluating the expenditure incurred for imparting further education and training to employees in terms of the benefits derived by the firm.
   - Identifying the causes of high labour turnover at various levels and taking preventive measures to contain it.

Contd...

Notes

- Locating the real cause of low return on investment, that is whether it is due to improper or under-utilisation of physical assets or human resource of both.

2. A financial analyst is interested in understanding and assessing the inner strength of the firm. Such inner strength does not merely depend on the physical assets owned and possessed by the firm. In case the human resources, specially the managerial resources at the disposal of the firm are impartially and systematically valued and disclosed in the financial statements, it will be a valuable information for persons interested in making long-term investment in the firm.
3. The Human Resource Accounting helps individual employees in improving their performance and bargaining power. It makes each of them conscious of the contribution that he is making towards the betterment of the firm vis-à-vis the expenditure incurred by the firm on him.

Self Assessment

Fill in the blanks:

4. HRA is essentially a tool to facilitate better planning and …….based on the information regarding actual HR costs and organisational returns.
5. The kind of …….. that needs to be managed systematically depends upon the purpose for which HRA is being used by an organisation.
6. Information on ……generates awareness regarding the actual cost of turnover and highlights the need for efforts by the management towards retention of manpower.
7. The Human Resource Accounting helps individual employees in improving their performance and ……...

6.3 Need and Scope of HRA

According to Likert (1971), HRA serves the following purposes in an organisation:

1. It furnishes cost/value information for making management decisions about acquiring, allocating, developing, and maintaining human resources in order to attain cost-effectiveness.
2. It allows management personnel to effectively monitor the use of human resources.
3. It provides a sound and effective basis of human asset control, that is, whether the asset is appreciated, depleted or conserved.
4. It helps in the development of management principles by classifying the financial consequences of various practices.

Basically, HRA is a management tool that is designed to assist senior management in understanding the long-term cost and benefit implications of their HR decisions so that better business decisions can be taken. If such accounting is not done, then the management runs the risk of taking decisions that may improve profits in the short run but may also have severe repercussions in future. For example, very often organisations hire young people from outside on very high salaries because of an immediate business requirement. Later on, however, they find that the de-motivating impact of this move on the existing experienced staff has caused immense long-term harm by reducing their productivity and by creating salary distortions across the organisational structure.

Notes

HRA also provides the HR professionals and management with information for managing the human resources efficiently and effectively. Such information is conserving, utilizing, evaluating and rewarding in a proper way. These functions are the key transformational processes that convert human resources from 'raw' inputs (in the form of individuals, groups and the total human organization) to outputs in the form of goods and services. HRA indicates whether these processes are adding value or enhancing unnecessary costs. In addition to facilitating internal decision-making processes, HRA also enables critical external decision-makers, especially the investors in making realistic investment decisions. Investors make investment decisions based on the total worth of the organisation. HRA provides the investors with a more complete and accurate account of the organisations' total worth, and therefore, enables better investment decisions. For example, conventional financial statements treat HR investments as "expenditures. Consequently, their income statement projects expenditures to acquire, place and train human resources as expenses during the current year rather than capitalizing and amortising them over their expected service life. The balance sheet, thus, becomes distorted as it inaccurately presents the "total assets" as well as the "net income" and, thereby, the "rate of return" which is the ratio of net income to the total assets. HRA helps in removing this distortion.

Furthermore, in a business environment where corporate social responsibility is rapidly gaining ground, HRA reflects the extent to which organisations contribute to society's human capital by investing in its development. Finally, in an era where performance is closely linked to rewards, the performance of all groups/departments/functions needs to be quantified to the extent possible. HRA helps in measuring the performance of the HR function as such.

Notes **Objections or limitations against Human Resources Accounting**

The following are some of the common objection against Human Resource Accounting:

1. Human beings cannot be owned like other physical assets. They, therefore, cannot command any value.
2. Tax laws do not recognise human beings as assets. Hence, human resource accounting remains merely as a theoretical concept.
3. There is no generally accepted model for valuation of human resources. The mode of presentation has also not yet been codified.
4. The valuation of human resources depends on a large number of abstract factors not measurable in precise monetary terms. Hence, the valuation lacks objectivity and preciseness.

Self Assessment

State true or false:

8. HRA helps in the development of management principles by classifying the financial consequences of various practices.
9. Tax laws recognise human beings as assets.
10. HRA does not help in measuring the performance of the HR function.

Task Identify the difference between HRA and historical accounting.

Notes

6.4 HRA in India

In India, the financial statements of companies have to be prepared as per the provisions of the Companies Act, 1956. The Act does not provide for disclosure of any significant information about human resources employed in a company except that the companies have to give by way of a note to the Profit & Loss Account, particulars of employees getting remuneration of ₹ 6,00,000 per annum or more. However, there is nothing in the Act which prevents a company from giving details about its human resources byway of supplementary information attached with its financial statements.

In view of the growing importance of human resource accounting, many corporate enterprises in India are voluntarily giving information about their human resources. They number about 15 in all and include many important public sector enterprise viz. Bharat Heavy Electricals Ltd. (BHEL), Steel Authority of India Ltd. (SAIL), Minerals and Metal Trading Corporation of India (MMTC), National Thermal Power Corporation (NTPC), Oil and Natural Gas Commission (ONGC) and Engineers India Ltd. (EIL), Among all these enterprises BHEL is the pioneer in the field of human resource accounting since mid-1 970.

Most of the Indian companies and corporations have followed basically Lev and Schwartz Model for valuation of human resources. This is one of the popular methods in India, which discounts the future earnings of human resource into present value till the retirement age.

$$Vy = \frac{It}{(1+R)\,t-y}$$

Vy = Human capital value of a person up to y years old

It = the personal annual earnings up to retirement

R = discount rate specific to the person

6.5 Summary

- Human resource accounting is the art of, valuing, recording and presenting systematically the worth of human resources in the books of account of an organisation.
- The American Accounting Association's Committee on Human Resource Accounting (1973) has defined Human Resource Accounting as "the process of identifying and measuring data about human resources and communicating this information to interested parties".
- Like any accounting exercise, HRA too depends heavily on the availability of relevant and accurate information.
- HRA is essentially a tool to facilitate better planning and decision-making based on the information regarding actual HR costs and organisational returns.
- Human Resources Accounting provides useful information to the management, financial analysts and employees.
- HRA is a management tool that is designed to assist senior management in understanding the long-term cost and benefit implications of their HR decisions so that better business decisions can be taken.
- HRA also provides the HR professionals and management with information for managing the human resources efficiently and effectively.

Notes

6.6 Keywords

Historical Accounting: Under historical accounting system, accounts are prepared without regard to changes in the price levels.

Human Resource Accounting: Human resource accounting is the art of, valuing, recording and presenting systematically the worth of human resources in the books of account of an organisation.

6.7 Review Questions

1. What is HRA? Why HRA?
2. How HRA is different form conventional accounting? Discuss with suitable example.
3. Like any accounting exercise, HRA too depends heavily on the availability of relevant and accurate information. How?
4. Human Resources Accounting provides useful information to the management, financial analysts and employees. Identify the key informations.
5. Identify the scope of HRA.
6. What are the key objections against HRA?

Answers: Self Assessment

1. Process
2. Presenting
3. Companies act 1956
4. Decision making
5. Data
6. Turnover cost
7. Bargaining power
8. True
9. False
10. False

6.8 Further Readings

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

Sudhindra Bhat, *Financial Management*, New Delhi, Excel Books, 2008.

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Online links

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Unit 7: Approaches of HRA

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Objectives

After studying this unit, you will be able to:

- Describe the cost and economic approach of HRA
- Measure group values
- Illustrate the recording and disclosure in financial statements

Introduction

The biggest challenge in HRA is that of assigning monetary values to different dimensions of HR costs, investments and the worth of employees. The two main approaches usually employed for this are:

1. The cost approach, which involves methods based on the costs incurred by the company, with regard to an employee.
2. The economic value approach, which includes methods based on the economic value of the human resources and their contribution to the company's gains. This approach looks

at human resources as assets and tries to identify the stream of benefits flowing from the asset.

7.1 Cost Approach

The cost approaches includes the following approaches:

7.1.1 Historical Cost Approach

According to this approach, the actual cost incurred on recruiting, selecting, hiring, training and developing the human resources of the organisation are capitalised and written off over the expected useful life of the human resources. The historical cost of human resources in case of this method is thus treated in the same manner as the cost of any other physical asset. Any expenditure incurred for training or development of the human resources increases the value of human assets like any other physical asset and is therefore capitalised in a similar manner. Amortization of the human assets is also done in a similar manner. In case the human asset expires before the end of the expected service life period, the whole of the amount not written off is charged against the revenue of the year in which such an event takes place.

Caution In case the useful life is recognised to be longer than the original expected, amortization is appropriately rescheduled.

Merits of Historical Cost Approach

The method has the following merits:

- The method is simple to understand and easy to work out.
- The method follows the traditional accounting concept of matching cost with revenue.
- The method can provide a basis for valuing a firm's returns on its investment on human resources.

Limitations of Historical Cost Approach

The method suffers from the following limitations:

- The method takes into account only a part of acquisition cost of employee. It does not consider the aggregate value of their potential services.
- It is difficult to estimate the period over which the human resource will provide service to the organisation. It thus creates problems in determining the amount to be amortized over the year.
- The value of human assets according to this method goes on decreasing every year due to amortization. However, in reality, the value of human assets increases over time on account of people gaining experience.

7.1.2 Replacement Cost Approach

This approach was developed by Rensis Likert and Eric G. Flamholtz. This approach values the human resources at their present replacement cost. In other words, human resources of an organisation are to be valued on the basis of the assumption of what it would cost the firm if the existing human resources need to be replaced with others of equivalent talents and experience.

Notes

Did u know? **What is replacement cost?**

Replacement cost occurs only at the moment of replacing the resources which is mainly based on the current value approach.

The approach is similar to the historical cost approach mentioned above except that it allows for changes in the cost for acquiring, training and developing the employees in place of taking their historical cost for capitalisation.

Merits of Replacement Cost Approach

The method has the following merits:

- The approach incorporates the current value of the firm's human resources. Thus, the financial statements prepared according to this approach are more realistic as compared to those prepared under historical cost approach.
- The method is more representative and logical.

Limitations of Replacement Cost Approach

The method has the following limitations:

- The method is at variance with conventional accounting practice of valuing assets at historical costs.
- It is almost impossible to ascertain correct replacement cost of existing human resources since there can be no complete replacement for them.
- There is no objective way for determination of replacement cost. Personal prejudices do work. Moreover, there is no foolproof method for verification of replacement cost.

7.1.3 Opportunity Cost Approach

This approach has been suggested by Hekimian and Jones. According to this approach, the value of an employee is determined according to his alternative use. In case an employee has no alternative use, no value will be placed on him. This approach specifically excludes those types of employees who can be hired readily from outside. The approach suggests competitive bidding process for the scarce employees in an organisation. It means that the opportunity cost is linked with scarcity. The opportunity cost of an employee or a group of employees in one department is calculated on the basis of the offers (bids) by other departments for those employees. This will be clear from the following example.

Example: A company has two departments X and Y. The amount of capital employed (in physical assets) in department X and Y is ₹10 lakhs and ₹ 5 lakh respectively. The required rate of return on total capital employed (physical as well as human) is 15%. It is projected that with the employment of a specific group of technocrats, department X can make a profit of ₹ 3 lakhs while department Y can make a profit of ₹ 2.5 lakhs.

The capitalised value of profit with the technocrats at the rate of 15% comes to ₹ 20 lakhs in case of department X and ₹16.67 lakhs for department Y. In case the value of physical assets is deducted from these figures, the value of human resources comes to ₹ 10 lakhs in case of department X and ₹11.67 lakhs in case of department Y. Hence, department Y can offer a higher bid for the technocrats as compared to department WIPRO.

Notes

In terms of salary, department X can offer a salary of ₹ 1.50 lakhs (₹ 10 lakhs × 15%) while department Y up to ₹1.75 lakhs (₹ 11.67 × 15%). Department Y, thus, also offer a high salary.

Department Y will have the technocrats on account of a higher bid and it will include ₹ 11.67 lakhs as its investment in human resources.

Merits of Opportunity Cost Approach

According to the authors of this approach, a bidding process, such as this, is a promising approach towards (a) more optimal allocation of personnel and (b) a quantitative base for planning, evaluating and developing human assets of the firm.

Limitations of Opportunity Cost Approach

This approach has several limitations:

- It has narrowed down the concept of opportunity cost by restricting it to the best use of the employee within the same organisation.
- It has specifically precluded from its purview those employees who are not scarce or, are not being bid by other department. This is likely to result in lowering of morale and productivity of the employees, who are not covered by the competitive bidding process.
- The total valuation of human resources based on this method may be misleading and inaccurate. This is because a person may be an expert in a particular area and therefore may be useful for one department, but useless for another department Thus, he may be a valuable person for the department he is working and command a high value. However, he may have a lower price in the bid by the other department where his services are not at all required.

7.1.4 Standard Cost Approach

David Watson has suggested this approach. According to this approach, standard costs of recruiting, hiring, training and developing per grade of employees are determined year after year. The standard cost so arrived at for all human beings employed in the organisation is the value of human resources for accounting purposes.

The approach is easy to explain and can work as a suitable basis for control purposes through the technique of variance analysis. However, determination of the standard cost for each grade of employee is a ticklish process.

7.1.5 Present Value Approach

According to this approach, the value of human resources of an organisation is determined according to their present value to the organisation. For determination of the present value, a number of valuation models have been developed. Some of the important models are as follows:

1. ***Present Value of Future Earnings Model:*** This model has been developed by Lev and Schwartz (1971). According to this model, the value of human resources is ascertained as follows:

   (a) All employees are classified in specific groups according to their age and skill.

   (b) Average annual earnings are determined for various ranges of age.

   (c) The total earnings that each group will receive up to retirement age are calculated.

Notes

(d) The total earnings calculated as above are discounted at the rate of cost of capital.

(e) The value thus arrived at will be the value of human resources/assets.

(f) The following formula has been suggested for calculating the value of an employee according to this model.

$$Vr = \sum_{t-r}^{T} \frac{1(t)}{(1+R)^{t-r}}$$

where

Vr = the value of an individual r years old.

I (t) - the individual s annual earnings up to the retirement

t = retirement age

r = present age of the employee

R = discount rate

Limitations: The method suffers from several limitations:

(a) A person s value to an organisation is not entirely determined by the salary paid to him. A person may like to work at a salary that is less than what he actually deserves. Moreover, salary does not remain constant over a period of time.

(b) The model ignores the possibility that an individual may leave the organisation for reasons other than death or retirement. Thus, it overstates an employee s prospected service life and his future earnings.

(c) The model does not take into account the changes that people make during their career, from one role to another, at one or more times within the organisation itself.

(d) The model also ignores other considerations such as seniority, bargaining capacity, etc.

2. ***Reward Valuation Model:*** This model has been suggested by Flamholtz (1971). This is an improvement on present value of future earnings model since it takes into consideration the possibility or probability or an employee s movement from one role to another in his career and also of his leaving the firm earlier than his death or retirement.

Caution The realisable value is estimated on the basis of the present worth of the set of future services he is projected to provide during the period he is likely to remain with the organisation.

The model suggests a five-step approach for this purpose.

(a) Identification of service states (i.e. roles or posts) that the employee might occupy during his service career including the possibility of his quitting the organisation.

(b) Estimation of the probable period for which a person will occupy each possible service state (posts or roles) in future in the organisation.

3. ***Net Benefit Model:*** This approach has been suggested by Morse (1973). According to this approach, the value of human resources is equivalent to the present value of net benefits derived by the organisation from the service of its employees. The method involves the following steps:

Notes

(a) The gross value of services to be rendered in future by the employees in their individual as well as their collective capacity is determined.

(b) The value of future payments (both direct and indirect) to the employees is determined.

(c) The progress of the value of future human resources (as per 1 above) over the value of future payments (as per 2 above) is ascertained. This, as a matter of fact, represents the net benefit to the organisation on account of human resources.

(d) The present value of the net benefit is determined by applying a predetermined discount rate (generally the cost of capital). This amount represents the value of human resources to the organisation.

4. ***Certainty Equivalent Net Benefit Model:*** This approach has been suggested by Pekin Ogan (1976). This, as a matter of fact, is an extension of "net benefit approach" as suggested by Morse. According to this approach, the certainty with which the net benefits in future will accrue should also be taken into account while determining the value of human resources. The approach requires determination of the following:

   (a) Certainty factor at which the benefits will be available.

   (b) The net benefits from all employees multiplied by their certainty factor will give certainty-equivalent net benefits. This will be the value of human resources of the organisation.

5. ***Aggregate Payment Approach:*** This approach has been suggested by Prof. S.K. Chakraborty (1976). As a matter of fact, he is the first Indian to suggest a model for valuation of human resources of an organisation. According to his model, the human resources are to be valued as a group and not on individual basis.

   Professor Chakraborty's model for valuation of human resources involves the following steps:

   (a) All the employees of an organisation are divided in two groups, managerial and non-managerial.

   (b) The average tenure of the employment of the employees in the group is estimated on the basis of past experience.

   (c) The average salary of the group is determined on the basis of the salary wage structure prevalent in the organisation.

   (d) The value of human resources is now determined by multiplying the average salary of the group with the average tenure of the employees in that group.

6. ***Total Cost Concept:*** This approach has been suggested by Prof. N. Dasgupta (1978). According to him the various approaches suggested in the previous pages take into account only those persons, who are employed and ignore those who are unemployed. In case the value of human resources of the nation is to be determined, it should be done in a manner that brings in its purview both employed and unemployed persons. The system should be such that it fits in preparation of a balance sheet showing the human resources not only of a firm but also of the whole nation.

Example: From the following details, compute the value of human resources of an employee group with an average age of 58 years.

Notes

(i)	Annual Average Earning of an employee till the retirement age	₹ 20,000
(ii)	Age of retirement	60 years
(iii)	Cost of capital	10%
(iv)	Number of employees in the group	10

Solution:

$$Vr = \sum_{t-r}^{T} \frac{1(t)}{(1+R)^{t-r}}$$

= 20,000/(1 + 0.10)(60 - 58) + (20,000)/(0.1 + 0.10)(60 - 59)

= 20,000/(1 + 0.10)2 + (20,000)/(0.1 + 0.10)1

= 16,528.93 + 18,181.82

= ₹ 34,710.75

Alternatively, the value of an employee can be computed with the help of Annuity Table. The present value of on annuity of ₹ 1 for two years at 10% is 1.736. Hence, the present value of ₹ 20,000 for two years comes to 20,000 Wipro 1.736 = 34,720. This is almost the same as calculated above.

Since the total number of employees in the group are 10, hence the total value of human resources of this group comes to 34,710 Wipro 10 = ₹ 3,47,100.

Self Assessment

Fill in the blanks:

1. ……occurs only at the moment of replacing the resources which is mainly based on the current value approach.
2. According to opportunity cost approach, the value of an employee is determined according to his ……..use.
3. According to ……, the value of human resources of an organisation is determined according to their present value to the organisation.
4. The present value of the net benefit is determined by applying a predetermined ……..(generally the cost of capital).
5. The opportunity cost of an employee or a group of employees in one department is calculated on the basis of the ……..by other departments for those employees.
6. The opportunity cost is linked with ……...

7.2 The Economic Value Approach

The value of an object, in economic terms, is the present value of the services that it is expected to render in future. Similarly, the economic value of human resources is the present worth of the services that they are likely to render in future. This may be the value of individuals, groups or the total human organisation. The methods for calculating the economic value of individuals may be classified into monetary and non-monetary methods.

7.2.1 Monetary Measures for Assessing Individual Value

Notes

The following are the key models of monetary measures for assessing individual models:

1. ***Flamholtz's Model of Determinants of Individual Value to Formal Organisations:*** According to Flamholtz, the value of an individual is the present worth of the services that he is likely to render to the organisation in future. As an individual moves from one position to another, at the same level or at different levels, the profile of the services provided by him is likely to change. The present cumulative value of all the possible services that may be rendered by him during his/her association with the organisation, is the value of the individual. Typically, this value is uncertain and has two dimensions. The first is the expected conditional value of the individual. This is the amount that the organisation could potentially realize from the services of an individual during his/her productive service life in the organization. It is composed of three factors:
   (a) Productivity or performance (set of services that an individual is expected to provide in his/her present position);
   (b) Transferability (set of services that he/she is expected to provide if and when he/she is in different positions at the same level);
   (c) Promotability (set of services that are expected when the individual is in higher level positions).

   These three factors depend, to a great extent, on individual determinants like activation level of the individual (his motivation and energy level) and organizational determinants like opportunity to use these skills or roles and the reward system.

   The second dimension of an individual value is the expected realizable value, which is a function of the expected conditional value, and the probability that the individual will remain in the organisation for the duration of his/her productive service life. Since individuals are not owned by the organisation and are free to leave, ascertaining the probability of their turnover becomes important.

   Caution The interaction between the individual and organizational determinants mentioned above, leads to job satisfaction. The higher is the level of job satisfaction, the lower is the probability of employee turnover. Therefore, higher is the expected realizable value.

