



MCM-505

ACCOUNTING THEORY AND PRACTICES



Department of Commerce
School of Management Studies and Commerce

MCM-505

ACCOUNTING THEORY AND PRACTICES



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Unit-1 NATURE, SCOPE AND ROLE OF ACCOUNTING THEORY

Structure

- 1.1 Introduction
- 1.2 Meaning of Accounting
- 1.3 Accounting Process
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- 1.5 Defining Accounting Theory
- 1.6 Nature of Accounting
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Objectives

After reading this unit you will be able to

- Explain the accounting concepts and nature.
- Differentiate between principles of accounting and accounting behavior.
- Understand the scope and advantages of accounting.
- Define and discuss the accounting principles.
- Understand the generally accepted accounting principles.

1.1 Introduction

In early days the business organizations and transactions were small and easily manageable by the owners of the business themselves. The businessmen used to remember the transactions by memorizing them. In those days accounting developed as a result of the needs of the business to keep relationship with the outsiders, listing of their assets and liabilities. The advent of industrial revolution and technological changes has widened the market opportunities. Most of the business concerns in these days are run by company type of organization. The business concern has constantly entered into transactions with outsiders. A transaction involves transfer of money or money's worth (goods or services) from one person to another. In addition to the transactions with outsiders, there are also events requiring monetary record.

It is not possible for a human being to keep in memory all the transactions. Therefore, it is necessary to record all these transactions properly to get required financial information. With the help of accounting records the businessman would be able to ascertain the profit or loss and the financial position of his business at the end of a given period and would be able to communicate the results of business operations to various interested parties. It is, therefore, necessary to record all the transactions systematically from time to time irrespective of the form of business organization.

The accounting information is useful both for the management and the outside agencies. The management needs it for the purpose of planning, controlling and decision making. The outsiders like banks, creditors etc. also require it for assessing the financial solvency of the business and the tax authorities use it for determining the amount of tax liability. In fact accounting is necessary not only for business organizations but also for non-business organizations like schools, colleges, hospitals, clubs etc.

1.2 Meaning of Accounting

In our day to day life, we generally reckon every matter that affects our routine aspects either quantifiable in numbers or expressed in monetary value. The mere tasking of 'reckoning' or 'recounting' these quantification is accounting. Thus, we noted here that everybody is aware of accounting. In context of any business too, 'accounting' has more or less same meaning. As we all need one common language or parlance to express ourselves same is true for business also, which contends an accounting as the language of business. Thus, we can say accounting as *lingua franca* for any business. As to any language which consists of its own rules and syntax similar is true for accounting too, which also has its own basic concepts, tenets and assumptions. The governing bodies

of these accounting principles are the Generally Accepted Accounting Principles, Accounting Standards, US GAAP, etc. The Indian Accounting Standards, International Accounting Standards, forming the Theoretical base of Accountancy, and the Double Entry Bookkeeping for recording the transactions provides the Practical base of the system.

The term accounting is decorous gradually much broader. This we can explain with the following definitions arranged in historical order:-

- i. **1941** The American Institute of Certified Public Accountant (AICPA) defined accounting as “the art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events, which are in part, at least, of a financial character and interpreting the results thereof.”
- ii. **1966** the American Accounting Association (AAA) defined accounting as “the process of identifying, measuring and communicating economic information to permit informed judgments’ and decisions by user of the information.”
- iii. **1970** Accounting Principles Board (APB) of AICPA states, “The function of Accounting is to provide quantitative information primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions.”

1.3 Accounting Process

From the above definitions, we have the following tasks that together make up the accounting process mentioned here under as follows:-

- **Recording:** The basic need of accounting begins with recording of financial transactions in an orderly manner in which they occur in the Journal. The important question pertaining to recordings are what to record, when to record, how to record and at which value it is to be recorded.
- **Classifying:** Refers to the rational segregation of the recorded information into related groups so as to make the record useful. Such of classification is called ledger. Where all those related items are posted, e.g. all the transactions consist of cash are posted to Cash Book.
- **Summarizing:** Next to recording and classifying all those financial transactions, third step is to summarize them in precise manner. The step involves financial statements which we abstract through trial balance and then create income statement as well as position statement.

1.4 Accounting Theory

There is always a reason behind each and every action of a human being. A man does not do anything without any sound reason. Regarding Finance, or financial matters, a man is always extra cautious and so, he never makes any financial transaction without any reason. As accounting deals with financial transactions, so every accounting work is also based on reasoning. Accounting Theories always try to explain with reason, the logic underlying a particular practice. Generally Accepted Accounting Principles cannot be changed completely as they are widely and universally accepted but they can be reformed and remodeled to suit the needs of any changed Society or Economy.

Accounting Theories point out to the scientific ways of thinking for the solution of any real world accounting problem.

According to **Prof.Hendriksen**, “Accounting Theory may be defined as logical reasoning in the form of a set of broad principles that provide a general frame of reference by which accounting practice can be evaluated and guide the development of new practices and procedures.”

To be absolutely able to solve any real world accounting problem, an accountant should have sufficient practical experience aided by adequate theoretical knowledge. Generally accepted accounting principles, widely used customs, conventions, doctrines, procedures and postulates constitute accounting theories. Thus, a logical and confirmed hypothesis, accepted a general by all, may be called Accounting Theory. As all other theories are based on sound and solid reasoning. Accounting Theories are similarly based on sound reasoning.

1.5 Defining Accounting Theory

Assumptions, methodologies and frameworks used in the study and application of financial principles. The study of accounting theory involves a review of both the historical foundations of accounting practices, as well as the way in which accounting practices are verified and added to the regulatory framework that governs financial statements and financial reporting.

Accounting theory and Accounting Practices are absolutely closely related. They are so close, as it is very difficult to make them separate. Accounting Theories have developed through observation, analysis, explanation, scrutiny and scanning of the day-to-day accounting practices. Again on the other hand, the day-to-day accounting practices are performed by successful application of those established and generally accepted theories and principles. As due to changes in the economy, the Society changes, similarly, due changes in the Socio-economic structure in any country, the pattern of accounting practices may also change. If there is any change in the accounting pattern, the

pertinent theories also need necessary modification and modulation. So then, theories also ought to be changed. So, the relations between the two are compensatory and not competitive. There cannot be any practice without the proper theoretical knowledge. Again, theories emerge out of constant observation, analysis, examination of the theoretical problems and procedures. So, one cannot even exist without the order. Theories are considered to be the pillars on which the whole structure of accounting stands. If the accountant is to perform his work of accounting successfully and skillfully, he will have to equip himself with complete and full theoretical knowledge. One cannot even think of practicing accounting without being properly equipped with theoretical knowledge. Not only has that, theories also helped the accountant in solving real world accounting problems which may crop up during the practice of accounting. So, Accounting Theory and Accounting Practices are very closely related-so close as not to be separated.

There are many advantages of learning accounting theory. These are enumerated as follows:

1. By learning accounting theory only one can know the basic reasons behind all accounting practices.
2. After learning theory only one can know that practical accounting is not so dull and monotonous as to be the summation of some debits and credits.
3. By learning accounting theory only the accountant can perform his work more skillfully and flawlessly.
4. an accountant, perfectly equipped with sound knowledge of accounting theory, cannot only understand his job-problems better, but also can make others understand the same in a better way.
5. There are many processes of practical accounting. A single process cannot be applicable to all cases. If the accountant knows the theories well, he can select the correct process of accounting applicable to a particular case.
6. There may be many flaws and defects in the accounting system of a concern. If the accountant has got sufficient knowledge of accounting theory, he can easily find these out and administer advices to the management as to the way of future protection.
7. Present day business is full of diverse Socio-economic problems. So, accounting, now-a-days has become complicated and complete. Knowledge of accounting theory helps the accountant to tide over real world-accounting problems very easily.

8. An accountant, fully equipped with the knowledge of accounting theory, can easily help the management in an effective manner by supplying proper accounting information at the proper time.
9. Valuation of various assets and liabilities can be more or less accurately if the accountant has the knowledge of accounting theory.
10. The various persons and parties interested in the business, like, the Government, public, investors, Money-lenders, Researchers etc., rely more on the accountant knowing theories than the accountant without any theoretical knowledge.

No one can deny now-a-days the usefulness of having theoretical knowledge in the practice of accounting. Needless to state that a man knowing theories is much better than a man who does not know those. Even if an ordinary man can be imparted with proper theoretical knowledge and practical training, it is sure that he will turn out to be a good accountant. So, during the present days, one cannot do any theoretical knowledge of accounting. It is essential now

1.6 Nature of Accounting

We know Accounting is the systematic recording of financial transactions and presentation of the related information of the appropriate persons. The basic features of accounting are as follows:

1. **Accounting is a process:** A process refers to the method of performing any specific job step by step according to the objectives, or target. Accounting is identified as a process as it performs the specific task of collecting, processing and communicating financial information. In doing so, it follows some definite steps like collection of data recording, classification summarization, finalization and reporting.
2. **Accounting is an art:** Accounting is an art of recording, classifying, summarizing and finalizing the financial data. The word 'art' refers to the way of performing something. It is a behavioral knowledge involving certain creativity and skill that may help us to attain some specific objectives. Accounting is a systematic method consisting of definite techniques and its proper application requires applied skill and expertise. So, by nature accounting is an art.
3. **Accounting is means and not an end:** Accounting finds out the financial results and position of an entity and the same time, it communicates this information to its users. The users then take their own decisions on the basis of such information. So, it can be said that mere keeping of accounts can be the primary objective of any person or entity. On the other hand, the main objective may be identified as taking decisions on the basis of financial information supplied by accounting. Thus,

accounting itself is not an objective, it helps attaining a specific objective. So it is said the accounting is 'a means to an end' and it is not 'an end in itself.'

4. Accounting deals with financial information and transactions : Accounting records the financial transactions and date after classifying the same and finalizes their result for a definite period for conveying them to their users. So, from starting to the end, at every stage, accounting deals with financial information. Only financial information is its subject matter. It does not deal with non-monetary information of non-financial aspect.

5. Accounting is an information system: Accounting is recognized and characterized as a storehouse of information. As a service function, it collects processes and communicates financial information of any entity. This discipline of knowledge has been evolved out to meet the need of financial information required by different interested groups.

1.7 Classifications

It is said that knowledge knows no bounds. This is equally true in cases of theories also. There are different types of theories in different branches of knowledge. However, some of the types of theories may be described as follows :

1. Descriptive Theory: This type of accounting theory is of descriptive approach. It explains the causes and effects of the day-to-day events of our life. Descriptive accounting theory helps us to predict how an event will be treated in accounting from the study of the explanations as to the happening of that particular event.

2. Normative accounting Theory: Normative accounting theory is of the type sermon in nature. It is mainly concerned with the future acts in the light of the present daily phenomena. Normative accounting theory also evolves possible theories which are independent of current practice and help in solving critical problems in future. So, these theories are advises in nature.

3. Evaluative accounting Theory: The theory which helps to know about the quality and quantity of any object or event or the qualitative quantity and quantitative quality is known as an evaluative accounting theory. Evaluative theories also measure the qualitative quantity of the event concerned.

4. Communicative accounting Theory: There are some basic and fundamental theories which give us the exact forecast of events which are called communicative theories. So, we can guess any event if we have the knowledge of communicative accounting theory. Future forecast of events is also supplied by the communicative accounting theory.

5. Inductive accounting Theory: The accounting theory which examines and analyses the happenings of past events is known as inductive accounting theory. It is based on repeated experiments and informs us that similar events in future will result in similar consequences.

6. Deductive accounting Theory: The accounting theory which is prepared by the following the method of deduction is the deductive accounting theory. It shows us the future way of behavior regarding the happening of any special phenomenon. Deductive theories are generally formulated to achieve some particular goal.

7. Generally accepted theories: The fundamental theories which can be applied equally in all cases and are adopted by all are called generally accepted theories. These theories do not generally vary and produce more or less similar results in most cases. Besides the above, there are other theories also in existence. But these are Philosophical Theories and are found in our ancient Indian Philosophy. There is no opportunity of discussing those theories in accounting.

1.8 Language of Business

As a man without language turns out to be somewhat useless or as a mute man cannot be understood clearly, so also, a business without the accounts of its activities becomes meaningless. A language is the representative of the progress of the people of that language –group. A developed language reflects a developed society. Socio-economic progress has always depended on its linguistic advancement.

In other words, human culture and economic activities have always been depending on language and literature for their nourishment and advancement as well. A business unit also has got its own language in which it expresses the results of its activities and that language in “Accounting” With the help of this language, i.e., accounting, it prepares its future plans, programmes and projects. The language of the business, i.e., accounting is always effectively used for analytical consideration of the present activities and for reporting the results to various interested persons as well.

As the language of The Sun is no sunrays, as that of a flower is its fragrance, and as the same of a thunderbolt is its lightning, so also the language of a business is accounting. As a human being expresses thoughts through language, so the results of the activities of a business are expressed through accounting in the form of final Accounts with Reports and Statements. The success or failure, the profits or losses and the daily activities or transactions of a business get life when they are transformed and translated into accounts.

Accounting, the language of the business, helps us to know its profitability or profit earning capacity. Not only this, the language of accounting also expresses the financial stability, strength of the Capital Structure and the inner worth or the real net worth of the business. The future prospects of a concern also can be clearly known from the published accounts. In fact, all the interested persons in a society, like Debtors, Creditors, Investors, Money-lenders, Bankers, Governments, Tax-collectors, Economists, Researchers, etc., can go through the activities of a business with the help of its languages, i.e., accounting. One can thus have a complete, true and fair view of the business through the language the language of accounting.

1.9 Accounting Theory vs. Accounting Practices:

Practically speaking, there is no rivalry between accounting theory and accounting practice. One is always dependent on the other. The practice of accounting is always guided and influenced by conventions, doctrines, and various other rules and methods which have been accepted by all. Practice without theory can never be conceived of. Again, there is no utility of any theory when there is no practice. Practice of accounting has developed through customs, usages and conventions which are called theories.

So, these may be considered as closely related. But still, there are some differences between the two which may be enumerated as follows:

Accounting Theory :

1. A theory means a definite directive principle.
2. Theories are framed by actually analyzing of accounting Practices.
3. Accounting Theories are based on sound reasoning and therefore they are scientific.
4. Theories, as such, cannot help us to know the financial position of the business or the amount of Profit or Loss during a particular period.
5. Accounting Theories can never be considered as a means of conveying information either internal or external.
6. Accounting Theories help us to solve any complicated problem arising out in course of practical accounting, especially during these modern days of complicated financial system.

ACCOUNTING PRACTICES

1. Accounting Practice is what is actually done in the way of recording and analyzing accounting activities.
2. Accounting Practices are only applications of accounting theories.
3. Accounting Practices need not always be strictly logical and scientific as practice depends upon prevailing customs, norms and conventions.
4. Accounting Practices are always designed to calculate the profit or loss of the business of the state of affairs.
5. Accounting Practices are considered as valid media for conveying various information to different interested parties.
6. Accounting Practices in the conventional method are unable to solve any such problem.

So, we see that Accounting Theory and accounting Practice are interdependent and thus closely related. One may be considered as a substitute for other because, theory cannot be separated from practice and practice is an integral part of theory.

1.10 Relation **between Accounting Theory and Accounting Practices** :

There is always a reason behind each and every action of a human being. A man does not anything without any sound reason. Regarding Finance, or financial matters, a man is always extra cautious and so, he never makes any financial transaction without any reason. As accounting deals with financial transactions, so every accounting work is also based on reasoning. Accounting Theories always try to explain with reason, the logic underlying a particular practice. Generally Accepted Accounting Principles cannot be changed completely as they are widely and universally accepted but they can be reformed and remodeled to suit the needs of any changed Society or Economy. Accounting Theories point out to the scientific ways of thinking for the solution of any real world accounting problem. According to Prof.Hendriksen, “Accounting Theory may be defined as logical reasoning in the form of a set of broad principles that provide a general frame of reference by which accounting practice can be evaluated and guide the development of new practices and procedures. To be absolutely able to solve any real world accounting problem, an accountant should have sufficient practical experience aided by adequate theoretical knowledge. Generally accepted accounting principles, widely used customs, conventions, doctrines, procedures and postulates constitute accounting theories. Thus, a logical and

confirmed hypothesis, accepted a general by all, may be called Accounting Theory. As all other theories are based on sound and solid reasoning. Accounting Theories are similarly based on sound reasoning. Accounting theory and Accounting Practices are absolutely closely related. They are so close, as it is very difficult to make them separate. Accounting Theories have developed through observation, analysis, explanation, scrutiny and scanning of the day-to-day accounting practices. Again on the other hand, the day-to-day accounting practices are performed by successful application of those established and generally accepted theories and principles. As due to changes in the economy, the Society changes, similarly, due changes in the Socio-economic structure in any country, the pattern of accounting practices may also change. If there is any change in the accounting pattern, the pertinent theories also need necessary modification and modulation. So then, theories also ought to be changed. So, the relations between the two are compensatory and not competitive. There cannot be any practice without the proper theoretical knowledge. Again, theories emerge out of constant observation, analysis, examination of the theoretical problems and procedures. So, one cannot even exist without the order. Theories are considered to be the pillars on which the whole structure of accounting stands. If the accountant is to perform his work of accounting successfully and skillfully, he will have to equip himself with complete and full theoretical knowledge. One cannot even think of practicing accounting without being properly equipped with theoretical knowledge. Not only that, theories also help the accountant in solving real world accounting problems which may crop up during the practice of accounting. So, Accounting Theory and Accounting Practices are very closely related-so close as not to be separated.

1.11 Scope of Accounting

Accounting has got a very wide scope and area of application. Its use is not confined to the business world alone, but spread over in all the spheres of the society and in all professions. Now-a-days, in any social institution or professional activity, whether that is profit earning or not, financial transactions must take place. So there arises the need for recording and summarizing these transactions when they occur and the necessity of finding out the net result of the same after the expiry of a certain fixed period. Besides, these also the need for interpretation and communication of those information to the appropriate persons. Only accounting use can help overcome these problems.

In the modern world, accounting system is practiced not only in all the business institutions but also in many non-trading institutions like Schools, Colleges, Hospitals, Charitable Trust Clubs, Co-operative Society etc. and also Government and Local Self-Government in the form of Municipality, Panchayat. The professional persons like Medical practitioners, practicing Lawyers, Chartered Accountants etc. also adopt some suitable types of accounting methods. As a matter of fact, accounting methods are used by all who are involved in a series of financial transactions.

The scope of accounting as it was in earlier days has undergone lots of changes in recent times. As accounting is a dynamic subject, its scope and area of operation have been always increasing keeping pace with the changes in socio-economic changes. As a result of continuous research in this field the new areas of application of accounting principles and policies are emerged. National accounting, human resources accounting and social Accounting are examples of the new areas of application of accounting systems.

Role of accounting theory

Accounting theory has great utility for improving accounting practices, resolving complex accounting issues and contributing in formulation of a useful accounting theory. Accounting theory has practical importance in many respects. Some of them are listed below:

Accounting theory has a great amount of influence on accounting and reporting practices and thus serves the informational requirement of external user. In fact, accounting theory provides a framework for evaluating current financial accounting practice.

Developing new practices

Whenever the need for a new practice arises the accounting theory should provide accountants with guidance on the most appropriate procedure to adopt in the circumstances. The corporate management and accountant, after having knowledge of accounting theory may respond to the needs of users of accounting information. Many users, especially external, use annual report to make investment and other decisions. Similarly if a company is concerned about the market value of its shares, the accounting method effect on shares price or to be analyzed.

Secondly accounting theory literature is useful to accounting policy makers, who are interested in making the accounting information useful. Theories are helpful as they apprise

policy maker of the underlying issues and clarifying the trade-offs implicit in various theory approaches.

Objectives of Accounting: The basic objectives of accounting are to provide necessary information to the persons interested who will make relevant decisions and form judgment. The persons interested in the business are classified into two types: i) Internal users, and ii) External users. Internal users are those who manage the business. External users are those other than the internal users such as investors, creditors, Government, etc. Information required by the external users are provided through Profit and Loss account and Balance sheet whereas the internal users get required information from the records of the business. Thus the main objectives of accounting are as follows:

To keep systematic records of the business: Accounting keeps a systematic record of all financial transactions like purchase and sale of goods, cash receipts and cash payments etc. It is also used for recording all assets and liabilities of the business. In the absence of accounting it is impossible to a human being to keep in memory all business transactions.

To ascertain profit or loss of the business : By keeping a proper record of revenues and expenses of business for a particular period, accounting helps in ascertaining the profit or loss of the business through the preparation of profit and loss account. Profit and Loss account helps the interested parties in assessing the profit or loss made by the business during a particular period. It also helps the management to take remedial action in case the business has not proved remunerative or profitable. A proper record of all incomes and expenses helps in preparing a profit and loss account and in ascertaining net operating results of a business during a particular period.

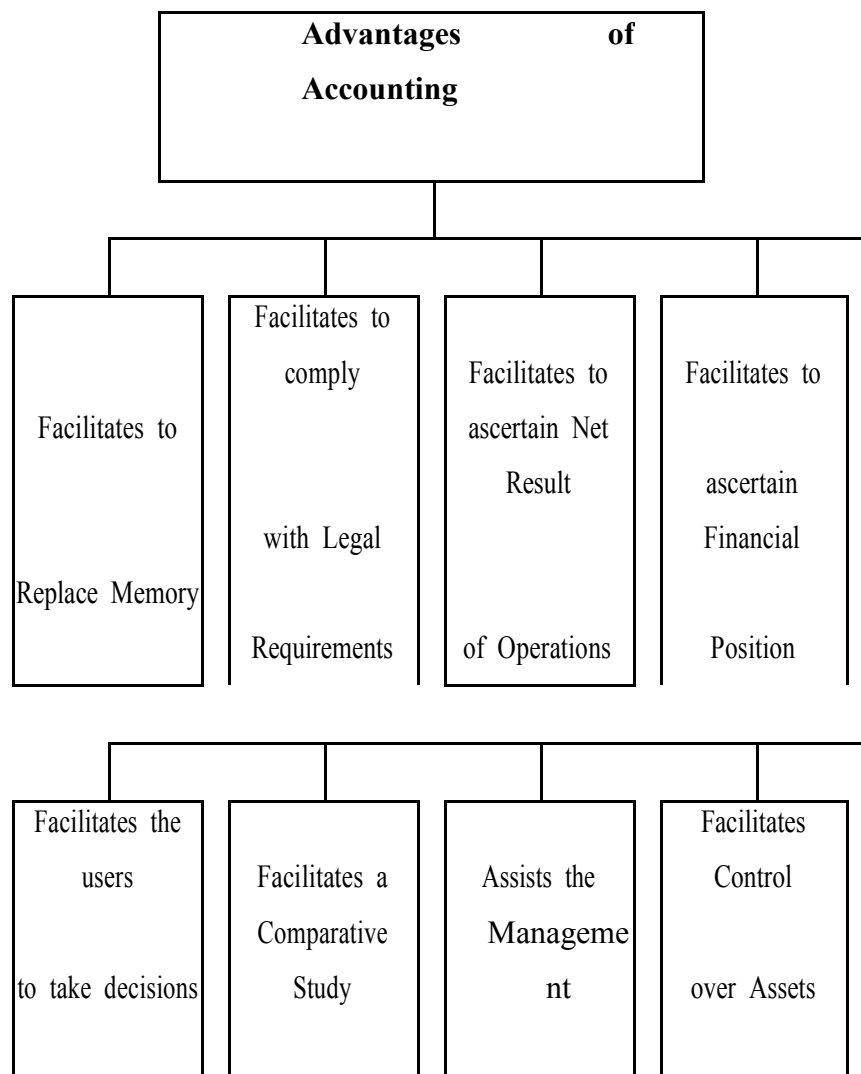
To ascertain the financial position of business : The business man is also interested to know the financial position of his business apart from operating results of the business during a particular period. In other words, he wants to know how much he owns and how much owes to others. He would also like to know what happened to his capital, whether it has increased or decreased or remained constant. A systematic record of assets and liabilities facilitates the preparation of a position statement called Balance Sheet which provides necessary information to the above questions. Balance Sheet serves as barometer for ascertaining the financial solvency of the business.

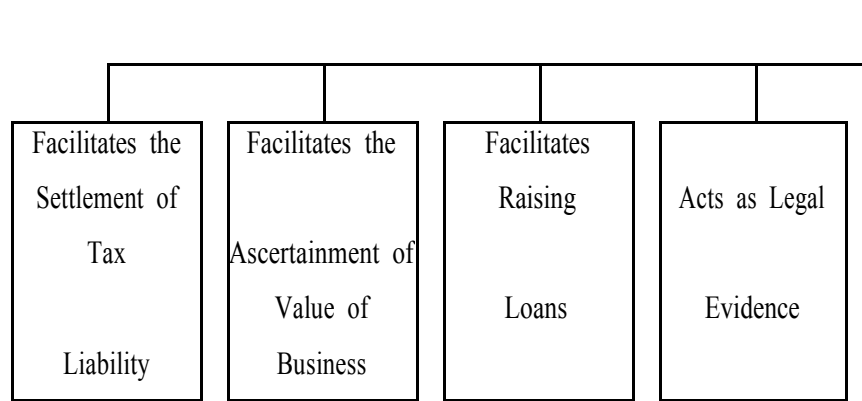
To provide accounting information to interested parties: Apart from owners there are various parties who are interested in the accounting information. These are bankers, creditors, tax authorities, prospective investors etc. They need such information to assess the profitability and the financial soundness of the Business. The accounting information is communicated to them in the form of an annual report.

- Maintaining proper record of business.
- Calculation of profit or loss.
- Depiction of the financial position
- Providing effective control over the business
- Making information available to various groups.

1.12 ADVANTAGES OF ACCOUNTING

The advantages of accounting are as follows:





Let us discuss these advantages one by one.

1. **Facilitates to Replace Memory** Accounting facilitates to replace human memory by maintaining complete record of financial transactions. Human memory is limited by its very nature. Accounting helps to overcome this limitation.
2. **Facilitates to Comply with Legal Requirements** Accounting facilitates to comply with legal requirements which require an enterprise to maintain books of accounts. For example, Sec 209 of The Companies Act, 1956, requires a company to maintain proper books of accounts on accrual basis, Sec 44AA of The Income Tax Act 1961 requires certain persons to maintain specified books of accounts
3. **Facilitates to Ascertain Net Result of Operations** Accounting facilitates to ascertain net results of operations by preparing Income Statement.
4. **Facilitates a Comparative Study** Accounting facilitates a comparative study in the following four ways:
 - (i) Comparison of actual figures with standard or budgeted figures for the same period and the same firm;
 - (ii) Comparison of actual figures of one period with those of another period for the same firm (i.e. Intra-firm Comparison);
 - (iii) Comparison of actual figures of one firm with those of another standard firm belong-ing to the same industry (i.e., Inter-firm Comparison); and
 - (iv) Comparison of actual figures of one firm with those of industry to which the firm belong (i.e. Pattern Comparison)
5. **Assists the Management** Accounting assists the management in planning and controlling business activities and in taking decisions. For example, Projected Cash Flow Statement

facilitates the management to know future receipts and payments and to take decision regarding anticipated surplus or shortage of funds.

6. **Facilitates Control over Assets** Accounting facilitates control over assets by providing information regarding Cash Balance, Bank Balance, Debtors, Fixed Assets, Stock etc.
7. **Facilitates the Settlement of Tax Liability** Accounting facilitates the settlement of tax liability with the authorities by maintaining proper books of accounts in systematic manner.
8. **Facilitates the Ascertainment of Value of Business** Accounting facilitates the ascertainment of value of business in case of transfer of business to another entity.
9. **Facilitates Raising Loans** Accounting facilitates raising loans from lenders by providing them historical and projected financial statements.
10. **Acts as Legal Evidence** Proper books of accounts maintained in systematic manner act as legal evidence in case of disputes.

The major limitations of accounting include the following:

1. Ignores the Qualitative Elements Since the accounting is confined to the monetary matters only, the qualitative elements like quality of management, quality of labour force, public relations are ignored.

2. Not Free from Bias In many situations, the accountant has to make a choice out of various alternatives available, e.g., choice in the method of depreciation (e.g., Straight Line or Written down), choice in the method of inventory valuation (e.g. FIFO, LIFO etc.). Since the subjectivity is inherent in personal judgment, the financial statements are therefore not free from bias. As a result, the analysis of financial statements also cannot be said to be free from bias.

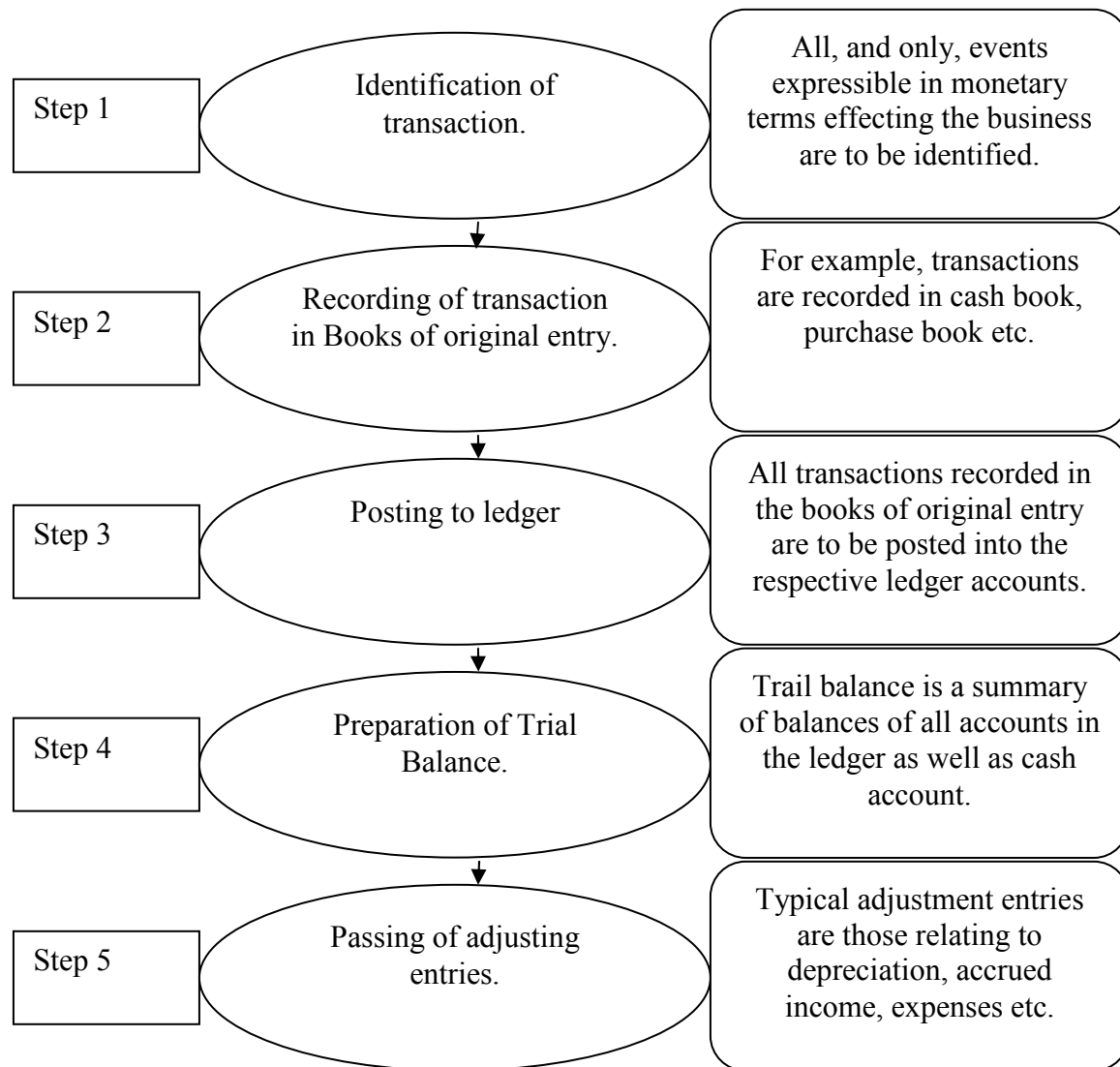
3. Estimated Position and not Real Position Since the financial statements are prepared on a going concern basis as against liquidation basis, they report only the estimated periodic results and not the true results since the true results can be ascertained only on the liquidation of an enterprise.

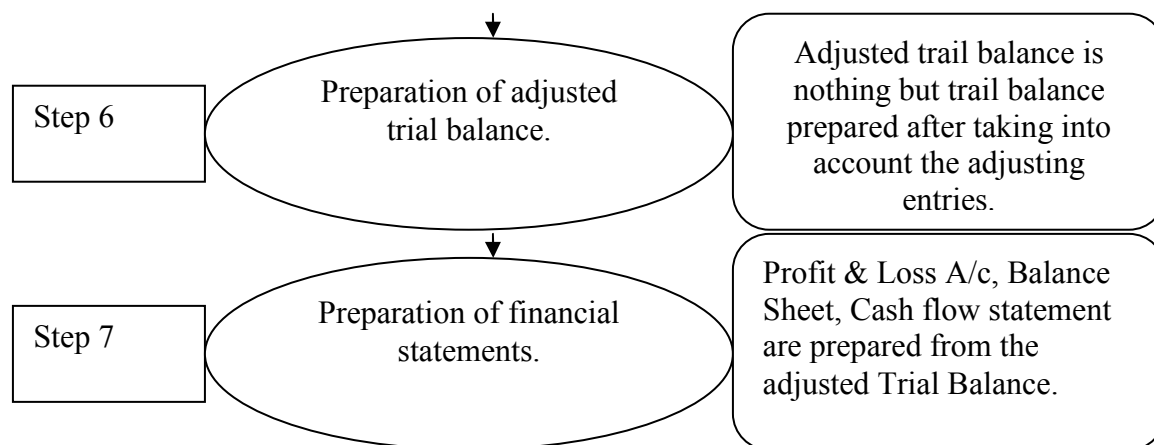
4. Ignores the Price-level Changes in Case of Financial Statements Prepared on Historical Costs In case of financial statements prepared on historical costs, the Fixed Assets are shown in the Balance Sheet at historical costs *less* depreciation and not at the replacement value which is often far higher than the value stated in the Balance Sheet. The analysis of such financial statements will not yield strictly comparable results unless the price-level changes are taken into account.

5. Danger of Window Dressing When the management decides to enter wrong figures to artificially inflate or deflate the figure of profits, assets and liabilities, the Income Statement fails to provide true and fair view of the result of operations and Balance Sheet fails to provide true and fair view of the financial position of the enterprise.

Figure 1

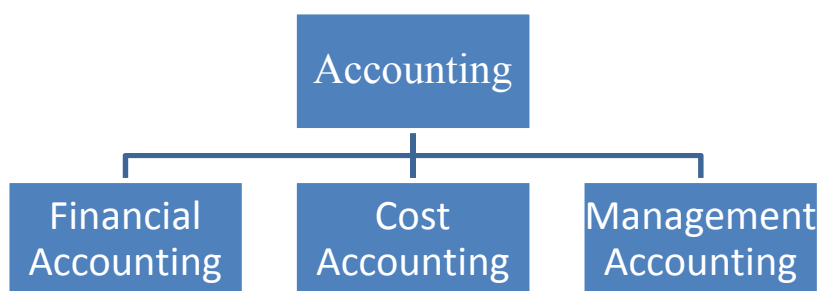
The Accounting Process





Accounting is in generally classified into three different disciplines as shown in Figure 2.

Figure 2



Financial Accounting: It deals with recording, classifying and summarizing the financial transactions so as to prepare the Financial Statements viz. Income Statement and Position Statement.

The American Institute of Certified Public Accountants has defined Financial Accounting as “the art of recording, classifying and summarizing in a significant manner in terms of money transactions and events which are in part at least of a financial character, and interpreting the results thereof”. Accounting is the language effectively employed to communicate the financial information of a business unit of various parties interested in its progress.

The object of financial accounting is to find out the profitability and to provide information about the financial position of the concern. Two important statements of financial accounting are Income and

Expenditure Statement and Balance Sheet.

All revenue transactions relating to a particular period are recorded in the Income and expenditure statement to decide the profitability of the concern. The balance sheet is prepared at a particular date to determine the financial position of the concern.