2. ***Flamholtz's Stochastic Rewards Valuation Model:*** The movement or progress of people through organizational 'states' or roles is called a stochastic process. The Stochastic Rewards Model is a direct way of measuring a person's expected conditional value and expected realizable value. It is based on the assumption that an individual generates value as he occupies and moves along organizational roles, and renders service to the organisation. It presupposes that a person will move from one state in the organisation, to another, during a specified period of time. In this model, exit is also considered to be a state. Use of this model necessitates the following information:
   (a) The set of mutually exclusive states that an individual may occupy in the system during his/her career;
   (b) The value of each state, to the organisation;
   (c) Estimates of a person's expected tenure in the organisation;
   (d) The probability that in future, the person will occupy each state for the specified time;
   (e) The discount rate to be applied to the future cash flows.

Notes

7.2.2 Non-monetary Methods for Determining Value

The non-monetary methods for assessing the economic value of human resources also measure human resources, but not in dollar or money terms. Rather, they rely on various indices or ratings and rankings. These methods may be used as surrogates of monetary methods and also have a predictive value. The non-monetary methods may refer to a simple inventory of skills and capabilities of people within an organization or to the application of some behavioural measurement technique to assess the benefits gained from the human resource of an organisation.

1. The skills or capability inventory is a simple listing of the education, knowledge, experience and skills of the firm's human resources.
2. Performance evaluation measures used in HRA include ratings, and rankings. Ratings reflect a person's performance in relation to a set of scales. They are scores assigned to characteristics possessed by the individual. These characteristics include skills, judgment, knowledge, interpersonal skills, intelligence, etc. Ranking is an ordinal form of rating in which the superiors rank their subordinates on one or more dimensions, mentioned above.
3. Assessment of potential determines a person's capacity for promotion and development. It usually employs a trait approach in which the traits essential for a position are identified. The extent to which the person possesses these traits is then assessed.
4. Attitude measurements are used to assess employees' attitudes towards their job, pay, working conditions, etc., in order to determine their job satisfaction and dissatisfaction.

Self Assessment

Fill in the blanks:

7. The methods for calculating the ……of individuals may be classified into monetary and non-monetary methods.
8. The ……methods may refer to a simple inventory of skills and capabilities of people within an organization or to the application of some behavioural measurement technique to assess the benefits gained from the human resource of an organisation.
9. The ……is a simple listing of the education, knowledge, experience and skills of the firm's human resources.
10. Assessment of …… determines a person's capacity for promotion and development.

7.3 Measurement of Group Values

Likert and Bowers propose causal, intervening, and end-result variables, which determine the group's value to an organization. Causal variables are those that can be controlled by the organization. These variables include managerial behaviour and organisational structure. Intervening variables reflect organizational capabilities and involve group processes, peer leadership, organization climate, and the subordinates' satisfaction. Both the causal and the intervening variables determine the end result variables of the causal and intervening variables. The end-result dependent variables reflect the achievements of the organization or the total productive efficiency in terms of sales, costs, earnings, market performance, etc. They are dependent on the causal and the intervening variables.

Notes

7.3.1 Managerial and Peer Leadership

Support-friendly—pays attention to what you are saying; Team-building—listens to subordinates' problems; encourages subordinates to work as a team, encourages exchange of opinions and ideas; Goal Emphasis—encourages best efforts; maintains high standards; Help with work—shows ways to do a better job; helps subordinates plan, organize and schedule; offers new ideas, and solutions.

7.3.2 Organisational Climate

- ***Communication flow:*** Communication flow is amicable.
- ***Decision-making:*** Subordinates know what is going on; superiors are practices receptive.
- ***Concern for persons:*** Subordinates are involved in setting goals; decisions are made at levels of accurate information; persons affected by decisions are asked for their ideas; know-how of people of all levels is used.
- ***Influence on department:*** The organization is interested in individual's welfare; tries to improve working conditions; organizes work activities sensibly.
- ***Technological adequacy:*** From lower level supervisors to employees who have no subordinates.
- ***Motivation:*** Improved methods are quickly adopted; equipment and resources are well managed. Differences and disagreements are accepted and worked through; people in organization work hard for money, promotions, job satisfaction and to meet high money, promotion, job satisfaction and to meet high expectations from others and are encouraged to do so by policies, working conditions, and people.

7.3.3 Group Process

(i) Planning together, coordinating efforts.

(ii) Making good decision's solving problems.

(iii) Knowing jobs and how to do them well.

(iv) Sharing information.

(v) Wanting to meet objectives.

(vi) Having confidence and trust in other members.

(vii) Ability to meet unusual work demands.

7.3.4 Satisfaction

With fellow workers; superiors; jobs; this organization compared with others; pay; progress in the organization up to now; opportunities for getting ahead in the future.

1. ***Brummet, Flamholtz, and Pyle's Economic Value Model:*** The Brummet, Flamholtz, and Pyle model follows the principle that a resource's value is equal to the present worth of the future services it can be expected to provide, and therefore, it can provide a basis of measuring the value of a group of people. According to this method, groups of human resources should be valued by estimating their contribution to the total economic value of the firm. Thus a firm's forecasted future earnings are discounted to determine the firm's present value, and a portion of these earnings is allocated to human resources according to their contribution.

Notes

2. ***Hermanson's Unpurchased Goodwill Model:*** According to Hermanson, the unpurchased goodwill notion is based on the premise that 'the best available evidence of the present existence of unowned resources is the fact that a given firm earned a higher than normal rate of income for the most recent year. Here Hermanson is proposing that supernormal earnings are an indication of resources not shown on the balance sheet, such as human assets. Even though his method of valuing human resources is explicitly intended for use in a company's published financial statements rather than for internal consumption, this would necessarily involve forecasting future earnings and allocating any excess above normal expected earnings to human resources of the organization. However, the assumptions would be subject to the uncertainties involved in any forecast of future events.

Caution This method suffers from several limitations: Firstly, since the methods limits recognition of human resources to the amount of earnings in excess of normal, the human resource base that is required to carry out normal operations is totally ignored. As a result, the value of human assets will be an underestimation. Secondly, the method only uses the actual earnings of the most recent year as the basis for calculating human assets, thereby, ignoring the forecasts of future earnings that are equally relevant for managerial decision-making.

3. ***Human Organizational Dimensions Method:*** Based on the Likert-Bowers model of group's value to an organization, discussed earlier, this method is based on the relationship among causal, intervening and end-result variables. The causal variables influence the intervening variables, which, in turn, determine the organization's end result variables. Hence changes in the key dimensions of organisation can be used as dependable indicators for forecasting future changes in productivity and financial performance.

Notes **Monetary estimations of changes in human value of organisations**

For computing a monetary estimate of the expected change in the value of human organization, the following steps are suggested:

1. Measure the key dimensions of human organization, using a Likert scale at specified time periods. These are in non-monetary measurements.
2. The scaled responses to questionnaire items called 'scores' are then standardized by statistical methods to take into account the degree of variability of the set of responses. This is done for responses in each time period.
3. The difference between two standardized scores from one period to the next is then calculated. This difference (called delta) represents the change in an index of specified dimensions of the human organization.
4. From present changes in dimensions of the human organization, the expected future change in end result variables is estimated. Specifically, for a given variable the delta is multiplied by coefficient or correlation between that variable and the end result variable. This provides an estimate in standard scores of the anticipated change in the end result variable attributable to a change in the human organisational dimension believed to cause that change.
5. Lastly, the standard scores are converted into the measuring monetary units for the end result variables. Likert points out that changes in the productive capability of a

Contd...

Notes

firm's human organization cannot be assessed correctly unless periodic measurements of causal and intervening dimensions of that organization are taken regularly. Current profit and loss reports often encourage us to believe that changes are occurring. When profits increase, it is often assumed that the human organization has become more productive, but steps taken to maintain earnings or prevent losses may actually result in a decrease in the productive capability of the human organization. There is some controversy about the validity and reliability of this method. According to Flamholtz, future research on this method is necessary because its validity and feasibility have not yet been established. Likert, however, maintains that the method is feasible where reliable and valid measurements of the coefficients are available.

Self Assessment

State true or false:

11. Intervening variables are those that can be controlled by the organization.
12. Causal variables include managerial behaviour and organisational structure.
13. The intervening variables reflect the achievements of the organization or the total productive efficiency in terms of sales, costs, earnings, market performance, etc.
14. The causal variables influence the intervening variables, which, in turn, determine the organization's end result variables.

7.4 Recording and Disclosure in Financial Statement

In the preceding pages, we have explained the various models dealing with the mode of valuation of human resources as an asset. The "present value of future earnings" model, as suggested by Lev and Schwartz, has been found to be most popular model on account of convenience and objectivity. The exponents of human resource valuation models in most cases have not dealt with the mode of recording and disclosure of the accounting information relating to human resources in the books of accounts or financial statements of the organisation. This has been left to the discretion of the accounting bodies, who have yet to develop a generally accepted basis for valuation, recording and disclosure of human resource accounting information in the financial statements of an organisation. In most cases, the human resource accounting information is given in the form of supplementary information attached to the financial statements.

Prof. N. Dasgupta has suggested in his total cost approach (explained earlier) the following mode for disclosure of human resources in the balance sheet of an organisation.

Human resources valued as per his model should be shown both on the 'assets' as well as 'liabilities' sides of the balance sheet. On the assets side, it should be shown after the fixed assets as human assets classified into two parts, (i) value of individual, (ii) value of firm's investment. On the liabilities side, it should be shown after the capital as human assets capital by that amount at which it has been shown on the asset side against 'value of individuals.' He has given the following example to clarify his point.

Example: A firm has started its business with a capital of ₹ 1,00,000. It has purchased fixed assets worth ₹ 50,000 in cash. It has kept ₹ 26,000 as working capital and incurred ₹ 24,000 on recruitment training and developing the engineers and a few workers. The value of engineers and workers is assessed at ₹ 80,000.

Notes

The items will be shown in the balance sheet as follows:

Balance Sheet

(Including Human Resources)

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	1,00,000	Fixed Assets	50,000
Human Assets	80,000	Human Assets:	
		(i) Individuals' value	80,000
		(ii) Value of firm's investment	24,000
		Current Assets	26,000
	1,80,000		1,80,000

Task From the following details, compute the value of human resources of an employee group with an average age of 58 years.

(i)	Annual Average Earning of an employee till the retirement age	₹ 10,000
(ii)	Age of retirement	55 years
(iii)	Cost of capital	10%
(iv)	Number of employees in the group	20

Self Assessment

Fill in the blanks:

15. In most cases, the human resource accounting information is given in the form of ……..attached to the financial statements.

16. The "present value of future earnings" model is suggested by …….

7.5 Summary

- The biggest challenge in HRA is that of assigning monetary values to different dimensions of HR costs, investments and the worth of employees.
- According to historical cost approach, the actual cost incurred on recruiting, selecting, hiring, training and developing the human resources of the organisation are capitalised and written off over the expected useful life of the human resources.
- The replacement cost approach values the human resources at their present replacement cost.
- According to opportunity cost approach, the value of an employee is determined according to his alternative use.
- According to standard cost approach, standard costs of recruiting, hiring, training and developing per grade of employees are determined year after year.
- According to present value approach, the value of human resources of an organisation is determined according to their present value to the organisation.

Notes

- The value of an object, in economic terms, is the present value of the services that it is expected to render in future. Similarly, the economic value of human resources is the present worth of the services that they are likely to render in future.

  The non-monetary methods for assessing the economic value of human resources also measure human resources, but not in dollar or money terms.

- Likert and Bowers propose causal, intervening, and end-result variables, which determine the group's value to an organization.

7.6 Keywords

Attitude Measurements: Attitude measurements are used to assess employees' attitudes towards their job, pay, working conditions, etc., in order to determine their job satisfaction and dissatisfaction.

Causal Variables: Causal variables are those that can be controlled by the organization.

Intervening Variables: Intervening variables reflect organizational capabilities and involve group processes, peer leadership, organization climate, and the subordinates' satisfaction.

Performance Evaluation: Performance evaluation measures used in HRA include ratings, and rankings. Ratings reflect a person's performance in relation to a set of scales.

The End-result Dependent Variables: The end-result dependent variables reflect the achievements of the organization or the total productive efficiency in terms of sales, costs, earnings, market performance, etc.

7.7 Review Questions

1. What are the two measurements in HRA (Two Approaches)?
2. Explain the Cost Approach, the Economic Value Approach: Monetary Value Based Approaches and the Non-Monetary Value Based Approaches.
3. Explain the concept of human resource accounting. State its importance.
4. Differentiate between the following approaches suggested for valuation of human resources: Historical Cost Approach and Replacement Cost Approach.
5. Write a note on Human Resource Accounting in India.
6. Illustrate the recording of human assets as per the "present value of future earnings" model.
7. For determination of the present value, a number of valuation models have been developed. What are those models?
8. Illustrate the total cost concept with a suitable example.
9. Critically evaluate the opportunity cost approach.
10. The movement or progress of people through organizational 'states' or roles is called a stochastic process. Discuss.

Answers: Self Assessment

1. Replacement cost
2. alternative

Notes

3. present value approach
4. discount rate
5. offers (bids)
6. scarcity
7. economic value
8. non-monetary
9. skills or capability inventory
10. potential
11. false
12. true
13. false
14. true
15. supplementary information
16. Lev and Schwartz

7.8 Further Readings

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

Sudhindra Bhat, *Financial Management*, New Delhi, Excel Books, 2008.

Van Horne, J.C. and Wachowicz, Jr, J.M., *Fundamentals of Financial Management*, New Delhi, Prentice Hall of India Pvt. Ltd., 1996, p. 2.

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Unit 8: Corporate Reporting

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Objectives

After studying this unit, you will be able to:

- Identify the disclosure requirements of publish accounts;
- Illustrate the preparation of corporate financial statements as per VI Part I of the Indian Companies Act;
- Describe the contents of auditors report.

Introduction

The form of presentation of financial reports of non-corporate business organisations suffers from non-conformity. Rigid rules and regulations, as to the manner of presenting financial reports, do not bind the individual businessman in a sole trading or the partners in a firm. They enjoy a higher degree of individuality, which is reflected in the myriad of forms in which financial reports are prepared. In fact, there is no legal compulsion for these organisations to present the financial reports at all. The reports are prepared for the own use of the businessman and are made available only to select groups, such as lenders of resources and to tax authorities. Corporates, which are governed by their respective acts, have not been given this latitude. The reasons are obvious—in corporate ownership is divorced from management. With a view to ensure that the funds made available by the shareholders (a majority of whom will not have a say in the day to day management of the business) are properly utilised by the managers, law has prescribed specific forms in which the financial reports are to be prepared and presented.

8.1 Qualitative Characteristics of Financial Reporting Informations

The qualitative characteristics will provide assistance when choices have to be made between reporting policies—whether by preparers, auditors, those participating in the standard-setting

Notes

process, regulators or others - and be indicative of the qualities that users can expect of the financial information provided to them.

The financial reporting informations should contain the following qualitative characteristics:

1. ***Comparability:*** It is not sufficient that financial information is relevant and reliable at a particular time, in a particular circumstance or for a particular reporting entity. The users of general-purpose financial reports need to be able to compare aspects of an entity at one time and over time, and between entities at one time and over time. This implies that the measurement and display of transactions and events need to be carried out in a consistent manner throughout an entity, and over time for that entity, and that there is consistency between entities in these regards. An important implication of this concept of comparability is that users need to be informed of the policies employed in the preparation of the general-purpose financial reports, changes in those policies and the effects of those changes.

2. ***Materiality Test:*** Once it has decided that financial information is, in general terms, capable of being classified as relevant and reliable, it is necessary to consider the information in the context of the individual circumstances of the reporting entity in question. For example, information may be relevant and reliable in general nature, but be immaterial in the circumstances of the reporting entity. The inclusion of immaterial information in financial reports may well impair their understandability.

   The materiality test is concerned with assessing whether omission, misstatement or non-disclosure of an item of relevant and reliable information could affect decision-making about the allocation of scarce resources by the users of a general-purpose financial report of an entity. For example, it may be argued that information about secured non-current liabilities could be expected to be relevant to the decisions of potential lenders and be capable of being reliably determined. However, in a particular entity it could be that total debt is so small in comparison to available collateral that dissection of existing debt between the secured and unsecured portions would be immaterial. Therefore, in this Statement materiality is employed as a threshold test of which relevant and reliable financial information should be excluded from a general purpose financial report of an entity.

3. ***Relevance:*** For financial information to be relevant it must have value in terms of assisting users in making and evaluating decisions about the allocation of scarce resources and in assessing the rendering of accountability by preparers. If information is to assist users in making decisions about the allocation of scarce resources, it must assist them in making predictions about future situations and in forming expectations, and/or it must play a confirmatory role in respect of their past evaluations. The predictive and confirmatory roles of financial information are interrelated. For example, financial information about the current level and structure of asset holdings will have value to users when they endeavor to assess an entity's ability to take advantage of opportunities in the market place. That same information will play a confirmatory role in respect of past predictions about the way in which the entity would be structured and about the outcome of planned operations. Analysis of the relationship between predictions and outcomes will assist users to identify the range of variables they ought to be considering when making predictions.

4. ***Reliability:*** The reliability of financial information will be determined by the degree of correspondence between what that information conveys to users and the underlying transactions and events that have occurred and been measured and displayed. Reliable information will, without bias or undue error, faithfully represent those transactions and events. It is important that financial information be reliable. Information may be of a type which bears upon users' decision-making, that is, be relevant, but be so unreliable in

nature or representation as to be useless or potentially misleading. For example, if an entity takes legal action against another entity for damages, and the validity and amount of the claim involved are seriously disputed, it would normally be inappropriate for the plaintiff to recognize prior to judgment an asset for the face value of the claim.

5. ***Understandability:*** The ability of users to understand financial information will depend in part on their own capabilities and in part on the way in which the information has displayed. General purpose financial reports ought to be constructed having regard to the interests of users who are prepared to exercise diligence in reviewing those reports and who possess the proficiency necessary to comprehend the significance of contemporary accounting practices.

Self Assessment

State true or false:

1. Materiality test means that quality of financial information which exists when users of that information are able to comprehend its meaning.
2. Reliability means that quality of financial information which exists when that information can be depended upon to represent faithfully, and without bias or undue error, the transactions or events that either it purports to represent or could reasonably be expected to represent.

8.2 Users Group and Financial Reporting

Each business is required to maintain a set of financial statements for its operations. The benefits may not seem to be many from an individual perspective; from the standpoint of a potential investor, such statements may deliver what may be called an opportunity to enhance funding.

Some believe that accounting, also called bookkeeping, is non-essential and tend to concentrate on generating sales and getting the best bargain from suppliers. Making journal entries and maintaining ledgers and books of accounts are not the only functions of an accountant or bookkeeper. It includes proper management of all relevant documents, such as invoices, purchases and sales orders, agreements, and tax returns etc., which assist in developing an impressive set of financial statements.

Investors

Investors fall into two categories, existing and potential. Some seek a takeover, leading to majority control and shareholding. This usually occurs when a company is losing public confidence resulting in low market value. Often considered as hostile takeovers, the investors tend to restructure the business and control it completely, issue shares or sell it off in the open market.

The other category consists of short and long-term investors, both interested in increasing their wealth with the minimal effort. This may be through either earning dividends or trading shares in the Stock Exchange.

Lenders

These may supply funds to the organization on short and/or long-term basis. There are several financial institutions and individuals willing to lend to progressive companies but few to support those with lower earnings levels. The loan carries a charge of interest payable annually or as agreed, on the principle or compounded principle, over the period that the loan has been issued.

Notes

The financial institutions mentioned above include banks, discount houses and factors. Banks usually provide overdraft and other flexible fund management facilities to companies, provided they have a strong financial performance backing. Discount houses provide invoice discounting facilities but require a proper debtor management system running in the company that ensures that debtors are not let loose or have a habit of defaulting. Factoring companies help in recovering the amount due by debtors but ask for a service charge, which varies with each situation and company status.

Suppliers

Suppliers of products and services to the company would like their investments—sales made on credit terms—received with surety. A creditor would be reluctant to trade any further if s/he is not guaranteed a timely payment against the issued invoice.

Employees

Many would consider employees the least affected of all when it comes to analyzing the company's accounts. The employees will be first to feel the change in circumstances as they may be promoted, demoted or fired. They would be very much interested in finding out if the company exhibits any points in their favor, mainly job security and facilities.

Government Bodies

As a rule, Companies House requires each company, private or public, to submit their financial statements and accounts annually. The list of registered companies and their most recent accounts are published in the Companies House official publication, which informs the public of their performance for the year or period ended. In addition, the government has the responsibility to ensure that the information is not delusive and the rights of the public are protected. Furthermore, it bears the responsibility of prosecuting any offender of the law, including corporate and consumer law. For example, a director of a PLC can be prosecuted for a criminal offence if the accounts have not been delivered to the Companies House.

Competitors

It may seem odd, but existing competitors and new entrants have to consider the likelihood of their success or failure in trying to conquer the market. Their primary interest lies in the business ratios of efficiency/productivity and cash, debtor and credit management. For the industry, it acts as a comparative for better performance of firms and companies of varying sizes. They also help in establishing a trend of the industry that is normally a guide to new entrants to study, analyze and perform.

Self Assessment

Fill in the blanks:

3. …… fall into two categories, existing and potential.
4. A …… would be reluctant to trade any further if s/he is not guaranteed a timely payment against the issued invoice.

Notes

8.3 Objectives of Corporate Reporting/Objectives of Financial Information

Basically, there are three objectives of financial reporting.