1.13 Functions of Financial Accounting

Financial accounting provides information regarding the status of the business and results of its operations to management as well as to external parties. The following are some of the important functions of financial accounting:

a) Recording of Information

In business, it is not possible to keep in memory all the transactions. These transactions need to be systematically recorded and pass through the journals, ledgers and worksheets before they could take the form of final accounts. Only those transactions are recorded which are measurable in terms of money. The transaction which cannot be expressed in monetary terms does not form part of financial accounting even though such transactions have a significant bearing on the working of a business.

b) Managerial Decision Making

Financial accounting is greatly helpful for managers in taking decisions. Without accounting, the managerial functions and decision making programmes may mislead. The performances of daily activities are to be compared with the predetermined standards. The variations of actual operations and their analysis are possible only with the help of financial accounting.

c) Interpreting Financial Information

Interpretation of financial information is very important for decision making. The recorded financial data is interpreted in such a manner that the end users such as creditors, investors, bankers etc., can make a meaningful judgment about the financial position and profitability of the business operations.

d) Communicating Results

Financial accounting is not only concerned with the recording of facts and figures but it is also connected with the communication of results. In fact accounting is the source of business operation. Therefore, the information accumulated and measured should be periodically communicated to the users. The information is communicated through statements and reports. The financial statements and reports should be reliable and accurate. A variety of reports are needed for internal management

depending upon its requirement. In communicating reports to outsiders, standard criteria of full disclosure, materiality, consistency and fairness should be adhered to.

Limitations of Financial Accounting

Financial accounting was able to cope up with the needs of business in the initial stages when business was not so complex. This is because financial accounting is mainly concerned with the preparation of final accounts, i.e., profit and loss account and balance sheet. But the growth and complexities of modern business have made financial accounting highly inadequate. The management needs information for planning, controlling and coordinating business activities.

The limitations of financial accounting are as follows:

- 1) **Historic nature:** Financial accounting is the record of all those transactions which have taken place in the business during a particular period. As management's decisions relates to future course of action, they are made on the basis of estimates and projections. Financial accounting provides information about the past data and not about the future. It does not suggest the measures about what should be done to improve efficiency of the business. Past data are needed for making future decisions but that does not alone sufficient.
- 2) **It records only actual costs:** Financial accounting has always been concerned with figures treating them as single, simple and silent items because it records only actual cost figures. The price of goods and assets changes frequently. The current prices may be different from recorded costs. Financial accounts do not record these price fluctuations. Therefore, the recorded information may not give correct information.
- 3) **It provides quantitative information:** Financial accounting considers only those factors which are quantitatively expressed. Anything which cannot be measured quantitatively will not constitute a part of financial accounting. Today business decisions are influenced by a number of social considerations. Governments policies have a direct bearing on the working of business. Therefore, in addition to social consideration the management has also to take into account, the impact of government policies on the business. But these factors cannot be measured quantitatively so their impact will not reflect in financial statement.
- 4) **It provides information about the whole concern:** Financial accounting provides information about the concern as a whole. It discloses only net results of the collective activities of a business. Detailed information regarding product- wise, process-wise, department wise, etc. is not recorded in

financial accounts. Thus, product wise or job wise cost of production cannot be determined. It is essential to record the transactions activity wise for cost determination and cost control purpose.

5) **Difficulty in price fixation:** The cost of the product can be obtained only when all expenses have been incurred. It is not possible to determine the prices in advance. Price fixation requires detailed information about variable and fixed costs, direct and indirect costs. Financial accounting cannot supply such information and therefore, it is difficult to quote the prices during the periods of inflation or depression in trade.

6) **Appraisal of policies is not possible:** Financial accounting do not provide data for evaluation of business policies and plans. There is no technique for comparing actual performance with the budgeted targets. Financial accounting does not provide any measure to judge the efficiency of a business. The only criteria for determining efficiency are the profit at the end of financial period. Therefore, the only yardstick for measuring the managerial performance is profit and loss account which is not a reliable test for ascertaining efficiency of the management.

7) **It is not helpful in Decision Making:** Financial accounting do not help the management in taking strategic decisions because they do not provide adequate information to compare the probable effect of alternative courses of action such as replacement of labour by machinery, introduction of new product line, expansion of capacity etc. The impact of these decisions and cost involved is to be ascertained in advance. Due to historic nature of accounting data available from financial accounts, it is not of much helpful to the management.

8) **Lack of uniformity in accounting principles:** Accounting policies differ on the use of accounting principles. There is lack of unanimity on the use of accounting principles and procedures. The financial statements prepared by two different persons of the same concern gives different results due to varying personal judgment in applying a particular convention. The methods of valuing inventory, methods of depreciation, allocation of expenses between revenue and capital etc. are the most controversial issues on which unanimity is not possible. The use of different accounting methods reduces the usefulness and reliability of financial accounting.

9) **It is not possible to control costs:** Another limitation of financial accounting is that the cost figures are known only at the end of financial period. When the cost has already been incurred then nothing can be done to control the cost. A

Constant review of actual costs from time to time is required for cost control and this is not possible in financial accounting.

10) **Possibility of manipulation of accounts:** The over and under valuation of inventory may affect the profit figures. The profit may be shown more or less to get more remuneration, to pay more dividends or to raise the share prices, or to save taxes or not to pay bonus to workers, etc. The possibility of manipulating financial accounts reduces their reliability.

11) **Technological revolution:** With the advancement in science and technology very minute and detailed break-up of all types of data relating to various parts of a business unit have become a must for the management of its day to day functioning. It is clear that financial accounting with its simple structure is not in a position to cater the needs of the management because it supplies only elementary information. The limitations of financial accounting have given scope for the development of Cost and Management accounting.

Cost Accounting: It shows allocation of different costs incurred on the basis of functions, processes, products, centers etc. so as to compute the cost further reduce the cost or cost saving.

Management Accounting: The rational need of decision making is done through the use of management accounting which seeks application of managerial economic concepts for decision making.

1.14 MEANING OF 'GENERALLY ACCEPTED ACCOUNTING PRINCIPLES' (GAAP)

Generally Accepted Accounting Principles may be defined as those rules of action or conduct which are derived from experience and practice and when they prove useful, they become accepted as principles of accounting. According to the American Institute of Certified Public Accountants (AICPA), the principles which have substantial authoritative support become a part of the generally accepted accounting principles.

The general acceptance of the accounting principles or practices depends upon how well they meet the following three criteria:

Relevance A principle is relevant to the extent it results in information that is meaningful and useful to the user of the accounting information.

Objectivity Objectivity connotes reliability and trustworthiness. A principle is objective to the extent the accounting information is not influenced by personal bias or judgment of those who provide it. It also implies verifiability which means that there is some way of ascertaining the correctness of the information reported.

Feasibility

These criteria often conflict each other, for instance, information about the value of a new product to the inventor is indeed relevant but the best estimate of the value of a new product made by the management is highly subjective. Accounting, therefore does not attempt to record such values. It sacrifices relevance in the interest of objectivity. In developing new principles, the essential problem is to achieve a trade-off between relevance on one hand and objectivity and feasibility on the other.

1.15 ACCOUNTING OF PRINCIPLES

Basic principles of accounting are essentially, the general decision rules which govern the development of accounting techniques. These principles guide how transactions should be recorded and reported.

1. Accounting Entity Principle

According to this principle, a business is treated as a separate entity that is distinct from its owner(s), and all other economic proprietors. For example, in case of a proprietary concern, though the legal entity of the business and its proprietor is the same, for the purpose of accounting, they are to be treated as separate from each other. If this assumption is not followed, the financial position and operating results of a business entity cannot be ascertained. In other words, this assumption requires that for accounting purposes, a distinction should be made between (i) personal transactions and business transactions, and (ii) transactions of one business entity and those of another business entity. For example, if the house-hold expenses (Rs 10,000) of a proprietor are shown as business expenses, the profits of a business will be understated to the extent of Rs 10,000.

2. Accounting Period Principle

Meaning It is also known as *periodicity principle* or *time period principle*. According to this principle, the economic life of an enterprise is artificially split into periodic intervals which are known as accounting periods, at the end of which an *income statement* and *position statement* are prepared to show the performance and financial position.

Implication The use of this assumption further requires the allocation of expenses between capital and revenue. That portion of capital expenditure which is consumed during the current period is charged as an expense to income statement and the unconsumed portion is shown in the balance sheet as an asset for future consumption.

Estimate and Not Actual Income Truly speaking, measuring the income following the concept of

accounting period is more an estimate than factual since, actual income can be determined only on the liquidation of the enterprise.

Reporting Period It may be noted that the custom of using twelve month period is applied only for external reporting. For internal reporting, accounts can be prepared even for shorter periods, say monthly, quarterly or half yearly.

3. Money Measurement Principle

According to this principle, only those transactions which are capable of being expressed in terms of money are included in the accounting records. In other words, the information which cannot be expressed in terms of money is not included in accounting records. For example, if the sales director is not on speaking terms with the production director, the enterprise is bound to suffer. Since, monetary measurement of this information is not possible, this fact is not recorded in accounting records. By expressing all transactions in terms of money, the different transactions expressed in different units are brought to a common unit of measurement (*i.e.* money). Besides ignoring the non-monetary facts or attributes, this assumption also ignores the changes in the purchasing power of the monetary unit. In other words, this assumption treats all rupees alike, whether it is a rupee of 1950 or 1999. Hence, now-a-days, it is considered to provide additional data showing the effect of price level changes on the reported income, assets and liabilities of the business.

4. Going Concern Principle

Meaning It is also known as *continuity assumption*. According to this assumption, the enterprise is normally viewed as a going concern that is, continuing in operation for the foreseeable future. It is assumed that the enterprise has *neither* the intention *nor* the necessity of liquidation or of curtailing materially the scale of its operations.

Implications It is because of the going concern assumptions:

- (i) that the assets are classified as *current assets* and *fixed assets*.
- (ii) the liabilities are classified as *short-term liabilities* and *long-term liabilities*.
- (iii) the unused resources are shown as *unutilized costs* (or *unexpired costs*) as against the break-up values as in case of liquidating enterprise. Accordingly, the earning power and not the break-up value evaluate the continuing enterprise.

Requirements of AS-1 According to Accounting Standard (1) issued by the Institute of Chartered Accountants of India, if this concept is followed, this fact need not be disclosed in the financial statements since its acceptance and use are assumed. In case this concept is not followed, the fact should be disclosed in the financial statement together with reasons.

5. Consistency Principle

Meaning According to this principle, whatever accounting practices (whether logical or not) are selected for a given category of transactions, they should be followed on a horizontal basis from one accounting period to another to achieve compatibility.

Examples if the inventory is valued on LIFO basis, this basis should be followed year after year and if a particular asset is depreciated according to WDV method, this method should be followed year after year.

Effect of not observing If this principle of consistency is not followed, the intra-firm comparison (*i.e.* comparison of actual figures of one period with those of another period for the same firm), Inter-firm comparison (*i.e.* comparison of actual figures of one firm with those of another firm belonging to the same industry) and Pattern comparison (*i.e.* comparison of actual figures of one firm with those of industry to which the firm belongs) cannot be made.

Differs from Uniformity The consistency should not be confused with mere uniformity or inflexibility and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

Disclosure The users should be informed of the accounting policies employed in the preparation of the financial statements, any change in these policies and the effects of such changes.

6. Prudence Principle (or Conservatism Principle)

Meaning According to this principle, the principle of ‘anticipate no profit but provide for all probable losses’ should be applied. In other words, the principle of conservatism requires that in the situation of uncertainty and doubt, the business transactions should be recorded in such a manner that the profits and assets are not overstated and the losses and liabilities are not understated.

Examples—The valuation of stock-in-trade at a lower of cost or net realizable value and making the provisions for doubtful debts and discount on debtors are the applications of this principle.

Conflicts with Consistency When the stock is valued at cost in one accounting period and at a lower of cost or net realizable value in another accounting period, this principle conflicts with the principle of consistency.

Conflicts with Full Disclosure When excessive provisions for doubtful debts and depreciation are charged, it leads to the creation of secret reserves, and thus, this principle conflicts with the principle of full disclosure.

Conflict with Objectivity The estimation of probable losses is a subjective judgment and thus, this principle conflicts with the principle of objectivity. The practice of making provisions for doubtful debts and the like implies lesser charges in the following accounting periods. In other words, it reduces the current income and raises the future income and thus it conflicts with the matching principle. Nowadays, the conservatism principle is being replaced by the prudence principle which requires that the conservation principle should be applied rationally only in circumstances in which great uncertainty and doubt exist as the over-conservatism may result in misrepresentation.

7. Full Disclosure Principle

According to this principle, the financial statements should act as means of conveying and not concealing. The financial statements must disclose all the relevant and reliable information which they purport to represent, so that the information may be useful for the users. For this, it is necessary that the information is accounted for and presented in accordance with its substance and economic reality and not merely with its legal form. The practice of appending notes to the financial statements has developed as a result of the principle of full disclosure. The disclosure should be full, fair and adequate so that the users of the financial statements can make correct assessment about the financial performance and position of the enterprise.

8. Materiality Principle

This principle is basically an *exception* to the Full Disclosure Principle. The full disclosure principle requires that all facts necessary to ensure that the financial statements are not misleading, must be disclosed, whereas the materiality principle requires that the items or events having an insignificant economic effect or not being relevant to the user's need not be disclosed. According to the materiality principle, all relatively relevant items, the knowledge of which might influence the decision of the users of the financial statements, should be disclosed in the financial statements. Which information is more relevant than others is largely a matter of judgment. For instance, accounting and recording of a small calculator as an asset in the balance sheet may not be justified

due to the excess of cost of recording over the benefits in terms of usefulness of recording and the accounting of calculators as assets. The materiality depends not only upon the amount of item but also upon the size of business, level and nature of information, level of the person/department who makes the judgment about materiality, for instance a worker reporting to his foreman about the production in grams (*e.g.* part of kilogram), a foreman to his supervisor in kilograms, a supervisor to his production manager in quintals and the production manager to the top management in tonnes, may be justified with regard to the circumstances. It hardly makes any difference if the production manager reports to the top management that the production is 1,99,000.90 kilograms or simply 200 tonnes (nearly). It is desirable to establish and follow uniform policies governing material or non-material items so that while measuring income for an accounting period, the non-material items can be ignored on uniform basis. This principle of materiality is to be applied even if the cost of its application exceeds its benefits.

9. Historical Cost Principle

According to this principle, an asset is ordinarily recorded in the accounting records at the price paid to acquire it at the time of its acquisition and the cost becomes the basis for the accounts during the period of acquisition and subsequent accounting periods. Accordingly, if nothing is paid to acquire an asset; the same will not be usually recorded as an asset, *e.g.* a favorable location and increasing reputation of the concern will remain unrecorded though these are valuable assets. The justification for the use of the cost concept lies in the fact that it is objectively verifiable. This does not mean that the asset will always be shown at cost. The cost of an asset is systematically reduced from year to year by charging depreciation and the asset is shown in the balance sheet at book value (*i.e.* cost less depreciation). It may be noted that the purpose of depreciation is to allocate the cost of an asset over its useful life and not to adjust its cost so as to bring it close to the market value.

10. Revenue Recognition Principle

This principle is mainly concerned with the revenue being recognised in the Income Statement of an enterprise. Revenue is the gross inflow of cash, receivables or other considerations arising in the course of ordinary activities of an enterprise from the sale of goods, rendering of services and use of enterprise resources by others yielding interests, royalties and dividends. It excludes the amount collected on behalf of third parties such as certain taxes. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other considerations. Revenue is recognised in the period in which it is earned irrespective of the fact whether it is

received or not during that period.

11. Matching Principle

According to this principle, the expenses incurred in an accounting period should be matched with the revenues recognised in that period, that is, if revenue is recognised on all goods sold during a period, cost of those goods sold should also be charged to that period. It is wrong to recognize revenue on all sales, but charge expenses only on such sales as are collected in cash till that period.

This concept is basically an accrual concept since, it disregards the timing and the amount of actual cash inflow or cash outflow and concentrates on the occurrence (*i.e.* accrual) of revenue and expenses. This concept calls for adjustment to be made in respect of prepaid expenses, outstanding expenses, accrued revenue and unaccrued revenues.

Matching does not mean that expenses must be identifiable with revenues. Expenses charged to a period may or may not be related to the revenue recognised in that period, for example, cost of goods sold and commission to salesmen are directly related to sales whereas rent, interest, depreciation accruing with the passage of time and stock lost by fire are not directly related to sales revenue, yet they are charged to the accounting period to which they relate. Thus, appropriate costs have to be matched against the appropriate revenues for the accounting period.

12. Duality Principle

Two fold aspect of a transaction is called dual aspect or duality of a transaction. This duality is the basis of double entry records. As the name implies, the entry made for each transaction is composed of two parts—one for debit and another for credit. The double entry system may be compared with the Newton's law of motion, viz, to every action there is always an equal and contrary reaction. Every debit has equal amount of credit. So the total of all debits must be equal to the total of all credits.

Example I Mr X sold goods for cash Rs 1,000 to Mr Y. In this case the dual aspects of this transaction for Mr X and Mr Y are as follows:

Dual Aspects for Mr X

Dual Aspects for Mr Y

¹.Receipt of cash Rs 1,000

1. Payment of Cash Rs 1,000

².Foregoing of goods of Rs 1,000

2. Receipt of goods of Rs 1,000

Example II Mr *X* sold goods for Rs 1,000 to Mr *Y* on credit. In this case the dual aspects of this transaction for Mr *X* and Mr *Y* are as follows:

<i>Dual Aspects for Mr X</i>	<i>Dual Aspects for Mr Y</i>
1.Acquisition of right to recover Rs 1,000	1. Assumption of obligation to pay Rs 1,000
2.Foregoing of goods of Rs 1,000	2. Receipt of goods of Rs 1,000

13. Objectivity Principle

According to this principle, the accounting data should be definite, verifiable and free from personal bias of the accountant. In other words, this principle requires that each recorded Transaction/event in the books of accounts should have an adequate evidence to support it. In historical cost accounting, the accounting data are verifiable since, the transactions are recorded on the basis of source documents such as vouchers, receipts, cash memos, invoices, and the like. These supporting documents form the basis for their verification by auditors afterwards. For items like depreciation and the provisions for doubtful debts where no documentary evidence is available, the policy statements made by management are treated as the necessary evidence. At the same time the accounting data is ‘bias free’ since the accounting data are *neither* subject to the bias of the management *nor* the accountant who prepares the accounts. On the other hand, in value-based accounting (e.g. current cost accounting) accounting data is not bias-free because value may mean different things for different persons.

14. Timeliness Principle

Meaning According to this principle, timely information (though less reliable) should be made available to the decision makers. If the quarterly reports are made available on half-yearly basis, the information contained in the quarterly report would not be very useful to the decision makers since, the information has lost its capacity to influence the decision during the period of half year, after the expiry of which the quarterly report had been submitted.

Effect of Delays If there is undue delay in reporting the information, it may lose its relevance. To

provide information on a timely basis, it may often be necessary to report before all aspects of a transaction or other events are known. In India there is a provision for publishing half-yearly financial report of the listed companies (listed in the stock exchanges). This provides timely information to investors and potential investors to make their investment decisions. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to the users who have had to make decisions in the interim period.

15. Substance Over Form

Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

16. Variation in Accounting Practices

The peculiar characteristics of an industry may require departure from the accounting guide-lines discussed above. For example, in case of the agricultural industry, it is a common practice to disclose the crops at market value rather than at a cost since it is costly to obtain accurate cost figures of individual crops.

17. Cost-Benefit Principle

According to this principle, the cost of applying an accounting principle should not be more than its benefits. If the cost is more, this principle should be modified. The balance between benefit and cost is pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. In India often it is stated that many investors are not using the information contained in the annual report of a company. So there is a provision for giving abridged accounts to the shareholders. However, those who are interested in full information can get full annual reports by requesting the company. In this process the company saves the expenditure relating to publication of annual reports to some extent.

1.16 Summary

It is not possible for a human being to keep in memory all the transactions. Therefore, it is necessary to record all these transactions properly to get required financial information. With the help of accounting records the businessman would be able to ascertain the profit or loss and the financial position of his business at the end of a given period and would be able to communicate the results of business operations to various interested parties. Accounting deals with financial transactions, so

every accounting work is also based on reasoning. Accounting Theories always try to explain with reason, the logic underlying a particular practice. Generally Accepted Accounting Principles cannot be changed completely as they are widely and universally accepted but they can be reformed and remodeled to suit the needs of any changed Society or Economy.

1.17 Glossary

Generally Accepted Accounting Principles (GAAP) – Standard rules and guidelines used for financial accounting and reporting.

Accounting Practices – Methods and procedures followed in recording and reporting financial transactions.

Accounting Process – Step-by-step procedure of identifying, recording, classifying, and summarizing financial transactions.

Trial Balance – A statement showing the balances of all ledger accounts to check the arithmetical accuracy.

Financial Accounting – Branch of accounting that records, summarizes, and reports financial transactions of a business.

1.18 Self Assessment Questions

True and False

- a) Timely information can be less reliable.
- b) Accounting is only concerned with recording financial transactions.
- c) Accounting helps in determine financial position of a company.
- d) Accounting information is useful for both internal and external users.

1.19 Answers to Self assessment Questions

a). false, b) false, c) true, d) true

1.20 TERMINAL QUESTIONS

Long Answers type questions

- 1) What are the nature and scope of accounting theory?
- 2) What is accounting theory? Describe the role of accounting theory?
- 3) What is GAAP? Describe the different types of GAAP?

SHORT ANSWER TYPE QUESTION:

- 1) Matching concept
- 2) Accounting process
- 3) Objective principles

1.21 References

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UNIT- 2 ACCOUNTING METHODOLOGY AND ACCOUNTING AS AN INFORMATION SYSTEM

Structure

- 2.1 Introduction
- 2.2 Accounting an Information System
- 2.3 Qualitative Characteristics of Accounting Information
- 2.4 Constraints on Relevant and Reliable Information
- 2.5 Types of accounting information
- 2.6 Users of accounting information and their need
- 2.7 Summary
- 2.8 Glossary
- 2.9 Check your progress
- 2.10 Answers to check your progress
- 2.11 Terminal Questions
- 2.12 Reference Books

Objectives

After reading this unit you will be able to understand

- Accounting as an information system.
- The qualitative characteristics of accounting information.
- The accounting information.
- The users of accounting information and their information requirements.

2.1 Introduction

An accounting information system (AIS) is a system for collecting, storing and processing financial and accounting data used by decision makers. Accountants provide information needed to determine and evaluate the long- and short-term financial stability of companies, organizations or individuals. Accountants track expenses, provide detailed information about expenditure and future path, and also prepare, analyze and verify financial documents.

Accounting methodology

There are the following two methodologies in accounting theory:-

- 1) Positive methodology

2.2 Accounting as an Information System

The term 'system' may be defined a set of elements which operates together in order to attempt a goal.

Accounting comprises as series of activities linked together among them. The accounting activities form a progression of steps, beginning with observing, then collecting, recording, analyzing and finally communicating information to its users. As an information system, accounting links and information sources or transmitter (generally the accountant), a channel of communication (generally the financial statement) and set of receivers (external users). When accounting is looked upon as a process of communication, it is define as “the process of encoding observations in the language of the accounting system, of manipulating the signs and statements of the systems and decoding and transmitting the results”

Alternatively sometimes, the proceed data are further proceeds are prepared to provide useful information to users. The proceed and prepared information is communicated to users and decisions maker in the form of financial statements, other statements, report etc. In this accounting system the business transaction and activities are the input and statements and report given to decision makers are the output.

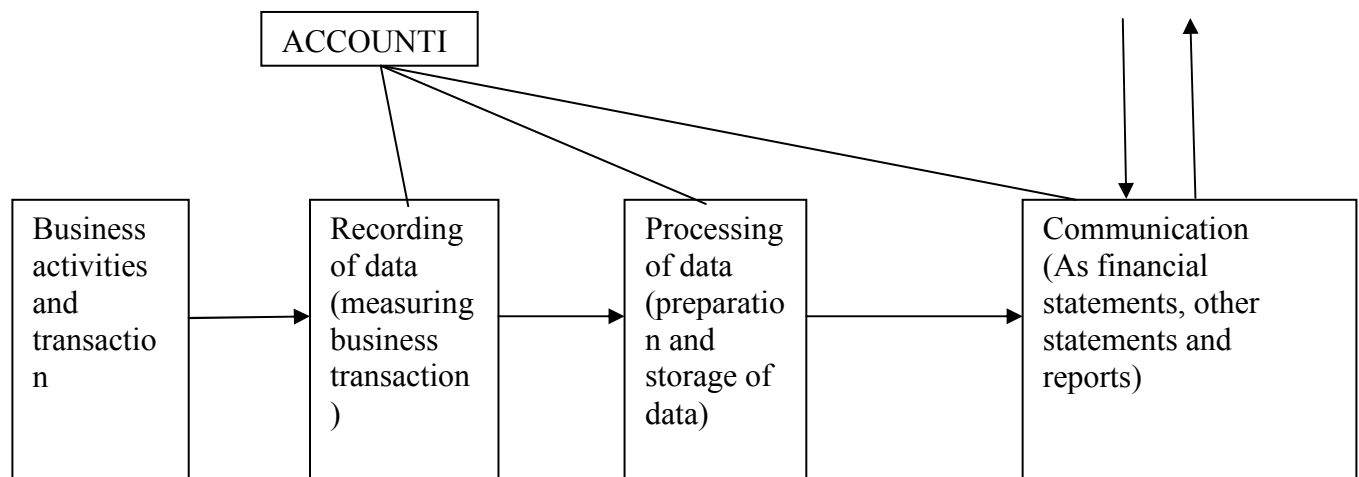
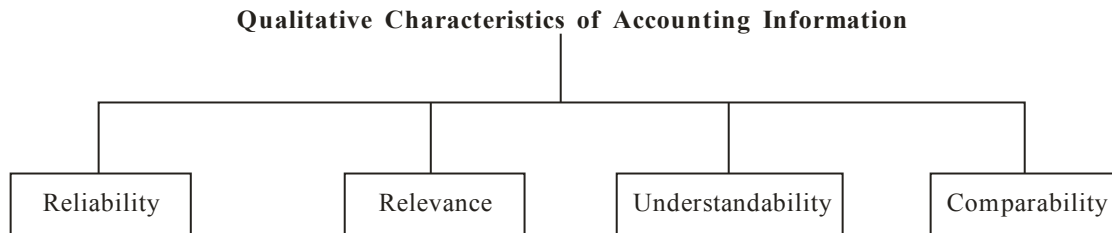


Figure: Accounting as an information in business decision

Thus, as information system accounting has a basic goal, i.e. to provide information. In order to accomplish this goal, the accounting system should be designed to classify financial information on a basis suitable for decision-making purposes and to process the tremendous quantities of data efficiently and accurately. Also, the information system must be designed to report the results periodically, in a realistic and concise format that is comprehensible to users who generally have only a limited accounting knowledge.

2.3 Qualitative Characteristics of Accounting Information :

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are:



Let us discuss these Qualitative Characteristics one by one:

1. Reliability To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it *either* purports to represent *or* could reasonably be expected to represent. Information may be relevant but so unreliable in nature *or* representation that its recognition may be potentially misleading and so it becomes useless. Reliability of the financial statements is dependent on the following:

(i) Faithful Representation—To be reliable, information must represent faithfully the transactions and other events which *either* purports to represent *or* could reasonably be expected to represent. Most financial information is subject to some risks of being. Less than faithful representation of that which it purports to portray. This is not due to bias, but rather to enhance difficulties *either* in identifying the transactions *or* other events to be measured in devising *or* applying measurements and presentation techniques that can convey messages that correspond with those transactions and events.

(ii) Substance Over Form—If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely by their legal forms. The substance of transactions or other events is not always consistent with that which is apart from their legal or contrived form.

(iii) Neutrality—To be reliable the information contained in financial statements must be neutral. Financial statements are not neutral if by selective presentation of information, they influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

(iv) Prudence—The preparers of financial statements have to contend with uncertainties that inevitably surround many events and circumstances. Such uncertainties are recognized by the

disclosure of their nature and extent and by exercise of prudence in the financial statements. Prudence is the inclusion of a degree of caution. In the exercise of judgment needed in making the estimate required under conditions of uncertainties so that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income or deliberate overstatement of liabilities or expenses.

(v) Completeness—To be reliable the information in the financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus, unreliable and deficient in terms of its relevance.

2. Relevance To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of the users by helping them to evaluate past, present or future events or confirming or correcting their past evaluation. The productive and confirmatory roles of information are interrelated. *For example*, information about the current level and structure of asset-holding has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past prediction about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

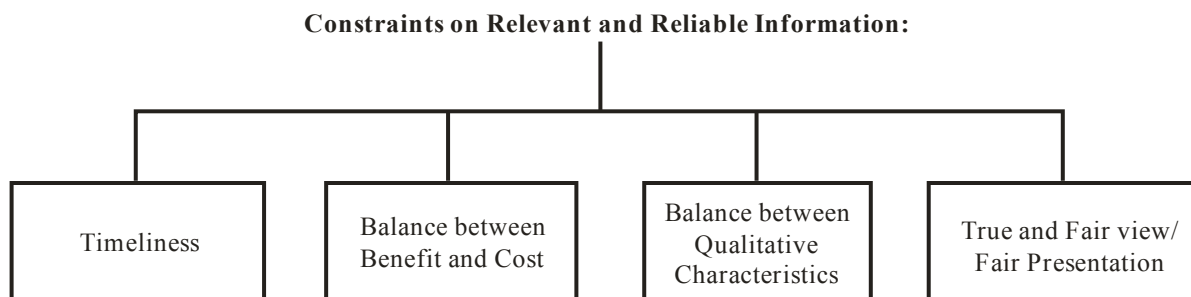
Materiality—The relevance of information is affected by its nature and materiality. Information is material if its omission or misstatement could influence the economic decisions of users made on the basis of financial statements. Materiality depends on the size of the item or error judged in the particular circumstance of its omission or misstatement. Thus, materiality provides a threshold or a cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

3. Understandability The information provided in financial statements must be readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the decision making needs of users should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

4. Comparability The financial statements of an enterprise should be comparable. For this purpose users should be informed of the accounting policies, any changes in those policies and the effects of such changes. This qualitative characteristic requires pursuance of consistency in choosing accounting policies. Lack of consistency may disturb the comparability quality of the financial statement information. Accordingly, accounting standard on disclosure of accounting policies consider consistency as a fundamental accounting assumption along with accrual and going concern.

2.4 Constraints on Relevant and Reliable Information:

The four constraints on relevant and reliable information are as follows:



Let us discuss these Constraints on Relevant and Reliable Information one by one:

(i) Timeliness If there is undue delay in reporting the information, it may lose its relevance. To provide information on a timely basis, it may often be necessary to report before all aspects of a transaction or other events are known. In India there is a provision for publishing half-yearly financial report of the listed companies (listed in the stock exchanges). This provides timely information to investors and potential investors to make their investment decisions. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to the users who have had to make decisions in the interim period.

(ii) Balance between Benefit and Cost The balance between benefit and cost is pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. In India often it is stated that many investors are not using the information contained in the annual report of a company. So there is a provision for giving abridged accounts to the shareholders. However, those who are interested in full information can get full annual reports by requesting the company. In this process the company saves the expenditure relating to publication of annual reports to some extent.

(iii) Balance between Qualitative Characteristics In practice a balancing between qualitative characteristics is often necessary. The relative importance of various qualitative characteristics in different cases is a matter of professional judgment.

(iv) True and Fair View/Fair Presentation financial statements are frequently described as showing a true and fair view, or as presenting fairly, the financial position performance and changes in financial position in an enterprise. It is believed that the application of the qualitative characteristics and the appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view.

In practice, it has also become necessary to achieve an appropriate balance among the qualitative characteristics in order to meet the objective of financial statements. Assessment of the relative importance of the characteristics is a matter of professional judgment.

2.5 Types of Accounting Information

Accounting information may be classified in number of ways on the basis of purpose of accounting information, on the basis of measurement criteria and so on. The various types of accounting

information are given below:

1. Accounting Information relating to financial transactions and events.

Financial Position—Information about financial position is primarily provided in a balance sheet.

The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates.

- (a) Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future.
- (b) Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting how successful the enterprise is likely to be in raising further finance.
- (c) Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

Financial Performance—Information about financial performance is primarily provided in a Statement of Profit and Loss (also known as Income Statement).

Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information about performance is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the enterprise might employ additional resources.

Cash Flows— Information about cash flows is provided in the financial statements by means of a cash flow statement.

Information concerning cash flows of an enterprise is useful in order to evaluate its investing, financial and operating activities during the reporting period. This information is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows.

Such information may further be classified as follows:

- (i) On the basis of Historical Cost

- (ii) on the basis of Current Cost
- (iii) on the basis of Realizable Value
- (iv) on the basis of Present Value

2. Accounting information relating to cost of a product, operation or function.

3. Accounting information relating to planning and controlling the activities of enter-prise for internal reporting.

Such information may further be classified as follows:

- (a) Information relating to Finance Area
- (b) Information relating to Production Area
- (c) Information relating to Marketing Area
- (d) Information relating to Personnel Area
- (e) Information relating to Other Areas (such as Research & Development)

4. Accounting information relating to Social Effects of business decisions.

5. Accounting information relating to Environment and Ecology.

6. Accounting information relating to Human Resources.

2.6 Users of An Accounting Information and their Needs :

The users of accounting information include present and potential investors, management, employees, lenders, suppliers and other trade creditors, customers, government and their agencies and the public. These users use accounting information in order to satisfy some of their varied needs for information.

Some of the users and their needs for information are shown below:

<i>Users</i>	<i>Need for Information</i>
1. Short-term Creditors [For example, suppliers of raw-materials/goods, suppliers of short-term loans]	Short-term creditors need information to determine whether the amount owing to them will be paid when due and whether they should extend, maintain or restrict the flow of credit to an individual enterprise.
2. Long-term Creditors [For example, suppliers of long-term loans]	Long-term creditors need information to determine whether their principals and the interest thereof will be paid when due and whether they should extend, maintain or restrict the flow of credit to an enterprise.
3. Present Investors [For example, equity share holders]	Present investors need information to judge prospects for their investment and to determine whether they should buy, hold or sell the shares.
4. Potential Investors [For example, those who want to invest]	Potential investors need information to judge prospects of an enterprise and to determine whether they should buy the shares.
5. Management	Management needs information to review the firm's (a) short term solvency, (b) long-term solvency, (c) activity (<i>viz.</i> Effective utilization of its resources), (d) profitability in relation to turnover, (e) profitability in relation to investments and to decide upon the course of action to be taken in future.
6. Employees	Employees and their representative groups are interested in information about the stability and profitability of the employers. They are also interested in information which enables them to assess the ability of the enterprise to pay remuneration, retirement benefits and to provide employment opportunities.
7. Tax Authorities	Tax authorities need information to assess the tax liabilities of an enterprise.
8. Customers	Customers have an interest in information about the continuation of an enterprise, especially when they have established a long term involvement with, or are dependent on, the enterprise.
9. Government and their agencies	Government and their agencies are interested in the allocation of resources and, therefore, the activities of enterprise. They also require information in order to regulate the activities of enterprise, determine taxation policies and as the basis for the national income and similar statistics.
10. Public	Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people, they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about trends and recent developments in the prosperity of the enterprise and the range of its activities. While all the information needs of these users cannot be made by financial statements,

there are some needs which are common to all users. The information contents of the financial statements which meet information needs of the investors or providers of risk capital will also meet most of the needs of other users.

2.7 Summary

Accounting involves a series of interrelated activities. Accounting activities form a step-by-step progression starting with observation, then gathering, recording, analyzing information and finally communicating the information to its users. The four qualitative characteristics of accounting information include reliability, relevance, understandability, and comparability. The four constraints on relevant and reliable information are: timeliness, balance between benefits and costs, balance between qualitative attributes, and accurate and fair presentation. Accounting information can be classified in many ways based on accounting information, accounting measurement, etc. The users of accounting information include present and future employers, management, employees, lenders, suppliers and other trade creditors, customers, government and its various agencies, and the public. These users use accounting information to satisfy their various information needs.. While financial statements cannot meet all the information needs of these users, some information needs are common to all users.

2.8 Glossary

Cash flow: Cash going in or out of the business.

Overstatement or understatement of income: Showing income at a higher or lower value than the actual.