1. To give information useful for making investment and credit decisions. Financial reporting should offer information that can help present and potential investors and creditors to make rational investment and credit decisions. The information should be in the form that is easy and understandable to those who have some understanding of business and are willing to study the information carefully.
2. To provide information useful in assessing cash flow prospects. Financial reporting should supply information to help present and potential investors and creditors appraise the amounts, timing and possible risk of expected cash receipts from dividends or interest and the proceeds from the sale, redemption or maturity of stocks or loans.
3. To provide information about business resources claims to those resources and changes in them. Financial information should give information about the company's assets, liabilities and shareholders equity.

Financial statements are the most important way of periodically presenting to parties outside the business the information that has been gathered and processed in the accounting system. These financial statements are "general purpose" because most of the users are outside the business. Because of potential conflict of interest between managers, who must prepare the statements and the investors or creditors, who invest in or lend money to the business, these statements are often audited by outside accountants (known as auditors) to increase creditability and reliability.

Objective of General Purpose Financial Reporting identifies the objective of general purpose financial reporting as the disclosure of information useful to users for making and evaluating decisions about the allocation of scarce resources. When general purpose financial reports meet this objective they will also be the means by which preparers of such reports discharge their accountability to those users. The purpose of this Statement is to identify those attributes (hereinafter "qualitative characteristics") that financial information should possess if it is to serve the specified objective.

Self Assessment

Fill in the blanks:

5. ……should give information about the company's assets, liabilities and shareholders equity.
6. Financial reporting should offer information that can help present and potential investors and creditors to make rational investment and ……decisions.

8.4 Concept of Disclosure in Relation to Publish Accounts

Section 210 of the Companies Act, 1956 stipulates that the board of directors of every company should submit, before the annual general meeting of the company, a duly audited profit and loss account and balance sheet. These documents should be placed before the meeting within six months of the expiry of the financial year. Three copies of the annual reports as approved by the shareholder are to be filed with the Registrar of Companies within thirty days of the meeting in which they were approved. The next section, Section 211 lays down that every balance sheet of a company shall be in the form set out in Part I of Schedule VI attached to the companies act and

Notes

that every profit and loss account shall comply with the requirements of Part II of the schedule. All the companies in India are, by force, made to adopt the format. Any deviation from the form prescribed shall be made only with the specific approval of Central Government. Corporates should, therefore, exercise utmost care in the preparation and presentation of the financial statements. It may be mentioned that the message conveyed by these statements are similar to that of non-corporate reports, except for the greater degree of disclosure, which are on the lines of the generally accepted accounting principles.

Self Assessment

Fill in the blanks:

7. ……of the Companies Act, 1956 stipulates that the board of directors of every company should submit, before the annual general meeting of the company, a duly audited profit and loss account and balance sheet.
8. Three copies of the annual reports as approved by the shareholder are to be filed with the ……within thirty days of the meeting in which they were approved.
9. The Institute of Chartered Accountants of India has issued standard on ……..AS17.
10. Companies with multiple ……..and those with area of operation extending beyond the boundaries of the country would have to present separate financial report for each of the activities and for each territory.

8.5 Disclosure Requirements of Balance Sheet

The balance sheet of a company must be in accordance with the proforma given in Schedule VI Part I of the Indian Companies Act. This is as per section 211 of the Indian Companies Act, 1956. Sub-section 3A, 3B and 3C of section 211 have made it compulsory that Profit and Loss account and Balance Sheet of a Company are prepared in accordance with Accounting Standards prescribed by the Central Government in consolation with National Advisory Committee on Accounting standards (NACAS).

The Act has laid down two forms of Balance Sheet. The two forms are generally known as:

1. Horizontal Form
2. Vertical Form

Caution The Balance Sheet must give a true and fair view of the company activities. This form may be in any other form with the consent of the Central Government.

8.5.1 Statutory Contents of Liabilities side of Balance Sheet

There are two types of items shown on the liabilities side of the Balance sheet.

1. The items relating to owners equity and
2. The items relating to borrowers' capital

The main items relating to owner's capital: The main item are as follows:

1. Share capital
2. Reserves and surplus

Notes

1. ***Share Capital:*** It means the share of the owner's in the company. There are different types of capital.

   (a) *Authorized Share Capital:* This is the amount of capital which the company is authorized to raise from the public. Generally authorized capital is given in the memorandum of association, popularly known as M/A at the time of incorporation of the company. There are two types of share capital – (i) Equity share capital, and (ii) Preference share capital. It is given by way of information in the balance sheet. It is not added to the liabilities of the company, unless the entire share capital is issued, subscribed, called up and received in full.

   (b) *Issued Share Capital:* It is that part of issued share capital, which is offered for the public to subscribe till the date of Balance Sheet. Various types of share capital along with classes and face value etc. are given.

   (c) *Subscribed Capital:*

      (i) It is that part of issued share capital which is actually, subscribed by the public along with share value called up.

      (ii) Shares, which are issued other than cash for different consideration and issued, as bonus shares must also be given.

      (iii) Shares on which calls are in arrear must also be shown by way of deduction from called up capital.

      (iv) Shares which are forfeited on account of non-payment must be shown separately.

      (v) If forfeited shares are reissued in full or in part, in case of profit must be transferred to capital reserve account only.

Example: The following are the key informations of Amazon Artifice Ltd.:

		₹
1.	*Authorised share capital:*	
	Equity share capital (400000 equity shares of ₹ 10 each)	4000000
	Preference share capital (10000 15% preference share capital @ ₹ 100 each)	1000000
2.	*Issued and Subscribed share capital:*	3000000
	Equity share capital (300000 equity shares of ₹ 10 each)	500000
	Preference share capital (5000 15% preference share capital @ ₹ 100 each)	1700000
3.	Paid up capital (equity 12 lakhs and preference 5 lakhs)	2600000
4.	Called up capital on allotment (14 lakhs + 12 lakhs)	12000
5.	Unpaid equity shareholders on allotment (3000 equity shares@ ₹ 4)	6000
6.	Unpaid equity shareholders on calls (2000 equity shares@ ₹ 3)	

The share capital will be collected as under

	Equity shares (₹)	Preference shares (₹)
with application	3	100
On allotment	4	—
On calls	3	—
	10	100

The public has subscribed, in full, to both equity and preference shares of the company. Shows the treatment of capital in company's balance sheet.

Notes

Solution:

Working note:

On allotment the 3,000 equity shareholders have not paid the allotment money so the paid up capital would, then, be (₹ 26 lakh – ₹ 12000) 25,88.000.

On the company calling up the balance 3 per share 2000 shareholders have not honoured the call. The paid up capital will, thus, be 34,73,000, i.e., subscribed equity capital 30 lakhs, less calls in arrears of 27,000 plus preference shares of 5 lakhs. The entire sequence will have to be shown as under in the balance sheet.

Amazon Artifice Ltd.
Balance sheet as on 31 March

Liabilities			
Capital			
Authorised			
4,00,000 equity shares of ₹ 10 each	40,00,000		
10,000. 15% Preference Shares of ₹ 100 each	10,00,000	50,00,000	
Issued and Subscribed			
3,00,000 Equity Shares of ₹ 10 each	30,00,000		
5000 15% Pref. shares of ₹ 100 each	5,00,000	35,00,000	
Less: Calls in arrears		27,000	
Paid up capital		34,73,000	

2. ***Reserves and Surplus:*** As per Companies Act, 1956 the following are the Reserves and Surplus:
   (a) Capital Reserves
   (b) Capital Redemption Reserve Account
   (c) Securities Premium Account
   (d) Other Reserves such as – General Reserve, Reserve for depreciation etc.
   (e) Surplus – The net-profit, as per profit and loss account, is to be given.
   (f) Proposed Addition to Reserves
   (g) Sinking Fund

Borrowers Capital Fund: There are the following types of loan capital.

1. ***Secured loans:*** If any security is given by way of a mortgage or charge on all or any of its property, the loan is termed as secured loan and shown in the following order:
   (i) Debentures: Types of debentures, redeemable and non-redeemable.
   (ii) Loans and Advances from Banks
   (iii) Loans and Advances from subsidiary company
   (iv) Other Loans and Advances if any
2. ***Unsecured loans:*** If a company borrows loans without giving any security, then such loans are termed as unsecured loans. Following are:
   (i) Fixed deposits
   (ii) Loans and Advances from Subsidiaries
   (iii) Loans and Advances from the banks
   (iv) Loans and Advances from others
3. ***Current Liabilities and Provisions:***
   (a) *Current Liabilities:* Which are payable within one year are shown in this such as
      - Acceptances
      - Sundry creditors

Notes

- Investor Education and Protection Fund
- Advance payments
- Unclaimed dividends
- Interest Accrued but not due
- Tax payable
- Tax deducted at source (TDS).

(b) ***Provisions:*** are shown separately such as

- Provision for taxation
- Proposed dividend
- Provision for contingencies
- Provision for provident fund
- Other provisions

Did u know? **What are the contingent liabilities?**

Contingent liabilities are such liabilities which may exist or may not exist subject to happening or not happening the event. It is given as a foot note in the Balance Sheet. Amount of such liabilities is not included in the total liabilities.

The following are the examples of contingent liabilities:

1. Claims against company, which are still not accepted by the company.
2. Liability for amount uncalled on partly paid shares.
3. Arrears of fixed cumulative dividends.
4. Estimated amount of incomplete contracts.
5. Other contingent liability.

Investor education and protection fund

According to section 205 A of the Companies Amendment Act, 1999, any amount transferred to unpaid dividend account of company which will remain unpaid or unclaimed in the said accounts for a period of seven years from the date of such transfer is required to be transferred by the company to Investor Education and Protection Fund. Such payment are:

1. Unpaid dividends
2. Matured deposit with companies for seven year
3. Matured debentures
4. Interest accrued on the above
5. Donations or Grants from Government

8.5.2 Statutory Contents of Assets side of Balance Sheet

1. ***Fixed Assets:*** Fixed assets are those assets, which are used for long-term in the business. Different assets are shown separately at their original cost and addition to and deductions for depreciation provided for. Fixed Assets include
   (a) Goodwill
   (b) Land and Building
   (c) Lease hold
   (d) Railway sidings

Notes

(e) Plant & Machinery

(f) Furniture & Fixture

(g) Patents, Trade Marks and Designs

(h) Development of property

(i) Copyrights

(j) Live stock

(k) Vehicles

2. ***Investments:*** Investments are shown after fixed assets. It is necessary to disclose nature and mode of its valuation of every investment. Market price or cost price, at which investments are valued, must be disclosed. All investments must be shown separately such as Govt., shares, debentures, etc.

3. ***Current Assets loans and advances:***

   (a) Current assets are such assets which are likely to be converted into cash within one year from one balance sheet. Such assets are. (1) Loose tools (2) Stock in trade (3) Work in progress (4) Sundry debtors (5) Cash and Bank balance

   (b) Loans and advances – it includes loans and advances against purchase of goods and various expenses.

4. ***Miscellaneous Expenditure:*** Expenses not written off– (1) Preliminary Expenses (2) Discount on issue of shares and debentures (3) Expenses including commission or brokerage on underwriting (4) Interest paid out of capital (5) Other sums.

5. ***Profit and Loss Account:*** If there is any debit balance in profit and loss account, it will be shown on the assets side of the balance sheet.

The given below is the proforma of Balance Sheet as per schedule VI and part I.

Form of Balance Sheet
(Horizontal Form)

Balance sheet of ..... as at .....
(Form of Balance Sheet as Per Schedule VI and Part I)

Figures for the previous year (₹)	Liabilities	Figures for the Current year (₹)	Figures for the previous year (₹)	Assets	Figures for the current year (₹)
	1. **Share Capital** Authorized .....shares of ₹.....each Issued.....shares of ₹.....each Subscribed and paid up..... shares of ₹.....each Less: Called unpaid Add: Forfeited shares			1. **Fixed Assets** (1) Goodwill (2) Land (3) Buildings (4) Leaseholds (5) Railway Sidings (6) Plant & Machinery (7) Furniture and Fittings (8) Development of Property	

Contd...

Notes

				(9) Patents, Trade Marks and Designs (10) Live Stock (11) Vehicles etc.	
	2. **Reserves and Surplus** (1) Capital Reserve (2) Capital Redemption Reserve (3) Securities Premium Account (4) Other Reserves Less: Debit Balance of P&L Account (5) Surplus, i.e., Balance of P&L Account (6) Proposed additions to Reserves (7) Sinking Funds			**2. Investments** (1) Investments in Govt. or Trust securities (2) Investments in Shares, Debentures and Bonds (3) Immovable Properties (4) Investment in the Capital of Partnership Firms	
	3. **Secured Loans** (1) Debentures (2) Loans and Advances from Banks (3) Loans and advances from Subsidiaries (4) Other Loans & Advances			3. **Current Assets, Loans and Advances** A. **Current Assets** (1) Interest accrued on Investments (2) Stores and spare parts (3) Loose Tools (4) Stock in Trade (5) Work in Progress (6) Sundry Debtors (a) Debt outstanding for a period exceeding six months. (b) Other Debts Less: Provision (7) Cash and Bank Balances	
	4. **Unsecured Loans** (1) Fixed Deposit (2) Loans and advances from subsidiaries (3) Short-term Loans & Advances (a) From Banks (b) From Others			B. **Loans & Advances:** (1) Acceptances & Loans to Subsidiaries (2) Exchange (3) Advances recoverable for value to be received by Rates, Taxes, Insurance etc. (4) Balance with Customs, poet Trust etc.	

Contd...

Notes

	5. **Current Liabilities & Provisions** A. **Current Liabilities** (1) Acceptance (2) Sundry Creditors (3) Advances payments & un-expired discounts for the portion for which value has still to be given (4) Unclaimed Dividend (5) Other liabilities but not due on Loans (6) Interest Accrued B. **Provisions** (1) Provisions for taxation (2) Proposed Dividends, (3) For Contingencies (4) For Provident Fund scheme (5) Fire Insurance, Pension and similar staff benefits scheme (6) Other Provisions [A footnote to the balance sheet may be added to show separately]			4. **Miscellaneous Expenditure** (1) Preliminary Expenditure (2) Expenses including commission and brokerage of shares and debentures (3) Discount allowed on issue of shares and debentures (4) Interest paid out of capital during construction (also state the rate of interest) (5) Development Expenditure not adjusted. (6) Other Items (specifying nature) 5. **Profit and Loss A/c** (1) Claims against the company not acknowledged as debts. (2) Uncalled liabilities on shares partly paid up (3) Arrears of fixed cumulative dividends. (4) Estimated amount of contracts remaining to be executed on capital account and not provided for (5) Other money for which company is contingently liable.	

Notes

Form of Balance Sheet
(Vertical Form)

Balance Sheet of …….Company
(As on……..)

Particulars	Schedule No.	Figures as at the end of the Current Year	Figures as at the end of the Previous Year
1	2	3	4
1. Sources of Funds (1) Share holders funds (a) Capital (b) Reserves and Surplus (2) Loan Funds (a) Secured Loans (b) Unsecured Loans			
Total			
2. Application of Funds (1) Fixed Assets. (a) Gross Block (b) Less Depreciation (c) Net Block (d) Capital work in progress (2) Investments (3) Current Assets, Loans and Advances (a) Inventories (b) Sundry Debtors (c) Cash and Bank Balance (d) Other current Assets (e) Loans and Advances Less: current liabilities provisions (a) Liabilities (b) Provisions Net Current Assets (4) (a) Miscellaneous Expenditure to the extent not written off or adjusted. (b) Profit and Loss Account			
Total			

Self Assessment

Fill in the blanks:

11. The balance sheet of a company must be in accordance with the proforma given in …….Part I of the Indian Companies Act.
12. Generally ……is given in the memorandum of association, popularly known as M/A at the time of incorporation of the company.
13. ……..are such liabilities which may exist or may not exist subject to happening or not happening the event.
14. ……..are those assets, which are used for long-term in the business.

Notes

15. If any security is given by way of a mortgage or charge on all or any of its property, the loan is termed as ……..

16. If a company borrows loans without giving any security, then such loans are termed as ……..

8.6 Disclosure Requirements Concerning Profit & Loss Accounts

A company shall disclose the following notes to their accounts :

1. ***Revenues from operations:*** Revenue from operations shall be classified as:

   (a) Sale of products;

   (b) Sale of Services;

   (c) Other operating revenues (specify nature);

   Less:

   (d) Discounts, allowances, and returns;

   (e) Excise duty/service tax.

   These shall include sales or service charges to customers for the goods and/or services provided during the period. This section shall include information about duties, taxes, discounts, allowances and returns in order to determine net sales or net revenues.

2. ***Cost of sales/services:*** These are costs directly associated with generating revenues and shall include (to be disclosed separately):

   (a) *Change in inventories* – Opening (less closing) inventories of finished goods and work-in-process;

   (b) Cost of direct materials consumed arrived at by adding net purchases (purchases less discounts, returns and allowances plus freight-in) to beginning inventory to obtain direct materials available. From the cost of direct materials available, the ending inventory is deducted;

   (c) Other external charges (such as the hire of plant and machinery or the cost of casual labour used in the productive process);

   (d) Direct labour (ESOP and ESPP expenses to be disclosed separately);

   (e) All direct production overheads;

   (f) Depreciation and amortization that can reasonably be allocated to the production function;

   (g) Indirect overheads that can reasonably be allocated to the production function;

   (h) Product development expenditure not qualifying for recognition as an intangible asset and amortization of development expenditure recognized as an intangible asset;

   (i) Inventory write downs/reversals;

   (j) All direct overheads in providing services;

   (k) All allocable indirect overheads in providing services;

   (l) Cost of goods traded-in arrived at by adding net purchases (purchases less discounts, returns, and allowances plus freight-in) to beginning inventory to obtain the cost of goods available for sale. From the cost of goods available for sale amount, the ending inventory is deducted;

   (m) Other cost of sales.

Notes

3. ***Operating expenses:*** Operating expenses are those that are incurred in order to generate sales. Operating expenses shall be classified as:

   (a) Selling and marketing expenses;

   (b) Administrative expenses;

   (c) Depreciation and amortization of assets;

   (d) Foreign currency exchange gains/(losses), net.

   (a) *Selling and marketing expenses* are those expenses that are directly related to the company's efforts to generate sales. These items shall include (to be disclosed separately):

      (i) Payroll costs of sales, marketing and distribution functions (ESOP and ESPP expenses to be disclosed separately);

      (ii) Advertising;

      (iii) Sales persons' travel and entertaining;

      (iv) Warehouse costs for finished goods;

      (v) Transport costs arising on the distribution of finished goods;

      (vi) All costs of maintaining sales outlets;

      (vii) Agents commission payable;

      (viii) Other selling and marketing expenses.

   (b) *Administrative expenses* are expenses related to the general administration of the company's operations. These items shall include (to be disclosed separately):

      (i) Payroll costs of office and administrative staff (ESOP and ESPP expenses to be disclosed separately);

      (ii) All costs of maintaining the administration buildings;

      (iii) Bad debts;

      (iv) Professional costs;

      (v) Amount paid to the auditor, whether as fees, expenses or otherwise for services

      (vi) Directors remuneration;

      (vii) Insurance expense;

      (viii) Utilities expense;

      (ix) Other administrative expenses.

   (c) *Depreciation and amortization of assets* other than used in the production process and included in cost of sales.

4. ***Other income:*** This shall include (to be disclosed separately):

   (a) Interest income;

   (b) Dividend income;

   (c) Rental on investment properties;

   (d) Increase (decrease) in carrying amounts of investments;

Notes

(e) Gains and losses on trading derivatives;

(f) Amounts withdrawn, as no longer required, from provisions created previously for meeting specific liabilities;

(g) Other miscellaneous income.

5. ***Other expenses:*** These shall be classified as:

(a) Finance costs.

(b) Others.

(a) *Finance costs* shall include (to be disclosed separately):

(i) Interest expense.

(ii) Dividends on preference shares classified as debt.

(b) *Others* shall include costs related to 'other income'.

6. ***Tax Expense – Others***: Others shall be specified separately.

Any item for which the expense exceeds one percent of the revenues from operations of the Company or ₹1,00,000 whichever is higher, shall be shown as a separate and distinct item under the appropriate head of expense in the notes to accounts and shall not be combined with any other item.

Results from discontinued operations included in the statement of profit and loss i.e. income (loss) from activities and gain (loss) from disposal of assets/settlement of liabilities shall be disclosed separately in the notes to accounts.

The given below is the proforma of profit & loss account:

Profit & Loss account of ...Ltd., for the year ended...

	₹		₹
Opening Stock		Sales	
Purchases		Less: Sales returns	
Less: Purchases Returns		Closing stock	
Carriage/Carriage Inwards/ Carriage on Purchases			
Freight, Duty & Clearing Charges			
Wages/manufacturing wages,			
productive wages			
Packing Materials (Primary)			
Fuel and Power			
Coal, Gas and Water			
Motive Power			
Salaries / Salaries and wages		By Gross Profit b/d	
Rent Rates and Taxes		Interest Received	
Lighting		Discount Received	

Contd...

Notes

Printing and Stationary		Commission Received	
Postage and Telegrams		Rent Received	
Telephone Charges		Miscellaneous Receipt	
Legal Expenses		Dividend from subsidiaries	
Audit Fees			
General Expenses		Net Loss	
Advertisement			
Salesmen salaries and commission			
Packing Expenses (Secondary)			
Bad Debts			
Provision for Doubtful Debts			
Provision for Discount			
Depreciation provisions			
Other Provisions			
Repairs and renewals			
Discount allowed			
Carriage Outwards			
Interest on Loan			
Interest on Capital			
Loss by fire or theft			
Charity			
Issue Expenses			
Commissions			
Managing Agents Commission			
Managerial Remuneration			
Provision for taxation			
Provision for Dividend			
Net Profit/Loss			

Self Assessment

State true or false:

17. Cost of direct materials consumed arrived at by adding net purchases to beginning inventory to obtain direct materials available.

18. Administration expenses are those that are incurred in order to generate sales.

19. Operating expenses are those expenses that are directly related to the company's efforts to generate sales.

Notes

8.7 Report of the Auditors to the Shareholders

The independent auditors report deals with the creditability of the financial statements. Management through its internal accounting system is logically responsible for record-keeping because it needs similar information for its own use in operating the business. The Certified Public Accountants (Chartered Accountant) acting independently, add the necessary creditability to management's figures for interested third parties. They report to the Board of Directors and the shareholders.

In form and language, most auditors' reports are like the one shown below. The report is divided into four parts:

- The first paragraph identifies the financial statements subject to the auditors report. The paragraph also identifies responsibilities of company management towards financial statements and the auditor is responsible for expressing an opinion on the financial statements based on the audit.
- Second paragraph contains the scope that states that the examination was made in accordance with generally accepted auditing standards (accepted in India). These standards call for an acceptable level of quality in special areas established by the Institute of Chartered Accountants of India. This paragraph also contains a brief description of the objectives and nature of audit.
- The third paragraph contains some information on specific areas as provided by the Companies (Auditors Report) Order 2003.
- The fourth paragraph, or opinion section, states the results of the auditor's examination. The use of the word opinion is very important because the auditor does not certify or guarantee that the statements are absolutely correct. Instead, the auditors simply give an opinion about whether, overall, the financial statements give true and fair view of the financial position, results of operations and cash flows. This means that the statements are prepared in accordance with generally accepted accounting principles (generally accepted in India). If in the auditor's opinion, the statements do not meet accepted standards, the auditors must give full disclosure and explanation.

Self Assessment

Fill in the blanks:

20. The independent …… report deals with the creditability of the financial statements.
21. The first paragraph of auditor's report identifies the …….subject to the auditors report.

Task Work out capital structure of Dawson and Ross Manufacturing Company Ltd. as it would appear in the balance sheet as on 31 December.

The company issued a prospectus offering 50,00,000 Equity Shares of ₹ 100 as face value and 10,00,000. 13.5% 2007 Redeemable Preference Shares of ₹ 250 each on 1 September. The issue was open for a week. The company's merchant bankers reported subscription of 48,50,000 Equity shares and the entire preference issue. The prospectus had stipulated ₹ 30 of the equity shares as application money, ₹ 40 to be paid on allotment and the balance at the call. The entire face value of the preference share is to be paid along with application.

Contd...

Notes

The company allotted all shares. However it was found that 17,500 equity subscribers had not paid the allotment money and another 12,750 subscribers, who had paid allotment, defaulted in meeting the call. The company, after due notice forfeited the shares on which allotment money was not paid. These shares were later reissued at ₹ 80.

8.8 Summary

- Financial reporting in corporate organisations is regulated by the laws under which the organizations are registered.
- As such, these reports are more transparent compared to non-corporate financial reports. The Companies Act, 1956 has prescribed a format in which corporates are to present their balance sheet.
- For profit and loss account, the act has laid down parameters to be followed.
- A corporate can present its financial reporting in a horizontal 'T' form or in a vertical statement form.
- Details on each of the items of balance sheet and profit and loss account are required to be furnished as schedules or notes.
- The prescribed corporate balance sheet follows the permanency method for marshalling assets and liabilities.
- The liability side of balance sheet has five segments—for share capital, reserves and surpluses, secured and unsecured loans, current liabilities and provisions.
- In the assets side, fixed assets, investments, current assets and miscellaneous expenses are the groups.
- The profit and loss account of a corporate can be prepared as per the pattern chosen by the directors.
- The financial statements are also to be accompanied by auditors' report and directors' report. The statements have to be audited and placed before the shareholders at the annual general meeting, within six months of the expiry of the financial year.
- Three copies of the report are to be furnished to the registrar of companies within thirty days of laying the report in annual general meeting.
- The reports should be signed by the managing director and at least one more director.

8.9 Keywords

Contingent Liabilities: Contingent liabilities are such liabilities which may exist or may not exist subject to happening or not happening the event.

Secured Loans: If any security is given by way of a mortgage or charge on all or any of its property, the loan is termed as secured loan.

Share Capital: It means the share of the owner's in the company.

Unsecured Loans: If a company borrows loans without giving any security, then such loans are termed as unsecured loans.

8.10 Review Questions

1. What on the Key qualitative characteristics of financial reporting informations?
2. Are non-corporate business organizations legally obliged to prepare financial statements?

Notes

3. Why should law prescribe format for financial reporting to corporates?
4. What does schedule VI of companies Act 1956 stipulate?
5. How are assets and liabilities of corporate organisations marshalled?
6. Describe the asset side of corporate balance sheet.
7. What are the groupings in liabilities of corporate balance sheet?
8. What, according to you, are the major differences between a corporate and non-corporate balance sheet?
9. What are the specific features of corporate income statement compared to that of non-corporates?
10. How are debtors presented in corporate balance sheet?
11. How do corporates income statements differ from that of non-corporate organisations?
12. State the provisions of the Companies Act, 1956, relating to the preparation and presentation of final accounts.
13. In what aspects do company final accounts differ from final accounts of a sole trader/ partner?

Answers: Self Assessment

1.	false	2.	true
3.	Investors	4.	creditor
5.	Financial information	6.	credit
7.	Section 210	8.	Registrar of Companies
9.	segmental reporting	10.	products or services
11.	Schedule VI	12.	authorized capital
13.	Contingent liabilities	14.	Fixed assets
15.	secured loan	16.	unsecured loans
17.	true	18.	false
19.	false	20.	auditors
21.	financial statements		

8.11 Further Readings

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

Sudhindra Bhat, *Financial Management*, New Delhi, Excel Books, 2008.

Van Horne, J.C. and Wachowicz, Jr, J.M., *Fundamentals of Financial Management*, New Delhi, Prentice Hall of India Pvt. Ltd., 1996, p. 2.

Online links

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Unit 9: Issues and Recent Trends in Corporate Reporting

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Objectives

After studying this unit, you will be able to:

- Explain the concept of segment and social reporting
- Define transfer pricing
- Describe the emerging concepts like corporate governance and human resource accounting

Introduction

Corporate reporting is now at the centre stage of reforms in view of the shareholders' education by the companies. Recent developments in corporate financial reporting indicate a greater emphasis on better voluntary disclosures by the companies regarding their performance and state of affairs. This makes their balance sheet more transparent than ever before.

9.1 Segment Reporting

In recent years, many business enterprises have broadened the scope of their activities to encompass different industries, foreign countries and markets. Due to the growth of diversified business and expansion of firms into foreign markets, consolidated information becomes non-homogeneous information. Consolidated statements enable the management to hide information from external reporting. Some segments may be running at a loss, but the consolidated statements will merely show the average profit figure (and other information) of all the segments taken together. It is, therefore, necessary that along with consolidated information segment information is also provided to the users.

With increasing tempo of globalisation, the trend in Indian corporates is to adopt international standards in financial reporting. The Institute of Chartered Accountants of India has issued standard on segmental reporting AS17. Indian corporates, listed or proposed to be listed on the stock exchanges has to adopt segmental reporting. Companies with multiple products or services and those with area of operation extending beyond the boundaries of the country would have to present separate financial report for each of the activities and for each territory. Each segmental

Notes

report will contain information as to the sales, costs, assets and liabilities pertaining to that segment. The important aspect is that segmental transfers are to be priced fairly and disclosed. There is also another accounting standard (AS21) which makes its compulsory to present consolidated financial data of holding company and its subsidiaries. It is expected that the disclosures, under the accounting standard would help the users of the data to have a holistic assessment of the risk and return of an enterprise, with multi-product line and multinational operations.

Business and Geographical Segments

Business and geographical segments of an enterprise for external reporting purposes should be those organisational units for which information is reported to the board of directors and to the chief executive officer for the purpose of evaluating the unit's performance and for making decisions about future allocations of resources.

A business segment or geographical segment should be identified as a reportable segment if:

1. Its revenues from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or
2. Its segment result, whether profit or loss, is 10 per cent or more of -
   - the combined result of all segments in profit, or
   - the combined result of all segments in loss,

   whichever is greater in absolute amount; or
3. Its segment assets are 10 per cent or more of the total assets of all segments.

Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. There is a presumption that the accounting policies that the directors and management of an enterprise have chosen to use in preparing the financial statements of the enterprise as a whole are those that the directors and management believe are the most appropriate for external reporting purposes. Since the purpose of segment information is to help users of financial statements better understand and make more informed judgements about the enterprise as a whole, this Standard requires the use, in preparing segment information, of the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. That does not mean, however, that the enterprise accounting policies are to be applied to reportable segments as if the segments were separate stand-alone reporting entities. A detailed calculation done in applying a particular accounting policy at the enterprise-wide level may be allocated to segments if there is a reasonable basis for doing so. Pension calculations, for example, often are done for an enterprise as a whole, but the enterprise-wide figures may be allocated to segments based on salary and demographic data for the segments.

Notes **Bases of Segmenting**

The following are, generally, the bases of segmenting:

- ***Product lines:*** If a company has diversified its production activities, and is manufacturing different and distinct types of products, financial information can be provided on the basis of product lines.

Contd...

Notes

For example, Delhi Cloth and General Mills Ltd., which manufacturers cloth, computers, automobiles, PVC, and other engineering products, and would thus need this kind of segment reporting.

- ***Geographical divisions:*** If a company has operations extended in foreign markets, geographical division-wise segmentation will be relevant. This will be more relevant in the case of multinational corporations and other big companies with extensive overseas operations. Even within a country (if it is big); there can be region-wise segmentation for better management and reporting purposes.
- ***Customer-type:*** Classification may be relevant in case of those who look for comparability among firms. In this case a uniform standard industrial classification is necessary. Comparability can be among firms of the same (absolute) size and type of operations. For investors, however, that classification which permits the greatest degree of predictability will be the most relevant.

Self Assessment

Fill in the blanks:

1. …….statements enable the management to hide information from external reporting.
2. The Institute of Chartered Accountants of India has issued standard on segmental reporting …….
3. Each segmental report will contain information as to the sales, …….., assets and liabilities pertaining to that segment.
4. If a company has diversified its production activities, and is manufacturing different and distinct types of products, financial information can be provided on the basis of ……..
5. If a company has operations extended in foreign markets, …….division-wise segmentation will be relevant.

9.2 Social Reporting

Social reporting is reporting on those activities of an organisation that have an impact on society at large and are not necessarily represented by its traditional financial report.

Aspects included in social reporting include such information disclosed in the annual reports viz., Statement on Human Resource Accounting, Statement of Value Added Report on Foreign Currency Transactions (revealing the balance of payments position) and Accounting for Various Social Objectives.

The concept of social reporting is gaining popularity on account of the following factors:

- Increasing awareness of society regarding the contributions the corporate units are making.
- Providing meaningful means of identifying and rewarding business for social contribution.
- Identifying adverse effects on the environment of the business houses.
- Social reporting improves credibility and reputation of business.
- Transferring cost of social activities to other segments of society.

The concept of social responsibility extends beyond the provisions embodied in current law. Essentially, it represents an emerging debate having its roots in political and social theory.

Notes

While designing the contents to be included in social reporting, due care should be taken to see that it does not conflict with the shareholders' interest.

Caution Social reporting presently is being either included in the Annual Reports or finds some reference in the Chairman's Address or the Director's Report. Social reporting format tends to vary from one company to another company as till date no format has been described by any Act in India.

Self Assessment

Fill in the blanks:

6. ……..is reporting on those activities of an organisation that have an impact on society at large and are not necessarily represented by its traditional financial report.
7. Social reporting presently is being either included in the …….or finds some reference in the Chairman's Address or the Director's Report.

9.3 Transfer Pricing

Large business units are usually organised into different divisions for better control. In such a situation, if one division supplies its finished output as input to other division, there arises a very important issue. The issue being at which price should be transferring unit transfer its product or service. Such price is known as transfer price.

Transfer prices are the amounts charged by one segment of an organization for a product or service that it supplies to another segment of the same organization.

Transfer price in simple words is the price that one sub-unit (segment, department, division and so on) of an organization charges for a product or service supplied to another subunit of the same organization. It is different from the normal price in that both divisions are a part of the same organisation and therefore it is only an internal transfer and not sale. The pricing of these flows is likely to have an impact on the performance evaluation of the divisions. Setting of transfer pricing policies within the company is of great significance. The important issue now is at what price should such transfers be made.

Did u know? **Why do transfer-pricing systems exist?**

- To communicate data that will lead to goal-congruent decisions.
- To evaluate segment performance and thus motivate managers toward goal-congruent decisions.

Multinational companies use transfer pricing to minimize their worldwide taxes, duties, and tariffs. Ideally, the chosen transfer-pricing method should lead each subunit manager to make optimal decisions for the organization as a whole. The three specific criteria that can help in choosing a transfer-pricing method are:

- ***Promotion of Goal Congruence:*** Goal congruence exists when each divisional or sub-unit manager acting in his or her own best interest takes actions that automatically result in achieving the organisation goals established by top management.
- ***Promotion of a Sustained High Level of Management Effort:*** Effort is defined as exertion towards a goal, for example, sellers are motivated to hold down costs of supplying product or service, and buyers are motivated to acquire and use inputs efficiently. The environment

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in the organisation should be such that a sustained high level of management effort is promised.

- ***Promotion of a High Level of Subunit Autonomy in Decision-making:*** Autonomy is the degree of freedom a division manager can exercise in decisions making. If top management favours a high degree of decentralization, this criterion is of particular importance.

Self Assessment

Fill in the blanks:

8. ……..are the amounts charged by one segment of an organization for a product or service that it supplies to another segment of the same organization.
9. ……companies use transfer pricing to minimize their worldwide taxes, duties, and tariffs.
10. …….is the degree of freedom a division manager can exercise in decisions making.

9.4 Corporate Governance

Corporate governance denotes of voluntary ethical code of business and management of companies. It aims to maximize the effectiveness and accountability of the brand of directors. Corporate Governance deals with terms, procedure, practices and implicit rules that determine a company's ability to take managerial decisions to maximize long term shareholders value and also to take care of all other shareholders in the enterprise. Cadbury Committee England and CII in India has framed certain rules for desirable corporate governance. The Companies in India now have started attempt to voluntary disclose the compliance of such codes.

Good corporate governance relates to systems of supervision and monitoring that maximise long term shareholder value of a company, and also addresses the interests of all other stakeholders in the enterprise. Although corporate governance varies across countries, there is a growing consensus about the need for four key elements. These are:

- ***Transparency:*** Transparency means a commitment that the business is managed along transparent lines.
- ***Fairness:*** Fairness to all stakeholders in the company, but especially to minority shareholders.
- ***Disclosure:*** Disclosure of all relevant financial and non-financial information in an easily understood manner.
- ***Supervision:*** Supervision of the company's activities by a professionally competent and independent board of directors.

Good corporate governance deals with building trust with customers, suppliers, creditors and diverse investors-trust that the company will be manage properly, will successfully perpetuate its businesses, will protect and enhance the capital of its investors, and will increase corporate value for its shareholders.

Bajaj Auto has believed in these principles since its inception and has always discharged its fiduciary obligations towards its shareholders. During the last two years, we have gone further by steadily increasing the levels of disclosure in our annual reports-disclosures that go beyond the statutes.

We have accelerated the trend this year. For instance, we have checked our corporate governance performance against the code prepared by the Confederation of Indian Industry (CII, Desirable Corporate Governance: A code, April 1988).

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Self Assessment

Fill in the blanks:

11. …….denotes of voluntary ethical code of business and management of companies.
12. Corporate Governance deals with terms, procedure, practices and implicit rules that determine a company's ability to take ……to maximize long term shareholders value and also to take care of all other shareholders in the enterprise.

9.5 Human Resource Accounting

The past few decades have witnessed a global transition from manufacturing to service-based economies. The fundamental difference between the two lies in the very nature of their assets. In the former, physical assets like plant, machinery, material, etc., are of utmost importance. In contrast, in the latter, knowledge and attitudes of the employees assume greater significance. For instance, in the case of an IT firm, the value of its physical assets is negligible when compared with the value of the knowledge and skills of its personnel. Similarly, in hospitals, academic institutions, consulting firms etc., the total worth of the organisation depends mainly on the skills of its employees and the services they render. Therefore, the success of these organizations is contingent on the quality of their human resource – their knowledge, skills, competence, motivation and understanding of the organisational culture.

In knowledge-driven economies therefore, it is imperative that the humans be recognised as an integral part of the total worth of an organisation. However, in order to estimate and project the worth of human capital, it is necessary that some method of quantifying the worth of the knowledge, motivation, skills, and contribution of the human element as well as that of the organisational processes, like recruitment, selection, training, etc., which are used to build and support these human aspects, is developed. Human Resource Accounting (HRA) denotes just this process of quantification/measurement of human resources.

Task Identify the key differences between human resource accounting and cost accounting.

Self Assessment

Fill in the blanks:

13. The past few decades have witnessed a global transition from manufacturing to ……economies.
14. ……denotes just this process of quantification/measurement of human resources.
15. In ……..economies it is imperative that the humans be recognised as an integral part of the total worth of an organisation.

9.6 Summary

- Recent developments in corporate financial reporting indicate a greater emphasis on better voluntary disclosures by the companies regarding their performance and state of affairs.

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- Companies with multiple products or services and those with area of operation extending beyond the boundaries of the country would have to present separate financial report for each of the activities and for each territory.
- Each segmental report will contain information as to the sales, costs, assets and liabilities pertaining to that segment.
- Social reporting is reporting on those activities of an organisation that have an impact on society at large and are not necessarily represented by its traditional financial report.
- Transfer prices are the amounts charged by one segment of an organization for a product or service that it supplies to another segment of the same organization.
- Corporate governance denotes of voluntary ethical code of business and management of companies. It aims to maximize the effectiveness and accountability of the brand of directors.
- Human Resource Accounting (HRA) denotes just this process of quantification/ measurement of human resources.

9.7 Keywords

Corporate Governance: Corporate governance denotes of voluntary ethical code of business and management of companies. It aims to maximize the effectiveness and accountability of the brand of directors.

Human Resource Accounting (HRA): Human Resource Accounting (HRA) denotes just this process of quantification/measurement of human resources.

Social Reporting: Social reporting is reporting on those activities of an organisation that have an impact on society at large and are not necessarily represented by its traditional financial report.

Transfer Prices: Transfer prices are the amounts charged by one segment of an organization for a product or service that it supplies to another segment of the same organization.

9.8 Review Questions

1. Indian corporates, listed or proposed to be listed on the stock exchanges has to adopt segmental reporting. Discuss.
2. Identify the key basis of segmentation.
3. Why social accounting is getting popularity in recent years?
4. Why do transfer-pricing systems exist?
5. What do you mean by corporate governance?
6. In knowledge-driven economies it is imperative that the humans be recognised as an integral part of the total worth of an organisation. Why?

Answers: Self Assessment

1. Consolidated
2. AS17
3. costs
4. product lines

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5. geographical
6. Social reporting
7. Annual Reports
8. Transfer prices
9. Multinational
10. Autonomy
11. Corporate governance
12. managerial decisions
13. service-based
14. Human Resource Accounting (HRA)
15. knowledge-driven

9.9 Further Readings

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

Sudhindra Bhat, *Financial Management*, New Delhi, Excel Books, 2008.

Van Horne, J.C. and Wachowicz, Jr, J.M., *Fundamentals of Financial Management*, New Delhi, Prentice Hall of India Pvt. Ltd., 1996, p. 2.

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Unit 10: IFRS and its Relevance

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Objectives

After studying this unit, you will be able to:

- Identify the scope of IFRS
- Describe the types of IFRS and their relevance
- Understand conceptual framework of IASB and IASC
- Describe the qualitative characteristics of IFRS

Introduction

The term International Financial Reporting Standards (IFRSs) has both a narrow and a broad meaning. Narrowly, IFRSs refers to the new numbered series of pronouncements that The International Accounting Standards Board (IASB) is issuing, as distinct from the International Accounting Standards (IASs) series issued by its predecessor. More broadly, IFRSs refers to the entire body of IASB pronouncements, including standards and interpretations approved by the IASB and IASs interpretations approved by the predecessor International Accounting Standards Committee.

Did u know? **What is the meaning of accounting standards?**

It is a set of certain generally accepted rules, principles, concepts and conventions issued by the Institute of chartered Accountants of India in consultation with other International Accounting bodies. The purpose of making uniform rules and principles is to make the preparation and presentation of financial statement easy, relevant, reliable, understandable and finally comparable. In other words, Accounting standards are the basis of accounting policies and practices to facilitate the recording of transactions and events in such a way which can change them into financial statements, to be used by the persons interested in getting the correct and reliable information with a view to take future decisions.

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10.1 International Accounting Standard Board

The International Accounting Standards Board (IASB) founded on April 1, 2001 is the successor of the IASC. It is responsible for developing International Financial Reporting Standards – a new name for International Accounting Standards – and promoting and application of the standards. The standards issued by IASB were named as International Financial Reporting Standards (IFRS). The International Accounting Standards Board is an independent privately-funded accounting standard board. Since its renaming, IFRS has issued 8 standards and had adopted many of the earlier standards issued by IASC with and without modifications. IFRS is finding favor with most of the advanced economies of the world.