2.9 Self Assessment

True and False

1. Information regarding cash flows is provided in the financial statements through the cash flow statement.
 2. Most financial information is not risky.
 3. If a company provides its shareholders with a summarized account, it can save the expenses associated with publishing annual reports to some extent.
 4. Customers are not interested in business continuity information.
-

2.10 Answers to self assessment

1(T), 2(F),3(T), 4(F)

2.11 Terminal Questions

LONG ANSWER TYPE QUESTION:

- 1) What are the accounting methodologies? Describe the accounting as an information system.

SHORT ANSWER TYPE QUESTION:

- 1) Positive methodology
- 2) Normative methodology
- 3) Users of accounting information.

2.12 References

S.N. Maheshwari, Advanced Accountancy

R.L. Gupta, Advanced Accountancy

Shukla, Grewal, Advanced Accounts

Agarwal & Jain, Advanced Financial Accounting

UNIT-3 ACCOUNTING STANDARDS IN INDIA AND ISSUES IN ACCOUNTING STANDARD SETTING

Structure

- 3.1 Introduction
- 3.2 Accounting Standards in India
- 3.3 Meaning of Accounting Standard
- 3.4 Objectives of Accounting Standards
- 3.5 Importance and objectives of Accounting Standard
- 3.6 Who issues Accounting Standards in India?
- 3.7 What is the duty of Statutory Auditor for Compliance with Accounting Standards.
- 3.8 Procedure for issuing Accounting Standards
- 3.9 Advantages of setting Accounting Standards
- 3.10 Arguments against setting Accounts Standards
- 3.11 Development of Accounting Standards
- 3.12 Accounting Standard Board of India
- 3.13 Compliance with accounting standard board
- 3.14 Summary
- 3.15 Glossary
- 3.16 Check your progress
- 3.17 Answers to check your progress
- 3.18 Terminal Questions
- 3.19 Reference Books

Objectives

- After reading this unit you will be able to understand.
 - Meaning of accounting standards, objectives, importance and advantages.
 - Procedure for issuing Accounting Standards.
 - Development and Compliance with accounting standard board.
-

3.1 Introduction

Financial statements are prepared to summarize the end-result of all the business activities by an enterprise during an accounting period in monetary terms. These business activities vary from one enterprise to other. To compare the financial statements of various reporting enterprises poses some difficulties because of the divergence in the methods and principles adopted by these enterprises in preparing their financial statements. In order to make these methods and principles uniform and comparable to the extent possible – standards are evolved.

3.2 Accounting Standards in India

Accounting Standards in India are a set of guidelines and principles issued to standardize accounting practices across various organizations. These ensure consistency, transparency, and comparability of financial statements. Accounting Standards are used as one of the main compulsory regulatory mechanisms for preparation of general-purpose financial reports and subsequent audit of the same, in almost all countries of the world. Accounting standards are concerned with the system of measurement and disclosure rules for preparation and presentation of financial statements.

Accounting Standards are the policy documents (authoritative statements of best accounting practice) issued by recognized expert accountancy bodies relating to various aspects of measurement, treatment and disclosure of accounting transactions and events.

3.3 Meaning of Accounting Standard:

Accounting as a ‘language of business communicates the financial performance and position of an enterprise to various interested parties by means of financial statements which have to exhibit a ‘true and fair’ view of financial results and its state of affairs. Like any other language, accounting

has its own complicated set of rules. The basic conventions or rules used in preparing financial statements had evolved over many years as a product of the collective experience of practicing accountants. As a result a wide variety of accounting methods were used by different companies. It was, then, felt that there should be some standardized set of rules and accounting principles to reduce or eliminate confusing variations in the methods used to prepare financial statements. However, such accounting rules should have a reasonable degree of flexibility in view of specific circumstances of an enterprise and also in line with the changes in the economic environment, social needs, legal requirements and technological developments. In order to suggest rules and criteria of accounting measurements several accounting standard setting bodies were established in developed and developing countries. The setting of accounting standards is a social decision. Standards place restrictions on behavior and therefore they must be accepted by affected parties.

DEFINITION

“Accounting Standards are the statements of code of practice of the regulatory accounting bodies that are to be observed in the preparation and presentation of financial statements. In layman terms, accounting standards are the written documents issued by the expert institutes or other regulatory bodies covering various aspects of measurement, treatment, presentation and disclosure of accounting transactions. “

“An accounting standard is a selected set of accounting policies or broad guidelines regarding the principles and methods to be chosen out of several alternatives. Standards conform to applicable laws, customs, and usage and business environment. So there is no universally acceptable set of standards.”

3.4 Objectives of Accounting Standard:

The main objective of accounting standards is to harmonize the diverse accounting policies and practices at present in use in India. However, harmonization does not mean that accounting standards should become very rigid. In fact, harmonizations of accounting standards do permit flexibility to make the necessary adjustments to suit their purpose.

The objective of Accounting Standards is to remove variations in the treatment of several accounting aspects and to bring about standardization in presentation. They intent to harmonize the diverse

accounting policies followed in the preparation and presentation of financial statements by different reporting enterprises so as to facilitate intra-firm and inter-firm comparison

3.5 Significance and Benefits of Accounting Standard

The adoption and application of accounting standards ensures uniformity, comparability and qualitative improvement in the preparation and presentation of financial statements.

The accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in companies' economic performance.

The benefits of accounting standards may be listed as follows:-

- 1) To improve the reliability of financial statements
- 2) Determining corporate accountability
- 3) Reform in accounting practices
- 4) Benefits to auditors and accountant.

3.6 Who issues Accounting Standards in India?

The Institute of Chartered Accountants of India (ICAI) recognizing the need to harmonize the diverse accounting policies and practices at present in use in India constituted Accounting Standards Board (ASB) on April 21, 1977. The main role of ASB is to formulate Accounting Standards from time to time.

3.7 What is the duty of Statutory Auditor for Compliance with Accounting Standards?

Section 211(3A) of Companies Act, 1956 provides that every profit and loss account and balance sheet of the company shall comply with the accounting standards.

The statutory auditors are required to make qualification in their report in case any item is treated differently from the prescribed Accounting Standard. However, while qualifying, they should

consider the materiality of the relevant item. In addition to this Section 227(3)(d) of Companies Act, 1956 requires an auditor to report whether, in his opinion, the profit and loss account and balance sheet are complied with the accounting standards referred to in Section 211(3C) of Companies Act, 1956.

3.8 Procedure for issuing Accounting Standards

Broadly, the following procedure will be adopted for formulating Accounting Standards:

Step 1 : To determine the broad areas in which accounting standards need to be formulated and the priority in regard to the selection thereof.

Step 2 : To hold a dialogue with the representatives of the government, public sector undertakings, industry and other organizations for ascertaining their views.

Step 3 : On the basis of the work of the study groups and the dialogue with the representatives, to prepare and issue the exposure of draft of the proposed standard for comments by members of the Institute and the public at large.

Step 4: To finalize the draft of the proposed standard after taking into consideration the comments received.

Step 5 : To submit the final draft of the proposed standard to the Council of the Institute.

The Council of the Institute will consider the final draft of the proposed standard, and if found necessary, modify the same in consultation with ASB. The accounting standard on the relevant subject will then be issued under the authority of the Council.

3.9 Advantages of setting Accounting Standards

1. ***Reduction in Variations***—Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.
2. ***Disclosure Beyond that Required by Law***—there are certain areas where important information is not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.

- 3. Facilitates Comparison**— the application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different.

3.10 Arguments against setting Accounts Standards

However there are some arguments against setting accounting standards:

1. *Restriction on Choice of Alternative Treatments*—Alternative solutions to certain accounting problems may each have arguments to recommend them. A standard which insists on one particular solution may be unduly restrictive. This can sometimes be avoided either by allowing a permitted choice between different accounting treatments, or by defining closely the circumstances where different treatments may be appropriate.
2. *Rigidity*—there may be a trend towards rigidity in applying the accounting standards. Michael Alexander, Director of Research and Technical Activities at the Financial Accounting Standards Board (FASB) said, ‘the demand for standards comes largely from an insatiable appetite for rules. The reliance on judgment in technical accounting matters seems to have gone’.
3. *Cannot Override the Statute*— accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

3.11 Developments of Accounting Standards

Prior to the 1970s, few academics paid much attention to the standard-setting process in accounting. Beginning in the 1970s, however, it became clear that standard setting was a fascinating process that had become intertwined with the economic self-interests of affected parties. Currently, standard-setting boards or committees are active in a number of countries, including the United States, United Kingdom, Australia, Canada, New Zealand, the Netherlands, Japan and India.

At International level In 1972 International Accounting Standards Committee (IASC), was formed for developing International Accounting Standards (IASs). The IASC comprises the professional accountancy bodies of over 75 countries (including The Institute of Chartered Accountants of India). During these three decades the IASC has issued 40 IASs through a due process involving the worldwide accountancy profession, the preparers and users of financial statements and the national standard-setting bodies. However the IASs are not accepted worldwide.

In 1978, another professional body, the International Federation of Accountants (IFAC) was established.

3.12 Accounting Standards Board of India

Formation of the Accounting Standards Board The Institute of Chartered Accountants of India, recognizing the need to harmonize the diverse accounting policies and practices at present in use in India, constituted an Accounting Standards Board (ASB) on April 21, 1977.

Scope and function of Accounting Standards Board The main function of ASB is to formulate accounting standards so that such standards may be established by the Council of the Institute in India. While formulating the accounting standards, ASB will take into consideration the applicable law, customs, usages and business environment.

The Institute is one of the members of the International Accounting Standards Committee (IASC) and has agreed to support the objectives of IASC. While formulating the accounting standards, ASB will give due consideration to International Accounting Standards issued by IASC and tries to integrate them, to the extent possible, in the light of the conditions and practices prevailing in India.

The accounting standards will be issued under the authority of the Council. ASB has also been entrusted with the responsibility of propagating the accounting standards and of persuading the concerned parties to adopt them in the preparation and presentation of financial statements. ASB will issue guidance notes on the accounting standards and give clarifications on issues arising there from. ASB will also review the accounting standards at periodic-cal intervals.

Accounting Standards issued so far In India, The Council of the Institute of Chartered Accountants of India has so far issued **thirty two** accounting standards. Some of these standards are mandatory. These accounting standards are mandatory in the sense that these are binding on the members of the Institute. These standards are as follows:

<i>No.</i>	<i>Title</i>	<i>Recommend- atory or Mandatory</i>	<i>Mandatory from accounting period begin- ning on or after</i>
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AS – 1	Disclosure of Accounting Policies	Mandatory	1.4.93
AS – 2	Valuation of Inventories (Revised)	Mandatory	1.4.99
AS – 3	Cash Flow Statement	Mandatory	1.4.2001
AS – 4	Contingencies and Events Occurring After the Balance Sheet Date (Revised)	Mandatory	1.4.95
AS – 5	Prior Period and Extra-ordinary items and Changes in Accounting Policies (Revised)	Mandatory	1.1.96
AS – 6	Depreciation Accounting (Revised)	Mandatory	1.4.95
AS – 7	Accounting for Construction Contracts(Revised)	Mandatory	1.4.03
AS – 8	Accounting for Research and Development Withdrawn and included in	Mandatory	1.4.93
AS – 9	Revenue Recognition	Mandatory	1.4.93
AS – 10	Accounting for Fixed Assets	Mandatory	1.4.93
AS – 11	Accounting for the Effects of Changes in Foreign Exchange Rates (Revised)	Mandatory	1.4.04
AS – 12	Accounting for Government Grants	Mandatory	1.4.94
AS – 13	Accounting for Investments	Mandatory	1.4.95
AS – 14	Accounting for Amalgamations	Mandatory	1.4.95
AS -15	Accounting for Retirement Benefits in the Financial Statements of Employers	Mandatory	1.4.95
AS – 16	Borrowing Costs	Mandatory	1.4.2000
AS – 17	Segment Reporting	Mandatory	1.4.2001
AS – 18	Related Parties Disclosures	Mandatory	1.4.2001
AS – 19	Leases	Mandatory	1.4.2001

AS – 20	Earnings Per Share	Mandatory	1.4.2001
AS – 21	Consolidated Financial Statements	Mandatory	1.4.2001
AS -22	Accounting for Taxes on Income	Mandatory	1.4.2001
AS -23	Accounting for Investments in Associates in Consolidated Financial Statements	Mandatory	1.4.2002
AS – 24	Discontinuing Operations	Mandatory	1.4.2004
AS – 25	Interim Financial Reporting	Mandatory	1.4.2002
AS – 26	Intangible Assets	Mandatory	1.4.2003
AS - 27	Financial Reporting of Interests in Joint Venture	Mandatory	1.4.2004
AS – 28	Impairment of Assets	Mandatory	1.4.2004
AS – 29	Provision, Contingent Liabilities and Contingent assets	Mandatory	1.4.2004
AS-30	Financial instruments: recognition and measurement	Mandatory	1.4.2011
AS-31	Financial instruments: presentation	Mandatory	1.4.2011
AS-32	Financial instruments: disclosures	Mandatory	1.4.2011

3.13 Compliance with Accounting Standards

During the period an accounting standard is recommendatory in nature, the members of the Institute should, while discharging their attest function, examine whether the standard has been followed or not. If the same has not been followed, the members should consider whether, keeping in view the circumstances of the case, a disclosure in their audit reports is necessary.

Once the standard becomes mandatory, it will be the duty of the members of the Institute to examine, while discharging their attest function, whether this accounting standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the accounting standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations.

3.14 Summary

Accounting standards are policy statements (authoritative statements of good accounting practice) issued by recognised specialist accounting firms regarding the measurement, treatment and disclosure of various aspects of accounting transactions and events. In order to suggest the rules and basis of accounting measurement, many accounting standard setting bodies have been established in developed and developing countries. Setting of accounting standards is a social decision. The setting of accounting standards is a social decision. Standards impose constraints on behavior and therefore must be accepted by affected parties. The objective of accounting standards is to eliminate deviations in the treatment of various accounting aspects and to standardize the presentation. Their purpose is to harmonize the various accounting policies adopted and presented in the financial statements. Section 211 (3A) of the Companies Act, 1956 provides that every profit and loss account and balance sheet of a company shall be in accordance with the accounting standards. There are many advantages of setting accounting standards but there are also some arguments against setting accounting standards. The main function of the Accounting Standards Board in India is to formulate accounting standards so that the council of institutions of India can establish such standards. While formulating standards, the Accounting Standards Board takes into account the prevailing law and business environment. So far 32 accounting standards have been issued in India. Some of these standards are mandatory.

3.15 Glossary

Accounting Standards: Accounting Standards are written policy documents issued by regulatory bodies that define how specific types of financial transactions and events should be reported in financial statements.

3.16 Check your progress

True/ False

1. There is no universally accepted standard.
2. Accounting Standards Board (ASB) was constituted on 22nd April, 1997.
3. Accounting Standards are not above the law.
4. Standards cannot require disclosures beyond those required by law.

3.17 Answers to check your progress

1 (t), 2(f), 3(t),4(f)

3.18 Terminal Questions

LONG ANSWER TYPE QUESTION:

- 1) What are the accounting standards? Describe the objects and significance of accounting standards.
- 2) Describe the various issues about the setting of accounting standards.

SHORT ANSWER TYPE QUESTION:

- 1) Who makes the AS?
- 2) Advantage of setting accounting standards
- 3) Objects of accounting standards.

3.19 Reference Books

S.N. Maheshwari, Advanced Accountancy
R.L. Gupta, Advanced Accountancy
Shukla, Grewal, Advanced Accounts
Agarwal & Jain, Advanced Financial Accounting

UNIT-4 DIFFERENT APPROACHES TO THEORY CONSTRUCTION

Structure

- 4.1 Introduction
- 4.2 Approaches to Theory Construction
- 4.3 Some other approaches in accounting theory
- 4.4 Summary
- 4.5 Glossary
- 4.6 Check your progress questions
- 4.7 Answers to check your progress
- 4.8 Terminal Questions
- 4.9 Reference Books

Objectives

After reading this unit you will be able to understand-

- Differentiate between the deductive and inductive approach to theory construction.
- Various approaches to accounting theory

4.1 Introduction

Accounting is a complete system which includes every activity related to measuring and recording every economic and financial information about an organization which is used by the general public to analyze the business and make decisions. When it comes to accounting principles, the most important step is to formulate them. There are several approaches that go into the study and formulation of these principles. The theoretical approach involves the adoption of various theories and qualitative analysis to develop different theories. Different theories and theoretical references are used by policy makers to develop different accounting principles. Thus the theoretical approach to the formulation of accounting principles involves many different approaches and references. Apart from the theoretical approach, policy makers also use many different non-theoretical approaches to formulate and develop various accounting principles. This approach involves various non-theoretical

references according to which new and different accounting principles are developed and then implemented by the accountants.

4.2 Approaches to Theory Construction

There are mainly two approaches in theory construction, which are as followings:-

- 1) Deductive approach
- 2) Inductive approach

Deductive approach

The deductive approach begins with basic accounting objectives or propositions and proceeds to derive by logical means accounting a principle that serves as guides and bases for the development of accounting techniques. The deductive approach includes the following process:-

- a) Determining the objectives of financial reporting
- b) Selecting the postulates of accounting
- c) Developing a set of definitions
- d) Formulating principles of accounting or generalized statements of policy
- e) Applying the principles of accounting to specific situation and
- f) Establishing procedures, methods and rules

Inductive approach

The inductive approach to accounting theory examines observation first and accounting practices and then derives principles and procedures from these observations. This approach emphasizes on drawing generalized conclusions and principles of accounting from detailed observation and measurements of financial information of business enterprises. This approach includes the following process:-

- a) Making observations and recording of all observations
- b) Analysis and classification of these observations to determine recurring relationships, similarities, and dissimilarities
- c) Derivation and formulation of generalizations and principles of accounting from the recorded observations that reflect recurring relationships
- d) Testing of generalizations and principles

4.3 Some other approaches in accounting theory

Event approach

The event approaches in accounting theory implies that the purpose of accounting is to provide information about relevant economic events that might be useful in a variety of possible decision models. The event approach suggests a large expansion of the accounting data presented in financial reports.

Value approach

It is a traditional approach in accounting which assumes that ‘users’ needs are known and sufficiently well specified so that accounting theory can deductively arrive at and produce optimal input values for user and useful decision models.

Predictive approach

In accounting theory predictive approach deals with deciding different accounting alternatives and measurement methods. This approach signifies that particular accounting method should be followed which has predictive ability, i.e., which can predict events that are useful in decision making and in which user are interested.

Pragmatic approach

The pragmatic approach aims to construct a theory characterized by its conformity to real world practices and that is useful in terms of suggesting practical solutions. According to this approach, accounting techniques and principles should be chosen because of their usefulness to users of accounting information and their relevance to decision making process.

Authoritarian approach

The authoritarian approach to the formulation of an accounting theory, which is used mostly by professional organizations, consists of issuing pronouncements for the regulation of accounting practices.

Ethical approach

The ethical approach to accounting theory places emphasis on the concepts of justice, truth and fairness. Fairness, justice, and impartiality signify that accounting reports and statements are not subject to undue influence or bias.

The ethical approach fails to provide a sound basis for the development of accounting principles or for the evaluation of currently accepted principles.

Sociological approach

The sociological approach to the formulation of an accounting theory emphasizes the social effects of accounting techniques. It is an ethical approach that centers on a broader concept of fairness, that is, social welfare. According to this approach, a given accounting principle or technique will be evaluated for acceptance on the basis of its reporting effects on all groups in society.

Economic approach

The economical approach to the formulation of an accounting theory emphasizes controlling the behavior of macroeconomic indicators that result from the adoption of various accounting techniques. According to this approach the choice of different accounting techniques depends on their impact on the national economic good.

Eclectic approach

The eclectic approach is basically the result of numerous attempts by individual writers and researchers professional organizations, government authorities in the establishment of accounting theory and principles and concept there in. Therefore, eclectic approach comprises a combination of approaches.

4.4 Summary

There are mainly two approaches in theory construction, these are Deductive approach and Inductive approach. The deductive approach begins with basic accounting objectives or propositions and proceeds to derive by logical means accounting a principle that serves as guides and bases for the development of accounting techniques. The inductive approach to accounting theory examines observation first and accounting practices and then derives principles and procedures from these observations. Besides that there are some other approaches in accounting theory also.

4.5 Glossary

Deductive Approach: begins with basic accounting objectives or propositions and proceeds to derive by logical means accounting.

Inductive Approach: examines observation first and accounting practices and then derives principles and procedures from these observations.

4.6 Check your Progress Questions

True and False

1. The deductive approach starts with the basic accounting objectives and assumptions.
2. The sociological approach is an ethical approach to the formulation of accounting theory.
3. The inductive approach first observes the accounting practices and then derives principles.
4. The mixed approach of accounting theory is a harmony of many approaches.

4.7 Answers to check your progress

1. True
2. True
3. True
4. True

4.8 Terminal Questions

LONG ANSWER TYPE QUESTION:

- 1) Describe the different approaches in theory construction.

SHORT ANSWER TYPE QUESTION:

- 1) Deductive approach
- 2) Inductive approach
- 3) Eclectic approach
- 4) Sociological approach
- 5) Pragmatic approach
- 6) Predictive approach
- 7) Event approach.

4.9 Reference Books

S.N. Maheshwari, Advanced Accountancy
R.L. Gupta, Advanced Accountancy
Shukla, Grewal, Advanced Accounts
Agarwal & Jain, Advanced Financial Accounting

UNIT-5 ACCOUNTING AND ECONOMIC CONCEPTS OF INCOME AND VALUE

STRUCTURE

- 5.1 Introduction
- 5.2 Concept of Income
- 5.3 Accounting Concepts and Income Measurement
- 5.4 Expired Cost and Income Measurement
- 5.5 Realization Concept and Income Measurement
- 5.6 Accountant's and Economist's Concept of Capital and Income
- 5.7 Summary
- 5.8 Glossary
- 5.9 Check Your Progress
- 5.10 Answers to Check Your Progress
- 5.11 Terminal and Model Questions
- 5.12 Suggested Readings

OBJECTIVES

After reading this unit, you should be able to

- ✓ Explain the concept of Income.
- ✓ Understand the effect of different accounting concepts on measurement of business income.
- ✓ Discuss the role of expired cost of income measurement.
- ✓ Identify the different alternatives regarding reorganization of the time when the income could be taken as realized.
- ✓ Distinguish between accountant's and economist's concepts of capital and income.

5.1 INTRODUCTION

The Income Statement measures the income of a business during a particular period of time. It is of greater importance than the Balance Sheet since the main objective of running a business enterprise is to maximize profit, and this depends to a great extent on the income made year after year. On account of this reason, management, workers, shareholders, government, etc., all are interested in the proper preparation and presentation of the Income Statement; it will be useful to know correctly the meaning of the term Income and the problems in its determination.

5.2 CONCEPT OF INCOME

In common parlance, the term 'Income' means the reward or payment received in exchange for the production of goods and services. For example, the salary received by the clerk is his income, since it is the reward received by him for his services. Similarly, the rent received by the owner of a property is his income, it is the reward for the services rendered by him through his property. In case a craftsman earns some money by selling some of the articles made by him, the money so earned will be taken as his income. Income may be of different types, e.g., Personal Income, National Income, Business Income, Gross Income, Net Income, etc. The term Income, therefore, by itself cannot give any precise meaning unless it is used with some adjective.

In accounting, we are mainly concerned with Business Income, a term which is synonymous with the term Business Profit. It can be defined as the excess of revenue over the expenditure incurred by the business over a period. According to Smith, "The Net Income for the period is the excess of revenues realized during the period by a specific accounting entity over the cost expired (including losses) during the same period."

The most accepted and authentic definition of Income is the one given by the American Accounting Association. It is being reproduced as follows:

"The Realized Net Income of an enterprise measures its effectiveness as an operative unit and is the change in its net assets arising out (a) the excess or deficiency of revenue compared with related expired cost and (b) other gains or losses to the enterprise from sales, exchange or other conversion of assets."

Moreover, according to the American Accounting Association, the term Business Income includes realized net income and not income alone. It means, income will be considered to be business income only when it has been actually realized. National Income such as appreciation in the market value of the assets of the firm cannot be taken as business income unless the assets have really been disposed off.

The computation of income thus involves, according to the definition given above, matching of the expired cost or expense with the revenue. However, there are practical difficulties that are confronted by the accountant in measuring business income. The difficulties arise on account of two reasons:

- (i) The measurement of accounting income is subject to several accounting concepts and conventions.
- (ii) Determination of the expired cost is a difficult exercise on account of complex series of business transactions of different multitudes.

5.3 ACCOUNTING CONCEPTS AND INCOME MEASUREMENT

Measurement of the accounting income is subject to a number of accounting concepts and conventions. Given below is the impact of these concepts and conventions on measurement of the accounting income.

1. Convention of Conservatism

According to the Convention of Conservatism, the accountant always follows the policy of playing safe while determining business income. The Conservatism Principle thus seeks to ensure that the reported profit is not overstated. However, it cannot be said that this principle will ensure that the reported profit is not understated. The business income can be understated by providing excessive depreciation, excessive provision for doubtful debts, etc. Thus, the income as disclosed by the Financial Statements may not be the real income of the business.

2. Consistency

According to this concept, a business enterprise should be consistent in the accounting practice that it follows in the treatment of its assets, liabilities, revenues and expenses. It may

sometimes be difficult for the accountant to strictly follow the concept of consistency. Charges may be required in the treatment of different items on account of legal requirements or change in the accounting methods. For example, a concern may change the method of valuation of its stock-in-trade or the method of charging depreciation from one year to another. Such a change will result in determination of the accounting income on a different pattern than what has been done so far. Thus, the measurement of business income also depends to a great extent upon the basis followed year after year regarding treatment of different items which form part of the Income Statement of the business. However, accounting profession and the corporate laws of most of the countries require that the financial statements must be made out on the basis that figures stated are consistent with those of the preceding year. In case if changes are made in the accounting treatment, the resulting changes in profit or loss should be disclosed separately.

3. Accounting Period Concept

As a matter of fact, the income of a business enterprise can be precisely determined only at the end of its life, i.e., when the business is finally closed down. However, in order to have an idea about the progress made by the business and to take remedial measures in time, business income is determined after the expiry of a reasonable period. Such a period is termed as 'accounting period'. The income disclosed by the Income Statement is the income made during the accounting period. However, this is only an interim report. Thus, the measurement of accounting income is also subject to the Accounting Period Concept.

4. Accrual Concept

The measurement of accounting income is also subject to the Accrual Concept. At the end of the accounting period, when the final accounts are prepared, there may be many business activities at different stages of progress – some of the goods might be lying unsold, some work may be still in progress, money due may have to be collected from the debtors, and so on. In accounting, the revenue is generally treated to be realized when the goods or services are furnished to the customers and not when cash or other valuable consideration has been received from them. It may be possible that some of the items for which the revenue has been treated as realized, may not result in any revenue on account of subsequent non-payments. Thus, the income disclosed by the Income Statement may not be the real income of the business.

5. Going Concern Concept

The measurement of business income is also subject to the Going Concern Concept. According to this concept, it is assumed that the business will continue for a fairly long time. On account of this reason, the accountant charges depreciation on the fixed assets not on the basis of their market values, but on the basis of their original cost. In case of inflationary economy, charging of depreciation on the basis of original cost of the fixed assets, while taking revenue on the basis of the current market prices may result in considerable overstatement of business income.

6. Separate Entity Concept

According to this concept, the business and the proprietor are taken as two different persons. Thus, income of the business cannot be taken as the income of the proprietor. For example, interest on capital is income from the point of view of the proprietor but it is an expense from the point of view of the business. Thus, one should not confuse 'business income' with 'personal income' of the proprietor of the business. Of course, ultimately the business income also becomes a part of the personal income of the proprietor.

5.4 EXPIRED COST AND INCOME MEASUREMENT

The definition of business income as given by American Accounting Association states that the revenue has to be compared with the related expired cost (or expense) for the purpose or determination of business income. In other words, the expired cost or the expense has to be identified in some fashion or the other with one or more elements of revenue. In real life situations, it is extremely difficult and in many cases it is almost impossible to achieve such identification. This is because of a series of transactions of different varieties and magnitudes in business. Moreover, it is not always necessary that income during the accounting period is earned only on account of the cost or expenditure incurred during that accounting period. It may be a result of the efforts or expenditure incurred during the preceding few years. Similarly, efforts or expenditure made or incurred during an accounting period may bring results in the years to come. It, therefore, becomes almost impossible to determine the actual cost incurred for particular revenue earned during the course of a particular year. For example, goods purchased or manufactured during a particular period may not be sold in that year. They may be sold in the next year together with part or whole of

the goods manufactured or purchased during that year. Similarly, advertisement costs incurred during a particular period may bring benefit to the business only in the next few years. It is almost an impossible task in such cases to decide how much expenses have been incurred for the revenue which is being earned during the accounting period.

In order to give a better idea about the real problem faced by the accountant in determining the real business income, the problem can be explained on the basis of different types of costs involved in the process of determination of business income. For the purpose of cost analysis, the business concerns can be divided into two categories:

- (i) Trading concerns
- (ii) Manufacturing concerns.

Trading concerns purchase goods from outside sources and sell them at profitable prices. Manufacturing concerns, on the other hand, purchase raw materials and convert them into finished goods through different manufacturing operations. The basic difference between these concerns lies in the kind of inventory they carry and the nature of the cost incurred.

In case of trading concerns, the stock primarily consists of finished goods while in case of manufacturing concerns, stock may be of raw materials, work-in-progress or finished goods.

For the purposes of income determination, in case of trading concerns, the cost of goods sold together with relevance to administrative, selling and distribution expenses are to be compared with the revenue of the period. While in case of manufacturing concerns, cost of goods manufactured and sold is to be compared with the revenue. Thus, in both, cost of goods sold has to be determined. In case of trading concerns, the cost of goods sold depends upon the purchase price of the goods; while in case of manufacturing concerns, it depends upon the manufacturing cost of the goods.

In both cases, for determination of income made during a particular period, the operating expenses of the business are also to be considered. Besides these costs, there are certain extraordinary expenses or losses such as losses due to natural calamities, development expenditure, etc., which are also to be considered for the purpose of determination of income. Thus, determination of business income requires determination of the expired cost or expense which may consist of the following types of costs: (i) cost of goods sold which includes both

direct and indirect costs, (ii) inventory cost, (iii) intangible cost, (iv) imputed cost, (v) extraordinary cost, etc. Determination of each of these costs is a complex and difficult affair. Below are explained the problems faced by the accountant in determination of these costs.

(i) Cost of Goods Sold/Purchased

Income determination requires in case of both manufacturing and trading concerns the cost of goods sold. In case of trading concerns, the job is comparatively easy since the cost of goods sold can be easily found out by taking into account the purchase cost of the goods. However, in case of manufacturing concerns, it is to be found out by taking into consideration the manufacturing cost. Manufacturing costs can be both direct as well as indirect. Direct costs are those which can be directly, conveniently and wholly identified with specific products, jobs or manufacturing processes, e.g., cost of raw materials used for manufacturing the products, cost of factory labour, etc. Indirect manufacturing costs are those which cannot be directly identified with specific jobs, products or processes, e.g., salary paid to the factory manager, rent, rates, lighting, depreciation of factory machines, etc. These costs are to be apportioned on different products on some reasonable basis, e.g., the salary paid to the factory manager may be charged to different products on the basis of direct wages for each product. Similarly, rent paid for the factory may be charged to different products on the basis of departmental area occupied by each of the production departments. Apportionment of the indirect costs so made cannot be fairly accurate, thus affecting the accuracy of computation of cost of products. Moreover, some costs such as depreciation of plant and machinery or depreciation of factory building cannot themselves be determined accurately. Depreciation depends on the cost of the asset, its scrap value and the estimated life of the asset. It is very difficult to make a fair estimate about the scrap value and life of the asset. The amount of depreciation charged may not, therefore, be very correct. Thus, when estimation of the various elements which constitute cost cannot be made correctly, the measurement of income on the basis of such estimates also cannot be very accurate.

(ii) Inventory Cost

The term 'Inventory' includes (i) Stock of raw materials, (ii) Stock of work-in-progress, and (iii) Stock of finished goods. The computation of the cost of inventory is also a tedious process. The valuation of the stock of raw materials will depend upon the method of

pricing material issues followed by the business. Materials may be issued to production according to First In First Out (FIFO) Method, Last In First Out (LIFO) Method, Weighted Average Price Method, etc. In each of these cases, the value of the inventory of raw materials may widely differ. This will be clear with the help of the following example.

A business buys raw materials in two different lots. In the first lot, 1,000 units are purchased @ Rs.10 per unit. In the second lot, 2,000 units are purchased @ Rs.12 per unit. In case the stock of raw materials at the end of the accounting period is 1,000 units, the value of the inventory according to each of the methods stated above will be as follows:

(a) FIFO Method

1,000 Units @ Rs.12 per unit = Rs.12,000

(Since materials first purchased will be taken to have been issued to production first of all, the inventory of raw material will, therefore, consist of latest purchases.)

(b) LIFO Method

1,000 Units @ Rs.10 per unit = Rs.10,000

(Since materials purchased in the last will be taken to have been issued to production first of all, the inventory will, therefore, consist of the earliest purchases.)

(c) Weighted Average Price Method

1,000 Units @ Rs.11.333 = Rs.11,333

(The total units purchased are 3,000 for a total cost of Rs.34,000. This gives a weighted average price of Rs.11.333 per unit.)

Whatever has been said about stock of raw materials is also true for stock of work-in-progress and finished goods. In case of work-in-progress, it may be valued at the factory cost or the total cost of production. The stock of finished goods is based on the principle of cost or market price whichever is less. Thus, the value of inventory may have no relevance with the actual costs incurred for purchasing or manufacturing the items involved in inventory valuation.

Further problems arise when the goods are sold. According to the matching concept, the costs are to be identified with the revenue earned. This is again a tedious task. It may be almost impossible to identify the cost of goods sold with the volume of sales made during a

particular period because the cost of goods sold will again depend upon FIFO, LIFO or Average method which may have been followed by a firm. Thus, determination of exact income made during a particular period is almost impossible.

(iii) Intangible Cost

The determination of the cost of intangible assets such as patents, goodwill, trademarks, etc., used in earning revenue poses another problem in determination of the income made by a business during a particular period. In case of some of these assets, such as patents, trademarks, copyrights, licenses, etc. which have a definite legal life, the determination of the cost is not difficult. However, difficulty arises in cases of assets like goodwill, heavy advertisement expenditure, preliminary expenses, whose utility life cannot be exactly determined. The cost incurred for acquisition of these assets or in respect of these assets is written off from the Profit and Loss Accounts of several years on some arbitrary basis. This brings inexactness in determination of the business income.

(iv) Imputed Costs

In determining business income, some imputed cost such as interest on capital, salary for the proprietor, rent of the building owned by the proprietor and used for the business purposes are considered. These costs are only notional costs and are taken into account only for managerial decision-making. For example, when a person intends to start a business with an investment of Rs.1,00,000, he should take into account, before deciding whether to start business or not, the interest that he could have earned on his investment (in the business) and the salary he could have earned otherwise. However, the charge for interest or salary is made on a notional basis. Their amounts cannot be exactly determined. Thus, the income computed after taking into account these notional charges cannot be taken as the real income of the business.

(v) Extraordinary Costs

In business, certain extraordinary costs or losses may also be incurred. Extraordinary expenditure might be incurred because of change in business policy or strategy in response to external events, e.g., when certain production facilities are abandoned or new lines of production are taken up due to reasons beyond management's control, factory premises may

have to be shifted from one place to another on account of legal requirements, etc., there may be some extraordinary losses due to natural calamities or accidents, e.g. losses due to floods, fire, etc. Identification of these costs or losses with the revenue cannot be made. Abnormal losses such as those on account of fire, etc., are usually not carried forward. They are charged against the revenue of the period in which they are incurred; while unusual costs such as those resulting on account of shifting of factory or office premises may be spread over a period of 2-3 years, in case they are heavy in amount. This is not exactly according to the Matching Cost Principle.

5.5 REALIZATION PRINCIPLE AND INCOME MEASUREMENT

It has already been stated that the American Accounting Association has laid emphasis on the realization aspect of income while defining the term 'Income'. It is, therefore, very important to decide when the income or revenue should be taken as realized.

There are four distinct alternatives regarding recognition of the time, when the revenue/income could be taken as realized.

- (i) Recognition at the time of sale.
- (ii) Recognition at the time when sales value is collected.
- (iii) Recognition when production is completed.
- (iv) Recognition proportionately over the performance of the contract.