The IASB has 15 Board members, each with one vote. They are selected as a group of experts with a mix of experience of standard-setting, preparing and using accounts, and academic work. At their January 2009 meeting the Trustees of the Foundation concluded the first part of the second Constitution Review, announcing the creation of a Monitoring Board and the expansion of the IASB to 16 members and giving more consideration to the geographical composition of the IASB.

The IFRS Interpretations of Committee has 14 members. Its brief is to provide timely guidance on issues that arise in practice. A unanimous vote is not necessary in order for the publication of a Standard, exposure draft, or final "IFRIC" Interpretation. The Board's 2008 Due Process manual stated that approval by nine of the members is required.

Notes **Need for Accounting Standards**

Different business enterprises were having different modes of recording the transactions and events and lack of uniform set of rules created a lot of problems, such as comparison was not truly possible but difficult also this was because of the nature of business, diversified and complex economic situations. This also made accounting information incomparable and less meaningful. Therefore a need was felt to have certain minimum standards which are universally applicable, so that the financial statements thus made, can be more reliable, comparable, relevant and understandable. Keeping this in view, International Accounting Standard Committee (IASC) was set up in 1973. The objectives of this Committee were:

- To formulate and publish, in the public interest, accounting standards to be observed in the presentation of financial statements and also its world wide acceptance, and
- To work for improvement and harmonization of regulation of accounting standards and procedure relating to the presentation of financial transactions.

Self Assessment

State true or false:

1. The International Accounting Standards Board (IASB) founded on April 1, 2001.
2. The IASB has 14 Board members, each with one vote.
3. The IFRS Interpretations OF Committee has 15 members.
4. The International Accounting Standards Board is an independent privately-funded accounting standard board.

10.2 Types of IFRS and their Relevance

Notes

The following are the key IFRS issued by International Accounting Standard Board (IASB):

- ***IFRS 1: First-time Adoption:*** IFRS 1 requires an entity to do the following in the opening IFRS statement of financial position that it prepares as a starting point for its accounting under IFRSs: (a) Recognize all assets and liabilities whose recognition is required by IFRSs; (b) Not recognize items as assets or liabilities if IFRSs do not permit such recognition; (c) Reclassify items that it recognized under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under IFRSs; and (d) Apply IFRSs in measuring all recognized assets and liabilities.
- ***IFRS 2: Share-based Payment:*** The objective of this IFRS is to specify the financial reporting by an entity when it undertakes a share-based payment transaction. In particular, it requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which share options are granted to employees.
- ***IFRS 3: Business Combinations:*** The objective of the IFRS is to enhance the relevance, reliability and comparability of the information that an entity provides in its financial statements about a business combination and its effects. It does that by establishing principles and requirements for how an acquirer (a) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; (b) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and (c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.
- ***IFRS 4: Insurance Contracts:*** The objective of this IFRS is to specify the financial reporting for insurance contracts by any entity that issues such contracts (described in this IFRS as an insurer) until the Board completes the second phase of its project on insurance contracts. In particular, this IFRS requires (a) limited improvements to accounting by insurers for insurance contracts; (b) disclosure that identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.
- ***IFRS 5: Non-current Assets Held for Sale and Discontinued Operations:*** The objective of this IFRS is to specify the accounting for assets held for sale, and the presentation and disclosure of discontinued operations. In particular, the IFRS requires (a) assets that meet the criteria to be classified as held for sale to be measured at the lower of carrying amount and fair value less costs to sell, and depreciation on such assets to cease; and (b) assets that meet the criteria to be classified as held for sale to be presented separately in the statement of financial position and the results of discontinued.
- ***IFRS 6: Exploration for and evaluation of Mineral Resources:*** The IFRS (a) permits an entity to develop an accounting policy for exploration and evaluation assets without specifically considering the requirements of paragraphs 11 and 12 of IAS 8. Thus, an entity adopting IFRS 6 may continue to use the accounting policies applied immediately before adopting the IFRS. This includes continuing to use recognition and measurement practices that are part of those accounting policies; (b) requires entities recognising exploration and evaluation assets to perform an impairment test on those assets, when facts and circumstances suggest that the carrying amount of the assets may exceed their recoverable amount; and (c) varies the recognition of impairment from that in IAS 36 but measures the impairment in accordance with that Standard once the impairment is identified.

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- ***IFRS 7: Financial Instruments: Disclosures:*** The IFRS applies to all entities, including entities that have few financial instruments (for example: a manufacturer whose only financial instruments are accounts receivable and accounts payable) and those that have many financial instruments (for example: a financial institution most of whose assets and liabilities are financial instruments).

  The objective of this IFRS is to require entities to provide disclosures in their financial statements that enable users to evaluate (a) the significance of financial instruments for the entity's financial position and performance; and (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks. The qualitative disclosures describe management's objectives, policies and processes for managing those risks. The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. Together, these disclosures provide an overview of the entity's use of financial instruments and the exposures to risks they create.

- ***IFRS 8: Operating Segments:*** This IFRS shall apply to (a) the separate or individual financial statements of an entity: whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or (ii) that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and (b) the consolidated financial statements of a group with a parent: (i) whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or (ii) that files, or is in the process of filing, the consolidated financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

Caution GAAP provides a general framework for financial accounting—objectives, standards, concepts, assumptions, methods and rules. It is not comparable to the physical laws, where causes lead to definite results.

Self Assessment

Fill in the blanks:

5. The objective of ……. is to specify the financial reporting by an entity when it undertakes a share-based payment transaction.
6. The objective of IFRS 5 is to specify the accounting for assets held for sale, and the presentation and disclosure of ……operations.
7. ……provides a general framework for financial accounting—objectives, standards, concepts, assumptions, methods and rules.
8. The …….. applies to all entities, including entities that have few financial instruments and those that have many financial instruments.

10.3 Qualitative Characteristics of IFRS Financial Statements

The qualitative characteristics will provide assistance when choices have to be made between reporting policies – whether by preparers, auditors, those participating in the standard-setting

process, regulators or others – and be indicative of the qualities that users can expect of the financial information provided to them.

For the purposes of this Statement:

- ***Comparability:*** Comparability means that quality of financial information which exists when users of that information are able to discern and evaluate similarities in, and differences between, the nature and effects of transactions and events, at one time and over time, either when assessing aspects of a single reporting entity or of a number of reporting entities;
- ***Materiality Test:*** Materiality test means that test which is used to assess the extent to which relevant and reliable information may be omitted, misstated or not disclosed separately without having the potential to adversely affect the decisions about the allocation of scarce resources made by users of a general purpose financial report or the rendering of accountability by preparers;
- ***Relevance:*** Relevance means that quality of financial information which exists when that information influences decisions by users about the allocation of scarce resources by:
  - helping them form predictions about the outcomes of past, present or future events; and/or
  - confirming or correcting their past evaluations; and which enables users to assess the rendering of accountability by preparers;
- ***Reliability:*** Reliability means that quality of financial information which exists when that information can be depended upon to represent faithfully, and without bias or undue error, the transactions or events that either it purports to represent or could reasonably be expected to represent; and
- ***Understandability:*** Understandability means that quality of financial information which exists when users of that information are able to comprehend its meaning.

General purpose financial reporting involves making decisions about the selection of financial information to be included in general purpose financial reports, the measurement of that information and its presentation. These decisions should be consistent with the objective of general purpose financial reporting and should yield information which possesses the qualitative characteristics set out in this Statement.

Notes **Benefits of IFRS**

The following points explain the benefits of using IFRS:

- It would benefit the economy by increasing growth of international business
- It would encourage international investing and thereby lead to more foreign capital inflows into the country.
- Investors want the information that is more relevant, reliable, timely and comparable across the jurisdictions.
- IFRS would enhance the comparability between financial statements of various companies across the globe.
- Better understanding of financial statements would benefit investors who wish to invest outside their own country.

Contd...

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- The industry would be able to raise capital from foreign markets at lower cost if it can create confidence in the minds of foreign investors that their financial statements comply with globally accepted accounting standards.
- It would reduce different accounting requirements prevailing in various countries there by enabling enterprises to reduce cost of compliances.
- It would provide professional opportunities to serve international clients.
- It would increase their mobility to work in different parts of the world either in industry or practice.

Self Assessment

Fill in the blanks:

9. …….. means that quality of financial information which exists when that information influences decisions by users about the allocation of scarce resources.
10. ……means that quality of financial information which exists when users of that information are able to comprehend its meaning.
11. IFRS would enhance the ……between financial statements of various companies across the globe.

Task Discuss the applicability of IFRS in India.

10.4 Challenges in Implementation of IFRS in India

The following are the key recommendations suggested by the task force set up by ICAI in 2006:

1. ***Lack of Awareness:*** Adoption of IFRS means a complete set of different reporting standards have to bring in. The awareness of these reporting standards is still not there among the stakeholders like firms, banks, stock exchanges, commodity exchanges etc.
2. ***Training:*** Professional accountants are looked upon to ensure successful implementation of IFRS. The biggest hurdle for the professionals in implementing IFRS is the lack of training facilities and academic courses on IFRS in India. The solution to this problem is that all stakeholders in the organisation should be trained and IFRS should be introduced as a full time subject in the universities.
3. ***Amendments to the Existing Laws:*** It is observed that implementation of IFRS may result in a number of inconsistencies with the existing laws which include the Companies Act 1956, SEBI regulations, banking laws and regulations and the insurance laws and regulations. Currently, the reporting requirements are governed by various regulators in India and their provisions override other laws. IFRS does not recognise such overriding laws. Although steps to amend these laws have been initiated, the authorities need to ensure that the laws are amended well in time.
4. ***Taxation:*** IFRS adoption will affect most of the items in the Financial Statements and consequently, the tax liabilities would also undergo a change. Currently, Indian Tax Laws do not recognize the Accounting Standards. A complete overhaul of Tax laws is the major challenge faced by the Indian Law Makers immediately. Enough changes are to be made in Tax laws to ensure that tax authorities recognize IFRS-Compliant financial statements otherwise it will duplicate the administrative work for the Firms.

Notes

5. ***Fair Value:*** IFRS uses fair value as a measurement base for valuing most of the items of financial statements. The use of fair value accounting can bring a lot of volatility and subjectivity to the financial statements. It also involves a lot of hard work in arriving at the fair value and valuation experts have to be used. Moreover, adjustments to fair value result in gains or losses which are reflected in the income statements. Whether this can be included in computing distributable profit is also debated.

6. ***Reporting Systems:*** The disclosure and reporting requirements under IFRS are completely different from the Indian reporting requirements. Companies would have to ensure that the existing business reporting model is amended to suit the reporting requirements of IFRS. The information systems should be designed to capture new requirements related to fixed assets, segment disclosures, related party transactions, etc. Existence of proper internal control and minimising the risk of business disruption should be taken care of while modifying or changing the information systems.

10.5 Major Difference between Indian accounting standards and IFRS

The following are the key differences between Indian accounting standards and IFRS:

Subject	IFRS	Indian GAAP
Components of Financial Statements	Comprises of ➢ Statement of Financial Position, ➢ *Statement of Comprehensive Income ➢ Statement of Cash flow ➢ Notes to Accounts ➢ Statement of Changes in Equity (Note * - Also includes items of other comprehensive income such as revaluation gains, foreign exchange fluctuations, etc)	Comprises of ➢ Balance sheet ➢ Profit and Loss A/c ➢ Cash flow statement and ➢ Notes to Accounts
Format of SOFP	No particular format prescribed. However IAS prescribes disclosure on the basis of current and non-current assets and liabilities.	According to the format prescribed in Schedule VI to the Companies Act 1956, Banking Regulation Act for Banks etc.
Format of Income Statement	IAS 1 prescribes the format of income statement.	According to the format prescribed in Schedule VI to the Companies Act 1956, Banking Regulation Act for Banks etc.
Statement of Cash Flows	Mandatory for all entities	Exempted for Level 3 entities as prescribed by ICAI.
Presentation of extraordinary items	IFRS prohibits the presentation of extraordinary items in the statement of comprehensive income or in the notes.	Indian GAAP requires extraordinary items to be presented in the profit and loss statement of the entity distinct from the ordinary income and expenses for the period. As a result, extraordinary items are considered to determine the profit / loss for the period.
Dividends proposed after the end of the reporting period	Dividends declared after the end of the reporting period but before the financial statements are authorised for issue are not recorded as liability in the financial statements.	Dividends declared after the end of the reporting period but before the financial statements are approved are recorded as liability in the financial statements.
Depreciation rates	Allocated on a systematic basis to each accounting period during the useful life of the asset.	Depreciation is based on the higher estimate of useful life of the asset, or the rates prescribed by Schedule VI of The Companies Act 1956.
Change in the depreciation method	Treated as a change in the accounting estimate and hence is accounted for prospectively.	Treated as a change in the accounting policy and is accounted for retrospectively (i.e. for all the relevant previous years). Any excess / deficit in the case of this kind of recalculation must be adjusted in the period in which the change is effected.

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Entire class to be revalued	If an item of property, plant and equipment is revalued, the entire class of assets to which that asset belongs should be revalued.	An entire class of assets can be revalued, or selection of assets for revaluation can be made on a systematic basis.
Component accounting	Mandates component accounting.	Recommends component accounting.
Functional and foreign currency	Functional currency is the currency of the primary economic environment in which the entity operates. Functional and presentation currencies may be different. The standard contains detailed guidance on this.	No concept of functional currency.
Goodwill	Goodwill is not amortised under IAS 38 but is subject to annual impairment test under IAS 36.	AS 14 provides that goodwill arising on amalgamation in the nature of purchase is amortised over a period of 5 years.
Measurement of intangible assets	Can be measured at cost or revalued amount.	Are measured at cost only.
Actuarial gain or loss	IAS 19 gives three choices for the treatment of actuarial gains or losses arising on measurement of employee benefits.	Actuarial gains and losses should be recognised immediately in the statement of profit and loss as an income or expense.
Contingent asset-disclosure	Contingent assets are disclosed in the financial statements only if the inflow of economic benefit is probable. (Para 37)	Contingent assets are disclosed as part of the director's report (approving authority)and are not disclosed in the financial statement.
Entities operating in hyper inflationary economies	IAS 29 – Financial Reporting in Hyper Inflationary Economies prescribes reporting requirement for entities operating in hyperinflationary economies.	There is no equivalent standard.

Self Assessment

Fill in the blanks:

12. IFRS uses ……..as a measurement base for valuing most of the items of financial statements.

13. The …… and reporting requirements under IFRS are completely different from the Indian reporting requirements.

10.6 Summary

- Accounting standards are the basis of accounting policies and practices to facilitate the recording of transactions and events in such a way which can change them into financial statements, to be used by the persons interested in getting the correct and reliable information with a view to take future decisions.
- The International Accounting Standards Board (IASB) founded on April 1, 2001 is the successor of the IASC.
- The International Accounting Standards Board is an independent privately-funded accounting standard board.
- IFRS has issued 8 standards and had adopted many of the earlier standards issued by IASC with and without modifications.
- GAAP provides a general framework for financial accounting— objectives, standards, concepts, assumptions, methods and rules. It is not comparable to the physical laws, where causes lead to definite results.
- The qualitative characteristics will provide assistance when choices have to be made between reporting policies - whether by preparers, auditors, those participating in the

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standard-setting process, regulators or others - and be indicative of the qualities that users can expect of the financial information provided to them.

- General purpose financial reporting involves making decisions about the selection of financial information to be included in general purpose financial reports, the measurement of that information and its presentation.

10.7 Keywords

Accounting Standards: Accounting standards are the basis of accounting policies and practices to facilitate the recording of transactions and events in such a way which can change them into financial statements, to be used by the persons interested in getting the correct and reliable information with a view to take future decisions.

Financial Statements: Financial statements are the most important way of periodically presenting to parties outside the business the information that has been gathered and processed in the accounting system.

IASB: International Accounting Standards Board

IFRS: International Financial Reporting Standards

10.8 Review Questions

1. The term International Financial Reporting Standards (IFRSs) has both a narrow and a broad meaning. Discuss.
2. Write a note on organisation structure of IASB.
3. Why accounting standards are important in preparing the financial statements?
4. The standards issued by IASB were named as International Financial Reporting Standards (IFRS). What are the key standards issued by IASB?
5. What are the key benefits of using IFRS?
6. Identify the key characteristics of IFRS financial statements.
7. Discuss the meaning and scope of IFRS 7.
8. What are the key challenges in implementation of IFRS in India?

Answers: Self Assessment

1.	true	2.	false
3.	false	4.	true
5.	IFRS 2	6.	discontinued
7.	GAAP	8.	IFRS 7
9.	Relevance	10.	Understandability
11.	comparability	12.	For value
13.	Disclosure		

Notes

10.9 Further Readings

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

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Unit 11: Introduction to Financial Reporting Framework

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Objectives

After studying this unit, you will be able to:

- Identify the contribution of financial statements in meeting the needs of users and capital market
- State the limitations of financial statements
- Understand the objectives of financial statements

Introduction

Accounting is thousands of years old; the earliest accounting records, which date back more than 7 million years, were found in Mesopotamia (Assyrians). The people of that time relied on primitive accounting methods to record the growth of crops and herds. Accounting evolved, improving over the years and advancing as business advanced.

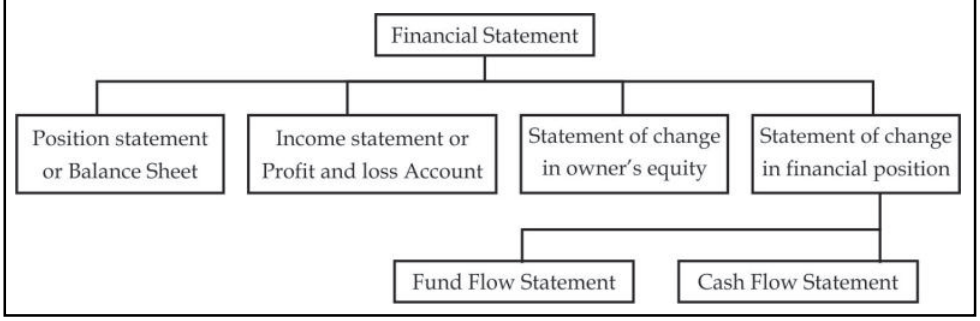
Accounting is the language of business throughout the world. Every business organization keeps its financial records so that the parties interested, can have an analysis through it. Accounting means recording each transaction that takes place and further, summarizing the records for financial communications. Accounting is the process by which the data generated in bookkeeping are processed, analyzed and interpreted, to be used as guidelines by the management in framing future policies of the business.

A financial statement is summarised data, collected and organised according to logical and consistent accounting procedure. Its purpose is to convey an understanding of some financial aspects of a business firm the term financial statement generally refer to two statements (i) the position statement or the balance sheet and (ii) the income statement/profit & loss account. These statements are used to convey to management and interested parties about the profitability and financial position of a firm.

Financial statements are the most important way of periodically presenting to parties outside the business the information that has been gathered and processed in the accounting system. These financial statements serve a "general purpose" as most of the users are outside the business.

Notes

Figure 11.1: Components of financial statement



11.1 Objectives of Financial Statements

Basically, there are three objectives of financial reporting:

- To give information useful for making investment and credit decisions. Financial reporting should offer information that can help present and potential investors and creditors to make rational investment and credit decisions. The information should be in the form that is easy and understandable to those who have some understanding of business and are willing to study the information carefully.
- To provide information useful in assessing cash flow prospects. Financial reporting should supply information to help present and potential investors and creditors appraise the amounts, timing and possible risk of expected cash receipts from dividends or interest and the proceeds from the sale, redemption or maturity of stocks or loans.
- To provide information about business resources claims to those resources and changes in them. Financial information should give information about the company's assets, liabilities and shareholders equity.

Financial statements are the most important way of periodically presenting to parties outside the business the information that has been gathered and processed in the accounting system. These financial statements are "general purpose" because most of the users are outside the business. Because of potential conflict of interest between managers, who must prepare the statements and the investors or creditors, who invest in or lend money to the business, these statements are often audited by outside accountants (known as auditors) to increase creditability and reliability.

Self Assessment

Fill in the blanks:

1. ……. means recording each transaction that takes place and further, summarizing the records for financial communications.
2. A ……..is summarised data, collected and organised according to logical and consistent accounting procedure.
3. Financial statements are the most important way of periodically presenting to parties outside the business the information that has been gathered and processed in the ……...

Notes

11.2 Contribution of Financial Statements in Meeting the Needs of Users

The accounting system generates accounting information in the form of financial reports. There are two major categories of these reports: External and Internal.

Individuals and organisations that have an economic interest in the business but are not a part of the management use external financial reports, included in the company's annual report. Information is provided to these external users in the form of general-purpose financial statements. Special reports are sometimes required by the government agencies, which the company has to provide. Internal users, which include managers and executives working for the company, have access to specialised management accounting information that is not available to outsiders.

11.2.1 External Users of Accounting Information

External users have limited access to an organisation's valuable information. The success of their decisions depends upon the use of external reports that are reliable, relevant and comparable. Typically, governmental and regulatory agencies have the power to get reports in specific forms. The rest of the external users rely on general-purpose financial statements like Balance Sheet, Income Statement and Cash Flow Statement. The term general purpose refers to the broad range of purposes for which external users rely on these statements.

Each external user has special information needs depending on the kind of decisions he has to take. These decisions involve getting answers to key questions, which are often available in accounting reports. Let us now discuss several external users and the questions that confront them.

Investors

Ravi owns a music cassettes store at Dehradun. He got an excellent job with a music company in Delhi so he moved here. He hired Raman to manage his store, who sends Ravi a cheque every month representing the profits from the business. How can Ravi know whether Raman is doing a good job of managing his store? Are the amount of profits is all that he can reasonably expect? Should he consider selling his business and invest his money elsewhere to earn more profit?

As investors, the current owners of a firm are obviously interested in knowing how the business is doing. If Ravi considers selling his business, he needs to know how much the business is worth. The buyer will also be interested in a fair valuation of the firm's assets.

Investors in a company are the shareholders (owners) of the company and in many cases they are not a part of management. They are exposed to the greatest return and risk from the company. Risk is high because there is no promise of either repayment of their investment or a return on their investment. Therefore, they want information that helps them estimate how much returns they can expect in the future if they invest in a business now. Financial statements coupled with knowledge of business plans, market forecast and the character of management helps investors in assessing these future cash flows. External reports aim to help answer shareholder questions such as:

- What is the income for current and previous years?
- Are assets adequate to meet future business plans? If the company requires raising more funds to meet its requirements, what are the sources that the company is planning to tap?
- Is the company competitive enough in its industry and how does it stand compared to other companies in the same industry?

Notes

Companies normally have a board of directors. These directors are elected representatives of the shareholders or the lenders, and are there to oversee that the company looks after the interests of shareholders and lenders.

Lenders

Lenders loan money (or other resources) to the organisation. They are interested in only one thing—being repaid with interest. Lenders include banks, financial institutions, finance companies and public. Lenders look for information to help them assess whether an organisation is likely to repay or not. External reports help them answer questions about the organisation such as:

- How promptly has the company paid its past loans?
- What are the risks that it currently faces?
- Can it repay its current obligations and current liabilities?
- How relevant are its cash flow projections with which it will repay its obligations?

Often, reports from the credit rating agencies are used to know the credit standing of the company. There are several international and Indian credit rating agencies. Among Indian agencies, the major ones are CRISIL (Credit Rating and Information Services of India Ltd.), CARE (Credit Appraisal and Rating Agency Ltd.) and ICRA (Information and Credit Rating Agency Ltd). All of them have one or the other financial institution as their promoter. Financial institutions floated these agencies because of their own credit appraisal and information requirements, but these agencies perform credit ratings on an independent basis, free of the influences of their promoters.

Caselet

Case: S&P Ups ICICI Rating

International credit rating agency Standard and Poor's (S&P) some time back revised its rating outlook on ICICI Ltd to 'stable' from 'negative', even as it reaffirmed the financial institution's long-term rating of 'BB' and short-term foreign currency rating of 'B'.

With the upward revision in outlook, ICICI's rating is on par with India's sovereign rating and a notch higher than the long-term outlook of other financial rivals like IDBI and BoB at 'negative'. The other major player SBI does not have a long-term rating.

In a release, S&P had stated the change in outlook was 'supported by continuing progress in the strengthening of ICICI's balance sheet and a lesser probability that asset quality will deteriorate significantly from current levels.'

S&P had said ICICI's steps towards universal banking have helped it diversify its risks better than its peers, which will give it a competitive advantage. However S&P said it would still take some time for ICICI's universal banking strategy to manifest itself fully in its balance sheet and earnings profile.

S&P has noted that by virtue of its expertise in innovative project and infrastructure financing, ICICI had taken a leadership position that should enable it to withstand increased competition from the commercial banks, which are now entering this market.

Contd...

Notes

But even while it revised its outlook upwards, S&P said that key concerns continued to be reflected in ICICI's ratings. This include a relatively higher risk business as it was predominantly project financing, although this had been reduced significantly in recent years; a high level of assets seen as impaired by global standards; wholesale funding concentrations and the risks associated with the Indian operating environment.

S&P's also commented on the company's improved accounting systems as the company passed provisions for non-performing assets through the profit and loss account, rather than the capital account. ICICI has already audited its balance sheet according to US GAAP accounting principles.

Regulators

The basic requirement of the regulators is to ensure that the company is working in accordance with the law and is not cheating the general public which is dependent on the company for various reasons. Regulators often have legal authority or significant influence over the activities of organisations. As the government exercises control over regulators, they can ask for special formats of reports that the company has to provide. The income tax authorities require organisations to use various reports for computing taxes. Registrar of Companies (RoC) requires list of top shareholders along with the annual report. Securities & Exchange Board of India (SEBI) and the Stock Exchanges (like National Stock Exchange and the Bombay Stock Exchange) require that the listed companies (companies which have wide public holding and whose shares are traded on the stock exchange) make adequate financial disclosures in order to make sure that investor gets sufficient information to make informed investment decisions.

Suppliers and Customers

In many cases, suppliers and customers are interested in the long-term staying power of the company. If you were going to put up a project that supplies its product to only one customer, you would be interested in knowing whether that customer can last for a long time. Similarly, if you were the customer you would be interested in the long-term viability of the supplier.

Caution Financial statements help you in understanding the other party's financial position.

Employees

Employees have a special interest in the company. They are interested in judging whether the salaries/wages paid to them are fair and also in assessing their future job prospects. They are also interested to know that if the company is doing well so that they can bargain for better wages or working conditions. External reports of other companies can also be used to look at the salaries paid by other competing organisations to look for better job prospects.

11.2.2 Internal Users of Accounting Information

Internal users are the individuals who are directly involved in managing and operating the organisation. Therefore, the internal role of accounting is to provide information to help improve the efficiency and effectiveness of their organisation in delivering products or services. Management accounting provides internal reports to help internal users improve an organisation's activities. Internal reports are not subject to the same rules as external reports because internal users are not constrained in the use of accounting information. They have access to a lot of

Notes

private and valuable information that is kept secret from the external users because of competitive concerns. Internal reports help answer questions like:

- What are the manufacturing costs of a product?
- What is the most profitable mix of products or services?
- At what level the product should be priced at for different levels of sales?
- What level of sales is necessary to break even?
- What are the costs that the organisation has to bear whether the company produces or not produces?
- Is it better to manufacture or do the activity in-house or the activity should be outsourced?

Information that help answers these questions is very critical for the success of the organisation. There are around seven functions that are common to most of the organisations as seen below. Some of these functions may be irrelevant for a particular type of organisation (like production function for banks). Bigger businesses usually have these operating functions as separate departments but smaller units usually have one department involved in more than one of these roles. For example, production department may also look after servicing in a small air-conditioning assembling organisation. Very small organisations tend to have no departmental break-ups at all.

Table 11.1: Seven Common Functions in Most Organisations

Function	Information requirement
Research and Development	Research & Development is aimed at creating or improving a company's products or services. Managers need information about current and projected costs and potential sales.
Purchasing	Purchasing involves buying and managing materials needed for operations. Managers need to know what, when and how much to purchase.
Production	Production is the function concerning use of raw material and other activities to produce products and services. Good production methods depend on information for effectively planning their operations, to monitor cost and to ensure quality.
Human Resources	Human resources aim to locate, screen, hire, train, compensate, promote and counsel employees. Managers require information about current and potential employees, their backgrounds, payroll costs, employee benefits related and other performance and compensation data.
Marketing	Marketing is required to promote and advertise company's products or services. Marketing people use accounting inputs about sales and costs to effectively target consumers and set prices. Marketing also uses accounting to monitor consumer needs, credit and price concerns.
Distribution	Involves timely and accurate delivery of products or services. Relevant information about how to minimise the costs of distribution is often key to quality distribution.
Servicing	Servicing customers after selling products is a key to success in today's competitive world. Information is needed on both the cost and benefits of servicing.

Both internal and external users rely on internal controls to monitor the company's operations. Internal controls procedures, set-up to protect assets and show reliable accounting reports, promote efficiency and encourage adherence to company's policies.

Self Assessment

Notes

Fill in the blanks:

4. The accounting system generates accounting information in the form of ……..
5. …… users are the individuals who are directly involved in managing and operating the organisation.
6. The internal role of accounting is to provide information to help improve the efficiency and ……. of their organisation in delivering products or services.
7. …….. is the function concerning use of raw material and other activities to produce products and services.
8. ……is aimed at creating or improving a company's products or services.

11.3 Capital Market Requirements for Preparing Financial Statements

Financial statements provide information of value to company officials as well as to various outsiders, such as investors and lenders of funds. Publicly owned companies are required to periodically publish general-purpose financial statements that include a balance sheet, an income statement, and a statement of cash flows. Some companies also issue a statement of stockholders' equity and a statement of comprehensive income, which provide additional detail on changes in the equity section of the balance sheet.

Caution Financial statements issued for external distribution are prepared according to Generally Accepted Accounting Principles (GAAP), which are the guidelines for the content and format of the statements.

In the United States, the Securities and Exchange Commission (SEC) has the legal responsibility for establishing the content of financial statements, but it generally defers to an independent body, the Financial Accounting Standards Board (FASB), to determine and promote accepted principles.

These statements provide an overview of organizations' financial condition in both short and long-term. Through financial statements all the relevant financial information of a business enterprise are presented in a structured manner and in a form easy to understand. There are four basic financial statements:

1. ***Balance sheet: Statement of financial position or condition.*** The balance sheet consists of three major sections: assets, the resources of the firm; liabilities, the debts of the firm; and stockholders' equity, the owners' interest in the firm. At any point in time, the total assets amount must equal the total amount of the contributions of the creditors and owners. This is expressed in the accounting equation:

   Assets = Liabilities + Stockholders' Equity

2. ***Income statement or Profit and Loss statement:*** These statements include reports on a company's income, expenses, and profits over a period of time. These include sale, the various types of operating and non-operating expenses and income, incurred during the processing state. It summarizes the results of operations for a particular period of time. Net income is included in retained earnings in the stockholders' equity section of the balance sheet.

Notes

3. ***Statement of retained earnings:*** This statement explains the changes in a company's retained earnings over the reporting period. Retained earnings links the balance sheet to the income statement. Retained earnings are increased by net income and decreased by net losses and dividends paid to stockholders. There are some other possible increases or decreases to retained earnings besides income (losses) and dividends. The income statement separately itemizes revenues and expenses, which result from the company's ongoing major or central operations, and the gains and losses arising from incidental or peripheral transactions. Certain irregular items (such as discontinued operations, extraordinary items, effects of accounting changes) are presented separately, net of tax effect, at the end of the statement. When revenues and gains exceed expenses and losses, net income is realized. Net income for the period increases equity. The results of the firm's operating activities for the period as presented in the income statement provide information that can be used to predict the amount, timing, and uncertainty of future cash flows. This statement is useful to investors, creditors, and other users in determining the profit ability of operations. The income statement must also show earnings per share (EPS), where the net income is divided by the weighted average number of shares of common stock outstanding. Since EPS scales income by the magnitude of the investment, it allows investors to compare diverse companies of different sizes; hence, investors commonly use it as a summary measurement of firm performance.

4. ***Statement of cash flows:*** These statements provide reports on a company's cash flow activities; particularly it's operating, investing and financing activities. The statement of cash flows consists of three sections: cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities. Information about key investing and financing activities not resulting in cash receipts or payments in the period must be provided separately. The statement of cash flow is prepared in accordance to guidelines issued by Accounting Standard -3 (AS -3). According to that sum of net cash flow from operating activity, net cash flow from investing activity and net cash flow from financing activity is equal to net change in cash. The cash from operating activities reported on the statement of cash flows must be reconciled to net income for the period. Because GAAP requires accrual accounting methods in preparing financial statements, there may be a significant difference between net income and cash generated by operations.

Did u know? **What is the purpose of preparing cash flow statement?**

The cash flow statement is used by creditors and investors to determine whether cash will be available to meet debt and dividend payments.

5. ***Footnotes (Notes):*** Footnotes (notes) accompany these financial statements. To evaluate the financial condition, the profitability, and cash flows of an entity, the user needs to understand the statements and related notes. The footnotes to the financial statements are used to present additional information about items included in the financial statements and to present additional financial information. Footnotes are an integral part of financial statements.

The financial statements of publicly owned companies also include an auditor's report, indicating that the statements have been audited by independent auditors. The auditor's opinion is related to fair presentation in conformity with GAAP.

The external financial statements required for not-for-profit organizations are similar to those for business enterprises, except that there is no ownership component (equity) and no income. Not-for-profit organizations present a statement of financial position, a statement of activities, and a statement of cash flows. The financial statements must classify the organization's net

assets and its revenues, expenses, gains, and losses based on the existence or absence of donor-imposed restrictions. Each of three classes of net assets — permanently restricted, temporarily restricted, and unrestricted—must be displayed in the statement of financial position, and the amounts of change in each of those classes of net assets must be displayed in the statement of activities. Governmental bodies, which are guided by the Governmental Accounting Standards Board (GASB), present general-purpose external financial statements that are similar to those of other not-for-profit organizations, but they classify their financial statements according to fund entities.

The rules for the recording, measurement and presentation of government financial statements may be different from those required for business and even for non-profit organizations. They may use either of two accounting methods: accrual accounting, or cash accounting, or a combination of the two (OCBOA). A complete set of chart of accounts is also used that is substantially different from the chart of a profit-oriented business.

Although laws differ from country to country, an audit of the financial statements of a public company is usually required for investment, financing, and tax purposes. These are usually performed by independent accountants or auditing firms. Results of the audit are summarized in an audit report that either provides an unqualified opinion on the financial statements or qualifications as to its fairness and accuracy. The audit opinion on the financial statements is usually included in the annual report.

There has been much legal debate over who an auditor is liable to. Since audit reports tend to be addressed to the current shareholders, it is commonly thought that they owe a legal duty of care to them. But this may not be the case as determined by common law precedent. In Canada, auditors are liable only to investors using a prospectus to buy shares in the primary market. In the United Kingdom, they have been held liable to potential investors when the auditor was aware of the potential investor and how they would use the information in the financial statements. Nowadays auditors tend to include in their report liability restricting language, discouraging anyone other than the addressees of their report from relying on it. Liability is an important issue: in the UK, for example, auditors have unlimited liability.

Self Assessment

Fill in the blanks:

9. …….provide information of value to company officials as well as to various outsiders, such as investors and lenders of funds.
10. The …….. to the financial statements are used to present additional information about items included in the financial statements and to present additional financial information.
11. The statement of cash flows consists of three sections: cash flows from operating activities, cash flows from ……., and cash flows from financing activities.
12. The statement of cash flow is prepared in accordance to guidelines issued by ……...

11.4 Limitations or Drawbacks of Financial Statements

The financial statements are based on certain accounting concepts and conventions which can not be said to be foolproof.

The following are the limitations of the financial statements:

1. Financial statements are essentially interim reports and therefore, cannot be final because the final gain or loss can be computed only at the termination of the business.

Notes

2. Financial statements take into consideration only the financial factors. They fail to bring out the significance of non-financial factors which may have considerable bearing on the operating results and financial conditions of an enterprise. For example, public image of the enterprise, the calibre of its management, efficiency and loyalty of its workers, etc.
3. It is not always possible to discover false figures in financial statements. Unscrupulous managements generally resort to 'window dressing' in the preparation of such statements.
4. Financial statements only reflect the progress and position of the business at frequent intervals during its life. The decision regarding the period of these statements is a matter of personal judgement and it gives rise to the problem of allocating expenditures over various periods.
5. Financial statements though expressed in exact monetary terms, are not absolutely final and accurate. As the balance sheet is prepared on the basis of a going concern asset valuation represents neither the realisable value nor replacement costs. They depend on the judgement of the management in respect of various accounting policies.
6. Financial statements are prepared primarily for shareholders. Other interested parties have to generally make many adjustments before they use them profitably.
7. Quite often, financial statements do not disclose current worth of the business. Only historical facts are presented and the true current worth is not reflected.

Task Prepare the proforma of key financial statements.

Self Assessment

Fill in the blanks:

13. The financial statements are based on certain accounting ……..
14. Financial statements are prepared primarily for ……...
15. Financial statements only reflect the progress and position of the business at frequent …… during its life.

11.5 Summary

- Accounting is the language of business throughout the world. Every business organization keeps its financial records so that the parties interested, can have an analysis through it.
- A financial statement is summarised data, collected and organised according to logical and consistent accounting procedure.
- Financial statements are the most important way of periodically presenting to parties outside the business the information that has been gathered and processed in the accounting system.
- The accounting system generates accounting information in the form of financial reports. There are two major categories of these reports: External and Internal.
- External users have limited access to an organisation's valuable information. The success of their decisions depends upon the use of external reports that are reliable, relevant and comparable.

Notes

- Internal users are the individuals who are directly involved in managing and operating the organisation.
- Both internal and external users rely on internal controls to monitor the company's operations.
- Publicly owned companies are required to periodically publish general-purpose financial statements that include a balance sheet, an income statement, and a statement of cash flows.
- Financial statements are essentially interim reports and therefore, cannot be final because the final gain or loss can be computed only at the termination of the business

11.6 Keywords

Accounting: Accounting means recording each transaction that takes place and further, summarizing the records for financial communications.

Financial Statement: A financial statement is summarised data, collected and organised according to logical and consistent accounting procedure.

Internal Users: Internal users are the individuals who are directly involved in managing and operating the organisation.

Statement of Cash Flows: These statements provide reports on a company's cash flow activities; particularly it's operating, investing and financing activities.

11.7 Review Questions

1. Accounting is the language of business throughout the world. Discuss.
2. What do owners expect from the business records?
3. What do lenders expect from the business records?
4. Each external user has special information needs depending on the kind of decisions he has to take. What are the key informations required by different external users?
5. Discuss the limitations of financial statements and point out how these limitations can be removed through management accounting.

Answers: Self Assessment

1. Accounting
2. Financial statement
3. Accounting system
4. Financial reports
5. Internal
6. Effectiveness
7. Production
8. Research & Development
9. Financial statements

Notes

10. Footnotes
11. Investing activities
12. Accounting standard -3 (AS -3)
13. Concepts and conventions
14. Shareholders
15. Intervals

11.8 Further Readings

Books

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Online links

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Unit 12 : Analysis of Financial Reporting Framework

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Objectives

After studying this unit, you will be able to:

- Describe the application of financial reporting framework
- Identify the strengths and weakness of accounting framework

Introduction

The purpose of reporting is to provide the information needed by the concerned party. The value of information is determined by how the information meets the needs of the users. This information creates an atmosphere for internal decision makers. The communication of the information between two or more parties through reports is known as reporting. Report is the essence of the management information system.

Did u know? **What are accounting reports?**

Report is a statement containing facts and if they contain accounting information and data they are called accounting reports.

So, report may be known as process of providing accounting information to those who needs to make decisions. Report may be for the past, present and for the future developments.

12.1 Applications of Financial Reporting Framework

Accounting reports consist of financial statistics. Management cannot analyse all significant facts regarding its business especially in case of large scale production where the business operations are more complex in nature. Accounting reports helps to get full information about the entire operative activity of the firm.

Notes

Need of reporting differs at different management levels. This also differs to the user community also. There are three levels of management and the reports can be classified according to the needs as follows:

- Top-Level Management Reports
- Middle Level Management Reports
- Lower Level Management Reports

12.1.1 Top Management Reports

At this level reports are concerned with the following matters:

- For determining the aims of the enterprise
- For formulation of policies and plans
- For delegation of responsibility in successful manner to executives for the best utlisation of resources
- For formulating special significant plans

It can be assumed that top brass of the business only needs reports for cost and operational control. The report submitted to the level should be brief or we can call it a summarized statement, which provides an overall view on the subject. Previously these reports used to be submitted within the time framework. The time framework may be monthly, quarterly or yearly. With the use of information technology and the real time accounting, the whole time framework has been changed and now these can be made available online.

Reports to top level management consist of the following:

1. Reports to the Board of Directors
2. Reports to the Chief Finance Officer
3. Reports to the Chief Production officer
4. Reports to the Chief Executive Marketing and Sales

Task Identify the key records prepared by the Board of Directors and CEO.

12.1.2 Middle Level Management Reports

The middle level management consists of the heads of various departments. The reports at this level should show the efficiency and cost data relating to different departments. At this level execution of plans formulated by the top management is worked out and all the managers in each department are concerned with this. It is also the function of middle level management to coordinate different activities of different departments.

12.1.3 Lower Level Management Reports

At this level foremen and supervisors are concerned at the floor and they prepare their reports physically without any expert opinion. They are concerned with the daily work and they infuse a certain amount of competitive spirit among the workers by comparing the output per man per hour in a similar job. These reports include the following factors:

Notes

- Workers efficiency report,
- Daily production report,
- Workers utilization report and
- Scrap report
- Overtime report
- Material spoilage report
- Accident report etc.

Self Assessment

Fill in the blanks:

1. …….. is the essence of the management information system.
2. Report is a statement containing facts and if they contain accounting information and data they are called …….
3. At lower level foremen and supervisors are concerned at the floor and they prepare their reports …… without any expert opinion.
4. The communication of the information between two or more parties through reports is known as …….
5. It can be assumed that top level of the business only needs reports for …….control.
6. The reports at …….. level should show the efficiency and cost data relating to different departments.

12.2 Strengths and Weakness of Accounting Framework

Accounting reports consist of financial statistics. Management cannot analyse all significant facts regarding its business especially in case of large scale production where the business operations are more complex in nature. Accounting reports helps to get full information about the entire operative activity of the firm.