All these alternatives are explained below.

(i) Recognition at the Time of Sale

This is the most common basis of revenue recognition. The objective of manufacturing or purchasing goods is achieved when the goods are sold. Thus, income is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that collection of the sales price is not reasonably assured. From the legal point of view, the sale is taken to be completed when the ownership of goods is transferred from the seller to the buyer. It should be noted that transfer of ownership does not depend on delivery of goods or payment of the price. Both these obligations may be performed in future also. What is necessary is that the buyer should be responsible to take delivery of the goods or make payment of the price for them, the time being immaterial.

Difficulties arise in recognizing revenue in case of those businesses which are engaged in providing services rather than selling of goods, e.g., public utility concerns such as Electricity Companies, Water Works, Railways, etc. Here, the revenue should be taken to be realized when the invoicing or billing is done for furnishing or services. In other words, accrual basis is the most appropriate basis for recognition of revenue in such cases.

(ii) Recognition at the Time When Sales Value is collected

Many concerns use the cash basis for recognizing revenue rather than the accrual basis. In case of accrual basis, revenue is taken to be realized when the payment for goods or services becomes due to the business. For example, in case of trading business, it is when the goods have been sold, though the payment might be received later on. This is because as the goods have been sold away the business becomes entitled to receive payment for them. In case if cash basis is followed, realization comes only when payment for goods or services has been actually received. This basis for recognizing revenue is generally followed in case of sale of goods on installment system (i.e., a system where sales value is to be collected in agreed number of installments). The basis is not very satisfactory because it fails to match cost with the revenue, where there is a considerable time lag between sale of goods or rendering of services and receiving payment for them.

(iii) Recognition when the Production is completed

It is generally recognized that income accrues only at the time of sale and gain should not be anticipated by reflecting assets at their current market prices. However, in case of certain industries where products have an immediate marketability at more or less fixed prices, the revenue may be recognized as soon as the production is completed. The amount of income earned is the excess of the estimated sale prices of the products completed over the costs of their production or extraction. However, any expenditure incurred in the disposal of these products should be charged and disclosed fully in the financial statements. This is particularly true in case of precious metals such as gold and silver and extractive industries (e.g., oil) and agriculture. In case of these industries, the inventories are stated at sales prices.

(iv) Recognition Proportionately over the Performance of the Contract

According to this basis, revenue is recognized even when the work has not been completed in all respects. This is particularly true in case of long-term contracts which may take few years to complete. In such cases, revenue is recognized on the basis of the work which has been completed and approved by the contractee (technically known as work certified). This is done on the basis of certain accepted norms which are given below:

- (i) When less than one-fourth of the contract is completed, no profit should be taken to the Profit and Loss Account.
- (ii) When one-fourth or more but less than one-half of the contract is completed, one-third of the profit made to date should be taken to the Profit and Loss Account. This may further be reduced on the basis of cash received by the contractor from the contractee. This is technically known as reducing profit on cash basis.
- (iii) If half or more of the contract has been completed, two-third of the profit as reduced on cash basis may be taken to the Profit and Loss account.

The degree of completion of the contract is computed by comparing the work certified with the contract price. The norms given above will be clear with the help of the following example.

Example 1

Contract Price: Rs.30,000. The contract is likely to take three years to complete. In the first year Rs.10,000 have been spent and the work has been certified by the contractee for Rs.15,000. The contractee pays cash to the extent of 80% of the work certified.

The profit to be taken to the Profit and Loss Account (i.e., the extent to which the income will be taken to have been realized) will be computed as follows:

	Rs.
Value of work certified	15,000
Cost incurred so far	10,000

Profit made during the accounting year	5,000

The contract price is Rs.30,000, while the value of the work certified is Rs.15,000. Hence, on-half of the contract has been completed. The amount to be taken to the Profit and Loss Account for the current year will be computed as follows:

$$= 5,000 \times \frac{2}{3} \times \frac{80}{100}$$

$$= 2,666.$$

Thus, according to the basis of recognition of revenue proportionately over performance of the contract, revenue/income has been recognized to the extent of Rs.2,666.

On the basis of whatever has been stated in the preceding pages, the factors to be taken into account by the accountant for measurement of business income can be summarized as follows:

- (i) Accounting concepts and conventions.
- (ii) Correct computation of expired cost.
- (iii) Correct recognition of revenue.

Each of these factors is affected by the dependent on a number of other factors as explained in the preceding pages. On account of this reason, the computation of business income is not only the most important but also the most difficult job of the accountant these days.

5.6 ACCOUNTANT'S AND ECONOMIST'S CONCEPT OF CAPITAL AND INCOME

The Economists' concepts of capital and income are different from those of the Accountant. According to Economists, the term 'capital' refers to such assets which are used for producing goods and services. It comprises of tangible assets, viz., building, land, plant and machinery, furniture, equipment, etc., and intangible assets, viz., human skills, technology, etc.

According to Accountants, the term 'capital' or capital employed' refers to all tangible and intangible assets owned and employed in the business for earning revenue. They include both fixed and current assets. Assets taken on lease are not included in the capital employed. Similarly, assets like human skills are also not included. As a matter of fact, the

salaries paid for utilizing human resources are taken as a revenue expenditure and hence written off from profits.

According to Economists, the term 'income' means 'the current flow of goods and services over a period of time'. For example, if the Economist says that the national income of India during 1997-98 was Rs.80,000 crores, he means, goods and services worth Rs.80,000 crores were produced during 1997-98. An Economist is mainly concerned with individual (per capita) or national income.

Moreover, while determining income, an Economist considers both monetary and non-monetary aspects. For example, if a factory is started in a particular area, it creates more employment opportunities for the people of that area. They stand to gain monetarily. However, pollution of the environment on account of poisonous gases from the factory chimneys creates health hazards making the people of that area suffer. An Economist while determining the impact of starting of the factory on the income of the people will consider both the aspects. Thus, he takes both monetary as well as non-monetary (imputed or social) benefits and costs of income determination. In other words, while determining the income of an individual or a society, an Economist considers the real income which, of course, is subject to high degree of subjectivity of value. On the other hand, an Accountant is mainly concerned with the monetary income earned by a business capable of being expressed in monetary terms. Thus, an Accountant is more exact in the computation of income as compared to an Economist.

The Economist's concept of the term 'profit' is also different from that of an Accountant. According to an Accountant, the terms 'profit' and 'income' are synonymous. Profit or Income is computed by deducting from the total revenue the expenditure incurred for earning that revenue. However, an Economist regards profit as a factor return like wages, interest and rent. If wages is the reward for the labour, profit is a return to the entrepreneur for his entrepreneurial ability. The term entrepreneurial ability includes ability to bear the risk and to take the initiative. In other words, profit is the reward to the entrepreneur both for bearing uncertainty and innovations. The return for the routine management matters (i.e., for his ordinary services) will be taken as wages and not profit.

An Accountant does not make such a distinction. According to him, the residue left after meeting all business expenses will be taken as the profit of the business. It includes remuneration both for entrepreneurial skill as well as routine management services.

Economists' concepts of capital and income are closely related to each other. According to Irving Fisher, the term 'capital' refers to 'stock of wealth existing at the given instant of time', while the term 'income' refers to 'a flow of benefits from wealth through a given period of time'. For instance, agricultural land is capital, but the benefit flowing from it in the form of agricultural produce is income. Thus, income is derived from capital. On the other hand, the value of an asset is the present value of all future benefits it can provide. This can be understood with the following illustration.

Illustration 10.1

A purchased a machinery for a sum of Rs.1,50,000 on January 1, 1990. He expects an annual cash flow of Rs.50,000 at the end of each year for 5 years. The cost of capital is 15% and the present value of an annuity of Re. 1 [annual payment of Re 1 for 5 years (in all Rs.5) at 15% discount factor per annum is 3.3522. You are required to calculate the value of the machinery on January 1, 1990, both according to the Accountant's and the Economist's concepts.

Solution

According to an Accountant, the value of machinery on January 1, 1990 would be Rs.1,50,000. This is based on the 'cost concept'.

According to an Economist, the machinery will be valued on January 1, 1990 at the present value of future benefits. It has been given in the question that Re. 1 paid annually for 5 years (i.e., Rs. 5 in all) has a present value of Rs.3.3522 at 15% discount factor. In other words, Rs.50,000 received annually over a period of 5 years have a present value of Rs.1,67,610 (Rs.50,000 x Rs.3.3522).

Ex-ante Income

The expectation about the cash flows at the end of the year (t_1) and the present values of the original cash flow (t_0) is termed as 'ex-post income'.

Ex-post Income

The expected cash flows from the asset concerned may be different after the expiry of a period. In such a case, the revised cash flows from the asset will have to be calculated. The income computed on the basis of the difference between the present value of the revised cash flow (t_1) and the present values of the original cash flows (t_0) is termed as 'ex-post income'.

Illustration 10.2

On the basis of the data given in Illustration 10.1, compute the ex-post income if the revised cash flows at the end of the year 1990 for the next 4 years are as follows:

<i>End of the year</i>	<i>Revised Cash Flows (Rs.)</i>	<i>Present Value Factor at 15%</i>
1991	60,000	0.756
1992	70,000	0.658
1993	80,000	0.572
1994	50,000	0.497

Solution

COMPUTATION OF EX-POST INCOME FOR 1990

<i>Sl. No.</i>	<i>At the end of the year</i>	<i>Cash Flows Rs.</i>	<i>Present Value Factor at 15%</i>	<i>Present Value Rs.</i>
1	1990	50,000	1.000	50,000
2	1991	60,000	0.756	45,360
3	1992	70,000	0.658	46,060
4	1993	80,000	0.572	45,760
5	1994	50,000	0.497	<u>24,850</u>
			Revised C_1t_1	2,12,030

$$\text{Ex-post Income} = \text{Revised } C_1t_1 - C_0t_0 = \text{Rs.} 2,12,030 - 1,67,610 = \text{Rs.} 44,420$$

It may be noted that, if there is no change in the expected cash flows at the end of period 1 (t_1) the ex-ante income and the ex-post income will be identical.

5.7 SUMMARY

The Income Statement measures the income of a business during a particular period of time. Income may be of different types, e.g., Personal Income, National Income, Business Income, Gross Income, Net Income, etc. In accounting, one is mainly concerned with Business Income, a term which is synonymous with the term Business Profit. According to the American Accounting Association, the term Business Income includes realized net income and not income alone. It means, income will be considered to be business income only when it has been actually realized. National Income such as appreciation in the market value of the assets of the firm cannot be taken as business income unless the assets have really been disposed off. Measurement of the accounting income is subject to a number of accounting concepts and conventions. For the purpose of cost analysis, the business concerns are divided into two categories namely trading concerns and manufacturing concerns. Income determination requires in case of both manufacturing and trading concerns the cost of goods sold. In case of trading concerns, the job is comparatively easy since the cost of goods sold can be easily found out by taking into account the purchase cost of the goods.

5.8 GLOSSARY

Income: The excess of revenue realized during a period by a specific accounting entity over the expired cost during the same period.

Accounting Period: In order to have an idea about the progress made by the business and to take remedial measures in time, business income is determined after the expiry of a reasonable period, such a period is termed as ‘accounting period’.

Imputed Cost: These are costs which are notional costs and are taken into account for managerial decision-making.

Ex-ante Income: The excess of the value of capital for the current period over that of the base period with reference to future expected returns on current period basis.

5.9 Check your Progress

1. State whether each of the following statement is true or false:
 - a. Revenue is recognized generally at the time when the sale of goods takes place.
 - b. Economists and Accountants have given different concepts of income.

- c. The actual income earned by the business can be known only when the business is finally closed down.
- d. The concept of conservatism ensures that the reported profit is not overstated.
- e. According to LIFO method, materials purchased in the last are taken to be issued last.
- f. The business income also includes the personal income of the proprietor of the business.
- g. An economist is more exact in computation of income than an accountant.
- h. Notional incomes should also be taken into account while computing business income.

5.10 ANSWERS TO CHECK YOUR PROGRESS

- a. True
- b. True
- c. True
- d. True
- e. False
- f. False
- g. False
- h. False

5.11 TERMINAL AND MODEL QUESTIONS

- 1. When can revenue be recognized in the case of a transaction of sale of goods?
- 2. When is business revenue considered accrued? What are the exceptions to this rule?
- 3. Distinguish between Accountant's concept of income and Economist's concept of income.
- 4. "The principle of recognizing revenue proportionately on the basis of work actually done is generally followed in case of long-term contracts". Explain.

5.12 REFERENCES

- 1. S N Maheshwari, Advanced Accountancy.
- 2. R.L. Gupta, Advanced Accountancy.

3. Sukhla and Grewal, Advanced Accounts.
4. Aggarwal and Jain, Advanced Financial Accounting.
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Unit 6- Financial Accounting Statements and Concepts

Structure

- 6.1 Financial Accounting: meaning and definitions
- 6.2 Accounting Principles: Concepts and Conventions
- 6.3 Types of Accounting Information
- 6.4 Summary
- 6.5 Glossary
- 6.6 Check your progress
- 6.7 Answers to check your progress
- 6.8 Terminal questions
- 6.9 Reference Books

Objectives

After reading this unit, you should be able to

- Understand the meaning and definition of Financial Accounting
- Explain the advantages of financial accounting
- Explain the Accounting Principles Concepts and Conventions

6.1 Financial Accounting: Meaning and Definition

Meaning:

Financial Accounting is the process of identifying, measuring, recording, classifying, summarizing, analyzing, interpreting and communicating the financial transactions and events. The purpose of this branch of accounting is to keep systematic records to ascertain financial performance and financial position and to communicate the accounting information to the interested parties.

It deals with recording, classifying and summarizing the financial transactions so as to prepare the Financial Statements viz. Income Statement and Position Statement.

Definition: Financial Accounting has been defined by different institutions and experts. Out of all definitions, the one given by AICPA is very simple and comprehensive which is as follows:

The American Institute of Certified Public Accountants has defined Financial Accounting as “the art of recording, classifying and summarizing in a significant manner in terms of money transactions and events which are in part at least of a financial character, and interpreting the results thereof”.

Accounting is the language effectively employed to communicate the financial information of a business unit of various parties interested in its progress.

The objective of financial accounting is to find out the profitability and to provide information about the financial position of the organisation. *Two important statements of financial accounting are*

1. *Income and Expenditure Statement and*

2. *Balance Sheet.*

All revenue transactions relating to a particular period are recorded in the Income and Expenditure statement to decide the profitability of the concern. The balance sheet is prepared at a particular date to determine the financial position of the concern.

Functions of Financial Accounting:

If we look at the functions of financial accounting, it provides information regarding the status of the business and results of its operations not only to the management but also to external parties. The following are some of the important functions of financial accounting:

a) **Recording of Information:** In business, it is not possible to keep in memory all the transactions.

These transactions need to be systematically recorded and pass through the journals, ledgers and worksheets before they could take the form of final accounts. Only those transactions are recorded which are measurable in terms of money. The transaction which cannot be expressed in monetary terms does not form part of financial accounting even though such transactions have a significant bearing on the working of a business.

b) **Managerial Decision Making:** Financial accounting is greatly helpful for managers in taking decisions. Without accounting, the managerial functions and decision making programmes may mislead. The performances of daily activities are to be compared with the predetermined standards.

The variations of actual operations and their analysis are possible only with the help of financial accounting.

c) **Interpreting Financial Information:** Interpretation of financial information is very important for decision making. The recorded financial data is interpreted in such a manner that the end users such as creditors, investors, bankers etc., can make a meaningful judgment about the financial position and profitability of the business operations.

d) **Communicating Results:** Financial accounting is not only concerned with the recording of facts and figures but it is also connected with the communication of results. In fact accounting is the source of business operation. Therefore, the information accumulated and measured should be periodically communicated to the users. The information is communicated through statements and reports. The financial statements and reports should be reliable and accurate. A variety of reports are needed for internal management depending upon its requirement. In communicating reports to outsiders, standard criteria of full disclosure, materiality, consistency and fairness should be adhered to.

Financial Accounting as Language of Business:

As a man without language turns out to be somewhat useless or as a mute man cannot be understood clearly, so also, a business without the accounts of its activities becomes meaningless. A language is the representative of the progress of the people of that language –group. A developed language reflects a developed society. Socio-economic progress has always depended on its linguistic advancement. In other words, human culture and economic activities have always been depending on language and literature for their nourishment and advancement as well.

A business unit also has got its own language in which it expresses the results of its activities and that language is “Accounting” With the help of this language, i.e., accounting, it prepares its future plans, programmes and projects. The language of the business, i.e., accounting is always effectively used for analytical consideration of the present activities and for reporting the results to various interested persons as well.

As the language of The Sun is sunrays, as that of a flower is its fragrance, and as the same of a thunderbolt is its lightning, so also the language of a business is accounting. As a human being expresses thoughts through language, so the results of the activities of a business are expressed through accounting in the form of final Accounts with Reports and Statements. The success or failure, the profits or losses and the daily activities or transactions of a business get life when they are transformed and translated into accounts.

Accounting, the language of the business, helps us to know its profitability or profit earning capacity. Not only this, the language of accounting also expresses the financial stability, strength of the Capital Structure and the inner worth or the real net worth of the business. The future prospects of a concern also can be clearly known from the published accounts. In fact, all the interested persons in a society, like Debtors, Creditors, Investors, Money-lenders, Bankers, Governments, Tax-collectors, Economists, Researchers, etc., can go through the activities of a business with the help of its languages, i.e., accounting. One can thus have a complete, true and fair view of the business through the language the language of accounting.

6.2 ACCOUNTING PRINCIPLES: CONCEPTS & CONVENTIONS

Basic principles of accounting are essentially, the general decision rules which govern the development of accounting techniques. These principles guide us the way transactions should be recorded and reported. These principles are classified into concepts and conventions which are explained as under :

Accounting Concepts: If we define accounting concepts, we can say that these are scientific rules and regulations on the basis of which accounting is done. As we know that scientific rules are based on cause and effect relationship, the same is the case with accounting concepts. Accounting concepts are discussed as under :

1. Separate Entity Concept: According to this concept, a business is treated as a separate entity which is distinct from its owner(s), and all other economic proprietors. For example, in case of a proprietary concern, though the legal entity of the business and its proprietor is the same, for the purpose of accounting, they are to be treated as separate from each other. If this assumption is not followed, the financial position and operating results of a business entity cannot be ascertained. In other words, this assumption requires that for accounting purposes, a distinction should be made between

(i) Personal transactions and business transactions, and

(ii) Transactions of one business entity and those of another business entity. For example, if the household expenses (Rs 10,000) of a proprietor are shown as business expenses, the profits of a business will be understated to the extent of Rs 10,000.

2. Accounting Period Concept: It is also known as periodicity principle or time period principle. According to this principle, the economic life of an enterprise is artificially split into periodic intervals which are known as accounting periods, at the end of which an income statement and position statement (balance sheet) are prepared to show the performance and financial position.

Implication The use of this assumption further requires the allocation of expenses between capital and revenue. That portion of capital expenditure which is consumed during the current period is charged as an expense to income statement and the unconsumed portion is shown in the balance sheet as an asset for future consumption. **Estimate and Not Actual Income** Truly speaking, measuring the income following the concept of accounting period is more an estimate than factual since, actual income can be determined only on the liquidation of the enterprise.

Reporting Period It may be noted that the custom of using twelve month period is applied only for external reporting. For internal reporting, accounts can be prepared even for shorter periods, say monthly, quarterly or half yearly according to the requirement of the business.

3. Money Measurement Concept: According to this Concept, only those transactions which can be expressed in terms of money are included in the accounting records. In other words, the information which cannot be expressed in terms of money is not included in accounting records. For example, if the sales director is not on speaking terms with the production director, the enterprise is bound to suffer. Since, monetary measurement of this information is not possible, this fact is not recorded in accounting records. By expressing all transactions in terms of money, the different transactions expressed in different units are brought to a common unit of measurement (*i.e.* money). Besides ignoring the non-monetary facts or attributes, this assumption also ignores the changes in the purchasing power of the monetary unit. In other words, this assumption treats all rupees alike, whether it is a rupee of 1950 or 1999. Hence, now-a-days, it is considered to provide additional data showing the effect of price level changes on the reported income, assets and liabilities of the business.

4. Going Concern Concept: It is also known as continuity assumption. According to this assumption, the enterprise is normally viewed as a going concern that is, continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

Implications of this concept may be understood by following examples:

(i) that the assets are classified as *current assets* and *fixed assets*.

(ii) the liabilities are classified as *short-term liabilities* and *long-term liabilities*.

(iii) the unused resources are shown as *unutilized costs* (or *unexpired costs*) as against the break-up values as in case of liquidating enterprise. Accordingly, the earning power and not the break-up value evaluate the continuing enterprise.

5. Historical Cost Principle : According to this principle, an asset is ordinarily recorded in the accounting records at the price paid to acquire it at the time of its acquisition and the cost becomes the basis for the accounts during the period of acquisition and subsequent accounting

periods. Accordingly, if nothing is paid to acquire an asset; the same will not be usually recorded as an asset, *e.g.* a favourable location and increasing reputation of the concern will remain unrecorded though these are valuable assets. The justification for the use of the cost concept lies in the fact that it is objectively verifiable. This does not mean that the asset will always be shown at cost. The cost of an asset is systematically reduced from year to year by charging depreciation and the asset is shown in the balance sheet at book value (*i.e.* cost less depreciation). It may be noted that the purpose of depreciation is to allocate the cost of an asset over its useful life and not to adjust its cost so as to bring it close to the market value.

6. **Revenue Recognition Principle:** This concept is mainly concerned with the revenue being recognised in the Income Statement of an enterprise. Revenue is the gross inflow of cash, receivables or other considerations arising in the course of ordinary activities of an enterprise from the sale of goods, rendering of services and use of enterprise resources by others yielding interests, royalties and dividends. It excludes the amount collected on behalf of third parties such as certain taxes. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other considerations. Revenue is recognised in the period in which it is earned irrespective of the fact whether it is received or not during that period.
7. **Matching Principle:** According to this principle, the expenses incurred in an accounting period should be matched with the revenues recognised in that period, that is, if revenue is recognised on all goods sold during a period, cost of those goods sold should also be charged to that period. It is wrong to recognize revenue on all sales, but charge expenses only on such sales as are collected in cash till that period.

This concept is basically an accrual concept since, it disregards the timing and the amount of actual cash inflow or cash outflow and concentrates on the occurrence (*i.e.* accrual) of revenue and expenses. This concept calls for adjustment to be made in respect of prepaid expenses, outstanding expenses, accrued revenue and unaccrued revenues.

Matching does not mean that expenses must be identifiable with revenues. Expenses charged to a period may or may not be related to the revenue recognised in that period, for example, cost of goods sold and commission to salesmen are directly related to sales whereas rent, interest, depreciation accruing with the passage of time and stock lost by fire are not directly related to sales revenue, yet they are charged to the accounting period to which they relate. Thus, appropriate costs have to be matched against the appropriate revenues for the accounting period.

8. **Duality Principle:** Two fold aspect of a transaction is called dual aspect or duality of a transaction. This duality is the basis of double entry records. As the name implies, the entry made for each transaction is composed of two parts—one for debit and another for credit. The double entry system may be compared with the Newton's law of motion, viz, to every action there is always an equal and contrary reaction. Every debit has equal amount of credit. So the total of all debits must be equal to the total of all credits.

Accounting Conventions: Conventions are basically the traditions which are followed in accounting. Although, they are not as scientific as the concepts are but due to their benefits, accountants follow them and they form a part of GAAP (Generally Accepted Accounting Principles). Accounting Conventions are discussed as under:

1. Materiality Convention: This principle is basically an *exception* to the Full Disclosure Principle.

The full disclosure principle requires that all facts necessary to ensure that the financial statements are not misleading, must be disclosed, whereas the materiality principle requires that the items or events having an insignificant economic effect or not being relevant to the user's need not be disclosed. According to the materiality principle, all relatively relevant items, the knowledge of which might influence the decision of the users of the financial statements, should be disclosed in the financial statements. Which information is more relevant than others is largely a matter of judgment. For instance, accounting and recording of a small calculator as an asset in the balance sheet may not be justified due to the excess of cost of recording over the benefits in terms of usefulness of recording and the accounting of calculators as assets.

The materiality depends not only upon the amount of item but also upon the size of business, level and nature of information, level of the person/department who makes the judgment about materiality, for instance a worker reporting to his foreman about the production in grams (*e.g.* part of kilogram), a foreman to his supervisor in kilograms, a supervisor to his production manager in quintals and the production manager to the top management in tonnes, may be justified with regard to the circumstances. It hardly makes any difference if the production manager reports to the top management that the production is 1, 99,000.90 kilograms or simply 200 tonnes (nearly). It is desirable to establish and follow uniform policies governing material or non-material items so that while measuring income for an accounting period, the non-material items can be ignored on uniform basis. This principle of materiality is to be applied even if the cost of its application exceeds its benefits.

2. Full Disclosure Convention: According to this convention, the financial statements should act as means of conveying and not concealing. The financial statements must disclose all the relevant and reliable information which they purport to represent, so that the information may be useful for the users. For this, it is necessary that the information is accounted for and presented in accordance with its substance and economic reality and not merely with its legal form.

The practice of appending notes to the financial statements has developed as a result of the principle of full disclosure. The disclosure should be full, fair and adequate so that the users of the financial statements can make correct assessment about the financial performance and position of the enterprise.

3. Consistency Convention: According to this conventions, whatever accounting practices (whether logical or not) are selected for a given category of transactions, they should be followed on a horizontal basis from one accounting period to another to achieve compatibility.

Examples if the inventory is valued on LIFO basis, this basis should be followed year after year and if a particular asset is depreciated according to WDV method, this method should be followed year after year.

Effects of not observing:

If this principle of consistency is not followed, the intra-firm comparison (*i.e.* comparison of actual figures of one period with those of another period for the same firm), Inter-firm comparison (*i.e.* comparison of actual figures of one firm with those of another firm belonging to the same industry) and Pattern comparison (*i.e.* comparison of actual figures of one firm with those of industry to which the firm belongs) cannot be made.

Differs from Uniformity The consistency should not be confused with mere uniformity or inflexibility and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

Disclosure The users should be informed of the accounting policies employed in the preparation of the financial statements, any change in these policies and the effects of such changes.

4. Prudence Principle (or Conservatism Convention): According to this principle, the principle of ‘anticipate no profit but provide for all probable losses’ should be applied. In other words, the principle of conservatism requires that in the situation of uncertainty and doubt, the business transactions should be recorded in such a manner that the profits and assets are not overstated and the losses and liabilities are not understated.

Examples—The valuation of stock-in-trade at a lower of cost or net realisable value and making the provisions for doubtful debts and discount on debtors are the applications of this principle.

Conflicts with Consistency convention: When the stock is valued at cost in one accounting period and at a lower of cost or net realizable value in another accounting period, this principle conflicts with the principle of consistency.

Conflicts with Full Disclosure When excessive provisions for doubtful debts and depreciation are charged, it leads to the creation of secret reserves, and thus, this principle conflicts with the principle of full disclosure.

Conflict with Objectivity The estimation of probable losses is a subjective judgment and thus, this principle conflicts with the principle of objectivity. The practice of making provisions for doubtful debts and the like implies lesser charges in the following accounting periods. In other words, it reduces the current income and raises the future income and thus it conflicts with the matching principle. Nowadays, the conservatism principle is being replaced by the prudence principle which requires that the conservation principle should be applied rationally only in circumstances in which great uncertainty and doubt exists as the over-conservatism may result in misrepresentation.

Accounting as an information system: The term ‘system’ may be defined a set of elements which operates together in order to attempt a goal.

Accounting comprises as series of activities linked together among them. The accounting activities form a progression of steps, beginning with observing, then collecting, recording, analyzing and finally communicating information to its users. As an information system, accounting links and information sources or transmitter (generally the accountant), a channel of communication (generally the financial statement) and set of receivers (external users). When accounting is looked upon as a process of communication, it is define as “the process of encoding observations in the language of the accounting system, of manipulating the signs and statements of the systems and decoding and transmitting the results”

Alternatively sometimes, the processed data are further processed to provide useful information to users. The processed and prepared information is communicated to users and decisions maker in the form of financial statements, other statements, report etc. In this accounting system the business transaction and activities are the input and statements and report given to decision makers are the output.

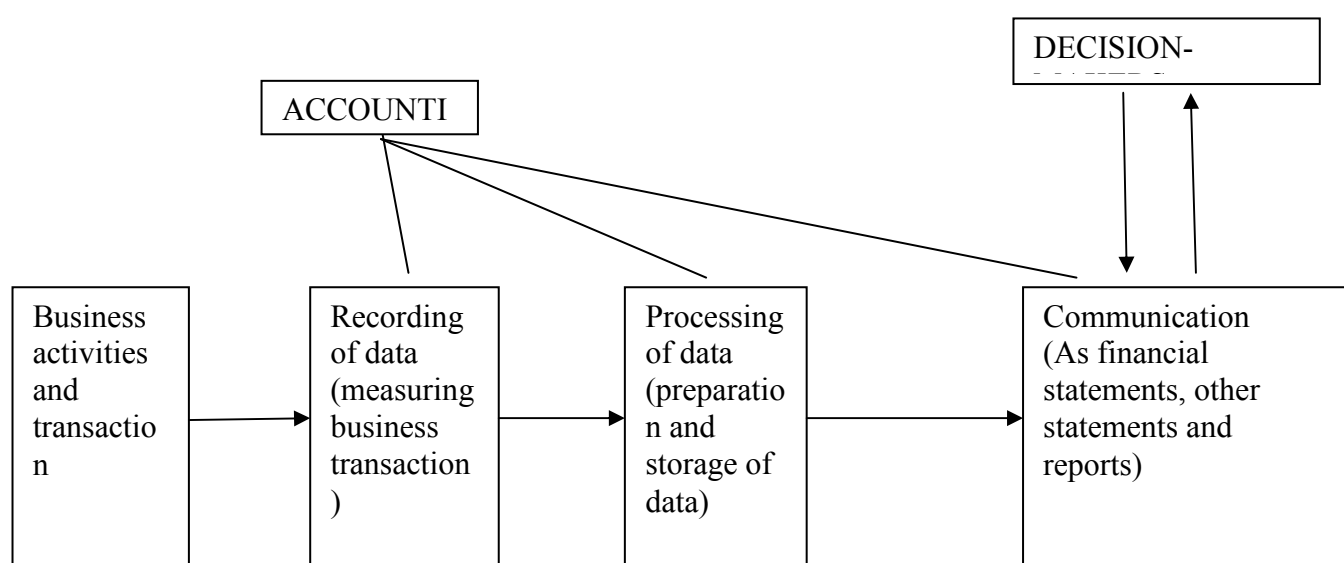


Figure: Accounting as an information in business decision

Thus, as an information system accounting has a basic goal, i.e. to provide information. In order to accomplish this goal, the accounting system should be designed to classify financial information on a basis suitable for decision-making purposes and to process the tremendous quantities of data efficiently and accurately. Also, the information system must be designed to report the results periodically, in a realistic and concise format that is comprehensible to users who generally have only a limited accounting knowledge.

6.3 TYPES OF ACCOUNTING INFORMATION:

Accounting information may be classified in number of ways on the basis of purpose of accounting information, on the basis of measurement criteria and so on. The various types of accounting information are given below:

1. Accounting Information relating to financial transactions and events.

Financial Position—Information about financial position is primarily provided in a balance sheet.

The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates.

- (d) Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future.
- (e) Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting how successful the enterprise is likely to be in raising further finance.
- (f) Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

Financial Performance—Information about financial performance is primarily provided in a Statement of Profit and Loss (also known as Income Statement).

Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information about performance is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the enterprise might employ additional resources.

Cash Flows—Information about cash flows is provided in the financial statements by means of a cash flow statement.

Information concerning cash flows of an enterprise is useful in order to evaluate its investing, financial and operating activities during the reporting period. This information is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows.

Such information may further be classified as follows:

- (i) On the basis of Historical Cost
- (ii) on the basis of Current Cost
- (iii) on the basis of Realizable Value
- (iv) on the basis of Present Value

7. Accounting information relating to cost of a product, operation or function.

8. Accounting information relating to planning and controlling the activities of enter-prise for internal reporting.

Such information may further be classified as follows:

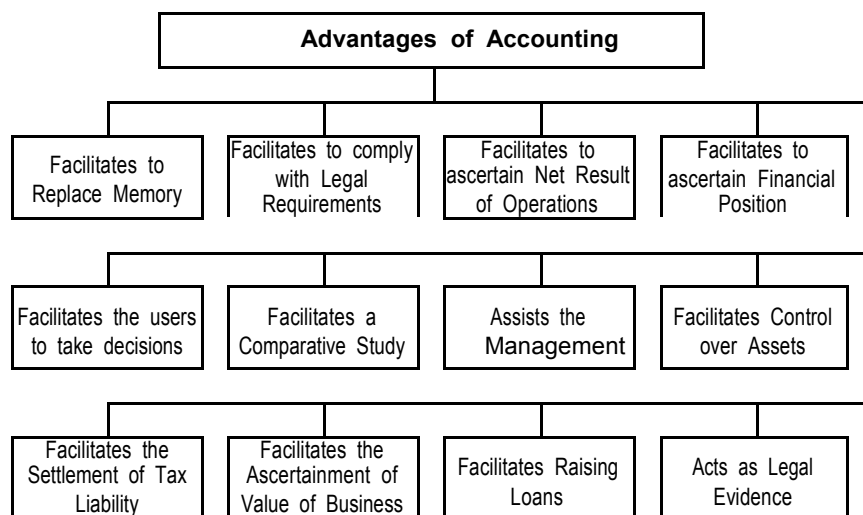
- (a) Information relating to Finance Area
- (b) Information relating to Production Area
- (c) Information relating to Marketing Area
- (d) Information relating to Personnel Area
- (e) Information relating to Other Areas (such as Research & Development)

9. Accounting information relating to Social Effects of business decisions.

10. Accounting information relating to Environment and Ecology.

11. Accounting information relating to Human Resources.

Advantages /benefits of Accounting: Following flow chart gives a brief account of advantages of accounting for a business:



Let us discuss these advantages one by one.

1. Facilitates to Replace Memory Accounting facilitates to replace human memory by maintaining complete record of financial transactions. Human memory is limited by its very nature. Accounting helps to overcome this limitation.

2. Facilitates to Comply with Legal Requirements Accounting facilitates to comply with legal requirements which require an enterprise to maintain books of accounts. For example, Sec 209 of The Companies Act, 1956, requires a company to maintain proper books of accounts on accrual basis, Sec 44AA of The Income Tax Act 1961 requires certain persons to maintain specified books of accounts.

3. Facilitates to Ascertain Net Result of Operations Accounting facilitates to ascertain net results of operations by preparing Income Statement.

4. Facilitates to Ascertain Financial Position: Accounting facilitates to ascertain financial position by preparing Position Statement.

5. Facilitates the Users to take Decisions : Accounting facilitates the users (i.e. Short-term Creditors, Long-term Creditors, Present Investors, Potential Investors, Employee Groups, Management, General Public, Tax Authorities) to take decisions by communicating accounting information to them.

7. Facilitates a Comparative Study Accounting facilitates a comparative study in the following ways:

- (i) Comparison of **actual figures with standard or budgeted figures** for the same period and the same firm; which is known as budgetary control.
- (ii) Comparison of actual figures of one period with those of another period for the same firm (i.e. Intra-firm Comparison); or **Comparative Analysis**.
- (iii) Comparison of actual figures of one firm with those of another standard firm belonging to the same industry (i.e., Inter-firm Comparison); and

(iv) Comparison of actual figures of one firm with those of industry to which the firm belong (i.e. Pattern Comparison)

8. Assists the Management Accounting assists the management in planning and controlling business activities and in taking decisions. For example, Projected Cash Flow Statement facilitates the management to know future receipts and payments and to take decision regarding anticipated surplus or shortage of funds.

9. Facilitates Control over Assets Accounting facilitates control over assets by providing information regarding Cash Balance, Bank Balance, Debtors, Fixed Assets, Stock etc.

9. Facilitates the Settlement of Tax Liability Accounting facilitates the settlement of tax liability with the authorities by maintaining proper books of accounts in systematic manner.

10. Facilitates the Ascertainment of Value of Business Accounting facilitates the ascertainment of value of business in case of transfer of business to another entity.

11. Facilitates Raising Loans Accounting facilitates raising loans from lenders by providing them historical and projected financial statements.

12. Acts as Legal Evidence Proper books of accounts maintained in systematic manner act as legal evidence in case of disputes.

Financial Statements are SUMMARY of detailed financial information of an enterprise which provides information regarding its Financial Performance and Financial Position. Accounting cycle can be understood by the following exhibit:

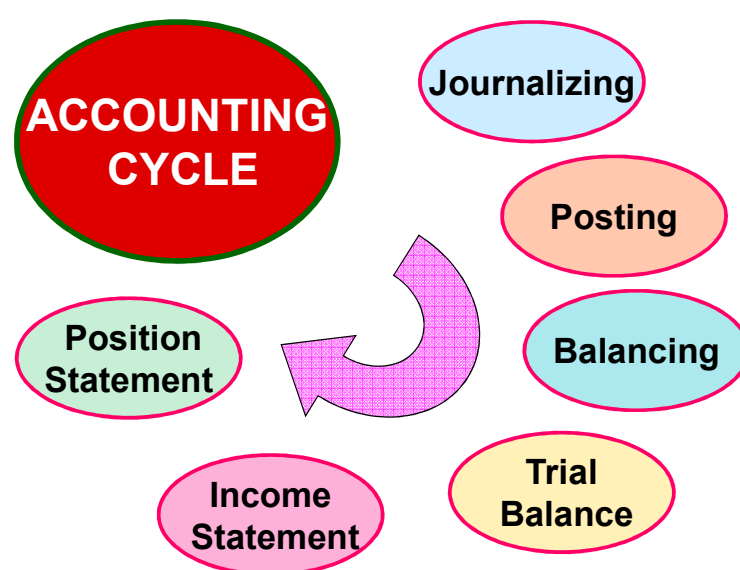


Exhibit: 1, Accounting Cycle

Financial statement consists of two statements:

- 1. Balance Sheet (Position Statement) and
- 2. Trading and Profit & Loss a/c (Income Statement)

Balance sheet or position statement is a:

- Statement on Financial Position *at a given date*.
- It exhibits: Assets, External Liabilities, Capital and Reserves.

Format of Trading, Profit & Loss Account:

Trading, Profit & Loss Account of ABC Limited

For the Year ending 31st March 201X

Particulars	Amounts	Particulars	Amounts
To Opening Stock	XXX	By Sales	XXX
To Purchases	XXX	Less : Returns	XX
To Wages	XXX	By Closing Stock	XXX
To Direct Expenses	XXX		
To Gross Profit	XXX		
	XXX		XXX
To Salary	XXX	By Gross Profit b/d	XXX
To Office Rent	XXX	By Rent Received	XXX
To Depreciation	XXX	By Interest	XXX
To Indirect Expenses	XXX	By Commission	XXX
To Bad debts	XXX	By Dividend received	XXX
To Loss on Sale of Plant	XXX		
To Net Profit	XXX		
	XXX		XXX

Format of Balance Sheet:

Balance Sheet
Of
ABC Limited
As on 31st March 201X

Liabilities	Amounts	Assets	Amounts
Share Capital : Equity Share Capital xx shares @ Rs.xx each x %Preference Share Capital @ Rs.xx each Reserve & Surplus x% Debentures Long term Loan Profit & Loss A/c (Profit)	XXX XXX XXX XXX XXX XXX	Fixed Assets: Land & Building Plant & Machinery Furniture and Fixtures Investments	XXX XXX XXX XXX
Current Liabilities : Outstanding Expenses Creditors Bills Payable	XXX XXX XXX	Current Assets : Cash & Cash equivalents Debtors Bills Receivable Intangible Assets : Goodwill Patent Copyright & Trademark Fictitious Assets : Preliminary Expenses Deferred Revenue Expenditure	XXX XXX XXX XXX XXX XXX XXX
	XXX		XXX

6.4 Summary

Financial Accounting is the process of identifying, measuring, recording, classifying, summarizing, analyzing, interpreting and communicating the financial transactions and events. The purpose of financial accounting is to find out the profitability and provide information about the financial position of the organization. All the income transactions related to a certain period are recorded in the income and expenditure statement to find out the profitability. Balance sheet is prepared to determine the financial position of the organization on a particular date. All the stakeholders of the society like debtors, creditors, investors, moneylenders, bankers, government, tax collectors, economists, researchers etc. can understand the activities of business through its language i.e. accounting.

Accounting principles are essentially general rules of judgment that govern the development of accounting techniques. These principles can be classified into concepts and conventions. Concepts are the scientific rules and regulations on the basis of which accounting is done, while accounting conventions are basically the customs that are followed in accounting. Accounting involves a series of interrelated activities. Accounting activities as an information system follow a step-by-step progression starting with observation, then gathering, recording, analyzing information, and finally communicating the information to its users.

6.5 Glossary

A.I.C.P.A American Institute of Certified Public Accountants

W.D.V Depreciation method

6.6 Check Your Progress

True and False

1. Information related to financial position is mainly displayed in the economic statements.
2. Accounting conventions are not as scientific as the concepts are.
3. As per section 209 of the Companies Act, 1956 it is not mandatory for a company to maintain books of accounts on acquisition.

6.7 Answers to check your progress

1. (T), 2.(T), 3(F)

6.8 Terminal Questions

- Q.1 What are accounting concepts and conventions? Explain in brief the use of these concepts and conventions in the preparation of financial statements.
- Q.2 What do you mean by financial statements? What is the purpose of preparing financial statements?
- Q.3 Explain different types of accounting information.
- Q.4 Distinguish between accounting concepts and conventions.
- Q.5 Write a short note on followings:
- Cash flow statement
 - Income Statement
 - Trend/pattern Analysis
 - Comparative Analysis

6.9 Reference Books

6. S N Maheshwari, Advanced Accountancy.
7. R.L. Gupta, Advanced Accountancy.
8. Sukhla and Grewal, Advanced Accounts.
9. Aggarwal and Jain, Advanced Financial Accounting.
10. S N Maheshwari, Corporate Accounting

Unit 7 - Financial Accounting and the Generation of Financial Accounting Data

Structure

- 7.1 Meaning of Financial Accounting
- 7.2 Trading Account
- 7.3 Profit & Loss Account
- 7.4 Balance Sheet
- 7.5 Methods of Presenting Final Accounts
- 7.6 Summary
- 7.7 Glossary
- 7.8 Check your progress questions
- 7.9 Answers to check your progress
- 7.10 Terminal Questions
- 7.11 Reference Books

Objectives

After reading this unit you will be able to understand

- Meaning of financial statements
- Trading Account, Profit & Loss Account & Balance Sheet
- Methods of presenting final accounts

7.1 MEANING OF FINANCIAL STATEMENTS

Basically, Financial Statements are organized summaries of detailed information about the financial position and performance of an enterprise. Traditionally, the term 'Financial Statements' is used to denote only two basic statements which are as under:

(a) Balance Sheet (or Position Statement) which shows the *financial position* of an enterprise *at a particular point of time*,

(b) Trading and Profit and Loss Account (or Income Statement) which shows the *financial performance* of business operations *during an accounting period*.

Nowadays, in addition to the aforesaid two basic financial statements, a Statement of Retained Earnings and a Cash Flow Statement of Changes and value Added Statement are also prepared in practice.

7.2 TRADING ACCOUNT

After preparing a tallied trial balance at the end of an accounting period, the next step is to prepare Trading Account.

Meaning of Trading Account

Trading account is one of the financial statements which shows the result of buying and selling of goods and/or services during an accounting period.

Purpose of Trading Account: *Trading account is prepared to know the gross profit or gross loss during the accounting period. The basis for the preparation of this account is the matching of*

selling prices of goods and services with the Cost of goods sold and services rendered. Gross Profit means excess of operating revenues over direct operating expenses.

Contents of Trading Account

Items to be Shown on the Debit Side of Trading Account Trading account is debited with the following items.

(a) ***Opening Stock*** refers to the closing stock of unsold goods at the end of previous accounting period which has been brought forward in the current accounting period.

(b) Purchases refer to those goods which have been bought for resale. Purchases include cash as well as credit purchases. The following items are shown by way of deduction from the amount of total purchases:

(i) Purchases Returns or Return Outwards (i.e., goods returned to suppliers)

(ii) Goods withdrawn by the proprietor for his personal use.

(iii) Goods distributed by way of free samples.

(iv) Goods given as charity.

(c) Direct expenses refer to all those expenses which are incurred from the stage of purchase till the stage of making the goods in saleable condition. Such expenses include the following expenses:

(i) Freight Inwards (ii) Import Duty (iii) Octroi (iv) Carriage Inwards and Cartage Inwards (v) Wages.

Items to be shown on the Credit Side of Trading Account Trading Account are credited with the following items:

(a) Sales refer to the sales of those goods which have been bought for resale. Sales include cash as well as credit sales. Sales Returns or Returns Inwards (i.e., goods returned by customers) are shown by way of deduction from the amount of total sales.

(b) Closing Stock refers to the stock of unsold goods at the end of the current accounting period. According to convention of conservatism, stock is valued at cost or net realizable value (NRV) whichever is lower. For example, if cost of closing stock is Rs 30,000 but its market value is Rs 40,000, closing stock will be taken at Rs 40,000. The rationale behind this practice is to provide for anticipated losses.

Preparation of Trading Account

The preparation of a Trading Account requires the passing of entries to transfer the balances of accounts of all the concerned items to the Trading Account. The entries required for such transfers are called ‘Closing Entries’, since such entries will close the accounts of all the concerned items.

Format of a Trading Account

A general format of a Trading Account is shown below :

Format of a Trading Account

Trading Account of....

for the period ending on ...

Dr.

Cr.

Particulars	Amounts	Particulars	Amounts
To Opening Stock	XXX	By Sales	XXX
To Purchases	XXX	XXX	
To Wages	XXX	Less : Returns	XXX
To Direct Expenses	XXX	XX	
To Gross Profit	XXX	By Closing Stock	
	XXX		XXX

7.3 PROFIT AND LOSS ACCOUNT

After preparing a Trading Account, the next step is to prepare Profit & Loss Account.

Meaning of Profit & Loss Account

The Profit and Loss account is one of the financial statements. It shows the financial performance of business during an accounting period.

Purpose of Profit & Loss Account

The Profit and Loss Account is prepared to ascertain the Net Profit earned or Net Loss incurred by the business entity during an accounting period.

Net Profit

Net Profit means the excess of all revenue (whether operating or non-operating) over expenses & losses (whether operating or non-operating).

Operating Profit

Operating Profit means the excess of operating revenues over operating expenses & losses. It arises as a result of carrying out operating activities. *Operating activities* are the principal

revenue producing activities of the enterprise and other activities that are not investing or financial activities. *For example-* Sales and Purchase of buildings by Builders and property dealers are operating activities. Granting loans to third parties by them are investing activities. Taking loans from third parties by them are financing activities.

Contents of Profit & Loss Account

All the indirect revenue expenses and losses (i.e., other than those shown on the debit side of the Trading Account) are shown on the debit side of the Profit and Loss Account, whereas all indirect revenue incomes (i.e., other than those shown on the credit side of the Trading Account) are shown on the credit side of the Profit and Loss Account.

Preparation of Profit & Loss Account

The preparation of the Profit and Loss Account requires (a) to bring down the gross profit/ gross loss and (b) to pass the necessary entries to transfer the balances of accounts of all the concerned items to the Profit and Loss Account.

Format of a Profit & Loss Account

A general format of a Profit and Loss Account is shown below:

Profit & Loss Account
For the Year ending 31st March 201X

Particulars	Amounts	Particulars	Amounts
To Gross Loss b/d	xxx	By Gross Profit b/d	xxx
To Salaries & Wages	xxx	By Discount Received	xxx
To Rent, Rates & Taxes	xxx	By Commission earned	xxx
To Fire Insurance Premium	xxx	By Interest on Marketable Securities	xxx
To Repairs & Maintenance	xxx	By Profit on sale of Maketable Securities	xxx
To Depreciation	xxx	By Rent earned	xxx
To Audit Fees	xxx	By *Net Loss transferred to Capital Account	xxx
To Bank Charges	xxx		
To Legal Charges	xxx		
To Expenses	xxx		
To Carriage Outward	xxx		
To Freight Outward	xxx		
To Commission to Salesmen	xxx		
To Travelling Expenses	xxx		
To Entertainment Expenses	xxx		
To Sales Promotion Expenses	xxx		
To Advertising and Publicity	xxx		
To Bad Debts	xxx		
To Packing Expenses	xxx		
To Interest on Loan	xxx		
To Loss on Sales of Fixed Assets	xxx		
To* Net Profit transferred to Capital Account	xxx		
	XXX		XXX

Note : *Either Net Profit or Net Loss shall appear.

7.4 BALANCE SHEET

After preparing the Profit & Loss Account, the next step is to prepare a Balance Sheet.

Meaning of Balance Sheet

A Balance Sheet is a statement on the financial position of an enterprise at a given date which exhibits its assets, external liabilities, capital and reserves. It is called a Balance Sheet because it is a sheet of balances of those ledger accounts (i.e. Personal Real Accounts and Fictitious Assets

Accounts) which have not been closed till the preparation of the Trading and Profit and Loss Account.

Characteristics of a Balance Sheet:

The characteristics of a Balance Sheet are summarized as follows:

- ❖ A Balance Sheet is *only a statement and not an account*. It has no debit side or credit side. The two sides are called 'Assets' and 'Liabilities'.
- ❖ A Balance Sheet is prepared *at a particular point of time and not for a particular period*. The information contained in a Balance Sheet is true only at that particular point of time at which it is prepared.
- ❖ A Balance Sheet is a *summary of balances of* those ledger *accounts* which have *not* been *closed* by transfer to the Trading and Profit and Loss Account.
- ❖ A Balance Sheet *shows the nature and value of assets* and the *nature and the amount of liabilities* at a given date.

Need for the Preparation of Balance Sheet

The purposes of preparing a Balance Sheet are as follows:

- To ascertain the nature and value of assets of a business.
- To ascertain the nature and amount of liabilities of a business.
- To find out the financial solvency of an enterprise. An enterprise is considered to be a solvent if its assets exceed its external liabilities.

Components of Balance Sheet:

In India, usually we prepare the Balance Sheet in '**T**' **shape** in which the right hand side of a Balance Sheet is called the 'Assets' side and the left hand side is called the 'Liabilities' although this practice is not common across the globe.

Grouping and Marshalling of Assets and Liabilities

The term '*Grouping*' means putting together items of a similar nature under a common heading. For example, under the heading 'Trade Creditors' the balances of the ledger accounts of all the suppliers from whom goods have been purchased on credit, will be shown. The term '*Marshalling*' refers to the order in which the various assets and liabilities are shown in the Balance Sheet. The assets and liabilities can be shown *either* in the order of liquidity *or* in the order of permanency.

Order of Liquidity

1. The *assets* are arranged *in the order of their liquidity*, i.e., the most liquid asset (e.g., cash-in-hand), is shown first. The least liquid asset (e.g., goodwill) is shown last. The least liquid asset does not mean an asset which cannot be encashed.
2. The *liabilities* are arranged *in the order of their urgency of payment*, i.e., the most urgent payment to be made (e.g., 'short-term creditors'), is shown first. The least urgent payment to be made (e.g., 'long-term creditors') is shown last. Usually, the banking and financial institutions, sole proprietorship and the partnership concerns prepare their balance sheets in the order of liquidity.

Format of Balance Sheet:

A general format of a Balance Sheet in order of liquidity is shown below:

Liabilities	Amounts	Assets	Amounts
<i>Current Liabilities:</i>		<i>Current Assets:</i>	
Bank Overdraft	xxx	Cash-in hand	xxx
Bills Payable	xxx	Cash at bank	xxx
Outstanding Expenses	xxx	Bills Receivable	xxx
Sundry Creditors	xxx	Sundry Debtors	xxx
Income received-in-advance	xxx	Prepaid Expenses	xxx
<i>Long-term Liabilities:</i>		Accrued Income	xxx
Loan	xxx	Closing Stock	xxx
<i>Capital: Opening balance</i> xxx		<i>Investments</i>	xxx
<i>Add: Net Profit</i> xxx		<i>Fixed Assets:</i>	
<i>(Less: Net Loss)</i> xxx			
<i>Less: Drawing</i>	xxx	Furniture and Fixture	xxx
		Plant and Machinery	xxx
		Building	xxx
		Land	xxx
		Goodwill	xxx
	Xxx		xxx

Order of Permanence

This order is exactly reverse of the liquidity order.

- The *assets* are arranged *in the order of their permanence* i.e. the least liquid asset (e.g., goodwill) is shown first and the most liquid asset (e.g., Cash-in-hand) is shown last.
- The least urgent payment to be made (e.g., owners) is shown first and the most urgent payment to be made (e.g., short-term creditors) is shown last.

- The company as defined under the Companies Act, 1956 is required to prepare the balance sheet in order of permanence.

7.5 METHODS OF PRESENTING THE FINAL ACCOUNTS

The Trading and Profit and Loss Account and the Balance Sheet can be presented *either* in Horizontal Form *or* in Vertical Form.

(a) Horizontal Form Under this form of presentation, the items are presented in ‘T’ shape.

(b) Vertical Form Under this form of presentation, the items are presented in a single column statement in a purposeful sequence. The vertical forms of presenting the Income Statement and the Balance Sheet are shown below :

Vertical Income Statement/Profits & Loss Account:

Income Statement of ABC Limited
For the year ending 31st March, 2013

Particulars	Amounts	Amounts
(1) Net Sales		
Sales (Gross)	xxx	xxx
Less: Returns	xxx	
(2) Cost of Goods Sold		
Opening Stock	xxx	
Add: Purchases	xxx	
Less: Returns	xxx	
Add: Direct Expenses:		
Carriage/Cartage/Freight Inwards	xxx	
Wages and Salaries	xxx	
Cost of Goods available for sale	xxx	xxx
Less: Closing Stock	xxx	xxx
(3) Gross profit (1-2)		xxx
(4) Operating Expenses		
a) Selling Expenses :		
Carriage outward	xxx	
Discount allowed	xxx	
Commission allowed	xxx	
Travelling Expenses	xxx	
Entertainment Expenses	xxx	xxx
Bad Debts	xxx	
b) Office and Administration Expenses		
Salaries & Wages		
Rent, Rates & Taxes	xxx	
Repairs	xxx	
Insurance	xxx	
Printing & Stationery	xxx	
Water & Electricity	xxx	
Postage & Telegram	xxx	
Staff Welfare Expenses	xxx	
Conveyance Charges	xxx	
Misc. Expenses	xxx	
Depreciation	xxx	xxx
(5) Net Operating Profit/Loss (3-4)		xxx

(6) Net Non-operating result		
(a) Interest earned	xxx	
Commission earned	xxx	
Discount earned	xxx	xxx
Miscellaneous Incomes		
(b) Non-operating Expenses & Losses	xxx	xxx
Interest allowed	xxx	
Loss on sale of a fixed Asset		
(7) Net Profit (5+6)		xxx

Vertical Form of Balance Sheet:

Particulars	Amounts	Amounts
Sources of Funds		
(a) Proprietor's Funds	xxx	
(b) Long-term Debts	xxx	
B. Application of Funds		xxx
(a) <i>Net Working Capital</i>		
(i) <i>Current Assets</i>		
Cash in hand xxx		
Cash at bank xxx		
Bills receivable xxx		
Accrued income xxx		
Debtors xxx		
Stock xxx		
Prepaid Expenses xxx	xxx	
(ii) <i>Less: Current Liabilities</i>		
Bank Overdraft xxx		
Accrued expenses xxx		
Bills payable xxx		
Trade creditors xxx		xxx
Income received in advance xxx	xxx	
(b) <i>Investments</i>		xxx
(c) <i>Fixed Assets</i>		
Furniture & Fixtures xxx		
Patents & Trade Marks xxx		
Plant & Machinery xxx		
Building xxx		
Land xxx	xxx	

Goodwill xxx		xxx
		Xxx

Statement showing Proprietor's Funds:

Particulars	Amounts	Amounts
A) Capital at the beginning		xxx
B. <i>Add:</i> Additional Capital Introduced xxx		
Interest on Capital xxx		
Salary to Partner xxx		
Profit for the current accounting period xxx	xxx	xxx
C. <i>Less:</i> Drawings xxx		
Interest on Drawings xxx		
Loss for the current accounting period xxxx	xxx	xxx
D. Capital at the end of the year (A + B – C)		Xxx

Adjustments in Final accounts: While preparing trial balance, there are certain transactions which are not included in Trial Balance due to their non-occurrence or sometimes some transactions are left by mistake. In order to ascertain the true and fair picture of profit & loss, it is necessary for the accountant to consider such transactions. These transactions, given at the end of trial balance are known as adjustments.

Rationale Of Making Adjustments At The Time Of Preparing The Final Accounts:

The important considerations in the preparation of Final Accounts with adjustments are as under:

- (a) *Revenue Recognition Principle* which requires that generally the revenue should be recognised in the period in which the sale is deemed to have occurred.
- (b) *Matching Principle* which requires that the expenses should be recognised in the same period as associated revenues. Expenses recognition is tied to revenue recognition. Let the expenses follow the revenue.

All incomes, expenditures and losses of revenue nature are shown in the Trading and Profit & Loss Account. In order to prepare the Trading and Profit & Loss Account on accrual basis, generally the following guidelines are followed in practice:

- (a) Any expenditure which has already been paid but pertains to the succeeding period(s) is excluded.
- (b) Any expenditure which pertains to the current accounting period whether paid in cash or not, is included.
- (c) Income or receipt which has already been received but pertains to the succeeding period(s) is excluded.
- (d) Income or receipt which pertains to the current accounting period whether received in cash or not, is included.

Treatment of items of adjustment appearing outside the Trial balance:

If any item of adjustment appears outside the Trial Balance, it will be shown at two appropriate places in the final accounts.

Treatment of Items of Adjustments Appearing In the Trial Balance:

If any item of adjustments appears inside the Trial Balance, it will be shown only once at one appropriate place in the final accounts. The treatment of such item has been shown below:

- (a) Closing Stock — Shown on the assets side as a Current Asset
- (b) Outstanding Expenses/ Accrued Expense — Shown on the Liabilities side as a Current Liability
- (c) Prepaid Expenses — Shown on the assets side as a Current Asset
- (d) Accrued Income — Shown on the assets side as a Current Asset
- (e) Unearned Income — Shown on the Liabilities side as a Current Liability.
- (f) Depreciation Shown on the debit side of P & L A/c as a separate item

Cash Flow Statement: Flows—Information about cash flows is provided in the financial statements by means of a cash flow statement. Information concerning cash flows of an enterprise is useful in order to evaluate its investing, financial and operating activities during the reporting period. This information is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows.

Format of Cash Flow Statement for the year ended.....

Particulars	Rs.	Rs.
Cash flows from operating activities		
Net profit	Xxx	
Adjustments for		
Depreciation [Working Note (iv)]	Xxx	
Profit on sale of plant	Xxx	
Interest expense	Xxx	
Operating profit before working capital changes	Xxx	
Adjustments for:		
Increase in debtors (less provision)	Xxx	
Increase in stock and work-in-progress	Xxx	
Increase in creditors	<u>Xxx</u>	
Net cash from operating activities		xxx
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of plant and machinery	Xxx	
Proceeds from sale of plant	Xxx	
Proceeds from sale of freehold property	Xxx	
Increase in trade investments	Xxx	
Net cash used in investing activities		(xxx)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from issuance of debentures at discount	Xxx	
Debenture interest paid	Xxx	
Dividend paid in respect of earlier year	<u>Xxx</u>	
Net cash from financing activities		<u>xxx</u>

OPENING BALANCE OF CASH		<u>xxx</u>
CLOSING BALANCE OF CASH		xxx

Problem : The following are the changes in the account balance taken from the Balance Sheets of ABC Ltd. as the beginning and end of the year:

	Changes in Rupees in debit or (Credit)
Equity share capital 30,000 shares of Rs. 10 each issued and fully paid	0
Capital reserve	(49,200)
8% debentures	(50,000)
Debenture discount	1,000
Freehold property at cost/revaluation	43,000
Plant and machinery at cost	60,000
Depreciation on plant and machinery	(14,400)
Debtors	50,000
Stock and work-in-progress	38,500
Creditors	(11,800)
Net profit for the year	(76,500)

Dividend paid in respect of earlier year	30,000
Provision for doubtful debts	(3,300)
Trade investments at cost	47,000
Bank	(64,300)
	0

You are informed that :

(a) Capital reserve as at the end of the year represented realised profits on sale of one freehold property together with surplus arising on the revaluation of balance of freehold properties.

(b) During the year plant costing Rs. 18,000 against which depreciation provision of Rs.13,500 was lying was sold for Rs. 7,000.

(c) During the middle of the year Rs. 50,000 debentures were issued for cash at a discount of Rs. 1,000.

(d) The net profit for the year was after crediting the profit on sale of plant and charging debenture interest.

You are required to prepare a statement which will explain, why bank borrowing has increased by Rs. 64,300 during the year end. Ignore taxation.

Solution :

Cash Flow Statement for the year ended.....

Particulars	Rs.	Rs.
Cash flows from operating activities	76,500	
Net profit		
Adjustments for		
Depreciation [Working Note (iv)]	27,000	
Profit on sale of plant	(2,500)	
Interest expense	<u>2,000</u>	
Operating profit before working capital changes	1,03,900	
Adjustments for:		
Increase in debtors (less provision)	(46,700)	
Increase in stock and work-in-progress	(38,500)	
Increase in creditors	<u>11,800</u>	
Net cash from operating activities		30,500
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of plant and machinery	(78,000)	
Proceeds from sale of plant	7,000	
Proceeds from sale of freehold property	6200	
Increase in trade investments	<u>(47,000)</u>	
Net cash used in investing activities		(1,11,800)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from issuance of debentures at discount	49,000	
Debenture interest paid	2,000	
Dividend paid in respect of earlier year	<u>(30,000)</u>	

Net cash from financing activities		<u>17,000</u>
EXCESS OF OUTFLOWS OVER INFLOWS		<u>64,300</u>

Working Note:

Thus, the shortfall of Rs. 64,300 was made up through borrowings from bank. Working Notes:

(i) *Acquisition of plant and machinery:*

Amount of increase, at cost	60,000
Add: Cost of plant disposed of	<u>18,000</u>
Cost of plant and machinery purchased	<u>78,000</u>

(ii) Profit on sale of plant = Rs. 7,000 - (Rs. 18,000 - Rs. 13,500)
= Rs. 7,000 - Rs. 4,500 = Rs. 2,500

(iii) *Proceeds from sale of freehold property:*

Capital reserve	49,200
Less: Increase in freehold property (given)	<u>43,000</u>
Proceeds from sale	<u>6,200</u>

(iv) *Depreciation on Plant and Machinery provided for the year:*

Increase in Provision for Depreciation (given)	14,400
Add: Accumulated depreciation on plant sold	<u>13,500</u>
Depreciation for the year	<u>27,900</u>

(v) Due to the absence of relevant information, income from investments has been ignored.

Practical Problems & their Solutions:

Problem: Find out the Cost of Goods Sold from the following information and also the Gross Profit.

Particulars	Rs.
Opening stock	15000
Purchases	150000
Sales	200000
Closing stock	18000
Direct Expense	5000

Solution:

Calculation of Cost of Goods Sold :

	Rs.
Opening Stock	15000
+ Purchases	150000
+ Direct Expenses	5000
- Closing stock	<u>18000</u>
Cost of Goods Sold	<u>152000</u>

Trading Account
For the Year ending 31st December, 2013

Particulars	Amounts	Particulars	Amounts
To Opening Stock	15000	By Sales	200000
To Purchases	150000	By Closing Stock	20000
To Direct Expenses	5000		
To Gross Profit	50000		
	220000		220000

Problem: Following is the Trial Balance of ABC Limited as on 31st March

<u>Trial Balance On 31.03.2008</u>		
	<u>Dr.</u>	<u>Cr. (Rs.)</u>
Capital		20000
Stock	8000	
Cash	1440	
Machinery	7560	
Purchases	28200	
Wages	10000	
Salaries	12000	
Discount	500	300
Office exp.	2000	
Sales		60000
Debtors /Creditors	16000	5400
	85700	85700
Closing stock (31.03.2008)		Rs. 3000

2008.

You are required to prepare Trading, Profit & Loss account of ABC Limited for the year ending 31st March 2008.

Solution :

Trading, Profit & Loss Account of ABC Limited

For the year ending 31st March 2008

Particulars	Amounts	Particulars	Amounts
To Opening Stock	8000	By Sales	60000
To Purchases	28200	By Closing Stock	3000
To Wages	10000		
To Gross Profit	16800		
	63000		63000
To Salary	12000	By Gross Profit b/d	16800
To Discount	500	By Discount	300
To Operating Expenses	2000		
To Net Profit	2600		
	17100		17100

7.6 Summary

Financial accounting is an organized summary of detailed information about the financial position and performance of an enterprise. Trading accounts are prepared to find out the gross profit or gross loss during an accounting period. To prepare the trading account, it is necessary to pass entries to transfer the account balances of all items relating to the trading account. The entries required for this transfer are called final entries because such entries will close all the related accounts. Profit and Loss Account is prepared to determine the net profit earned or net loss incurred by an accounting unit during an accounting period. All direct income, expenses and losses i.e., except those items shown on the debit side of the trading account are shown on the debit side of the profit and loss account Whereas all indirect income (i.e. except the items shown on the credit side of the profit and loss account) is shown on the credit side of the profit and loss account. Trading and Profit and Loss Account and Balance Sheet can be presented either in horizontal format or vertical format. The transactions shown at the end of the trial balance are called adjustments. If any item of adjustment is shown within the trial balance then it is shown at only one appropriate place in the final accounts, whereas if any item of adjustment is shown outside the trial balance then it is shown at two appropriate places in the final accounts. Apart from these two basic financial statements, statement of retained earnings, cash flow statement and value addition statement are also prepared in practice.

7.7 Glossary

Prepaid Expenses: Payments made in advance for goods or services that will be consumed or used in the future.

Accrued Income: Revenue earned but not yet invoiced or received in cash.

Trial Balance: A trial balance is a report that lists the balances of all general ledger accounts of a company at a certain point in time.

7.8 Check Your Progress

True /False Questions:

State with reasons whether each of the following statement is true or false?

1. Financial statements are organized summaries of detailed information about the financial position and performance of an enterprise.
2. The term 'Financial Statements' is used to denote basic statement 'Balance Sheet'.
3. Manufacturing Account is prepared by an enterprise engaged in manufacturing activities with a view to ascertain the gross profit.
4. A Balance Sheet is a statement of assets and liabilities of an enterprise for a particular accounting period.
5. Grouping means putting together items of similar nature under a common heading.
6. Marshalling refers to the order in which the various assets and liabilities are shown in the Balance Sheet.

7. The most liquid asset is shown first and the most urgent payment to be made is shown last in order of liquidity.

8. The least liquid asset is shown first and the least urgent payment to be made is shown last in order of permanence.

7.9 Answers to Check Your Progress

1.(T),2(F), 3(T),4(T),5(T),6(T),7(T),8(F)

7.10 Terminal Questions

1. What are Financial Statements?
2. What is a Trading Account?
3. What is the need of preparing a Trading Account?
4. What is a Manufacturing Account? What is the object of preparing it?
5. What is a Profit and Loss Account?
6. What is the need of preparing a Profit & Loss Account?
7. What is a Balance Sheet?
8. What are the characteristics of a Balance Sheet?
9. What is the need of preparing a Balance Sheet?
10. What is meant by Grouping of Assets and Liabilities?
11. What is meant by Marshalling of Assets and Liabilities?
12. Enumerate the ways in which a Balance Sheet may be marshalled.
13. At what price should the closing stock be valued and why?

14. At what price should the fixed assets be valued and why?
15. Name the principle involved in the valuation of inventory.
16. What are the benefits of vertical balance sheet? How is it prepared?

7.11 Reference Books

11. S N Maheshwari, Advanced Accountancy.
- 12.** R.L. Gupta, Advanced Accountancy.
13. Sukhla and Grewal, Advanced Accounts.
14. Aggarwal and Jain, Advanced Financial Accounting.
15. S N Maheshwari, Corporate Accounting

Unit 8- International Financial Reporting Standards

Structure

- 8.1 Introduction
- 8.2 Meaning of IFRS
 - 8.2.1 Convergence with IFRS in India
- 8.3 Opportunities for India in the adoption of IFRS
- 8.4 Challenges for India in the adoption of IFRS
- 8.5 Summary
- 8.6 Glossary
- 8.7 Check your progress
- 8.8 Answers to check your progress
- 8.9 Terminal Questions
- 8.10 Reference Books

Objectives

After reading this unit you will be able to understand

- Meaning of IFRS
- Opportunities for India to adopt IFRS
- Challenges for India to adopt IFRS

8.1 Introduction

Globalization of financial markets has meant an increased focus on international standards in accounting and has intensified efforts towards a single set of high quality; globally acceptable set of accounting standards. Financial statements prepared in different countries according to dissimilar set of rules, mean numerous national sets of standards, each with its own set of clarification about a similar transaction, making it challenging to compare, analyse and interpret financial statements across nations.

8.2 MEANING OF IFRS

International Financial Reporting Standards (IFRS) are a set of accounting standards developed by the International Accounting Standards Board (IASB)* that is becoming the global standard for the preparation of financial statements of companies.

International Financial Reporting Standards has become numero-uno accounting framework with extensive worldwide recognition. In 2001, the International Accounting Standard Board (IASB) substituted the International Accounting Standards Committee (IASC) as the organization liable for setting IFRS. The term IFRS has a narrow and a broad meaning. Narrowly, IFRS signifies the new number series of pronouncements that IASB has issued as divergent from the IAS series issued by its predecessors.

In a broad manner, IFRS refers to the whole body of IASB pronouncements including standards and interpretations approved by the IASB, IFRIC, IASC and SIC.

The IASB is an independent accounting standard-setting body, based in London. It consists of 15 members from nine countries, including the United States.

The standards set by the IASC are referred to as International Accounting Standards (IAS), and new standards set by the IASB are referred to as IFRS. There are 29 IAS and 9 IFRS currently issued. The basic feature of IFRS is that it is a principle-based standard rather than rule based.

8.2.1 CONVERGENCE WITH IFRS IN INDIA

'National GAAP' is becoming erratic as the global capital markets are increasingly integrating, various countries are stirring towards IFRS. The high quality standards of financial reporting, auditing and ethics form the foundations of the trust that investors place in financial information and therefore play an integral role in contributing to a country's economic growth and financial stability (Trade and Development Board, 2006). More than 100 countries such as European Union, Australia, New Zealand and Russia currently permit the use of IFRS in their countries. In context of India, though the Indian Accounting Standards were based on standards issued by the IASB, there were certain differences due to the legal and regulatory environment prevailing in the country, theoretical issues and the economic environment. In 2007, the Institute of Chartered Accountants of India (ICAI) had decided that India should converge with IFRS in a definite time frame in the wake of developments enhancing in other major jurisdictions which had set up time schedules for the adoption of IFRS.

The ICAI presented a position paper in 2007 and a concept paper in 2009. In January 2010, the Ministry of Corporate Affairs (MCA) in India issued the roadmap for the IFRS convergence procedure in India mandating the convergence of Indian Accounting Standards with IFRS with effect from April 1, 2011. In general terms, 'convergence' means to attain synchronization with IFRS. India has consciously preferred the 'convergence' model instead of the 'adoption' model taking into consideration the impending legal and regulatory challenges as well as the business

and economic environment of the country. Although, it has not been implemented yet and is likely to be implemented w.e.f. 2014.

The existing Indian accounting standards have conceptual differences with IFRS. Keeping in view the extent of difference between existing IAS and the corresponding IFRSs, the considerable attention has been given to all the above mentioned challenges in the conversion process. By introducing a new company law, the Indian Government has initiated the process to amend the legal and regulatory framework, much needed to adopt IFRS. As per the announcement by the Ministry of Corporate Affairs (MCA), there will be two separate sets of Accounting Standards under Section 211(3C) of the Companies Act, 1956 i.e. IFRS converged standards named as IND-AS and existing accounting standards. The accounting standards converging to global accounting standards i.e. IFRS facilitates comparability between enterprises which are operational in different nations (ASA & Associates, 2011).

In India ,though IFRS –Converged Ind-Ass have not been implemented but many companies as a part of preparation of transitioning to Ind-Ass are carrying out studies to assess requirements and impact of this convergence.