The key strengths and weakness of accounting framework can be describes as follows:

12.2.1 Strengths of Accounting Framework

The following are the key strengths of a accounting framework:

1. ***Providing accounting information:*** Accounting reports consist of financial statistics. Management may not analyse all significant facts regarding its business operations especially in case of large scale production where the business operations are more complex in nature. Accounting reports help to get full information about its entire operative activity of the firm. Thus important objective of the reporting is to provide accounting information to operating and top level management in accurate form in understandable brief manner.
2. ***To take right decision:*** To help the management in taking the right decisions with suitable statements provided by the management accountant.
3. ***Acceptability of the decision by all:*** Reporting leads to motivate people, increases efficiency and boosting the morale of the people engaged in the various aspects of the work of the enterprise.

Notes

4. ***Maximizing the profits:*** To achieve this ultimate goal of any business reporting at the right time, at right place to the right person in right manner becomes an essential feature.

5. ***For better control:*** Abnormal events can be checked in time by obtaining the necessary information in respect of each operating activity. Control through reports become effective as compared to personal investigations.

12.2.2 Weakness of Accounting Framework

Financial reports are incapable of providing all relevant information. There are a number of reasons including those related to the nature of the financial accounting processes, and those related to cost and benefit considerations. Financial reporting is not an adequate source of information needed by users of the reports. They also need to consider pertinent information from other sources. The users of accounting informations should aware about the weaknesses of accounting framework.

The following are some weakness of accounting framework:

1. Financial accounting is concerned mainly with measuring the financial effect of transactions and other events on the entity's financial position, results of operations and cash flows.

   Accordingly, financial accounting is not usually able to produce information to assist in the evaluation of the entity's ability to achieve objectives that are not capable of financial measurement in an objective manner.

2. Financial accounting does not differentiate, through its processes, between the entity's performance and that of its management. Although, management's ability is one of the important factors that affect the entity's performance, there are other factors beyond management control which affect the entity's performance such as natural disasters and external political and economic changes. Accordingly, it is not possible for financial accounting to provide information which can assist in evaluating management's performance aside from the entity's performance.

3. The information currently provided by financial accounting is predominantly historical in nature which may or may not be indicative of the future. Yet, decisions made by those who need this information are usually concerned with the future impact of alternative courses of action.

4. To a significant extent, financial reporting information is based on estimates, judgments and models of the financial effects in an entity of transactions and other events and circumstances that have happened or that exists rather than on exact depictions of those effects. The framework establishes the concepts that underlie those estimates, judgments and models and other aspects of financial reporting.

Self Assessment

Fill in the blanks:

7. Accounting reports helps to get full information about the entire ……. activity of the firm.

8. Accounting reports consist of ……..statistics.

9. Financial accounting is concerned mainly with measuring the ……effect of transactions.

10. Financial accounting is not usually able to produce information to assist in the evaluation of the entity's ability to achieve objectives that are not capable of ……..in an objective manner.

Notes

Caselet

Case: Tata group in Global Financial Reporting Panel

The Tata Group has joined the select group of international companies such as Nestle, EDF, HSBC and others to launch an initiative, the International Integrated Reporting Committee (IIRC), aimed at overhauling international company reporting in the wake of the recent financial crisis.

Mr Ishat Hussain, Group Finance Director, Tata Sons, has been inducted into the steering committee of London-based IIRC. When contacted, a spokesman for the Tata Group confirmed it. No other Indian company has representation in the committee.

The move to form IIRC was initiated in December 2009 when The Prince of Wales convened a high-level meeting of investors, standard setters, companies, accounting bodies and UN representatives.

It was agreed at the meeting that the Prince's Accounting for Sustainability and the Global Reporting Initiative should work together with other organisations to establish and international body to oversee the creation of a generally accepted integrated reporting framework that would connect financial and sustainability reporting.

It was recommended that a working group and a steering committee be formed to establish the IIRC. While the responsibilities of the working group would include drafting proposals for the governance arrangements and developing proposal relating to the scope and content of integrated reporting, the steering committee would provide expert and informed guidance to the working group and consider and adopt, as appropriate, the proposals drawn up the working group.

The steering committee will be chaired by Sir Michael Peat, Principal Private Secretary to The Prince of Wales and the Duchess of Cornwall. The working Committee has co-chairmen, Mr. Paul Druckman, as Executive Board Chairman and Mr. Ian Ball, Chief Executive Officer, International Federation of Accountants.

The big four auditors such as PwC, Deloitte, Ernst & Young, and KPMG, international business schools including Harvard Business School and influential non-profit groups are also involved.

The steering committee, it is learnt, plans to publish later this year a framework for a global integrated reporting model that would make annual reports comparable across borders.

It would be presented to G20 in 2011. The G20 already supports creation of a single set of reporting standards.

Source: http://www.thehindubusinessline.com

12.3 Summary

- Report is a statement containing facts and if they contain accounting information and data they are called accounting reports.
- Accounting reports consist of financial statistics. Management cannot analyse all significant facts regarding its business especially in case of large scale production where the business operations are more complex in nature.

Notes

- Accounting reports helps to get full information about the entire operative activity of the firm.
- The report submitted to the top level should be brief or we can call it a summarized statement, which provides an overall view on the subject.
- The reports at the middle level should show the efficiency and cost data relating to different departments.
- At the lower level foremen and supervisors are concerned at the floor and they prepare their reports physically without any expert opinion.
- Accounting reports helps to get full information about the entire operative activity of the firm.
- Financial reports are incapable of providing all relevant information that might be required by those who use them.

12.4 Keywords

Report: Report is a statement containing facts and if they contain accounting information and data they are called accounting reports.

Reporting: The communication of the information between two or more parties through reports is known as reporting.

12.5 Review Questions

1. Accounting reports helps to get full information about the entire operative activity of the firm. How you will frame a good accounting report?
2. Identify the scope of financial reporting at all the levels of management.
3. List the key reports prepared at middle and lower level.
4. What are the key strengths and weakness of accounting framework?
5. What are the key reports prepared at top level management?

Answers: Self Assessment

1. Report
2. accounting reports
3. physically
4. reporting
5. cost and operational
6. middle
7. operative
8. financial
9. financial
10. financial measurement

12.6 Further Readings

Notes

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

Sudhindra Bhat, *Financial Management*, New Delhi, Excel Books, 2008.

Van Horne, J.C. and Wachowicz, Jr, J.M., *Fundamentals of Financial Management*, New Delhi, Prentice Hall of India Pvt. Ltd., 1996, p. 2.

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Unit 13 : Critical Evaluation of Principles and Practices

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Objectives

After studying this unit, you will be able to:

- Explain the concept of accounting principles
- Evaluate the accounting principles and practices

Introduction

Externally communicated accounting information must be prepared in accordance with accounting standards that are understood by both the senders and the users of that information. These standards are known as Generally Accepted Accounting Principles (GAAP) and provide the general framework for determining what information is included in financial statements and how this information is to be presented. Since accounting is a service activity, these principles reflect the society needs and not those of accountants or any other single constituency. These are the guidelines for measurement and presentation of accounting information and are used by professional accountants in preparing accounting information and reports.

Notes

13.1 Meaning and Concept of Accounting Principles

Accounting principles were historically developed through common acceptance and usage. A principle was acceptable, if most professionals permitted it. These general principles became the basic assumptions, concepts and guidelines for preparing financial statements. Specific principles, based on these general principles, were then developed as detailed rules for reporting business transactions and events. General principles, therefore, stem from long-used accounting practices and specific principles arise more often from the ruling of authoritative groups. Therefore, these specific rules differ may from country to country.

Significant differences in the specific rules create a lot of problems for multinational businesses when they are trying to consolidate accounting information. Therefore, a need was felt to have an international organisation that specifies the accounting standards that can be used throughout the world. International Accounting Standards Committee (IASC) was born as a result of this need. It issues International Accounting Standards (IAS) that identifies preferred accounting practices worldwide and encourages their worldwide acceptance. More and more countries are modifying their practices to confirm to these standards. As expected, India is far behind.

We need an understanding of both general and specific principles to effectively use accounting information. Because general principles are especially crucial in using accounting information, we will discuss them right now. Specific rules are described wherever required and connected with the broad principles so as to help understand their applications in the practical situations.

Notes There are 12 general accounting principles that you should be aware of:

1. Money Measurement
2. Entity
3. Going Concern
4. Cost
5. Dual aspect
6. Accounting period
7. Conservatism
8. Realisation
9. Matching
10. Consistency
11. Materiality
12. Objectivity

Self Assessment

Fill in the blanks:

1. ……were historically developed through common acceptance and usage.
2. Externally communicated accounting information must be prepared in accordance with accounting ……that are understood by both the senders and the users of that information.

Notes

13.2 Analysis of Accounting Principles and Practices

The following are the key accounting principles and their application in financial reporting:

13.2.1 The Money Measurement Concept

Records should be made only of that information that can be expressed in monetary terms. Although the business may own seven buildings, five boilers, fifty cars, thirty trucks, you cannot add them together simply and get to know what the business is worth. Expressing these items in monetary terms by saying that you have buildings worth ₹ 15 crores, boilers worth ₹ 50 lacs, cars worth ₹ 1 crore and trucks worth ₹ 2 crores would make it easier for you to add up these items by adding their monetary values. You cannot add apples and oranges directly but they can be added easily by expressing them in monetary terms.

Thus, money provides a common denominator by which the resources and other factors about the business entity can be expressed and valued. Expressing in monetary terms also helps in understanding the changes their impact on value of the resources.

Example: If R has invested ₹ 200,000 in the "R Enterprise" then it can be recorded in the books of "R Enterprise" but on the other hand if R has put a lot of efforts for the welfare of the company then the efforts can not be measure in terms of money.

As you can see, this concept imposes a severe limitation on the scope of accounting. It is impossible for the accounting to record or report the dearth of the key people of the organisation, or that a plant is not working, that labourers are going on strike, or that key people are leaving the organisation and other important factors that may have a direct bearing on the future of the organisation.

13.2.2 Entity Concept

Accounts can only be kept for entities, which are different from the persons who are associated with these entities.

The business entity principle means that business is accounted for separately from its owner(s). It also means that we account separately for each business that is controlled by the same owner. The reason behind this principle is that different users for decision-making need separate information about each business.

Example: If 'R' has invested cash of ₹2,00,000 in 'R Enterprise' then from the point of 'R Enterprise' on one hand the enterprise has a cash property of ₹2,00,000 and on the other hand, the it has a responsibility to return it to 'R' finally. In accounting terms the property is called asset and the responsibility is called liability.

Thus the 'separate entity' concept helps to identify asset and liability of the business. It also helps to look at two sides of the same transaction. Here, on one side the business 'R Enterprise' is able to consider ₹ 2,00,000 cash as asset and on the other the same is a liability towards the owner 'R'. In a similar way suppose 'K' has agreed to lend ₹ 3,00,000 to 'R Enterprise' for some reason. Now the property side increases by ₹ 3,00,000 cash while there is an additional liability towards 'K' let us write these in a format. (Show the above in a T form)

Notes

R Enterprise

Property or asset (₹)	Responsibility or liability (₹)
Cash from R 2,00,000	Towards R 2,00,000
Cash loan from K 3,00,000	Towards K 3,00,000

As a matter of practice and conventionally we could show the above as follows

R Enterprise

Liabilities	Assets
R 2,00,000	Cash 5,00,000
K 3,00,000	

The second one is acceptable globally. We thus introduced here how 'one' transaction can have two faces just as a coin has two faces. This has its own conveniences too. It is easy to verify or cross check in case one of them is recorded wrongly. You would notice that it helps to keep the two sides balanced i.e. the total of each side is equal (₹ 5,00,000)

Caution In sole proprietorships and partnerships, it is difficult to separate the entity from the owners, as there is no distinction as per the law between the financial affairs of the partnership and the partners or the proprietorship concern and the proprietor. The difficulties in separating the expenses of the partners or the proprietor from the concern make it easier for them to pass on their personal expenses to the concern. This is precisely the reason why a lot of proprietorships and partnership concerns hardly pay any income tax.

For a company, this distinction is easier to make because company maintains separate legal identity and its accounts correspond exactly to the scope of its activities.

13.2.3 The Going Concern Concept

Accounting records, events and transactions on the assumption that the entity will continue to operate for an indefinitely long period of time.

Unless there is strong evidence to the contrary, accounting assumes that an entity is a going concern. The significance of this assumption can be seen by contrasting it with another possible alternative, i.e., that the concern would be liquidated. Under the latter assumption, accounting should attempt to measure what the entity's resources are currently worth to potential buyers. The going concern concept assumes that the resources currently available to the entity will be used in its future operations.

This helps in distributing the effects of big expenses over several periods because their benefits also accrue over several periods.

13.2.4 The Cost Concept

Assets are always shown at their cost and not at their current market value. One of the most fundamental concepts of accounting, the cost concept says that the asset is ordinarily entered into the accounting records at the actual cost incurred to acquire it. Cost is measured on a cash or equal-to-cash basis. This means if cash is given for an asset or service, its cost is measured as the

Notes

amount of cash paid. If something besides cash is exchanged (such as a car traded for a truck), cost is measured as the cash equivalent of what is given up or received. We know that the real worth of asset may change over a period of time so the value in the accounting records may not reflect the real value of the assets owned by the concern. Land purchased in 1975 for ₹ 5 lacs and a car purchased for ₹ 5 lacs in 1999 would both be recorded at these respective values in the books of accounts. Irrespective of the fact that the land could be worth ₹ 5 crores today and the car would be worth ₹ 3 lacs now. Accountants are fully aware of this fact but do not attempt to reflect such changes in the accounts, as there could be significant differences in values estimated by different entities.

The cost concept does not mean that all assets will remain in the accounting records at their original purchase price. The cost of the asset that has a long, but limited, life is systematically reduced over that life by the process of depreciation. The purpose of the depreciation process is to systematically remove the cost of the asset from the account and show it as the cost of operations. Still, depreciation has no necessary relationship to changes in market value or to the real worth of the asset.

To emphasise the distinction between the accounting concept and value, as we understand it, the term book value is used for the historical cost amounts as shown in the accounting records and the term market value for the actual value of the asset in the market.

The cost concept provides an excellent illustration of the objectives of the accounting principles; relevance, objectivity and feasibility. These three criteria can often conflict with each other. For example, if a company develops a new product, it can have a significant effect on the real value of the company. This information of the new product is very relevant to the creditors and the investors as also the internal users but the value of this product would normally be estimated by the management and is highly subjective. Therefore, accounting does not attempt to record such values thereby sacrificing relevance in the interest of objectivity. Therefore, the cost concept fulfils the criteria of objectivity and feasibility but does not fulfil the criteria of relevance. It is not purely objective also but is relatively more objective than estimating market values and reporting them.

13.2.5 The Dual Aspect Concept

The value of the assets owned by the concern is equal to the claims on these assets. The fundamental accounting equation is the formal expression of the dual aspect concept. All accounting procedures that we will discuss later are derived from this equation. The equation is written as:

Assets = Liabilities + Owner's Equity

Economic events, which are recorded in the accounting system, are called transactions.

Did u know? **What is double entry system of accounting?**

Every transaction that an organisation undertakes has a dual impact on the accounting records, i.e., it will have an impact on two (or more) accounts simultaneously. This is why accounting is also called a double-entry system.

Example: Suppose that Ms. Sharda starts a dry-cleaning business and her first act is to buy an industrial washing machine for ₹ 1 lac with her own money. The dual aspect of this transaction would be that a proprietorship business now has an asset, an industrial washing machine, of ₹ 1 lac and Ms. Sharda, the owner, has a claim of ₹ 1 lac against this asset. Putting this in the above equation, we get

Notes

Assets (Industrial Washing Machine), ₹ 1 lac = Liabilities + Owner's Equity, ₹ 1 lac

Ms. Sharda borrows another ₹ 3 lacs from the bank for buying a shop. This will change her accounting records in two ways:

1. It would show ₹ 3 lacs increase in cash on the asset side, and
2. On the right hand side, it would show a liability of ₹ 3 lacs, which is the bank's claim against the asset.

Cash	= ₹ 3 lacs	Owner's equity	= ₹ 1 lac
Machinery	= ₹ 1 lac	Bank loan	= ₹ 3 lacs
Total Assets	= ₹ 4 lacs	Total liabilities	= ₹ 4 lacs + Owner's Equity

There is no conceivable way that a transaction can result in only a single change in the accounts. There is another system where only a single entry is maintained for every transaction but companies cannot use this system in India, as the Companies Act does not allow it.

13.2.6 The Accounting Period Concept

Accounting measures activity for a specified interval of time, usually a year. Net income is easy to measure if you are only dealing once but the company deals constantly and we expect the company to continue forever (remember going concern principle). Therefore, it becomes difficult to find out whether the business is earning anything or not. Both the managers and external users are unwilling to wait for the closure of the business to know how the business has fared. They need to know how things are going in the business at frequent intervals. This leads to the accounting period concept. The first author of a known accounting text, Pacioli, wrote in 1494; "Books should be closed each year, especially in a partnership, because frequent accounting makes for long friendship." Therefore, the books of the organisation are closed at regular intervals (usually a year) and the financial statements prepared for reporting purposes. The Companies Act also requires that a report should be prepared annually for reporting purposes and income tax reporting is also on an annual basis.

In India, the majority of the businesses follow 'April 1—March 31' (April of this year and March of next year) as the accounting year (also known as fiscal year) but many businesses also use calendar year as the accounting year, especially the multinational companies. This is because its makes it easier for them to club the result of their activities with the parent companies overseas which normally use calendar year as the accounting year. Still, they have to prepare and report to income tax authorities following the 'April 1– March 31' accounting year. The accounting period for shareholder reporting purposes could be more or less than one year but for taxation purposes it remains the same.

For internal reporting, there is no time period specified anywhere. Companies can use any period that they want to as computerisation have made it easier for them to take out accounting reports as and when required. Still, many of the companies, which are not dependent on the computers, commonly use a month as the reporting period. SEBI requires that the companies that are listed on the stock exchanges should issue quarterly income statements for the benefit of the external users.

13.2.7 The Conservatism Concept

Anticipate no profits but provide for all possible losses. Like most humans, managers have a tendency to give a favourable report of the working of the entity that is under them. Accounting safeguards are designed to offset this natural tendency of optimism. The idea behind this principle is that the recognition of increase in entity's earnings requires better evidence then does the

Notes

expenses. For example, if customer signs an MoU for buying ₹ 10 lacs worth of products you would not recognise this revenue in your accounting system because the products have not changed hands and no transaction has taken place. You will only recognise the revenue once the sale is made and the product is delivered to the customer so that you have a legal right to claim payment. Now you can say that only the product has been delivered but the money has not come in so you should not recognise the sale till the time the money is paid. A cash system of accounting does exactly that. But the point this product has been given to him, he is under a legal obligation to pay you the amount that is due to you. Therefore, under the accrual system of accounting, you would recognise that this sale as revenue and the customer owns you money till the time he pays up. Now this debt could also become a bad debt (money owned to you but never paid) and therefore, you would provide for some losses that can happen due to bad debt even before they happen depending upon the past experiences with your debtors.

The conservatism principle therefore, has two aspects:

1. Recognise revenues only when they are reasonably certain
2. Recognise expenses as soon as they are reasonably possible

These guiding principles are used while deciding the period in which the expenses and the revenues fall in. Obviously, it leaves certain gaps in deciding what is meant by reasonably certain and reasonably possible in various situations. Accounting standards do provide certain guidelines for many specific problem areas but their abuse is quite common in India.

Therefore, you have to provide for losses that you reasonably expect but not the revenues that you may expect in the future to make the accounting figures reflects a conservative approach.

13.2.8 The Realisation Concept

The sale is considered to have taken place only when either the cash is received or some third party becomes legally liable to pay the amount.

We have just learned from the conservatism principle when the revenue should be recognised. Realisation concept indicates the amount and revenue that should be recognised from a given sale. The concepts states that the amount recognised is the amount that is reasonably certain to be realised. Note the words 'reasonably certain'. Differences of opinion are there when interpreting what is 'reasonably certain.'

The concept allows for the amount of the revenues recognised to be less than the selling price of the goods or services sold. If the products are sold at a discount, then the revenue is recorded at the lower amount and not at the normal price (also called the list price). When the goods are sold on credit, you can never be sure of the amount that would be realised, so, you provide for bad debts also.

13.2.9 The Matching Concept

When an event affects the revenues and expenses, the affect on each should be recognised in the same accounting period.

As you already know, the sale of the products has two aspects:

1. Revenue aspect
2. Expense aspect

Revenues earned because the sale is going to fetch you some money and expenses incurred for producing that product or providing that service. Correct measurement of the net effect of the sale and expenses in any accounting period can only be made when you match the relevant expenses to its related sales. Otherwise, it will allow a lot of freedom for not showing the true

profitability of the business. If you want to increase the profits, you can show the sales but not the expenses and vice versa if you want to reduce the profits for any given period. Therefore, the matching principle is applied by first determining the items that constitute revenues for the period and their amount in accordance with the conservatism concepts and then matching items of cost to these revenues. The only problem is to determine which costs match with these revenues and hence, are expenses for the period.

13.2.10 The Consistency Concept

The accounting policies and methods followed by the company should be the same every year. The consistency concept states that once an entity has decided on one method, it should use the same method for all subsequent events of the same character unless it has a sound reason to change the method. This is done because frequent changes in the manner of handling same type of events, would make it very difficult for the external users to compare financial statements over different periods. The term consistency as used here refers to consistency over a period of time and not the logical consistency. The external auditors have to specify in their reports if the company is changing any of its policies or methods and the effect of these changes on the reported figures.

13.2.11 The Materiality Concept

Insignificant events would not be recorded if the benefit of recording them does not justify the cost.