8.3 OPPORTUNITIES FOR INDIA IN THE ADOPTION OF IFRS

The adoption of the converged accounting standards will enable Indian corporates to have access to international markets without having to go through the cumbersome conversion and filing process. The decision to converge with IFRS is a milestone decision and is likely to provide the significant opportunities which are given below:

1. Phased Approach to Transition

MCA, which regulates the corporate and the accounting body in India, followed a consultative procedure in its approach for implementing the converged IFRS in India. The interest of several industries, regulators and professionals on board has been considered while making efforts for the implementation of IFRS. The phased approach to IFRS convergence is immensely worthwhile in the context of the large number of corporates that will be wedged by the transition.

2. Internationally Compatible Financial Statements

The major benefit of convergence to Indian Inc. will have is that of easy comparison and benchmarking of financial statements with international competitor on a common platform (Barbole A. N. et.al, 2011). The stakeholders and users at the international level will be able to effectively analyse the financial statements of the Indian companies after the convergence of the Indian accounting standards to IFRS. This convergence will enable the comparability of those statements with their global peers. It has been examined that IFRS adoption improves financial statement comparability across firms (Francois, Brochet et.al, 2011). It will also enhance the decision-making of the global investors. Consequently, there will be an increase in the foreign capital flow in the Indian economy as internationally acceptable accounting practices will result in improving the investors' confidence on the quality of such financial statements.

3. Convergence Approach

The convergence approach has been decided in such a manner that the Indian standard setters can review the prevailing IFRS standards, and determines that certain specific provisions under these standards are not adequate for application in India due to the local regulatory requirement

or economic condition. 'Carve-outs' (deviations from IFRS) could accordingly be decided where the Indian converged standards would not be in conformity with IFRS.

Improved Access to International Capital Markets

World has become an economic village and India has emerged as a strong economy on the global economy map. The Indian companies will reap the benefits of the adoption of the IFRS as Indian Firms are mounting and they are not only establishing plants in other nations but also acquiring other businesses across the globe. There will be a demand of cheaper funds for these Indian corporates which will be available in countries like America, Europe and Japan. The Indian companies should present their financial statements according to IFRS for meeting the regulatory requirements of these markets. As a result implementation of IFRS will not only open the door for Indian corporations in global capital markets for funds but also get them funds at cheaper cost. Global accounting standards would remove a frictional element to capital flows and lead to wider and deeper investment in markets (Dr Chakrabarty, K. C. 2011).

5. Relaxed Cross Border Listing

IFRSs by bringing in a global language for accounting, that is understood by all reduces the risk premiums charged by markets on capital raising as information barriers are removed (Dr. Kanan, R. 2009). As stated earlier, there is requirement for the expansion plans in Indian companies which are not confined to the regulatory and economic boundaries of India. The Indian corporates are getting themselves listed in the European and other foreign capital market through raising funds and acquiring firms there. The major pre-requisites of getting listed on these markets is preparation of Accounts as per IFRS requirements. A few Indian Companies which have raised funds through the European Capital Markets have started preparing their Financial

Statements as per IFRS. Apart from this, IFRS adoption has the potential to reinforce cross-border equity investments by individual investors (Bruggemann, Ulf et. al, 2011).

6. Enhanced Quality of Financial Reporting

The accounting principles which are followed in the IFRS are very consistent as a single body i.e. IASB is preparing them. These standards are very reliable and ensure better quality of financial reporting. Among several modern trends-based theories, IFRS follows fair value approach which can support Indian firms to reveal their true worth of Assets held in the financial reports. The mandatory adoption of IFRS will significantly improve the forecast accuracy and other measures of the quality of the information environment (Horton, J. et.al, 2009).

7. Eradication of multiple Reporting

The convergence to IFRS, by various group entities, will enable management to bring all components of the group into a single financial reporting platform. This will eliminate the need for multiple reports and significant adjustment for preparing consolidated financial statements or filing financial statements in different stock exchanges (ASA & Associates, 2011). Large Business Houses in India like TATA, BIRLA, and Reliance have companies listed in India and also companies registered in other foreign capital markets. Companies registered in India prepare their Accounts as per Indian Accounting Standards whereas companies registered in other nations prepare their financial reports as per the Reporting standards of the respective nation. The implementation of IFRS ensures the eradication of multiple financial reporting standards by these companies.

8. Benefits for Professionals

The professionals like CA and CFA who are having sound and practical knowledge and expertise in IFRS are likely to have more opportunities in the industry.

List of Ind ASs :

35 Indian Accounting Standards (Ind ASs) equivalent to all the IFRS/IAS applicable as on April 1,2011 have been finalised and placed by the Ministry of Corporate Affairs on its website after the recommendation of the National Advisory Committee on Accounting Standards (NACAS). These standards will be implemented in a phased manner from the date yet to be notified by MCA separately after resolving the Tax and other related issues.

Followings are the converged Indian Accounting Standards (Ind ASs) hosted by MCA on its website.

1. Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards
2. Ind AS 101 First-time Adoption of Indian Accounting Standards
3. Ind AS 102 Share based Payment
4. Ind AS 103 Business Combinations
5. Ind AS 104 Insurance Contracts
6. Ind AS 105 Noncurrent Assets Held for Sale and Discontinued Operations
7. Ind AS 106 Explorations for and Evaluation of Mineral Resources

8. Ind AS 107 Financial Instruments: Disclosures
9. Ind AS 108 Operating Segments
10. Ind AS 1 Presentation of Financial Statements
11. Ind AS 2 Inventories
12. Ind AS 7 Statement of Cash Flows
13. Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors
14. Ind AS 10 Events after the Reporting Period
15. Ind AS 11 Construction Contracts
16. Ind AS 12 Income Taxes
17. Ind AS 16 Property, Plant and Equipment
18. Ind AS 17 Leases
19. Ind AS 18 Revenue
20. Ind AS 19 Employee Benefits
21. Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance
22. Ind AS 21 The Effects of Changes in Foreign Exchange Rates
23. Ind AS 23 Borrowing Costs
24. Ind AS 24 Related Party Disclosures
25. Ind AS 27 Consolidated and Separate Financial Statements
26. Ind AS 28 Investments in Associates
27. Ind AS 29 Financial Reporting in Hyperinflationary Economies
28. Ind AS 31 Interests in Joint Ventures
29. Ind AS 32 Financial Instruments: Presentation

30. Ind AS 33 Earnings per Share
31. Ind AS 34 Interim Financial Reporting
32. Ind AS 36 Impairment of Assets
33. Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets
34. Ind AS 38 Intangible Assets
35. Ind AS 39 Financial Instruments: Recognition and Measurement
36. Ind AS 40 Investment Property

Note : The aforementioned list of Ind –AS has been taken from the resource portal of ICAI.

Comparison of IFRS as applicable on 1st April 2011 with Ind AS placed at MCA’s website*

Following table gives an idea about the IAS/IFRS and corresponding Ind-ASs prepared by ICAI to converge with IFRSs :

S.No	IFRS / IAS No.	Corresponding Indian Accounting Standard	Name
1.	IAS 1	Ind AS 1	Presentation of Financial Statements
2.	IAS 2	Ind AS 2	Inventories
3.	IAS 7	Ind AS 7	Statement of Cash Flows
4.	IAS 8	Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
5.	IAS 10	Ind AS 10	Events after the Reporting Period
6.	IAS 11	Ind AS 11	Construction Contracts
7.	IAS 12	Ind AS 12	Income Taxes
8.	IAS 16		Property Plant and

9.	IAS 17	Ind AS 16 Ind AS 17	Equipment Leases Revenue
10.	IAS 18	Ind AS 18	Employee Benefits
11.	IAS 19	Ind AS 19	Accounting for Government Grants and Disclosure of Government Assistance
12.	IAS 20	Ind AS 20	
13	IAS 21	Ind AS 21	The Effects of Changes in Foreign Exchange Rates
14	IAS 23	IND AS 23	Borrowing Costs
15	IAS 24	IND AS24	Related Party Disclosures
16.	IAS 26	*	Accounting and Reporting by Retirement Benefit Plans
17	IAS 27	IND AS 27	Consolidated and Separate Financial Statements
18	. IAS 28	Ind AS 28	Investments in Associates
19	IAS 29	Ind AS 29	Financial Reporting in Hyperinflationary Economies
20.	IAS 31	Ind AS 31	Interests in Joint Ventures
21.	IAS 32	Ind AS 32	Financial Instruments:

			Presentation
22.	IAS 33	Ind AS 33	Earnings per Share
23.	IAS 34	Ind AS 34	Interim Financial Reporting
24.	IAS 36	Ind AS 36	Impairment of Assets
25.	IAS 37	Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
26.	IAS 38	Ind AS 38	Intangible Assets
27.	IAS 39	Ind AS 39	Financial Instruments: Recognition and Measurement
28. 29.	IAS 40 IAS 41	Ind AS 41 **	Investment Property Agriculture
30.	IFRS 1	Ind AS 101	First-time Adoption of Indian Accounting Standards
31.	IFRS 2	Ind AS 102	Share based Payment
32.	IFRS 3	Ind AS 103	Business Combinations
33.	IFRS 4	Ind AS 104	Insurance Contracts
34.	IFRS 5	Ind AS 105	Non-current Assets Held for Sale and Discontinued Operations
35.	IFRS 6	Ind AS 106	Exploration for and Evaluation of Mineral Resources
36	IFRS 7	Ind AS 107	Financial Instruments: Disclosures
37.	IFRS 8	Ind AS 108	Operating Segments
38.	IFRS 9	***	Financial Instruments

Source : www.mca.gov.in

*The term 'IFRS' includes only the International Financial Reporting Standards (IFRSs) issued by the ASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

* Ind AS corresponding to IAS 26, Accounting and Reporting by Retirement Benefit Plans, has not been placed on MCA's website as this standard is not applicable to companies

** Ind AS corresponding to IAS 41, Agriculture, is being redrafted.

*** It has been decided that Ind AS corresponding to IFRS 9, Financial Instruments, should not be issued since it was felt that it was incomplete; instead of this standard, Ind AS 39 has been issued.

8.4 CHALLENGES FOR INDIA IN THE ADOPTION OF IFRS

An IFRS monopoly is evolutionarily disadvantageous as it eliminates the opportunity to compare alternative practices. Apart from this It also disallows the tailoring of financial reporting to local variations in economic, business, commercial, legal, auditing, regulatory and governance conditions across the globe (Sunder, Shyam, 2011). India has converged its accounting standards with the IFRS, but there are some challenges which are listed below that Indian economy is facing:

1. Potential High Cost of Compliance

Though the convergence approach allows the flexibility to issue 'carve-outs', this can potentially lead to the departure of Indian converged standards with IFRS as issued by IASB. The corporates and investors need to pick up the important changes as compared with IFRS to determine the extent of differences as well as the impact of the same in efficient decision-making. This will lead to additional cost of compliance.

2. Regulatory Amendments to Keep Pace with Changes in IFRS

The Indian regulators are still coming to terms with changes due to IFRS. The Indian Revenue Services is in the process of assessing whether Indian corporations should be permitted to file tax returns under the revised Indian converged standards or under the existing Indian standards. In this connection, Institute of Chartered Accountants of India (ICAI) has constituted a group comprising members of the Council of the Institute and of the Indian Tax Administrative Body (CBDT) to identify direct tax issues arising out of convergence. Recently, this group has prepared a position paper emphasizing major tax issues (such as timing differences on valuation of inventory, depreciation, withholding tax issues, Minimum Alternative Tax implications, etc.) and recommended certain options to government to achieve equity amongst all corporations and revenue neutrality. However, pending amendments to various regulatory requirements, the uncertainty continues for India on the potential tax impact due to implementation of IFRS.

3. Effect on financial results and Disclosures

There will be a lot of changes in the financial statements. For example, treatment of depreciation differs. Hence, the value of assets as well the profitability of the company may fluctuate, consequently net worth will be affected. The disclosure of financial information lays more stress on quantitative information such as details of sales, amount of transactions with related parties, production capacities, and income and expenditure in foreign currency, etc. On the other hand IFRS is more focussed on qualitative information (Khatri, Jameel and Master, Akeel, 2009).

4. Awareness of International Financial Reporting Practices

The adoption of IFRS will result in a complete set of different reporting standards. The awareness of these reporting standards is still not there among the stakeholders like Firms, Banks, Stock Exchanges, and Commodity Exchanges etc. It is a very difficult task to bring a

complete awareness of these standards among these parties. The changed reporting format will require awareness of these new norms and system among the affected parties. IFRS is a principle based approach to standard-setting. It is less reliant on bright lines and detailed rules as compared to the US GAAP (Prof. Dr. Sharma, Ravi, 2010).

5. Training

Professional Accountants are looked upon to ensure successful implementation of IFRS. Along with these Accountants, Government officials, Chief Executive Officers, Chief Information officers are also responsible for a smooth adoption process. India lack training facilities to train such a large group. It has been observed that India does not have enough number of fully trained professionals to carry out this task of adoption of IFRS in India.

6. Taxation

As most of the items in the Financial Statements will be affected by the implementation of the IFRS as a result, the tax liabilities would also undergo a transformation. Presently, Indian Tax Laws do not recognize the Accounting Standards. There is a requirement for complete overhaul of Tax laws and it is a major challenge which will be faced by the Indian Law Makers instantaneously. Adequate modifications are to be incorporated in Tax laws to ensure that tax authorities recognize IFRS-Compliant financial statements otherwise it will duplicate the administrative work for the companies.

7. Use of Fair Value

The concept of fair value is used in IFRS for measuring maximum items which can bring a lot of volatility and subjectivity to the financial statements. Consequently, adjustments to fair value

result in gains or losses which are presented in the Profit and Loss Account and valuation is reflected in the statement of financial position. The Indian Companies which has been preparing its Financial Statements on Historical Cost Basis will have hard-hitting period while shifting to Fair Value Accounting.

8. Impact on the Indian Banking Industry

The implementation of IFRS has significant consequences on advances, Investments, financial instruments, hedge accounting valuation including regulatory compliances, information technology systems, tax calculations and other areas in the banking sector. It shall affect the reporting practices of net worth, capital adequacy, position of advances, valuation of derivatives, financial instruments and so on. It shall also affect the measurement of financial performance of the Indian banking industry (CA. Mohammad Firoz, et. al, 2011).

9. Economic Environment

The economic environment and trade customs and practices prevailing in India, may in a few cases not be conducive for adoption of an approach prescribed in an IFRS (Trade and Development Board, 2006)

Finally ,we can say that frequent changes to IFRS-converged standards due to changes in IFRS by IASB would pose significant challenge for the companies. Companies will have to keep themselves abreast of the latest standards in order to implement the IFRSs in its true spirit.

8.5 Summary

Accounting statements being prepared according to disparate sets of rules in different countries has led to focus on international accounting standards. International Financial Reporting Standards (IFRS) are a set of accounting standards developed by the International Accounting Standards Board (IASB) that are considered as the global standard for preparing financial statements of companies. Till date, 29 IAS and 9 IFRS have been issued. The basic feature of IFRS is that it is a principle based standard rather than a rule based one. Integration with IFRS brings many benefits and opportunities for companies. However, changes in AIFRS and many changes in IFRS integrated standards have also posed significant challenges for companies. India has integrated its accounting standards with IFRS but there are certain challenges that the Indian economy is facing. Integration with IFRS requires Indian companies to keep themselves updated with the latest standards and avail the opportunities available.

8.6 Glossary

IAS.	International Accounting Standards
IFRS.	International Financial Accounting Standards
INDAS.	Integrated Indian Standards
CBDT.	Central Board of Direct Taxes

8.7 Terminal Questions

Q.1 What do you mean by IFRS? What is the difference between the Convergence and adoption of IFRS ?

Q.2 What are the challenges before India in implementing IFRS ?

Q.3 What is the difference between Accounting Standards (applicable as of now in India) and International Financial Reporting Standards (IFRS) ?

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Unit 9- Financial Accounting and Reporting: Recent Developments

Structure

9.1 Introduction

9.2 International Financial Reporting Standard (IFRS)

9.3 Extensible Business Reporting Language (XBRL)

9.4 Forensic Accounting

9.5 Human Resource Accounting

9.6 Environment Accounting/ Green Accounting

9.7 Summary

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9.9 Check your progress

9.10 Answers to check your progress

9.11 Terminal Questions

9.12 Reference Books

9.1 Introduction

With the emergence of Globalization, entire world has come closer and territorial boundaries are not treated as a hurdle at least in Trade and Commerce. If you look at Indian economy, you will find that many foreign multinational companies are operating in India and many Indian companies are having their operations abroad which proves that markets are becoming 'Globalised', getting closer to each other. This globalization has caused elimination of regional boundaries and companies are feeling at home in every part of the world. All this has changed the environment of business and poses very unique challenges before the entrepreneurs. One of the important challenges is related to the accounting and reporting of the business due to different policies, currency, accounting practices prevailing in different part of the world. In order to overcome this problem IFAC has issued IFRSs to ensure uniform financial reporting practices across the globe. Other than IFRS there are many other developments which has actually changed the face of financial accounting and reporting.

Recent Developments: Followings are the recent developments which may also be referred to as emerging trends in the field of Financial Accounting and Reporting:

- ❖ International Financial Reporting Standards (IFRS)
- ❖ eXtensible Business Reporting Language (XBRL) and Revised Schedule VI
- ❖ Forensic Accounting
- ❖ Human Resource Accounting
- ❖ Environmental Accounting /Green Accounting

Let us discuss these emerging trends in the field of accounting and reporting one by one:

9.2 International Financial Reporting Standard (IFRS)

If we consider the scenario of Accounting and Financial reporting the year 2011 is considered to be a turning point in India's financial reporting and regulatory landscape. Lawmakers and the regulatory framework for Accounting Profession in India made a commitment to update the old and somewhat old-fashioned requirements to converge with International Financial Reporting Standards (IFRS).

International Financial Reporting Standards (IFRS) are a set of accounting standards developed by the International Accounting Standards Board (IASB) that is becoming the global standard for the preparation of financial statements of companies.

International Financial Reporting Standards has become numero-uno accounting framework with extensive worldwide recognition. In 2001, the International Accounting Standard Board (IASB) substituted the International Accounting Standards Committee (IASC) as the organization liable for setting IFRS. The term IFRS has a narrow and a broad meaning. Narrowly, IFRS signifies the new number series of pronouncements that IASB has issued as divergent from the IAS series issued by its predecessors.

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The standards set by the IASC are referred to as International Accounting Standards (IAS), and new standards set by the IASB are referred to as IFRS. The fundamental unique feature of IFRS is that it is a principle-based and not rule based.

The existing Indian accounting standards have conceptual differences with IFRS. Keeping in view the extent of difference between existing IAS and the corresponding IFRSs, the considerable attention has been given to all the above mentioned challenges in the conversion process. By introducing a new company law, the Indian Government has initiated the process to amend the legal and regulatory framework, much needed to adopt IFRS. As per the announcement by the Ministry of Corporate Affairs (MCA), there will be two separate sets of Accounting Standards under Section 211(3C) of the Companies Act, 1956 i.e. IFRS converged standards named as IND-AS and existing accounting standards. The accounting standards converging to global accounting standards i.e. IFRS facilitates comparability between enterprises which are operational in different nations

35 Indian Accounting Standards (Ind Ass) equivalent to all the IFRS/IAS applicable as on April 1,2011 have been finalised and placed by the Ministry of Corporate Affairs on its website after the recommendation of the National Advisory Committee on Accounting Standards (NACAS). These standards will be implemented in a phased manner from the date yet to be notified by MCA separately after resolving the Tax and other related issues.

Note : List of IFRSs and challenges involved in adopting IFRSs in India has been discussed in Unit 15 in detail.

9.3 eXtensible Business Reporting Language (XBRL) :

Amidst the deferments like IFRS, Direct Tax Code and GST in Indian scenario, the Ministry of Corporate Affairs (MCA) in India introduced a couple of new requirements which will change the manner in which companies compile, present and file financial information. It will include

amendments to the prescribed format of balance sheet and profit and loss accounts as well as introducing eXtensible Business Reporting Language (XBRL) for annual corporate (return) filings; both of these are steps in the right direction for the bigger change which is expected to follow.

Format of balance sheet and profit and loss accounts:

Indian companies have been required to use the format of financial statements prescribed in *Schedule VI to the Companies Act, 1956*, and since the format has largely remained unchanged for several decades, the financial statements of Indian companies have become outdated in relation to the companies in other parts of the world.

The MCA has finally introduced the **revised Schedule VI (New Schedule)**, which prescribes a format at par with the current international practice and is largely consistent with IFRS as well. Meanwhile, the MCA has formulated another variant of the New Schedule, which would be made applicable once the IFRS convergent standards are introduced in India.

The New Schedule became applicable with effect from April 1, 2011 and it further requires the comparative information to be recast as per this format in the year of transition. Moving further, this requirement to recast comparative periods will also be applicable on the companies which are accessing the capital markets for an issue of equity shares from 1 April 2012.

What is different into it?

The New Schedule comes up with the following significant changes:

- ❖ The structure of the Balance sheet will be as per vertical form and profit and loss accounts to be prepared using nature of expense method.

- ❖ **Current and non-current classification of assets and liabilities on the balance sheet :**

A significant new requirement is to classify all assets and liabilities into current and non-current categories. What constitutes a current asset or a current liability is defined. Essentially, assets or liabilities that are expected or due to be realised or settled within 12 months from the balance sheet are classified as current.

Due to this change in presentation, several assets and liabilities will now be classified as current. For example, even a long-term loan, repayable within 12 months from the balance sheet, will be shown as a current liability. This could have an impact on reported financial ratios such as working capital, current asset and debt-equity ratios, which, in turn, may have an implication on other terms of the loan, including the interest rate or repayment terms.

- ❖ Additional disclosure requirements on share capital, including names of shareholders having more than 5% shareholding.
- ❖ Additional disclosures on long-term borrowings.
- ❖ Disclosures on sundry debtors getting overdue.
- ❖ Removal of certain outdated disclosure requirements relating to quantitative information on inventory licensed and installed capacity, etc.

The New Schedule will require a focused effort from companies to ensure smooth implementation. Apart from training personnel involved in the financial reporting process, companies would also be required to make changes to IT and other reporting systems to capture the required information at source. Further, companies would also need to monitor the impact of

these new requirements on their contractual arrangements, such as loan contracts, etc, as the key financial ratios are likely to be impacted by these changes.

The implications of the revised Schedule VI are varied and may present several implementation challenges for large companies. This would include restating the financial statements for previous comparative periods to conform to the new requirements.

The introduction of the revised Schedule VI is a step in the right direction to align local financial reporting practices to global ones, and will benefit the users of financial statements. The regulators should provide further guidance, where required, to ensure smooth and consistent implementation.

XBRL for annual filing of different Returns:

The Ministry of Corporate Affairs has mandated that certain companies in India file their annual financial information with the MCA for the year ended 31 March 2011 using XBRL. The use of XBRL to convert financial information into machine readable data is already being used in other economies of the world such as the USA and the UK.

XBRL, eXtensible Business Reporting Language, is a royalty-free, international information format designed specifically for business information, also referred to as ‘interactive data’ by the SEC. The idea behind XBRL is simple: instead of treating business information as a block of text – as in a printed paper document or a standard Internet page – it provides a unique, electronically readable tag for each individual disclosure item within business reports.

In 1998, Charlie Hoffman, a single CPA who worked for a small CPA firm in Washington state, had the idea of XBRL as a way of totally transforming business reporting.

Charlie solicited the support of the AICPA to spearhead the development of XBRL with the goal of providing a standard, XML-based language for digitizing business reports in accordance with the rules of accounting in every country around the world.

XBRL can be applied to a very wide range of business and financial data. Among other things, it can handle:

- Company's internal and external financial and business reporting;
- Business reporting and exchange of information within various types of regulators, including tax and financial authorities, central banks, and governments;

Benefits of using XBRL :

- By using XBRL, companies may automate the processes of their financial data collection. For example, data from different company divisions with different accounting systems can be assembled on real time basis and at a very lower cost, if the sources of information are upgraded to this new language .
- XBRL will also help in streamlining the preparation of business and financial reports for decision making. It will significantly improve the ability of accountants in publishing financial information to investors, regulators, analysts, lenders, and other key stakeholders in a more precise and direct manner.
- XBRL may also facilitate convergence of accounting standards by the ability to align financial concepts among public taxonomies.
- XBRL also facilitates principle-based accounting because it is principle based and not rule based.

- XBRL better enables the accounting profession in the accomplishment of its primary mission to protect the public interest by improving investor access to the capital markets and increasing analyst coverage of both small and large companies through a reduction in the cost associated with covering a company.

9.4 Forensic Accounting

Forensic Accounting is basically an integration of accounting, auditing and investigative skills in a systematic manner. The term 'Forensic accounting' was coined by Maurice E. Peloubet, who explained it as "Financial statements have some but not all the characteristics of Forensic Accounting". If we go to the dictionary meaning of it, the term 'forensic' means 'of or used in courts of law'.

Thus, Forensic Accounting as a special practice area which provides accounting analysis which is acceptable to the court and which forms the basis for discussion, debate and ultimately the settlement of disputes. Forensic accounting looks beyond numbers only and primarily focuses on the exact reality of the situation by applying all three i.e. intelligent, emotional and social quotients.

oddities, irregularities, and even transactions of abnormal nature. There are no standard procedures or checks and controls in forensic accounting to discover these frauds, as each type of fraud is unique in its nature and prima-facie, it is very difficult to find it. But meanwhile it is the duty of an auditor to find out these points and bring it into the knowledge of management.

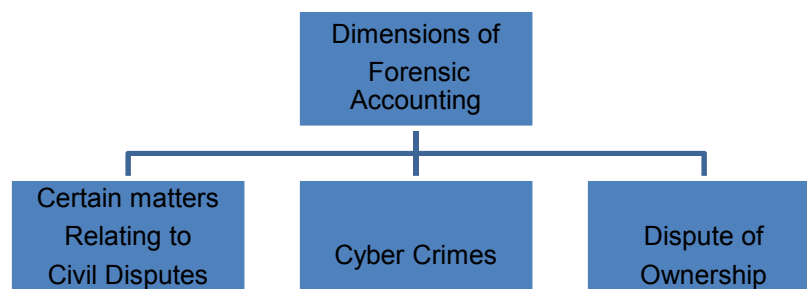
As per Companies (Auditors' Report) Order, 2003 auditors are required to report, amongst others, "whether any fraud on or by the company has been *noticed* or *reported* during the year. If

yes, the nature and amount are required to be indicated”. Keeping in mind the Indian context, forensic accounting has gained paramount importance in this background.

The term Forensic Accounting encompasses a wide range of activities including:

- The Expert Witness – preparation of formal Reports for filing in Court and giving evidence as an Expert
- Litigation Consultancy – working with lawyers and their clients engaged in litigation and
- Assisting with evidence, strategy and case preparation.
- Fraud Detection – assisting clients in detecting financial fraud by employees and others and tracing misappropriated funds.
- Computer Forensics – assisting in electronic data recovery and enforcement of IP rights etc.

Dimensions of Forensic Accounting: Forensic Accounting can be understood by dividing it into the following three major classifications:



- **Certain engagements related to civil disputes** viz. disagreements related to company acquisitions like business valuation, calculating and quantifying losses and economic damages through breach of contracts etc.
- **Shareholders and Partnership disputes** involving detailed analysis of numerous years accounting records to quantify the issues in dispute.
- **Cyber Crimes** like credit card frauds, ATM card frauds, cyber extortion, cyber stalking, phishing i.e. sending unsolicited e-mails & collection of sensitive information by simple techniques.

Forensic accounting also deals with **areas of professional negligence claims**, involving assessment and reporting on work of other professionals. This involves investigating whether breach of ‘Generally agreed accounting and/or auditing principles’ has occurred.

Business investigations involving fund tracing, asset identification and recovery, forensic intelligence gathering and due diligence reviews.

Employee fraud investigations involving procedures to determine existence, nature and extent of fraud and may involve identification of the perpetrator.

Business Economic Losses viz. contract disputes, trademark and patent infringements, losses arising from breach of non-compete clauses etc.

Cases involving medical insurance claims, medical malpractices resulting in economic losses.

Mediation and arbitration in alternative dispute resolution mechanisms due to familiarity of forensic accountants with legal issues and procedures, helping individuals and businesses resolve disputes with minimum disruption and loss of time.

Normally two terms are used in forensic accounting viz; Forensic Investigation and forensic audit.

Forensic Investigation: This refers to using specialized investigative skills to undertake inquiry in such a manner that outcome shall have application in court of law. Forensic investigation may be grounded in areas like accounting, medicine or engineering.

Forensic Audit: This refers to investigation of a fraud or presumptive fraud with a view to gathering evidence that could be presented in courts of law. It is essentially a blend of propriety, investigative, regularity and financial audits. The objective is to ascertain whether true business value has been reflected in the financial statements and during the course of examination to find whether any fraud has taken place.

The critical aspects of Forensic accounting, which should be dealt with the due-diligence and vigilant approach :

- ❖ The objective of forensic accounting is *to determine correctness of accounts and whether any fraud has taken place or not.*
- ❖ Some of the techniques used could be analysis of past trends or ‘substantive’ or in-depth checking of selected transactions.
- ❖ There is no limitation of time period unlike statutory audits and thus accounts may be examined in detail from very beginning.
- ❖ In case of, verification of stock, realizable value of current assets and provisions or liability estimation etc. independent verification of selected/suspected items may be carried out.

- ❖ In case of off-balance-sheet items like contracts, regularity and propriety of these transactions are examined.
- ❖ In case of adverse findings, legal determination of fraud and naming persons behind the fraud is contemplated.

Although the entire accounting fraternity have accepted this new dimension of accounting as ***Forensic accounting*** but keeping in mind the nature of work performed it would be better to call it Forensic Auditing rather forensic Accounting. It is also very well known to us that unless an auditor is well-versed into the accounting, he can not successfully conduct the audit and give his opinion that the financial statements are presenting the true and fair picture of the enterprise.

Hence, whatever the duties the Accountant is performing as an accountant is a part of his Auditing work. So it would be better to call it Forensic auditing rather Forensic Accounting.

9.5 Human Resource Accounting

Human Resource Accounting tends to measure the cost and value of the people (i.e. of employees and managers) working in the organization. It computes the cost incurred in recruitment, training and development of workforce.

It also finds out the present economic value of its employees and managers. After computing the cost and value of its employees and managers, the accountant prepares a report which is called HRA Report. It is submitted to the top management for necessary action.

Methods of Human Resource Accounting:

There are different methods of human resource accounting, some of which are as follows :

- ❖ Actual Cost Method,
- ❖ Replacement Cost Method
- ❖ Standard Cost method, etc.

Definition:

According to American Accounting Association,"HRA is the process of identifying and measuring data about human resources and communicating this information to interested parties."

Thus, we can say that this is a stream of accounting which identifies and measures the financial data about human resource of an organization and calculates the cost involved into the human resource.

Benefits of Human Resource Accounting: followings are benefit of human resource accounting:

- 1) **It provides inputs for manpower planning:** HRA provides useful information about the cost and value of human resources. It also indicates the strengths and weakness of the human resources which helps the managers in planning and making the right decisions about human resources.
- 2) **Information for formulating HR Policies:** HRA provides useful information for formulating sustainable personnel policies about promotion, congenial working environment, job satisfaction of employees and many other dimensions of Human Resource Management.

- 3) It ensures optimum utilization of human resources.
- 4) Human resource accounting increases morale and motivation of employees and managers of the organization.

Conclusively, we can say that human resource accounting ensures the optimum utilization of human resources and valuation of human capital.

9.6 Environmental Accounting/Green accounting

Environmental Accounting is a term which is used to describe different aspects of this emerging field of accounting. It is a process of identifying and measuring data about the environment costs incurred by an organization in the process of manufacturing and trading and communicating the same to the management.

Environmental accounting has two aspects viz; management aspect and financial aspect. Accordingly it is termed as Environmental Management Accounting (EMA) and Environmental Financial Accounting (EFA).

The focus of EMA is basically as a management accounting tool which is used to formulate and take internal business decisions, especially for environmental management activities of the organisation.

EMA was developed to recognize certain limitations of conventional management accounting approaches to environmental costs, consequences, and impacts. For example, overhead accounts were the destination of many environmental costs in the past. Cost allocations were inaccurate and could not be traced back to processes, products, or process lines. Wasted raw materials were also inaccurately accounted for during production.

Difference between Management accounting and Environmental Management Accounting:

Management Accounting entails the identification, collection, estimation, analysis, and use of cost, or other information used for organizational decision-making. Environmental Management Accounting is Management Accounting with a focus on materials and energy flow information, with environmental cost information.

Difference between financial accounting and Environmental Financial Accounting:

Financial Accounting comprises the development and organizational reporting of financial information to external parties, such as stockholders and bankers. Environmental Financial Accounting builds on financial Accounting, focusing on the reporting of environmental liability costs with other significant environmental costs.

Environmental Management Accounting is an emerging facet of accounting with benefits for industry, government, and society across the globe. As more companies come to see the environmental impacts in their decision making, the value of EMA will continue to grow.

9.7 Summary

The year 2011 can be considered as a turning point in the financial reporting and regulatory sphere in India with the implementation of International Financial Reporting Standards (IFRS). International Financial Reporting Standards (IFRS) are a set of accounting standards developed by the International Financial Accounting Standards Board (IASB) that have become the global standard for preparing financial statements of companies. As per the MCA

announcement, there are two separate sets of accounting standards under section 211 (3C) of the Companies Act: one is IFRS Integrated Standards, called I&AS (Ind. AS) and the other is Existing Accounting Standards. Global accounting standards such as IFRS facilitate comparisons among enterprises operating in different countries. Following the recommendations of the National Advisory Committee on Accounting Standards, 35 Indian Accounting Standards have been implemented from 1 April 2011 and have been placed on the website of the Ministry of Corporate Affairs. These standards will be implemented in a phased manner from a date to be announced by the MCA after resolution of tax and inter-related issues. Other recent developments also known as emerging trends in financial accounting and reporting include Extensible Business Reporting Language (XBRL) and Revised List IP, Forensic Accounting and Human Behavior Accounting. XBRL ACPS is a standard developed by Charlie Hoffman. MCA has required scheduled companies in India to use XBRL for filing their annual financial statements for the year ending 31 March 2011. It provides a unique electronically readable tag for each individual item of disclosure in business reports. By using XBRL, companies can automate the compilation of their financial data. Human resource accounting is the branch of accounting that identifies and measures the financial figures of an organization's human resources and calculates the cost involved in human resources. Management accounting deals with the identification, collection, forecasting, analysis and use of cost or other information for organizational decision making. Environmental accounting is a term used to describe various aspects of an emerging field of accounting. Environmental management accounting is management accounting focusing on material and energy flow reporting and environmental cost reporting. It is a process of identifying and measuring the environmental costs incurred by an organization in its production and business activities and communicating them to managers.

9.8 Glossary

IASB: International Accounting Standards Board IFRS: International Financial Reporting Standards

MCA: Ministry of Company Affairs IND: AS: IFRS: Integrated Standards

CPA: Chartered Public Accountants

HRA: Human Resource Accounting

9.9 Check your progress

a) Fill in the blanks

1. The year is considered as the turning point in accounting and financial reporting in India.
2. The new standards prescribed by IASB are called

b) Write True/False

1. There is no time limit in forensic accounting.
2. XBRL is rule based, not theory based.

9.10 Answers

a) (1) 2011 (2) IFRS

(b) (1) True (2) False

9.11 Terminal Questions:

Q.1 Explain the term IFRS. What are the benefits of IFRS in the field of accounting globally?

Q.2 Write a brief note on Revised Schedule VI in Indian scenario .

Q.3 What is eXtensible Business Reporting Language? What are the benefits of XBRL in the field of financial reporting?

Q.4 What is Human Resource Accounting? Discuss the advantages of Human Resource accounting.

Q.5. Discuss the concept of Environmental Accounting. What is the difference between environmental management accounting and management accounting.

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Unit 10 - Objectives, Disclosure Requirements and Harmonization of Corporate Reports

Structure

- 10.1 Introduction
- 10.2 Meaning of Corporate Financial Reporting
- 10.3 Objectives of Corporate Reports
- 10.4 Disclosure Requirements
- 10.5 Company Act 1956
- 10.6 Profit and Loss Account
- 10.7 Narrative Statements
- 10.8 Supplementary Statements
- 10.9 Cash Flow Statements
- 10.10 Harmonization of Corporate Annual Reports
- 10.11 Summary
- 10.12 Glossary
- 10.13 Check your progress
- 10.14 Answers to check your progress
- 10.15 Terminal Questions'
- 10.16 Reference books

Objectives

After reading this unit, students will be able to understand:

- Meaning of Corporate Financial Reporting
- Kinds of Corporate Reports
- the objectives of corporate reports
- needs of the varied kinds of users of corporate reports
- conceptual framework regarding disclosure requirements
- Need of harmonization in corporate reporting practices

- Role of International Accounting Standards Committee

10.1 Introduction

Corporate Reports is the main source of information about the company activities for a wide range of stakeholders like shareholders, employees, creditors, government and social organizations etc. Different stakeholders use corporate reports for meeting their different informational needs. Though there is a great debate going on regarding the exact objectives of the corporate reports, it is accepted that the general objective of the corporate reports is to meet the informational needs regarding financial position, financial performance and changes in financial position.

Further, the informational needs of the users are different but they lack authority to call for the information from the companies. Keeping in view the informational requirements, Institute of Chartered Accountants of India has issued a conceptual framework containing provisions regarding the contents of financial statements which aim to ensure the informational needs of the various kinds of users.

Harmonization is aimed at bringing uniformity in corporate disclosure practices all over the world. International Accounting Standards Committee has been constituted at the global level to bring harmonization in corporate reporting at the global level.

10.2 Meaning of Corporate Financial Reporting

Corporate Financial Reporting is a means of communication. It is concerned with recording and reporting of information about the financial transactions of a business to a wide variety of users. The series of activities forming part of corporate reporting include recording, classifying, summarizing the financial transactions and reporting of this information to the general public through financial statements.

Kinds of Corporate Reports

Income statement, Balance Sheet and Cash Flow Statement are the general purpose corporate reports prepared by the companies to meet the informational needs of their users.

Balance Sheet

Balance sheet is a statement of corporate financial position. It reports the information about the value of assets owned by the business, amount of liabilities i.e. the amount of money it owes to outsiders and the value of capital i.e. the amount of money contributed by the shareholders.

Income Statement

Income statement is a statement prepared to report about the financial performance of the organization. It is a statement of incomes earned and expenses incurred by the company during

the year. This statement reports profit if income earned is more than the expenditure incurred and reports loss in the reverse case.

Cash Flow Statement

This statement is prepared to report on the liquidity position of the company and is based on the movement of cash over the coverage period. This statement records the information about cash inflows and cash outflows and helps the user in assessing the liquidity position of the organization and also helps in finding out the causes of change in the liquidity position over a period of time.

10.3 Objectives of Corporate Reports

Financial Accounting Standards Board of USA has identified the following objectives of Corporate Reports

1. To provide useful information to the present and potential investors, creditors and other users with a view to help them in making rational investment, credit and other decisions.
2. To provide information to the present and potential investors, creditors and other users to assess the amount, timing and uncertainty of the prospective cash flows to the enterprise.
3. To provide information about the economic resources of the enterprise, the claims to those resources and also report on the effect of transactions, events and circumstances that change the resources and claims to those resources.
4. To provide information about the financial performance of the enterprise during the period.
5. To provide information about the financial performance of the enterprise provided by the components of earnings
6. To provide information about how the enterprise has obtained cash, and how this cash has been spent, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise's resources to owners and about other factors that may affect an enterprise's liquidity or solvency.
7. Provide useful information to the managers for decision making
8. To provide information about how management has discharged its responsibility towards the management regarding utilization of the assets entrusted to it.

10.4 Disclosure Requirements

Disclosure of information in the corporate reports is very important as this is the only means through which large number of different types of users meets their informational needs. The information requirements of the different users are different as they have different objectives. Therefore, it is very difficult to design a single set of corporate reports which can meet the informational requirements of all the users. Among the various kinds of users, investors are the main contributor of risky capital and are regarded as the main users. ICAI conceptual

framework which deals with disclosure requirements in corporate reports states that corporate reports which meet the requirements of investors will also meet the requirement of other users.

Basic Issues in Corporate Disclosure

In deciding about the information to be disclosed in corporate reports, management of business enterprises particularly corporate entities is required to decide on the following issues:

1. Who are the users of the corporate reports or for whom the information is meant?
2. What Information should be disclosed?
3. How much Information should be disclosed?
4. How should information be disclosed?
5. When should information be disclosed?

Legal Framework Regarding Disclosure of Information in Corporate Reports

Corporate Disclosure practices in India is governed by the centre government thorough Companies Act, 1956, Securities and Exchange Board of India (SEBI) guidelines and guidelines issued by the professional accounting body i.e. ICAI. Companies Act, 1956 prescribes the disclosure guidelines for all the companies registered with it. Further, SEBI has also imposed some corporate disclosure guidelines on the listed companies. Besides the reporting requirements imposed by the above two bodies, professional accounting body i.e. ICAI has also issued a number of accounting standards and a conceptual framework dealing with corporate disclosure contents.

10.5 Companies Act, 1956

Companies Act, 1956 list out the detailed guidelines regarding the contents of corporate annual reports. Act gives detailed provisions regarding maintenance of books of accounts and preparation of final accounts. It specifies the matters to be reported in the corporate reports and also fix the responsibilities of the board of directors in regard to disclosure of information. Besides stating the contents of the corporate reports, the main requirement of the act is that the corporate reports should present a true and fair view of the financial performance and financial position of the company. The meaning of ‘true and fair’ is not given in the act. However section 211(5) states that if the Balance Sheet and Profit and loss account does not disclose the information as required under schedule VI or any other notification given by the central government, then corporate reports will be deemed to have failed in disclosing ‘True and Fair’ view. Companies act requires that the company should maintain books to record the following information:

- All receipts and disbursements of money and the matters in respect of which receipts and disbursements take place.

- All sales and purchases of the goods of the company
- The assets and liabilities of the company (Section 209).

Further, till 1988 as per the provisions of the companies act, compliance with accounting standards by the companies while preparing corporate reports was not compulsory. However, through an amendment made in the companies act in 1988, sections 3A, 3B and 3C have been inserted in section 211. These sections have made compliance with the accounting standards compulsory.

Disclosure Requirements as Per Companies Act, 1956

Initially Corporate entities were required to prepare and present only two financial statements i.e. Balance Sheet and Profit and Loss account. A majority of the Indian companies are now also required to prepare Cash Flow statement and also report on number of other financial and non-financial items along with the above referred two principal financial statements.

Mandatory Information which is required to be disclosed in the corporate annual reports by virtue of the provisions of companies act and/or accounting standards is detailed below:

1. Balance Sheet
2. Statement of Income and Expenditure
3. Narrative disclosure
4. Cash flow statement
5. Auditor's Report
6. Director's Report
7. Supplementary Statements

I. Balance Sheet

Companies act requires that every balance sheet of the company prepared at the end of accounting year should give a true and fair view of the financial position of the company. It should be prepared as set out in PART –I(revised) of schedule VI of section 211 or as near thereto as circumstances permit. The format of the Balance Sheet and Profit and Loss account as given in schedule VI is revised by the Ministry of Corporate Affairs vide notification dated 28th March, 2011. The revised Schedule VI is applicable for the financial year commencing on or from 01st April 2011. The main reason for revision of schedule VI is convergence of Indian Accounting Standards with IFRS. The content of the balance sheet and the detailed explanation as stated in the above referred notification is given below:

Revised Format of Balance Sheet

Name of the Company.....

Balance Sheet as at

(Rupees in.....)

Particulars	Note No.	Figures as at the end of	Figures as at the end of
--------------------	-----------------	-------------------------------------	-------------------------------------

		current reporting period	the previous reporting period
1	2	3	4
I. EQUITY AND LIABILITIES			
(1). Shareholders' funds			
(a) Share capital			
(b) Reserves and surplus			
(c) Money received against share warrants			
(2). Share application money pending allotment			
(3). Non-current liabilities			
(a) Long-term borrowings			
(b) Deferred tax liabilities (Net)			
(c) Other Long term liabilities			
(d) Long-term provisions			
(4). Current liabilities			
(a) Short-term borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short-term provisions			
TOTAL			
II. ASSETS			
(1). Non-current assets			
(a) Fixed assets			
(i) Tangible assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under development			
(b) Non-current investments			
(c) Deferred tax assets (net)			
(d) Long-term loans and advances			
(e) Other non-current assets			
(2). Current assets			
(a) Current investments			
(b) Inventories			
(c) Trade receivables			

- (d) Cash and cash equivalents
- (e) Short-term loans and advances
- (f) Other current assets

TOTAL

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is expected to be realized within twelve months after the reporting date; or
 - (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.
 All other assets shall be classified as non-current.
2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have duration of 12 months.
3. A liability shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be settled in the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is due to be settled within twelve months after the reporting date; or
 - (d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification. All other liabilities shall be classified as non-current.
4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.
6. A company shall disclose the following in the notes to accounts:

A. Share Capital

 for each class of share capital (different classes of preference shares to be treated separately):
 - (a) the number and amount of shares authorized;
 - (b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
 - (c) par value per share;

- (d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;
- (e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;
- (f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;
- (g) shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held;
- (h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;
- (i) For the period of five years immediately preceding the date as at which the Balance Sheet is prepared:
 - Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.
 - Aggregate number and class of shares allotted as fully paid up by way of bonus shares.
 - Aggregate number and class of shares bought back.
- (j) Terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date.
- (k) Calls unpaid (showing aggregate value of calls unpaid by directors and officers)
- (l) Forfeited shares (amount originally paid up)

B. Reserves and Surplus

- (i) Reserves and Surplus shall be classified as:
 - (a) Capital Reserves;
 - (b) Capital Redemption Reserve;
 - (c) Securities Premium Reserve;
 - (d) Debenture Redemption Reserve;
 - (e) Revaluation Reserve;
 - (f) Share Options Outstanding Account;
 - (g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
 - (h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.
(Additions and deductions since last balance sheet to be shown under each of the specified heads)
- (ii) A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-Term Borrowings

(i) Long-term borrowings shall be classified as:

- (a) Bonds/debentures.
- (b) Term loans
 - from banks.
 - from other parties.
- (c) Deferred payment liabilities.
- (d) Deposits.
- (e) Loans and advances from related parties.
- (f) Long term maturities of finance lease obligations
- (g) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by installments, the date of maturity for this purpose must be reckoned as the date on which the first installment becomes due.

(v) Particulars of any redeemed bonds/ debentures which the company has power to reissue shall be disclosed.

(vi) Terms of repayment of term loans and other loans shall be stated.

(vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest shall be specified separately in each case.

D. Other Long Term Liabilities

Other Long term Liabilities shall be classified as:

- (a) Trade payables
- (b) Others

E. Long-term provisions

The amounts shall be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

F. Short-term borrowings

(i) Short-term borrowings shall be classified as:

- (a) Loans repayable on demand

- from banks.
 - from other parties.
- (b) Loans and advances from related parties.
- (c) Deposits.
- (d) Other loans and advances (specify nature).
- (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) Period and amount of default as on the balance sheet date in repayment of loans and interest shall be specified separately in each case.

G. Other current liabilities

The amounts shall be classified as:

- (a) Current maturities of long-term debt;
 - (b) Current maturities of finance lease obligations;
 - (c) Interest accrued but not due on borrowings;
 - (d) Interest accrued and due on borrowings;
 - (e) Income received in advance;
 - (f) Unpaid dividends
 - (g) Application money received for allotment of securities and due for refund and interest accrued thereon.
- Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities'
- (h) Unpaid matured deposits and interest accrued thereon
 - (i) Unpaid matured debentures and interest accrued thereon
 - (j) Other payables (specify nature);

H. Short-term provisions

The amounts shall be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

I. Tangible assets

(i) Classification shall be given as:

- (a) Land.
- (b) Buildings.
- (c) Plant and Equipment.
- (d) Furniture and Fixtures.
- (e) Vehicles.
- (f) Office equipment.
- (g) Others (specify nature).

(ii) Assets under lease shall be separately specified under each class of asset.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

(iv) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

J. Intangible assets

(i) Classification shall be given as:

- (a) Goodwill.
- (b) Brands /trademarks.
- (c) Computer software.
- (d) Mastheads and publishing titles.
- (e) Mining rights.
- (f) Copyrights, and patents and other intellectual property rights, services and operating rights.
- (g) Recipes, formulae, models, designs and prototypes.
- (h) Licenses and franchise.
- (i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions

through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

(iii) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

K. Non-current investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

- (a) Investment property;
- (b) Investments in Equity Instruments;
- (c) Investments in preference shares
- (d) Investments in Government or trust securities;
- (e) Investments in debentures or bonds;
- (f) Investments in Mutual Funds;
- (g) Investments in partnership firms
- (h) Other non-current investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled (special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

(iii) The following shall also be disclosed:

- (a) Aggregate amount of quoted investments and market value thereof;
- (b) Aggregate amount of unquoted investments;
- (c) Aggregate provision for diminution in value of investments

L. Long-term loans and advances

- (i) Long-term loans and advances shall be classified as:
 - (a) Capital Advances;
 - (b) Security Deposits;
 - (c) Loans and advances to related parties (giving details thereof);
 - (d) Other loans and advances (specify nature).
- (ii) The above shall also be separately sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
- (iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

M. Other non-current assets

Other non-current assets shall be classified as:

- (i) Long Term Trade Receivables (including trade receivables on deferred credit terms);
- (ii) Others (specify nature)
- (iii) Long term Trade Receivables, shall be sub-classified as:
 - (i) (a) Secured, considered good;
 - (b) Unsecured considered good;
 - (c) Doubtful
- (ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- (iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

N. Current Investments

- (i) Current investments shall be classified as:
 - (a) Investments in Equity Instruments;
 - (b) Investment in Preference Shares
 - (c) Investments in government or trust securities;
 - (d) Investments in debentures or bonds;
 - (e) Investments in Mutual Funds;
 - (f) Investments in partnership firms
 - (g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid).

In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) The following shall also be disclosed:

- (a) The basis of valuation of individual investments
- (b) Aggregate amount of quoted investments and market value thereof;
- (c) Aggregate amount of unquoted investments;
- (d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as:

- (a) Raw materials;
- (b) Work-in-progress;
- (c) Finished goods;
- (d) Stock-in-trade (in respect of goods acquired for trading);
- (e) Stores and spares;
- (f) Loose tools;
- (g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

P. Trade Receivables

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:

- (a) Secured, considered good;
- (b) Unsecured considered good;
- (c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q. Cash and cash equivalents

(i) Cash and cash equivalents shall be classified as:

- (a) Balances with banks;
- (b) Cheques, drafts on hand;
- (c) Cash on hand;
- (d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months maturity shall be disclosed separately.

R. Short-term loans and advances

(i) Short-term loans and advances shall be classified as:

- (a) Loans and advances to related parties (giving details thereof);
- (b) Others (specify nature).

(ii) The above shall also be sub-classified as:

- (a) Secured, considered good;
- (b) Unsecured, considered good;
- (c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

S. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities and commitments

(to the extent not provided for)

(i) Contingent liabilities shall be classified as:

- (a) Claims against the company not acknowledged as debt;
- (b) Guarantees;
- (c) Other money for which the company is contingently liable

(ii) Commitments shall be classified as:

- (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;
- (b) Uncalled liability on shares and other investments partly paid
- (c) Other commitments (specify nature).

U. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on preference shares shall also be disclosed separately.

V. Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilized amounts have been used or invested.

W. If, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated.

10.6 Profit and Loss Account

Companies are required to set out the contents of their profit and loss account as per revised format given in PART –II of schedule VI, section 211 of the companies act, 1956. The format of the profit and loss account and other detailed instructions required to be followed by the companies regarding disclosure requirements are detailed below:

FORMAT OF STATEMENT OF PROFIT AND LOSS

Name of the Company.....

Profit and loss statement for the year ended

(Rupees in.....)

Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
1	2	3	4
I. Revenue from operations		xxx	xxx
II. Other income		xxx	xxx

III. Total Revenue (I + II)	xxx	xxx
IV. Expenses:		
Cost of materials consumed	xxx	xxx
Purchases of Stock-in-Trade	xxx	xxx
Changes in inventories of finished goods	xxx	xxx
work-in-progress and Stock-in-Trade	xxx	xxx
Employee benefits expense	xxx	xxx
Finance costs	xxx	xxx
Depreciation and amortization expense	xxx	xxx
Other expenses	xxx	xxx
Total expenses	xxx	xxx
V. Profit before exceptional and extraordinary items and tax (III-IV)		
	xxx	xxx
VI. Exceptional items	xxx	xxx
VII. Profit before extraordinary items and tax (V - VI)	xxx	xxx
VIII. Extraordinary Items	xxx	xxx
IX. Profit before tax (VII- VIII)	xxx	xxx
X Tax expense:		
(1) Current tax	xxx	xxx
(2) Deferred tax	xxx	xxx
XI Profit (Loss) for the period from continuing operations (VII-VIII)	xxx	xxx
XII Profit/(loss) from discontinuing operations	xxx	xxx
XIII Tax expense of discontinuing Operations	xxx	xxx
XIV Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)	xxx	xxx
XV Profit (Loss) for the period (XI + XIV)	xxx	xxx
XVI Earnings per equity share:		
(1) Basic	xxx	xxx
(2) Diluted	xxx	xxx

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-section (2) of Section 210 of the Act, in like manner as they apply to a statement of profit and loss.

2. (A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from

- (a) sale of products;
- (b) sale of services;
- (c) other operating revenues;

Less:

- (d) Excise duty.

(B) In respect of a finance company, revenue from operations shall include revenue from

- (a) Interest; and
- (b) Other financial services

Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

3. Finance Costs

Finance costs shall be classified as:

- (a) Interest expense;
- (b) Other borrowing costs;
- (c) Applicable net gain/loss on foreign currency transactions and translation.

4. Other income

Other income shall be classified as:

- (a) Interest Income (in case of a company other than a finance company);
- (b) Dividend Income;
- (c) Net gain/loss on sale of investments
- (d) Other non-operating income (net of expenses directly attributable to such income).

5. Additional Information:

A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:-

(i) (a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].

(b) Depreciation and amortization expense;

(c) Any item of income or expenditure which exceeds one per cent of the revenue from operations or Rs.1,00,000, whichever is higher;

(d) Interest Income;

(e) Interest Expense;

(f) Dividend Income;

(g) Net gain/ loss on sale of investments;

(h) Adjustments to the carrying amount of investments;

- (i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);
- (j) Payments to the auditor as (a) auditor, (b) for taxation matters, (c) for company law matters, (d) for management services, (e) for other services, (f) for reimbursement of expenses;
- (k) Details of items of exceptional and extraordinary nature;
- (l) Prior period items;
- (ii) (a) In the case of manufacturing companies,-
 - (1) Raw materials under broad heads.
 - (2) goods purchased under broad heads.
- (b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.
- (c) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.
- (d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.
- (e) In the case of other companies, gross income derived under broad heads.
- (iii) In the case of all concerns having works in progress, works-in-progress under broad heads.
- (iv) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance-sheet is made up.
- (b) The aggregate, if material, of any amounts withdrawn from such reserves.
- (v) (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.
- (b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.
- (vi) Expenditure incurred on each of the following items, separately for each item:-
 - (a) Consumption of stores and spare parts
 - (b) Power and fuel
 - (c) Rent
 - (d) Repairs to buildings
 - (e) Repairs to machinery
 - (g) Insurance
 - (h) Rates and taxes, excluding, taxes on income
 - (i) Miscellaneous expenses

- (vii) (a) Dividends from subsidiary companies.
- (b) Provisions for losses of subsidiary companies.
- (Viii) The profit and loss account shall also contain by way of a note the following information, namely:-
 - a) Value of imports calculated on C.I.F basis by the company during the financial year in respect of –
 - I. Raw materials;
 - II. Components and spare parts;
 - III. Capital goods;
 - b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;
 - c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;
 - d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;
 - e) Earnings in foreign exchange classified under the following heads, namely:-
 - I. Export of goods calculated on F.O.B. basis;
 - II. Royalty, know-how ,professional and consultation fees;
 - III. Interest and dividend;
 - IV. Other income, indicating the nature thereof

Other General Instructions

1. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head/sub-head or any changes interse, in the financial statements or statements forming part thereof, the same shall be made and the requirements of the Schedule VI shall stand modified accordingly.
2. The disclosure requirements specified in Part I and Part II of this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 1956. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

3. Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (a) narrative descriptions or disaggregation of items recognized in those statements and (b) information about items that do not qualify for recognition in those statements. Each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts. In preparing the Financial Statements including the notes to accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and not providing important information as a result of too much aggregation.
4. Depending upon the turnover of the company, the figures appearing in the Financial Statements may be rounded off as below:
Turnover Rounding off (i) less than one hundred crore rupees: To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
(ii) one hundred crore rupees or more: To the nearest, lakhs, millions or crores, or decimals thereof.
Once a unit of measurement is used, it should be used uniformly in the Financial Statements.
5. Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.
6. For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards.

10.7 Narrative Statements

Besides the detail given in the financial statements, companies are also required to give narrative statements. The need to give narrative statements emerges from the provisions of the companies act, 1956 and the accounting standard. Narrative statements may contain quantitative and qualitative information. Information given in narrative statement may be classified into two broad categories i.e. accounting policies and notes to accounts.

i) Accounting Policies

Accounting Standard 1 requires the disclosure of accounting policies followed in the preparation of financial statements. This standard requires that all significant accounting policies followed in the preparation of financial statements should be disclosed, significant accounting policies should form part of the financial statements, all changes in the accounting policies which are going to have significant effect in the current year or are expected to have significant effect in the coming years should be disclosed in the year of change. In case change in accounting policy is going to have significant effect in the current year, then the effect in monetary terms on all the items which are going to be effected because of this change should be disclosed to the extent possible.

ii) **Notes to Accounts**

Notes to accounts are an integral part of the financial statements. Huge quantum of information is disclosed by the companies in the notes to accounts section. There are certain categories of information which is mandatory for the companies to disclose in the Notes to accounts section. However, some companies use this section for disclosure of voluntary information. Information which is mandatory for disclosure in this section include :

1. Contingent liabilities
2. Managerial Remuneration
3. Information related to small scale industry
4. Capital Commitment
5. Statement showing computation of net profit for managerial remuneration
6. Auditors Remuneration
7. Quantitative Information about capacity and production
8. Value of Imports
9. Earnings in Foreign exchange
10. Prior Period items
11. Amalgamation
12. Extraordinary items
13. Related Party Transactions
14. Lease
15. Disclosure of Interest in Joint Ventures
16. Disclosure of Earning Per Share
17. Disclosure of taxes on Income

10.8 Supplementary Statements

Section 212 of the companies act, 1956 contains information about the supplementary statements. All the holding companies are required to provide some information about their subsidiary companies in the form of supplementary statements. Section 212 requires that holding company must attach the following documents to their balance sheet:

1. A copy of recent balance sheet of the subsidiary company
2. A copy of the recent profit and loss account of the subsidiary company
3. A copy of the recent report of the board of directors of the subsidiary company
4. A copy of the recent report of the auditors of the subsidiary company

Besides above information, holding company is also required to provide the information about the extent of its interest in the subsidiary company and the portions of current and previous year's profits separately that belong to the holding company.

10.9 Cash Flow Statement

Companies Act, 1956 does not require companies to prepare Cash Flow Statement. However, ICAI has issued accounting standard AS-3 which requires company to prepare and present along with balance sheet and profit and loss account, a statement of cash flows. Besides AS-3, preparation and presentation of cash flow statement is one of the requirements of listing also.

In a cash flow statement, activities which generate cash flows are required to be classified into three categories i.e. Cash flow from operating activities, Cash Flow from investing activities and Cash Flow from financing Activities. Cash flow from operating activities cover cash inflows and outflows related to business activities; Cash flow from investing activities cover cash inflows and outflows related to purchase and sale of fixed assets; and cash flow from financing activities cover cash inflows and outflows related to borrowing and lending of money, payment of interest and dividend etc.

Securities and Exchange Board of India Guidelines Regarding Contents of Corporate Reports

Securities and Exchange Board of India has been established with the objectives of protecting the interest of shareholders, regulation and promotion of securities market in the country. SEBI has imposed number of disclosure guidelines on the listed companies. The mandatory disclosure guidelines are related to:

1. Disclosure of Cash Flow Statement (Clause 32)
2. Disclosure of material developments and price sensitive information (Clause 36)
3. Compliance with takeover code (Clause 40B)
4. Disclosure of Interim unaudited financial statements (Clause 41)
5. Corporate Governance Report (Clause 49)
6. Compliance with Accounting Standards issued by ICAI (Clause 50)
7. Disclosure regarding listing fee status and information regarding stock exchanges where the stock of the company is listed (Clause 48B)

10.10 Harmonization of Corporate Annual Reports

Meaning

“Harmonization of accounting standards” can be defined as the continuous process of ensuring that the Generally Accepted Accounting Principles (GAAP) are formulated, aligned and updated to international best practices (GAAPs in other countries) with suitable modifications and fine tuning considering the domestic conditions.

In simple language, accounting harmonization is to narrow down the differences within accounting standards, procedures and practices that exist between countries.

Academicians, regulators and governments have been constantly striving to harmonize domestic Accounting Standards (AS), with the International Accounting Standards (IAS) issued by the UK based International Accounting Standards Board (IASB). The IASB has been trying to harmonize international accounting principles since 1973.

The Need for Harmonization

The idea of accounting harmonization becomes more important when considered against the revolution in information technology, the fast growing globalization. In a well-connected world economy, accounting harmonization is expected to assist investors in understanding the various investment environments in the world by facilitating comparison. Few benefits of harmonization are as under:

- It ensures high quality financial reporting and disclosures.
- Comparison of the financial performance of a company against its domestic and international peers becomes possible and meaningful
- It helps in conducting systematic review and evaluation of the financial performance of multinational companies having subsidiaries in various countries.
- Accessing international capital markets for funds becomes easy
- Helps the companies in gaining global stature
- Provides a level playing field where no country is advantaged or disadvantaged because of domestic accounting standards.

Recent revision of schedule VI of the companies act made applicable from 1st April, 2011 is an effort in the direction of harmonization of Indian accounting practices with International accounting practices.

10.11 Summary

The main objective of the financial statements is to meet the informational needs of the users regarding financial performance and financial position of the enterprise. Section 211, Schedule VI of companies act 1956 details the disclosure contents of the financial statements. Besides company's act 1956, Securities and Exchange Board of India act also imposes some disclosure requirements on listed companies. Further, the major issue before the accountants in the world is mismatch between the accounting practices followed by different countries of the world. A body known as International Accounting Standards Board has been established at the international level, the task of this body is to promote harmonization in accounting practices over the globe.

10.12 Glossary

SEBI Securities and Exchange Board of India

A.S	Accounting Standard
I.A.S.B	International Accounting Standard Board
GAAP	Generally Accepted Accounting Principles

10.13 SELF-ASSESSMENT QUESTIONS

FILL IN THE BLANKS

1. Section.....of the companies act deals with format and contents of corporate reports.
2. Accounting standard.....provides the guidelines for the preparation of cash flow statement.
3. Compliance with accounting standards has been made compulsory through insertion of sub-sections
4. IASB is working for the harmonization of corporate reports at the international level since.....
5. Clauseof SEBI requires companies to prepare and present report on corporate governance.

TRUE/FALSE

6. Corporate Financial Reporting is a means of communication.
7. Revised Schedule VI has been issued to bring uniformity with IFRS.
8. Corporate Reports are designed to meet the informational needs of Investors only.
9. Goods-in-transit are shown in the balance sheet under the head cash and cash equivalents.
10. Notification regarding revision of Schedule VI was issued on 28th March, 2011.

10.14 Answer to SELF-ASSESSMENT QUESTIONS

1. 211
2. 3
3. 3A, 3B and 3C in Section 211
4. 1973
5. 49
6. True
7. True

8. False
9. False
10. True

10.15 Long answer type questions

1. What do you mean by corporate reports? Explain in detail the objectives of corporate reports.
2. Discuss in detail the revised format of Balance sheet as given in Part I of section 211 of the companies act, 1956. Give in brief the general instructions to be followed in writing the balance sheet of the company.
3. Discuss in detail the revised format of profit and loss account as given in part II of section 211 of the companies act, 1956.
4. Explain the role of ICAI in regulating the contents and format of corporate reports.
5. Explain the role of SEBI in regulating the contents of corporate reports.

10.16 Reference Books

S.N. Maheshwari, Advanced Accountancy

R.L. Gupta, Advanced Accountancy

Shukla, Grewal, Advanced Accounts

Agarwal & Jain, Advanced Financial Accounting

UNIT 11-FINANCIAL REPORTING FOR A GROUP OF COMPANIES

Structure

11.1 Introduction

11.2 Definitions

11.3 Legal Requirements Regarding Presentation of Financial Information of a Group of Companies

11.4 Accounting Standard 21-Consolidation of Financial Statements

11.5 Accounting Treatment of Other Items

11.6 Summary

11.7 Glossary

11.8 Check your progress

11.9 Answers to check your progress

11.10 Terminal Questions

11.11 Reference Books

Objectives

After reading this unit, students will be able to

- Explain the meaning of different terms associated with financial reporting of group of companies
- Explain the provisions of the companies act regarding financial reporting of a group of companies
- Explain the provisions of Accounting Standard 21 regarding consolidation of financial statements
- Prepare the consolidated financial statements for a group of companies

11.1 Introduction

Group of companies' mean a group of two or more companies where one company is a holding company and rest of the companies are subsidiary companies. Holding company is one which has the power to influence the decision making and control the affairs of management of other companies.

Subsidiary companies are the companies whose affairs are so controlled. In this era of globalization, privatization and liberalization, business enterprises are enjoying full autonomy to grow, they are growing by leaps and bounds. This growth many of them are achieving through mergers and acquisitions, amalgamation etc. For example Tata Motors acquired Jaguar Land Rover, Bank of Rajasthan merged with ICICI Bank, Centurion Bank of Panjab merged with HDFC Bank. Most common approaches adopted by the companies for achieving growth is to float its subsidiaries or acquire more than 50% shares in other companies, or gain the power to exercise control over the board of directors of other companies, to acquire voting power in other company. Companies which are so connected to each other are referred to collectively as group of companies. In India preparation of corporate annual reports of a group of companies is governed by the provisions of section 212 of the companies act 1956 and Accounting Standard 21 issued by the Institute of Chartered Accountants of India. In this unit, we have explained the meaning of terms associated with Consolidation of Financial Statements, Provisions of companies act regarding financial reporting of a group of companies, guidelines regarding consolidation of financial statements as contained in accounting standard 21. Process of preparation of consolidation financial statements has been explained with the help of suitable examples.

In this era of liberalization and globalization, business growth passages have become smooth and are offering easy rides for expansion. Mergers, acquisitions, amalgamations, establishment of new businesses by existing or new entrepreneurs are the common news. One of the most common approaches being adopted by the business houses for expansion these days is start their own new subsidiary companies or acquire controlling interest in the existing companies by buying sufficient number of shares of that company. This approach enables the acquiring company to expand its business and at the same time retain its identity. The controlling company is known as holding company and the company whose affairs are so controlled is called as subsidiary company. The companies which are so connected are referred to as 'Group of Companies' as one unit. In case of companies so connected, users of their information/financial statements are interested in knowing the financial information of the group as a whole because companies so connected affect each other's financial performance and financial position. Shareholders of the holding company are also interested in knowing the consolidated financial position and performance of the group as the money invested by the holding company in its subsidiaries belongs to its shareholders.

In some countries of the world it is compulsory for the holding companies to prepare and present consolidated financial statements of the group. In India, section 212 of the companies act, 1956 and Accounting Standard 21 provides the reporting framework for a group of companies. Besides this, International Accounting Standard 27 also provides a framework for consolidation of the financial statements of a group of companies.

11.2 Definitions of Terms

Consolidated financial statements: Financial statements of a group i.e. holding and subsidiary company presented as those of a single economic entity. These statements are prepared and presented by the holding company by incorporating the financial statements of its subsidiaries in a single set of financial statements and the whole group is presented as one entity. Consolidated Financial Statements are prepared and presented by the holding company for all the companies that are, directly or indirectly, controlled by the parent company.

Control: It is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control exists when parent company has either

- i) Ownership control, directly or indirectly through other subsidiaries, of more than 50% of the voting power. For example A ltd. holds 67% shares in B Ltd. In this case A has controlling power of more than 50% in B Company. Hence A ltd. is holding company and B Ltd. is subsidiary company.
- ii) Has the power, direct or indirect, to control the composition of the board of directors of other enterprise so as to obtain economic benefits from that enterprise.

Group: Group of holding and Subsidiaries Company together is known as group.

Non-Controlling Interest (Minority Interest): Non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent.

Parent: A parent is an entity that has one or more subsidiaries.

Separate Financial Statements: These are those financial statements which are presented by a parent, an investor in an associate or an entrepreneur in a jointly controlled entity, in which the

investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.

Subsidiary: A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

11.3 Legal Requirements Regarding Presentation of Financial Information of a Group of Companies

Companies Act, 1956

Section 212 of the companies act requires that there shall be attached to the balance-sheet of a holding company having a subsidiary or subsidiaries at the end of the financial year as at which the holding company's balance-sheet is made out, the following documents in respect of such subsidiary or of each such subsidiary, as the case may be:—

- (a) A copy of the balance-sheet of the subsidiary;
- (b) A copy of its profit and loss account;
- (c) A copy of the report of its Board of directors;
- (d) A copy of the report of its auditors;
- (e) A statement of the holding company's interest in the subsidiary as specified in sub-section (3);
- (f) The statement referred to in sub-section (5) of section 212 if any; and
- (g) The report referred to in sub-section (6) of section 212, if any.

The statement regarding holding company's interest referred above at (e) should contain the following information:

- a) The extent of holding company's interest in the subsidiary company as at the end of the subsidiary company's financial year.
- (b) The net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts, of the subsidiary's profits after deducting its losses or vice versa—

- (i) For the financial year or years of the subsidiary aforesaid; and
 - (ii) For the previous financial years since it became subsidiary;
 - (c) The net aggregate amount of the profits of the subsidiary after deducting its losses or vice versa:—
 - (i) For the financial year or years of the subsidiary aforesaid; and
 - (ii) For the previous financial years since it became the subsidiary,So far as those profits are dealt with, or provision is made for those losses, in the holding company's accounts.
- Profits and losses as referred at b & c above include only revenue profits.

Sub-section 5 of section 212 requires that where the financial year or years of a subsidiary do not coincide with the financial year of the holding company, a statement containing information on the following matters shall also be attached to the balance-sheet of the holding company:—

- (a) A statement on nature and extent of change, in case there has been some change in interest of the holding company in the subsidiary company between the close of subsidiary accounts and the date of balance sheet.
- (b) Details of any material changes which have occurred between the end of the financial year or of the last of the financial years of the subsidiary and the end of the holding company's financial year in respect of—
 - (i) the subsidiary's fixed assets; (ii) its investments; (iii) the moneys lent by it; (iv) the moneys borrowed by it for any purpose other than that of meeting current liabilities.

11.4 Accounting Standard 21-Consolidation of Financial Statements

Accounting standard 21 is issued by the Institute of Chartered Accountants. It became effective from 1-04-2001. It requires that companies should prepare and present their consolidated financial statements in accordance with the provisions of this standard. Basic theme of this standard is that the financial statements about the holding company and the subsidiary company should be presented as statements of single economic entity, should disclose resources controlled by the group and liabilities owed by the group.

Consolidated financial statements are required to include information about all the subsidiaries be it domestic or foreign subsidiaries. However, consolidation is not required in the following cases:

- (a) When the control of the holding company on the subsidiary company is of temporary nature; or
- (b) When subsidiary company operates under severe long-term restrictions resulting in inability to transfer funds to the parent company.

Such unconsolidated subsidiaries should be accounted for in accordance with AS13.

Consolidation Procedures:

1. Consolidation of financial statements of parent and its subsidiaries is done on line by line basis by adding together like items of assets, liabilities, income and expenses.
2. Investment in subsidiary account (In the books of parent company) and the share of parent in the equity of subsidiary on the date on investment should be eliminated.
3. Difference if any, arising from such elimination should be shown as Goodwill if the value of investment made is more than the value of net assets acquired in the subsidiary. On the other hand difference should be booked in Capital Reserve account if the value of investment made in the subsidiary is less than the value of net assets acquired.