In law, there is something called 'de minimis non curat lex', which means that the court will not consider trivial matters. Similarly, the accounting does not attempt to record events so insignificant that the work of recording them is not justified by the usefulness of the results. For example, when the pencils are issued to the employees they are written off as expenses even though when they may be used over a period of time and are assets of the organisation. This is done because keeping a track of the use of the pencil would require more expenses and does not serve any real purpose, as the value of the item is too small. In other words, insignificant events will be clubbed together and recorded because the organisation has to account for every single paisa.

The line separating material events from immaterial events is so thin that the decision depends only on judgement and common sense. The guiding force is to look at the expense in the light of the total expense and see whether any real benefit could be served by going into the details of that item. The concept is very useful when estimating the costs associated in any particular accounting period and revenues. Because many of them would not be very close estimates and it may not be worthwhile to attempt to refine these estimates and make these more exact.

But you should remember that there is no definitive rule that separates material information from immaterial information. So, the materiality concept may be taken to mean that although insignificant events may be disregarded but there must be full disclosure of all-important information.

13.2.12 The Objectivity Concept

An evidence of the happening of the transaction should support every transaction. The objectivity principle means that financial information is supported by independent and unbiased evidence. It involves more than one person's opinion. Information is not reliable if it is based only on preparer's perception. A preparer can be too optimistic or pessimistic. An unethical preparer might even try to mislead users by intentionally misrepresenting the truth. The objectivity principle is intended to make financial statements useful by ensuring that they report reliable and verifiable information.

Notes

Caselet

Case: Rule versus Principle

Students of accounting would be well aware of the long discussed differences between rule-based accounting and principle-based accounting. Both have their protagonists. While the US GAAP is rule-based, the International Accounting Standards (IAS), both as IAS and IFRS, are principle-based.

The debate on which is better will be put to rest when the US GAAP converges with IFRS eventually and becomes principle-based. Being principle-based means that broad principles are laid out by the standard-fixing body and the interpretation is left to the users of these standards.

The problem (and also the benefit) with principle-based accounting is that most of the times, in a situation which requires a finding, one would have to exercise a great deal of judgment based on substance as opposed to a readymade solution being available for a particular issue prescribed in the rule-based accounting.

While the US accounting is considered to be rule-based, one can find echoes of principle-based accounting also in it. In the widely publicised 1969 case of Continental Vending where the auditors were questioned for lack of professional standards, the court gave a direction to the jury to look at the facts and the substance of the case rather than rules of accountancy and mere adherence to GAAP.

The court held that in the audit report the statement "fairly presented … in accordance with generally accepted accounting principles" is two statements rather than one, i.e., "fairly presented" is principle-based and the other "in accordance with generally accepted accounting principles" is rule-based.

Problems for Auditors

The preparation of financial statements in accordance with the GAAP in a rule-based environment, however, presents problems to the auditors. If an auditor were to confront the management over a certain treatment of a transaction, the management is likely to ask the auditor "show me where it says I can't do that".

In other words, in a rule-based environment, the onus is on the auditor to demonstrate clearly that the particular treatment is not permitted and hence closes the avenues for the auditor to develop further arguments that would be available in a principle-based accounting environment (Principles-based Accounting, by Ronald M. Mano, Matthew Mouritsen and Ryan Pace, published in the CPA Journal, February 2006).

Since accounting standards followed in India have their origin in the IAS, the Indian accounting standards are principle-based. However, there are exceptions to the rule. One prime example is the Income Recognition and Asset Classification (IRAC) norms prescribed by the Reserve Bank of India for provisioning for non-performing assets applicable to banks.

Thus, if any asset is non-performing, based on certain prescribed criteria, a provision is created for the potential loan loss irrespective of the security available with the bank.

Subjectivity Issue

Principle-based accounting has its own issues too. Ian Wright, Director of Corporate Reporting at the Financial Reporting Council of UK, writing in accountancy magazine (October 2008), talks about the subjectivity that is present in the IFRS.

Contd...

Notes

The IFRS is full of words and phrases that are open to interpretation. The accompanying table has a selection of the probabilities in IFRS literature that a user is expected to interpret in the context of understanding what an accounting standard requires.

Ian Wright also identifies other issues that are potentially problematic.

The IFRS literature contains an increasing range of technical terms which don't translate well into languages other than English. Also, the standards were written in different eras and sometimes by individual national standard-setters due to which the usage of the English language differs resulting in them being structured in disparate ways.

One can therefore see the potential hazards in interpreting a principle-based accounting standard that contains highly subjective phraseology.

In this context, one can expect problems of interpretation in India also. For instance, the word "shall" (a key word in accounting standards) is used in a manner that is completely different from its usage in countries where English is the mother tongue. Any user of IFRS would therefore need to be alive to these issues when interpreting IFRS.

Source: www.thehindubusinessline.com

Self Assessment

Fill in the blanks:

3. Records should be made only of that information that can be expressed in ..... terms.
4. The business entity principle means that business is accounted for ..... from its owner(s).
5. Assets are always shown at their cost and not at their current .....
6. Assets = ... + Owner's Equity
7. Accounting records, events and transactions on the assumption that the entity will continue to operate for an ..... long period of time.
8. Cost is measured on a cash or .....basis.
9. The ..... is considered to have taken place only when either the cash is received or some third party becomes legally liable to pay the amount.
10. The ..... principle means that financial information is supported by independent and unbiased evidence.

Task Compare the Indian accounting principle with the accounting principles used in US.

13.3 Summary

- Externally communicated accounting information must be prepared in accordance with accounting standards that are understood by both the senders and the users of that information.
- Accounting principles were historically developed through common acceptance and usage.

Notes

- A principle was acceptable, if most professionals permitted it.
- There are 12 general accounting principles.
- Records should be made only of that information that can be expressed in monetary terms.
- Accounts can only be kept for entities, which are different from the persons who are associated with these entities.
- Accounting records, events and transactions on the assumption that the entity will continue to operate for an indefinitely long period of time.
- Assets are always shown at their cost and not at their current market value.
- The value of the assets owned by the concern is equal to the claims on these assets.
- Accounting measures activity for a specified interval of time, usually a year.
- Anticipate no profits but provide for all possible losses.
- The sale is considered to have taken place only when either the cash is received or some third party becomes legally liable to pay the amount.
- When an event affects the revenues and expenses, the affect on each should be recognised in the same accounting period.
- The consistency concept states that once an entity has decided on one method, it should use the same method for all subsequent events of the same character unless it has a sound reason to change the method.
- Insignificant events would not be recorded if the benefit of recording them does not justify the cost.
- The objectivity principle means that financial information is supported by independent and unbiased evidence.

13.4 Keywords

Accounting Conventions: Customs and traditions which guide the accountants to record the financial transactions.

Accounting Process: It includes the recording of financial transactions, ledger posting, preparation of financial statements and analyzing and interpretation of them.

Cost Accounting: Accounting relating to the ascertainment of cost of the product.

Management Accounting: Presenting of accounting information in such a way as to assist the management in taking the important decisions and making the policies.

13.5 Review Questions

1. Why accounting principles are important for preparing the financial reports?
2. Identify the key accounting principles of financial reporting.
3. Records should be made only of that information that can be expressed in monetary terms. Discuss.
4. The business entity principle states that business is accounted for separately from its owner. Illustrate with a suitable example.

Notes

5. Illustrate the concept of dual aspect.
6. When an event affects the revenues and expenses, the affect on each should be recognised in the same accounting period. Why?
7. Anticipate no profits but provide for all possible losses. Discuss the statement with suitable examples.
8. According to cost concept assets should be shown at their cost and not at their current market value. Why?

Answers: Self Assessment

1. Accounting principles
2. standards
3. monetary
4. separately
5. market value
6. Liabilities
7. indefinitely
8. equal-to-cash
9. sale
10. objectivity

13.6 Further Readings

Books

Chandra, P., *Financial Management - Theory and Practice*, New Delhi, Tata McGraw Hill Publishing Company Ltd., 2002, p. 3.

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Unit 14: Forensic Accounting

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Objectives

After studying this unit, you will be able to:

- Define forensic accounting;
- Explain the characteristics of forensic accounting;
- Identify the scope of forensic accounting;
- Describe the financial statements frauds.

Introduction

The concept of forensic accounting is a rapidly growing area of accounting. The term forensic accounting is concerned with the detection and prevention of business fraud and related white-collar crimes. Forensic accounting is different from financial auditing. Financial auditing is performed by certified charted accountants to check the regulations of financial statements of an organisation. On the other hand forensic accounting is performed by an expert in the field to verify information or to investigate frauds.

Caution Forensic accounting requires the expertise to identify that someone is lying or not telling the whole truth.

14.1 Meaning and Concept of Forensic Accounting

Forensic accounting is the specialized practice area of accounting. The term 'Forensic' means "suitable for use in Court," and it is to that standard and potential outcome that forensic

accountants generally have to work. The forensic engagement is distinguished by engagement objective, emphasis on gathering evidence, and the application of a variety of techniques often custom-developed to the requirements of the specific engagement.

The definition of forensic accounting is changing in response to the growing needs of corporations.

"Forensic Accounting is the application of accounting principles, theories and discipline to facts or hypothesis at issues in a legal dispute and encompasses every branch of accounting knowledge" AICPA.

"Forensic Accounting is a science that deals with the relation and application of finance, accounting, tax and auditing knowledge to analyse, investigate, inquire, test and examine the mater in civil law, criminal law in an attempt to obtain the truth from which to render an expert opinion" Horty.

Simply we can say that forensic accounting includes the use of accounting, auditing, and investigative skills to deal with the legal matters. It consists of two major components: litigation services that recognise the role of an accountant as an expert consultant, and investigative services that use a forensic accountant's skills and may require possible courtroom testimony.

Self Assessment

Fill in the blanks:

1. Forensic accounting is the ……..practice area of accounting.
2. Financial auditing is performed by …….to check the regulations of financial statements of an organisation.
3. Forensic accounting includes the use of accounting, auditing, and investigative skills to deal with the …….matters.
4. Forensic accounting consists of two major components: litigation services and …….. services

14.2 Characteristics of Forensic Accounting

The following are the key characteristics of forensic accounting:

- Forensic Accounting involves the use of accounting/ auditing, investigative skills and data mining as an audit tool
- It emphasizes a forensic approach in place of a risk management approach to the analysis of corporate governance
- The objective of forensic accounting is to check up for cyber frauds, prevention and detection.
- The key industries requiring the forensic accounting are insurance companies, banks, police, and government agencies considering the growing incidence of cyber crimes or frauds and corporate failures
- Chartered Accountants, with their sound grounding in accounting/auditing/business requirements/legal requirements, are the most appropriate professionals to offer Forensic Accounting and Fraud Detection service.

Did u know? **What is the meaning of cyber crime?**

Cyber crimes may be defined as unlawful acts wherein the computer is either a tool or a target or both.

Notes

Self Assessment

Fill in the blanks:

5. Forensic accounting emphasizes a forensic approach in place of a …….approach to the analysis of corporate governance.
6. Forensic Accounting involves the use of accounting/ auditing, investigative skills and data mining as an …….tool.

14.3 Forensic Accounting Engagement

A forensic accountant has to analyse, interpret, summarise and present complex financial and business-related issues for investigation.

Coenen (2005) identify the following as areas of specialty in forensic accounting:

- Investigating corporate fraud
- Litigation services
- Business valuation
- Computer forensic

However, Zysman (2001) in a more elaborate form captured the assignment performed by forensic accountant as including:

- Criminal investigation, which are usually on behalf of the police with the aim of presenting evidence in a professional and concise manner.
- Shareholders and partnership dispute that involve analysis of numerous year financial record for valuation and qualification of the issue in dispute;
- Personal injury claim, where for example economic losses from motor accident or wrongful dismissal may need to be quantified.
- Business interruption and other type of insurance claim. These assignments involve a detailed review of the policy to investigate coverage issues and the appropriate methods of calculating the loss.
- Business/employee fraud investigations which can involve fraud tracing, asset identification and recovery, forensic intelligence gathering and due diligence review.
- Business economic losses, where contract disputed, construction claims, expropriation, product liability claim and trade mark are the issues.
- Professional negligence, to ascertain the breach and quantify the loss involved, and
- Mediation and arbitration, as a form of alternative dispute resolution.

14.4 Skill Requirement of Forensic Accountant

A Forensic Accountant should have the following characteristics:

- curiosity
- persistence
- creativity
- discretion
- organization

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- confidence
- sound professional judgement

A Forensic Accountant must be open to consider all alternatives, scrutinize the fine details and at the same time see the big picture. In addition, a Forensic Accountant must be able to listen effectively and communicate clearly and concisely.

14.5 Scope of Forensic Accounting

Forensic accounting encompasses both litigation support and investigative accounting.

Litigation support provides assistance of all nature in a matter involving existing or pending litigation. It deals primarily with issues related with the quantification of economic damages, while investigative accounting is associated to the investigation of criminal matters (Zysman, 2001). Under litigation support, forensic accountant assist in:

- Obtaining document necessary to support or refute a claim
- Reviewing of the relevant documentation to form an initial assessment of the case in an identified area of loss
- Examination for discovering, including the formulation of the act regarding the financial residence
- Attendance at the examination for discovery to review the testimony, assist with understanding the financial issues and to formulate additional questions to be asked

Investigative accountant on the other hand;

- reviews factual situation and provides suggestions regarding possible courses of action
- assist with the protection and recovery of assets
- Co-ordinate other experts (Zysman, 2001).

Self Assessment

Fill in the blanks:

7. Forensic accounting encompasses both ……..and investigative accounting.
8. ……provides assistance of all nature in a matter involving existing or pending litigation.
9. Investigative accounting is associated to the investigation of ……matters.

14.6 Difference between Forensic Accountant and Auditors

The following table explains the key differences between a forensic accountant and auditor:

Forensic Accountant	Auditor
1. Forensic accountants are public accountants that have completed specialized training in the investigation of crimes such as bankruptcies, fraud, contract disputes and other criminal financial actions.	1. Auditors work to ensure their organization is running efficiently and that mismanagement of funds, waste of resources, or fraudulent activities are not occurring.

Contd...

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2.	Forensic accountants use their expertise in accounting to determine when illegal transactions and activity have taken place.	2.	Auditors also manage financial records and internal information to verify accuracy of employees and technology-based practices.
3.	Forensic accountants, however, will look at nearly every transaction in their area of inquiry, checking to whom money was sent and whether there was adequate documentation for a transaction or series of transactions. They are also much more proactive and skeptical in their confirmation of financial transactions.	3.	Auditors try to look at a representative sample of transactions, working under the assumption that if a few transactions follow generally accepted accounting principles, then all similar transactions likely follow those principles.

14.7 Forensic Accounting Process

Zysman (2005) outlined the following steps in executing Forensic Accounting engagement;

1. Meet with the client to obtain an understanding of the important facts, players and issues at hand.
2. Perform a conflict check as soon as the relevant parties are established.
3. Perform an initial investigation to allow subsequent planning to be based upon a more complete understanding of the issues.
4. Develop an action plan that take into account the knowledge gained by meeting with the client and carrying out the initial investigation and which will set out the objectives to be achieved and the methodology to be utilized to accomplish them.
5. Obtain the relevant evidence: This may involve locating documents, economic information, asset, a person or company, another expert or proof of the occurrence of an event.
6. Perform the analysis: This may involve:
   - calculating economic damages
   - summarizing a large number of transactions
   - performing a tracing of assets
   - performing present value calculations utilizing appropriate discount rates
   - performing a regression or sensitivity analysis
   - utilizing a computerized application such as spread sheet, data base or computer model
   - utilizing charts and graphics to explain the analysis
7. Prepare the report. Often a report will be prepared which may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitation of scope and findings and/or opinions. The report will include schedules and graphics necessary to properly support explain. Joshi, (2003) stated that the job demands reporting, where the accountability of the fraud is established and the report is considered as evidence in the court of law or in the administrative proceeding.

Self Assessment

Fill in the blanks:

10. ……. work to ensure their organization is running efficiently and that mismanagement of funds, waste of resources, or fraudulent activities are not occurring.

Notes

11. ……..use their expertise in accounting to determine when illegal transactions and activity have taken place.

Caselet

Case: Forensic Accounting to Prevent White-collar Frauds: ICAI

With corporate accounting frauds on the rise, the Institute of Chartered Accountants of India (ICAI) has decided to promote forensic accounting to equip chartered accountants with adequate tools to detect white-collar crimes and identify malpractices like money laundering and routing terrorist funds.

Pointing out that it is difficult to detect sophisticated frauds through traditional accounting methods, ICAI President Ved Jain said, "Forensic accounting will help professionals to deal with this new problem in the corporate world."

The emphasis of the ICAI on forensic accounting comes in the backdrop of the US financial meltdown, caused due to misreading risks involved in complex derivative instruments by credit rating agencies and other investors.

Similar, the $50 billion fraud by Wall Street trader Bernard Madoff reinforces the need for a stronger accounting system. Madoff siphoned off billions of dollars through fake bogus investment schemes.

Forensic accounts, Jain said, "will encompass the use of accounting and auditing skills and will use computers as an audit tool. Chartered accountants will be trained in forensic accounting". Forensic accounting, which includes data mining and fraud detection, will provide India Inc., private equities and other stakeholders an effective tool to verify the accounts of companies and present a clear and transparent picture of the financial health of the entity concerned, Jain said.

Under the current dispensation a chartered accountant is trained to verify and check books of accounts, he said, adding with the development of new business practices and evolution of complex company structures, new skill sets are needed to identify accounting frauds.

Welcoming the decision of the ICAI to promote forensic accounting, KPMG Executive Director Neville M Dumasia said investors are becoming cautious with the rising number of frauds and PE investors, wanting to invest in companies, are opting for this mode of auditing to have a true picture of the books of accounts.

Improvement in accounting practices, he added, is the best way to curb white-collar frauds, like in the case of France-based Societe Generale, and check money laundering, in addition to keeping a tab on terrorist money flowing into the country.

Grant Thornton's India head Vinod Chandiok said companies are increasingly looking at newer methods to scrutinise the books of accounts, a practice that still is in initial stages in India.

Forensic account, he said, can also help in resolving disputes pertaining to failed joint venture agreements, ascertaining economic damages and fixing monetary liabilities.

Banks and financial institutions can also adopt forensic accounting to detect internal frauds and those committed by customers and outsiders, he added.

Source: http://www.business-standard.com

Notes

14.8 Financial Statements Frauds

In recent years financial statement fraud is a major problem for most of the companies. It is observed that people in positions of power within organizations sometimes intentionally mislead investors and creditors with deliberately inaccurate financial statements. The financial statements frauds include the following:

- The falsification, alteration or manipulation of material financial records
- Material, intentional omissions or misrepresentations of events, transactions, accounts, or other vital information used in preparation of financial statements
- Deliberate misapplication of accounting principles, policies, and procedures used to measure, recognise, report, and disclose economic events and business transactions
- Intentional omissions of disclosures or presentation of inadequate disclosures regarding accounting principles and policies and related financial amount

Did u know? **What are the key activities performed by forensic accountants to detect frauds?**

Activities usually carried out by forensic accountants involve:

- Investigating and analysing financial evidence
- Developing computerised applications to assist in the analysis and presentation of financial evidence
- Communicating their findings in the form of reports, exhibits and collections of documents
- Assisting in legal proceedings, including testifying in courts, as an expert witness and preparing visual aids to support trial evidence

Self Assessment

Fill in the blanks:

12. A …….has to analyse, interpret, summarise and present complex financial and business-related issues for investigation.
13. It is observed that people in positions of power within organizations sometimes intentionally mislead investors and creditors with ……inaccurate financial statements.

Task Give some examples of cyber crime in India.

14.9 Summary

- The term forensic accounting is concerned with the detection and prevention of business fraud and related white-collar crimes.
- Forensic accounting is the specialized practice area of accounting.
- The term 'Forensic' means "suitable for use in Court," and it is to that standard and potential outcome that forensic accountants generally have to work.

Notes

- Forensic accounting includes the use of accounting, auditing, and investigative skills to deal with the legal matters.
- It consists of two major components: litigation services that recognise the role of an accountant as an expert consultant, and investigative services that use a forensic accountant's skills and may require possible courtroom testimony.
- Forensic Accounting involves the use of accounting/ auditing, investigative skills and data mining as an audit tool
- A forensic accountant has to analyse, interpret, summarise and present complex financial and business-related issues for investigation.
- It is observed that people in positions of power within organizations sometimes intentionally mislead investors and creditors with deliberately inaccurate financial statements.

14.10 Keywords

Financial Auditing: Financial auditing is performed by certified charted accountants to check the regulations of financial statements of an organisation.

Forensic Accounting: Forensic accounting includes the use of accounting, auditing, and investigative skills to deal with the legal matters.

14.11 Review Questions

1. How forensic accounting is different form financial auditing?
2. A forensic accountant has to analyse, interpret, summarise and present complex financial and business-related issues for investigation. Discuss.
3. According to Zysman (2001), what are the key assignments performed by a forensic accountant.
4. How you will identify the financial statements frauds?
5. Identify the scope of forensic accounting.
6. What are the key skills required for forensic accounting?
7. State the difference between forensic accountant and auditor.

Answers: Self Assessment

1. Specialized
2. Certified charted accountants
3. Legal
4. Investigative
5. Risk management
6. Audit
7. Litigation support
8. Litigation support

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9. Criminal
10. Auditors
11. Forensic accountants
12. Forensic accountant
13. Deliberately

14.12 Further Readings

Books

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Online links

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