NOTE: (1) If two or more investments are made over a period of time, the equity of the subsidiary on the date of investment is determined on a step-by-step basis.

(2) If small investments are made over a period of time and then an investment is made resulting in control, the date of latest investment which resulted in holding company acquiring control over subsidiary company may be considered as the date of investment.

4. Minority Interest is the share of outside shareholders in the equity of subsidiary. It is shown on liability side of Consolidated Balance Sheet.

Note: If in any financial year share of Minority shareholders in loss exceeds their share of equity, then minority interest is shown as nil in the Consolidated Balance Sheet. Such unabsorbed loss of minority interest is transferred to consolidated profit and loss account.

However, in subsequent years, interest of minority in share of profits is not recognized unless such unabsorbed loss has been fully recovered.

5. Group profits are arrived at after deducting share of minority interest from consolidated profits of all subsidiaries.
6. Intra-group balances on account of debtors/creditors, Bills Receivable/Bill payable and other transactions such as sale/purchase, expenses/income are eliminated fully. Unrealized profits resulting from intra-group transactions should be eliminated by creating a reserve for unrealized profit. Such reserve does not affect Minority Interest.

Similarly, unrealized losses which cannot be recovered are eliminated.

7. Different reporting dates of parent and subsidiaries:
 - (a) Consolidation is done on Balance sheet date of parent company.
 - (b) Adjustments should be made for significant events and transactions between the two dates.
 - (c) Difference in reporting dates should not exceed 6 months.
8. Uniform Accounting policies: In case there is deviation between the accounting policies followed by the subsidiary and holding companies, then the financial statements of the subsidiary should be adjusted prior to consolidation, in order to ensure uniformity of accounting policies. Where such adjustments could not be done, the fact should be disclosed. Policies and figures are not disturbed in the respective books. But at the time of preparing the consolidated financial statements, adequate adjustments should be made.

For example : Let us say that holding company has closing stock of Rs. 20,000 and Subsidiary company has closing stock of Rs. 25,000. Holding company follows FIFO method for valuing the inventory and subsidiary company follows weighted average method for valuing inventory. In case subsidiary also follows FIFO method for valuing inventory then the value of inventory of subsidiary company will come out to be Rs. 20,000. In this case closing stock in the consolidated balance sheet will be shown at Rs. 40,000 (20,000+20,000).

Note: In case it is not possible to adjust the consolidated statements for difference in accounting policies, this fact should be disclosed in consolidated financial statements along with the amount of all those items to which different accounting policies have been applied.

9. Post-acquisition profits/losses (of subsidiary companies) are shown in CBS under

10. Reserves and Surplus as group profits/losses after due adjustment for Minority Interests' share.
11. Disposal of Investment in Subsidiary
- (a) If the parent-subsidiary relationship ceases to exist, then the profits of such subsidiary till the date of disposal only are included in consolidated Profit and loss account.
 - (b) Profit/Loss on disposal is recognized in consolidated profit and loss account as well as in parent's separate P & L a/c.
 - (c) Investment in an enterprise, from the date that enterprise ceases to be a subsidiary, is dealt in accordance with AS13 or AS 23, as the case may be.
12. Cumulative Preference Share held by Outsiders:
- (a) Paid-up value of such shares is added in Minority Interest.
 - (b) Parent's share in profits of subsidiary is derived after deducting the arrears of preference dividend. However, if profits are insufficient to cover such arrears (belonging to minority interest.) then this information is disclosed in the form of a footnote to the consolidated balance sheet.
13. **Disclosure Requirements**
- a) A list of all subsidiaries including the name, country of incorporation or residence, Proportion of ownership interest and, if different, proportion of voting power held should be disclosed in the consolidated financial statements
 - b) In consolidated financial statements, wherever applicable
 - i) The nature of the relationship between the parent and a subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than one-half of the voting power of the subsidiary;
 - ii) The effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period, and
 - iii) The names of the subsidiaries of which reporting dates are different from that of parent and the difference in reporting dates.

Step by Step Process of Preparing the Consolidated Financial Statements

Process of preparing the consolidated financial statements is explained below step by step with the help of illustrations.

Calculation of Goodwill or Capital Reserve

Sometimes the holding company at the time of acquiring controlling interest in the subsidiary company pays more money than the value of assets it acquire in return and sometimes it pays less money. In case the money invested is more than the value of assets acquired in return, then the excess money invested is referred to as 'Goodwill'. In case value of money invested is less than the value of assets acquired in return, then the difference is referred to as 'Capital Reserve'. The process of calculating the value of goodwill or capital reserve is explained below with the help of example 18.1 and 18.2.

Illustration 18.1

X ltd. Acquires 60% shares in Z ltd. @ Rs. 22 per share. Following is the extract of the Balance Sheet of Z Ltd. You are required to calculate the value of goodwill or Capital Reserve to be recorded in the consolidated financial statement.

	Rs.
10,00,000 Equity Shares	1,00,00,000
10% Debentures	10,00,000
Creditors	6,00,000
Fixed Assets	75,00,000
Investments	45,00,000
Current Assets	63,00,000
Loans and advances	19,00,000

On the same day Z ltd. Declared a dividend @ 10% . Both the parties agreed to charge depreciation @ 10% on fixed assets. Investments were to be taken at market value of Rs. 55,00,000.

Solution

Calculation of Goodwill/Capital Reserve

A. Value of Interest Acquired	Rs.
Fixed Assets after Depreciation (75,00,000 – 7,50,000)	67,50,000
Current Assets	63,00,000

Loans and advances	19,00,000
Investment at Market value	<u>55,00,000</u>
Total assets	2,04,50,000
Less Liabilities towards outsiders	
Debentures	10,00,000
Creditors	<u>6,00,000</u>
Net worth of business	1,84,50,000
B. Interest of X Ltd. In Z Ltd. (60% of 1,84,50,000)	1,10,70,000
C. Amount Invested to acquire 60% Interest(6,00,000 X 22)	<u>1,32,00,000</u>
D. Dividend Received (6,00,000 x 2)	12,00,000
Value of Goodwill (C-B -D)	9,30,000

Note: In case holding company has more than one subsidiary then Goodwill and Capital Reserve can be netted, at the time of preparing the consolidated Balance Sheet.

Calculation of Goodwill or Capital Reserve when investment is made in Installment

In case holding company has made investment in installments to acquire control in the subsidiary company then the date from which holding company acquired control over subsidiary company will be considered for step by step consolidation of the financial statements. The process of calculating value of goodwill or capital reserve in such a scenario is explained below with the help of illustration no. 18.2.

Illustration 18.2

P Ltd. Purchased 40% shares of Q Ltd. @ Rs. 11 per share. After three years P Ltd. Purchased another 40% shares in Q Ltd. Total capital of Q Ltd. is Rs. 10,00,00,000 divided into 1,00,00,000 equity shares of Rs. 10 each. The purchase deal was approved on the following terms :

1. Purchase price per share is Rs. 8.70
2. Total assets of Q Ltd. is worth Rs. 11,20,00,000. The market value has appreciated by Rs. 50,00,000.
3. Total Liabilities towards outsiders is Rs. 2,60,00,000. One creditors to whom an amount of Rs. 20,00,000 was payable has died and nothing is now payable to him

Calculate the value of goodwill or capital reserve as the case may be.

Solution

A. Value of controlling interest acquired

	Rs.
Market value of assets of Q Ltd.	11,70,00,000
Less Liabilities of Q Ltd.	<u>2,40,00,000</u>
Net worth of Q Ltd.	9,30,00,000
Value of 80% of net worth acquired by P Ltd.	7,44,00,000

B. Money invested by P Ltd.

$40,00,000 \times 11 + 40,00,000 \times 8.70$	7,88,00,000
Goodwill (B-A)	44,00,000

Minority Interest

Minority interest is the interest of outsiders in the subsidiary company. In other words it can be described as the value of shares of subsidiary company held by the shareholders other than holding company. Minority Interest is shown as liability in the consolidated balance sheet. Care should be taken of the following points at the time of calculation of minority interest.

1. Share of minority shareholders in the post and pre-acquisition profits of the subsidiary should be calculated and should be added in the minority interest.
2. Care should be given to the treatment of outstanding preference share capital. Preference share capital held by the outsiders should also be added in the minority interest. Adjustment should be made for cumulative preference dividend. The adjustment should be made irrespective of whether or not dividends have been declared.
3. Minority interest in the net assets of the subsidiary should be assessed and presented in the consolidated balance sheet separately from the liabilities and equity of the parents shareholders. Minority interest in the net assets of the subsidiary consists of :
 - i) The amount of equity attributable to minorities at the date on which the investment in subsidiary is made and
 - ii) The minority's share of movement in equity since the date the parent-subsidiary relationship came in existence.

The process of calculation of minority interest is explained below with the help of illustration 18.3.

Illustration 18.3

Following is the extract of information taken from the balance sheet of A Ltd.

	Rs.
Profits of pre-acquisition period	10,00,000
Profits of post-acquisition period	8,00,000
General Reserve	7,00,000
Share Capital of A Ltd. (5,00,000 shares @Rs.10)	50,00,000
Preference Share Capital	10,00,000

B Ltd holding of A Ltd acquired 75% shares in A Ltd. at a premium of 30%.

You are required to calculate the minority interest from the above information.

Calculation of Minority Interest

	Rs.
Minority's Interest in post-acquisition profits	2,00,000
Minority's Interest in pre-acquisition profits	2,50,000
Minority's Interest in General Reserve	1,75,000
Minority's Interest in Preference Capital	10,00,000
Minority's Interest in equity capital	<u>12,50,000</u>
Minority's Interest	28,75,000

Note: In case of loss, minority interest in losses is deducted from their value unless minority interest is nil. In case of excessive loss i.e. share of minority in the losses exceeds the value of their holdings in the company, excess loss is adjusted from the consolidated group profits. Share of loss of minority is not adjusted from consolidated group profits in case minority has binding obligation and is in a position to make the loss good.

Further, in case share of loss of minority is adjusted from consolidated group profits in any year, then it will be reimbursed to them by adjustment from the profits of subsequent years i.e. when subsidiary makes profits in the subsequent years minority share in profits is added to majority share to the extent minority losses were absorbed by them in previous year/s.

For Example

In case share of loss of minority in a year Rs.35 lacs and their capital is Rs.30 lacs. In this year Rs. 5 lacs of losses of minority share will be adjusted from consolidated group profits. Let us say share of minority in the profit in next year is Rs. 10 lacs. Out of these Rs. 10 lacs of profits Rs. 5 Lacs will be added to consolidated group profits to compensate the group for sharing loss of Rs. 5 lacs of minority group in the previous year.

11.5 Accounting Treatment of Other Items

Inter-Group Transactions: In case holding and subsidiary companies are in a business of buying and selling goods with each other, then effect of any unrealized profits from inter-group transactions should be eliminated from the consolidated financial statements. Unrealized profits is that portion of the profit earned by holding from subsidiary or subsidiary from holding on goods sold to each other and which is unrealized because such goods or part of such goods is lying unsold with the buying company.

Example: R Ltd. Sold goods for Rs. 10,000 to S Ltd., S Ltd is the subsidiary of R Ltd. The goods have been sold by R Ltd. at a gross profit of 20% on sales. On the date of consolidated balance sheet, S Ltd. has goods worth Rs. 2000 lying unsold out of the goods purchased from R Ltd.

Unrealized profit included in the above stated unsold stock is Rs. 400 ($2000 \times 20/100$).

In the consolidated balance sheet, value of closing stock will be shown at Rs.1,600 (Rs. 2000 – Rs. 400) i.e. after deducting unrealized profit.

Reporting Date: As far as possible, the reporting dates of the holding companies and subsidiary companies should be same. In case the reporting dates of the subsidiary company and holding company are different because of unavoidable reasons, then the effect of transactions which have taken place between the reporting dates of the subsidiary company and holding company should be ascertained and consolidated financial statements should be adjusted to give the effect of such transactions. In any case the difference between the reporting dates of two companies should not be more than six months.

Disposal of Investment in Subsidiary

Explained with the help of illustrations no. 18.4 and 18.5 below:

Illustration 18.4

A Ltd. acquired 70% shares in B Ltd. at a cost of Rs20 lacs. The value of assets owned by B Ltd. on the day of acquisition was Rs. 20 lacs. During the year A ltd. sold his stake of B Ltd for Rs. 34 Lacs. On the date of sale of stake the net value of assets of B Ltd. was Rs. 40 Lacs. You are required to calculate the profit or loss made by the holding company to be recorded in the consolidated financial statements.

Solution:

Calculation of Profit/Loss on sale of Investment in Subsidiary

	Rs.
A. Value of Investment on the date of sale (40,00,000 X 70/100)	28,00,000
B. Selling Price of Investment in Subsidiary	<u>34,00,000</u>
C. Profit on Sale of Investment(B-C)	6,00,000
D. Goodwill in Consolidated Financial Statements	
i)Value of Investments on the day of purchase	14,00,000
ii)Price paid to acquire the Investment	<u>20,00,000</u>
Goodwill (ii – i)	<u>6,00,000</u>
E. Profit or loss on disposal of Investment (C-D)	0

Illustration 18.5

A Ltd. acquired 70% shares in B Ltd. at a cost of Rs.10 lacs. The value of assets owned by B Ltd. on the day of acquisition was Rs. 20 lacs. During the year A ltd. sold his stake of B Ltd for Rs. 34 Lacs. On the date of sale of stake the net value of assets of B Ltd. was Rs. 40 Lacs. You are required to calculate the profit or loss made by the holding company to be recorded in the consolidated financial statements.

Solution:

Calculation of Profit/Loss on sale of Investment in Subsidiary

	Rs.
A. Value of Investment on the date of sale (40,00,000 X 70/100)	28,00,000
B. Selling Price of Investment in Subsidiary	<u>34,00,000</u>

C. Profit on Sale of Investment(B-C) 6,00,000

D. Capital Reserve in Consolidated Financial Statements

i)Value of Investments on the day of purchase	14,00,000
ii)Price paid to acquire the Investment	<u>10,00,000</u>
Goodwill (ii – i)	<u>4,00,000</u>

Profit or loss on disposal of Investment (C+D) 10,00,000

Disclosure Requirements

The aspects to be disclosed are explained below with the help of illustration no. 18.6.

Illustration 18.6

X, Y and Z are the subsidiaries of A Ltd. The accounts of H Ltd. for the year ending 31.3.12 have been prepared and the income from subsidiaries only in the form of dividend, if any, received has been accounted.

Following is the information about subsidiaries

Particulars	X Ltd. Rupees	Y Ltd. Rupees	Z Ltd. Rupees
Financial Year ends on	31 st March	31 st Dec.	31 st October
Equity Share Capital @ Rs. 10 per share	1,00,00,000	10,00,000	10,00,000
%age of Share Capital held by A Ltd on 31-03-2012	80	60	60
Dividend Received in 2011-12 by A Ltd in respect of last year			1,00,000
Dividend Received in 2011-12 by A Ltd. in respect of earlier years	2,10,000		
Total distributable profits for the last year	2,00,000	2,50,000	4,00,000
Accumulated profits of previous years since the companies since they became subsidiary of A Ltd.	9,00,000	9,00,000	17,00,000

Other Information

1. No new shares have been acquired by the holding company in any of the three subsidiaries during last year.
2. Y Ltd. purchased assets worth Rs. 5,00,000 and invested Rs. 1,20,000 in government securities since the date of last balance sheet.

3. Z Ltd. purchased assets worth Rs. 2,00,000 since the date of last balance sheet.

You are required to prepare a statement which is required to be attached to consolidated financial statements as per the requirements of section 212 of company's act 1956.

Solution

Statement Required to be attached with Consolidated Financial Statements

As per requirements of section 212

Sr. No.	Particulars	X Ltd.	Y Ltd.	Z Ltd.
1	Financial Years of the Subsidiary Companies end on	31 st March, 2012	31 st Dec.2011	31 st Oct.2011
2	a) No. of shares held by the holding company at the end of the financial year	8,00,000	60,000	60,000
	b) Percentage of shareholding	80%	60%	60%
3	Net aggregate profit/loss of the subsidiary so far as it relates to A Ltd.			
	a) Not dealt with in the accounts of A Ltd. for the year ended 31 st March, 2012			
	i) For subsidiary's financial year ending as above in (1)	1,60,000	1,50,000	1,40,000
	ii) For previous financial years of the subsidiary since it became subsidiary of A Ltd.	5,10,000	5,40,000	10,20,000
	b) Dealt with in the accounts of A Ltd for the year ended 31 st March, 2012			
	i) For the subsidiary's financial year as in (1) above			1,00,000
	ii) For the previous financial years of the subsidiary since it	2,10,000		

	become subsidiary of A Ltd.			
4	Changes in the interest of H Ltd; between the end of the financial year of the subsidiary and 31 st March, 2012			
	a) No. of shares	Nil	Nil	Nil
	b) Percentage of shareholding	Nil	Nil	Nil
5.	Material Changes between the end of the financial year of the subsidiary and 31-03-2012			
	a) Fixed Assets		5,00,000	2,00,000
	b) Investments		1,20,000	

Comprehensive Illustrations

18.7

From the below given balance sheets of holding company A Ltd and its subsidiary B Ltd. Prepare consolidated balance sheet as on 31-03-2012.

Balance Sheet of A Ltd. and B Ltd.

as on 31st March, 2012

Liabilities	A Ltd. (Rs.)	B Ltd. (Rs.)	Assets	A Ltd. (Rs.)	B Ltd. (Rs.)
Equity Share Capital @ Rs. 100 per share	12,00,000	2,00,000	Machinery	6,00,000	1,80,000
Reserves	4,00,000	1,50,000	Furniture	3,00,000	34,000
Profit and Loss Account	2,00,000	50,000	Other Non-current assets	8,80,000	3,00,000
Creditors	3,00,000	1,14,000	Investment : shares in B Ltd. 1600 shares@ Rs. 200 per share	3,20,000	
Total	21,00,000	5,14,000	Total	21,00,000	5,14,000

Additional Information

1. Reserves and profits of B Ltd. stood at Rs. 50,000 and Rs, 30,000 respectively on 1-04-2011 when A Ltd. acquired stake of 80% in B Ltd.
2. On the date of acquisition of share in B Ltd. value of machinery was appreciated and that of furniture depreciated by Rs. 1,00,000 and Rs.10,000 respectively. Rate of depreciation on machinery is 10% and on furniture it is 15%.

Solution

Consolidated Balance Sheet of A Ltd and its subsidiary B Ltd.

as on 31-03-2012

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Equity Share Capital	12,00,000	Goodwill	24,000
Reserves	4,80,000	Machinery	8,70,000
Profits	2,09,200	Furniture	3,25,500
Creditors	4,14,000	Other Non Current Assets	11,80,000
Minority Interest	96,300		
	23,99,500		23,99,500

Working Notes

1. Pre-acquisition profits and Reserves of B Ltd

	Rs.
Profits	30,000
Reserves	<u>50,000</u>
Total	80,000
Share of A Ltd in pre-acquisition profits(80%)	64,000
Share of Minority Interest(20%)	16,000

2. Profit on Revaluation of Assets of B Ltd.

	Rs.
Machinery appreciation	1,00,000
Furniture(depreciation)	<u>10,000</u>
Net profit on revaluation	90,000

Share of A Ltd in revaluation profits(80%)	72,000
Share of Minority Interest(20%)	18,000
3. Post-acquisition profits of B Ltd.	Rs.
Accumulated Profits as per current Balance Sheet	50,000
Less Profits as per previous year Balance Sheet	30,000
Current Year Profits	20,000
Adjustment for depreciation	
Add Excess depreciation charged on furniture (15% of 10,000)	1,500
deduct less depreciation charged on machinery	10,000
Current Year Profits after adjustment for depreciation	11,500
Share of A Ltd in B Ltd.'s Post-acquisition Profits(80%)	9,200
Minority holders' share in post acquisition profits(20%)	2,300
4. Post –acquisition Reserves of B Ltd.	
Reserves as per current Balance Sheet	1,50,000
Less Reserves as per previous year balance sheet	50,000
Post acquisition reserves	1,00,000
Share of A Ltd. in post acquisition reserves(80%)	80,000
Share of Minority Holders in post acquisition reserves	20,000
5. Minority Interest	
Paid up value of shares capital held by minority	40,000
Share of Minority in pre-acquisition profits and reserves	16,000(working note 1)
Share of Minority Interest on revaluation of assets(20%)	18,000(working note 2)
Minority holders' share in post acquisition profits(20%)	2,300 (working note 3)
Share of Minority Holders in post acquisition reserves	<u>20,000</u> (working note 4)
Total	96,300
6. Calculation of Goodwill	
Paid up value of 1600 shares held by A Ltd @Rs.100	1,60,000
Share in pre-acquisition profits and reserves	64,000

Share in revaluation reserves	<u>72,000</u>
Intrinsic Value of shares on date of acquisition	2,96,000
Price paid to acquire shares	<u>3,20,000</u>
Goodwill	24,000

Illustration 18.8

From the following information of A Ltd. and its subsidiary B Ltd. You are required to prepare consolidated profit and loss account.

Profit and Loss account of A Ltd. and its subsidiary B Ltd.

For the year ending 31-03-2012

Particulars	A Ltd	B Ltd.	Particulars	A Ltd	B Ltd.
To opening Stock	21,00,000	2,00,000	By Sales	50,00,000	10,00,000
To Purchases	18,00,000	9,00,000	By Closing stock	31,00,000	12,00,000
To Gross Profit	42,00,000	11,00,000			
Total	81,00,000	22,00,000	Total	81,00,000	22,00,000
To wages and salary	4,00,000	2,00,000	By Gross Profit	42,00,000	11,00,000
To administrative expenses	3,50,000	1,00,000			
To selling and distribution expenses	1,50,000	80,000			
To depreciation	80,000	20,000			
To Net Profit	32,20,000	7,00,000			
	42,00,000	11,00,000		42,00,000	11,00,000

Additional Information

1. A Ltd sold goods worth Rs. 5,00,000 to B Ltd at a profit of 20% on sale. Stock of B Ltd. includes goods (purchased from A Ltd.) valued at Rs. 1,00,000 lying unsold with it.
2. Administrative expenses of B Ltd. include Rs. 50,000 paid to A Ltd. on account of advisory services. Selling and distribution of A Ltd. include Rs. 10,000 paid to B Ltd as agency commission.

3. A Ltd holds 80% stake in B Ltd.

Solution

Consolidated Profit and Loss Account
as on 31-03-2012

Particulars	A Ltd	Particulars	A Ltd
To opening Stock	23,00,000	By Sales	54,40,000
To Purchases	22,00,000	By Closing stock	42,80,000
To Gross Profit	52,20,000		
Total	97,20,000	Total	97,20,000
To wages and salary	6,00,000	By Gross Profit	52,20,000
To administrative expenses	4,00,000		
To selling and distribution expenses	2,20,000		
To depreciation	1,00,000		
To Net Profit	39,00,000		
	52,20,000		52,20,000

Working Notes

1. Calculation of Income from sales

	Rs
A Ltd.	50,00,000
B Ltd.	<u>10,00,000</u>
Total	60,00,000

Less Inter-company sales and other income

Intercompany Sales	5,00,000
Advisory Fees Received by A Ltd from B Ltd	50,000
Agency commission received by B Ltd from A Ltd.	10,000
Amount of Sales and other income for consolidated P&L Account	54,40,000

2. Unrealized Profits Included in Closing stock

Value of unsold stock lying with B Ltd

from the stock purchased from A Ltd	1,00,000
Unrealized Profits Included in this unsold stock (1,00,000 X 20/100)	20,000
3. Value of Closing stock to be recorded in Consolidated P&L account	
A Ltd.	31,00,000
B Ltd.	12,00,000
Less Unrealized Profit	<u>20,000</u>
	<u>42,80,000</u>
4. Administrative Expenses	
A Ltd.	3,50,000
B Ltd.	1,00,000
Less advisory fee paid by B to A	<u>50,000</u>
Total for consolidated P&L account	4,00,000
5. Selling and Distribution Expenses	
A Ltd.	1,50,000
B Ltd.	80,000
Less agency fee paid by A to B	<u>10,000</u>
Total for consolidated P&L account	2,20,000

11.6 Summary

Companies holding more than 50% share capital of other companies are called holding companies. Holding companies are required to prepare and present consolidated financial statements for the perusal of their users. Section 212 and Accounting standard 21 provides the framework for preparation and presentation of consolidated financial statements. Step by step procedure is followed by the holding companies for the preparation and financial statements. The main issues which demand attention of the accounting at the time of preparation of consolidated financial statements include assessment of Goodwill or Capital Reserve as the case may be, calculation of minority

interest, settlement of inter-group transactions, adjustment for the difference between accounting policies and reporting dates.

11.7 Glossary

FIFO First in First Out

AS 21 Accounting Standard 21

ICAI Indian Charter Accountant Association

11.8 SELF-ASSESSMENT QUESTIONS

FILL IN THE BLANKS

1. Sectionof the companies act, 1956 deals with consolidation of financial statements of the holding and subsidiary companies
2. Sub Sectionof sectionrequires disclosure of any material changes which have occurred between the end of the financial year or of the last of the financial years of the subsidiary and the end of the holding company's financial year in respect of—
 - (i) the subsidiary's fixed assets; (ii) its investments; (iii) the moneys lent by it; (iv) the moneys borrowed by it for any purpose other than that of meeting current liabilities.
3. Non-controlling interest in the subsidiary company is known also as.....
4. Company which has the power to control the affairs of one or more other companies is known as.....
5. To gain control over the management of affairs of other company, parent company is required to have voting right of more than.....

True and False

6. Minority Interest is shown on the asset side in consolidated financial statements.
7. Difference between reporting dates of holding company and subsidiary company is allowed to exceed six months
8. Accounting Standard 16 deals with preparation of consolidated financial statements.
9. Excess of the value of assets acquired in the subsidiary company over the money invested by the holding company to acquire the right is termed as Goodwill.

10. Minority interest has no right in post acquisition profits

11.10 ANSWER TO SELF –ASSESSMENT QUESTIONS

1. 212
2. 5,212
3. Minority Interest
4. Holding Company
5. 50%
- True and False Answers
6. False
7. False
8. False
9. False
10. False

11.10 LONG ANSWER TYPE QUESTIONS

11. Explain in detail the provisions of the companies act regarding presentation of financial statements of parent and subsidiary companies.
12. Explain the framework for preparation and presentation of consolidated financial statements as given in accounting standard 21.
13. Write a note on the advantages of consolidated financial statements
14. Write note on the process of calculating the following
 1. Cost of Control
 2. Minority Interest
 3. Unrealized profit on inter-company sale of stock

11.11 Reference Books

S.N. Maheshwari, Advanced Accountancy

R.L. Gupta, Advanced Accountancy

Shukla, Grewal, Advanced Accounts

Agarwal & Jain, Advanced Financial Accounting

UNIT- 12: MANAGEMENT CONTROL SYSTEM AND RESPONSIBILITY ACCOUNTING

Structure

- 12.1 Introduction
- 12.2 Management Control System
 - 12.2.1 Meaning
 - 12.2.2 Elements of Management Control System
 - 12.2.3 Importance of Management Control System
 - 12.2.4 Characteristics of an Effective Management Control System
 - 12.2.5 Clear Objectives
 - 12.2.6 Future Oriented
 - 12.2.7 Minimum Control Losses
- 12.3 Types of Management Control System
- 12.4 Components of Management Control System
 - 12.4.1 Formal Control Process
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- 12.5 Approaches to management control system
 - 12.5.1 Cybernetic Approach to Management Control Systems
 - 12.5.2 Contingency Approach to Management Control Systems
 - 12.5.3 Strategy and Control Systems
- 12.6 Factors influencing the design of MCS
- 12.7 Responsibility Accounting
 - 12.7.1 Types of Responsibility Centers
 - 12.7.2 Objectives of Responsibility Accounting
 - 12.7.3 Process of Responsibility Accounting

12.7.4	Significance of Responsibility Accounting
12.8	Transfer Pricing
12.9	Summary
12.10	Glossary
12.11	Self Assessment Questions
12.12	Answers to self assessment questions
12.13	Terminal Questions
12.14	Reference Books

Objectives

After studying this unit, students will be able to:

1. Understand the meaning and characteristics of management control system
2. Understand the benefits of management control system
3. Issue involved in design and implementation of management control system
4. Understand the meaning and characteristics of responsibility accounting
5. Understand the meaning and types of responsibility centers
6. Understand the link between management control system and responsibility accounting

12.1 Introduction

Management control system and Responsibility accounting is a system which helps the owner of business enterprise to influence the subordinates to act in the organization's interests. With the passage of time, introduction of liberalization, privatization and globalization and also because of the introduction of forms of business organizations like Joint Stock Companies, Multinational Companies, there has emerged a change in the way businesses houses used to be managed. These days business houses operate on a very large scale, therefore it has become very difficult or almost impossible for the owners and business managers to manage the day-to-day affairs of the business and be in touch with business affairs on daily basis. To ensure the smooth working of the

organization they are required to delegate decision making power down the line to their subordinates. In this modern business management era, where management is divorced from ownership, management control system and responsibility accounting is a technique which helps the management in assessing the performance of the subordinates and in bringing alignment in the activities of the subordinates with the organizational goals. Further, there have been cases where companies have lost million of rupees because effective control systems were not in place. In this unit efforts have been made to explain the meaning, characteristics, utility, components and types etc. of the management control system and responsibility accounting.

12.2 Management Control System

Meaning

Management Control system is a technique which helps the management in steering the organizational activities towards the organizational goals. This technique collects and uses the information about human and other resources owned by the organization, evaluate their performance with the aim of ensuring effective and efficient use of these resources. Management control system may be formal or informal.

In the words of Robert N. Anthony, “Management Control is the process by which managers influence other members of the organization to implement the organization’s strategies. Management control systems are tools to aid management for steering an organization toward its strategic objectives and competitive advantage. Management controls are only one of the tools which managers use in implementing desired strategies. However strategies get implemented through management controls, organizational structure, human resources management and culture.”

According to Anthony & Young, “Management control system is a black box. The term black box is used to describe an operation whose exact nature cannot be observed. MCS involves the behavior of managers and these behaviors cannot be expressed by equations.”

Horngren has defined, “Management control system as an integrated technique for collecting and using information to motivate employee behavior and to evaluate performance.”

According to Simons, “Management Control Systems are the formal, information-based routines and procedures managers use to maintain or alter patterns in organizational activities”.

In the words of Maciariello, “Management control is concerned with coordination, resource allocation, motivation, and performance measurement. The practice of management control and the design of management control systems draw upon a number of academic disciplines. Management control involves extensive measurement and it is therefore related to and requires contributions from accounting especially management accounting. Second, it involves resource allocation decisions and is therefore related to and requires contribution from economics especially managerial economics. Third, it involves communication, and motivation which means it is related to and must draw contributions from social psychology especially organizational behavior.”

Therefore, management control system can be described as a set of formal and informal procedures which helps the management in steering the organizational actions towards organizational goals through effective and efficient use of natural and manmade organizational resources.

Elements of Management Control System

There are four elements of management control system which are detailed below:

1. **Detector:** It is also known as sensor. The main task of the assessor is to collect the information about the organizational activities. It provides information about the situation to the management.
2. **Assessor:** The task of the assessor is to assess the performance of the responsibility centre against the standards and benchmarks. The comparison helps in finding out the favourable and unfavourable deviations of the actual performance from the standard performance. In simple words, it can be said that assessor helps in finding out the areas for improvement.

3. **Effector:** Effector's task is to reduce the gap between actual and expected results. At this stage efforts are made to find out the reasons of deviation of actual performance from the standard fixed. The reasons for deviation may be beyond the control of the business enterprise, in which case it will have to revise the standard. In case the reasons for deviation are because of negligence, efforts will be made to ensure that those mistakes are not repeated in the future.
4. **Communication System:** The role of communication system is to serve as a link between the sensor, assessor and effector.

Importance of Management Control System

1. Helps Management in Achieving Organizational Goals

Management Control system helps the organization in achieving its goal. It checks the activities of the organization on continuous basis and guides the management of the organization in case any deviation of actual activities taking the organization away from its mission is detected.

2. Helps to keep the long term planning on track

Management control system helps the organization in keeping its activities on track in consensus with long term planning. There are high chances of the organizations losing sight of their long term objectives because of long period and the same has been seen in the past as well. Management control system keeps sending signal to the management on frequent basis about the deviations from planned objectives.

3. Helps in delegation of authority

In the present era when the business organizations are operating on large scale and have taken the form of multinationals and transnational corporations, decentralization of organizational functioning is inevitable for the smooth running of the organization. But the management at the same time must ensure that the authority delegated down the line is

properly used by the subordinates. Management Control system helps the management in assessing the efficiency and sincerity with which the subordinates are using the power delegated to them. Since a mechanism of management control system is there to ensure right use of the delegated authority, it provides courage to the management for delegation of authority.

4. Helps Management in improving performance by working on the concept of Management By Exception

Management must not waste its time by assessing and working on each area of business and must focus its attention on critical areas. This is the principle of Management by Exception. Management Control system helps in identifying critical areas which need special attention of the management and hence therefore helps management to follow the approach of managing the enterprise by focusing attention on exceptional areas.

5. Promotes Coordination

Organization is divided into various departments each assigned with different responsibilities. Management Control system brings in synchronization between the activities of various organizational departments and organizational goals.

6. Improves Effectiveness and Efficiency

Effectiveness means doing right things and efficiency means yielding maximum output for a given input or using minimum input for a given output. Management control system by ensuring synchronization between organizational activities and organizational goals ensure maximum effectiveness. Further by conducting performance analysis it helps in achieving maximum efficiency. Incentives and penalties can be linked with favourable and unfavourable deviations identified under management control system to motivate the good performers and punish the poor performers.

Characteristics of an Effective Management Control System

An effective management control system goes a long way in helping the organization in achieving its goals and making the organization successful. Effective management control

system here means that the goals of the organization are communicated very clearly without any ambiguity to the employees, and a system is put in place for helping the employees in assessing whether their performance is in the right direction or not and promoting the confidence in them about performing their tasks well. An effective management control system is must for effective management of critical organizational resources like cash, inventory, receivables, production system and human resources etc. Following are the characteristics of an effective management control system:

Clear Objective

The foundation of successful Management Control System rests on the clarity with which the objectives of the organization have been framed. For the effective design and successful conduct of the management control system clarity of the organizational objectives is of utmost importance. All the organizational divisions and individual should be clear about the objectives of the organization and their roles in the light of organizational objectives. Good control cannot be established unless the multiple objectives of a particular task are considered separately. For example, production department must be aware clearly about the production and quality policy of the organization Like Raymond's a company into garments business aims to cater the garment needs of premium segment customers. Production department should aim at producing premium quality garments only. An American pharmaceutical company received a proposal for manufacturing packing material for its medicines. The proposal was dropped because it did not fit into the company objective of meeting need of medicine of society.

Future-oriented

Management Control system is designed to help the organization in achieving its future goals. Therefore management control system should therefore focus on future and should be designed keeping in mind the future organizational scenario and requirements.

Minimum control losses

Putting Management control system in place involves cost; more intensive the control system, higher is the cost of establishing and maintaining it. While designing the control system, proper cost benefit analysis should be done. Control system should be put in place only if benefits exceed costs.

However, effort should be made to ensure minimum loss of control and that too in those areas which are not that critical from the angle of achieving organizational goals.

12.3 TYPES OF MANAGEMENT CONTROL SYSTEMS

Control systems used in an organization can be divided into two areas i.e. formal management control systems and informal management control systems. Detailed explanation of formal and informal control systems is given below:

Formal Control System

Formal control systems are those systems of control which are put in place by the management of the organization. They are in writing and enjoy full support of the management and influence the behavior of employees in achieving the organization's goals. Breaking of formal control systems can invite the ire of management for the responsible employee. Examples of Formal Controls are Budgets, Standards, and Policies etc. Based on the nature of management intervention formal controls can be further divided into three types as stated below:

Input controls

These controls can also be designated as preventive control systems as these are the actions taken by the company before a planned activity is implemented. These controls are used by the company to select the right course of action. Examples of input controls include designing the selection criteria, recruitment procedure, conduct of training programs, manpower allotments i.e. placing right man on the right job, putting in place strategic plans etc.

Process controls

Process controls are concerned with rectifying the deviations. These controls involve identifying certain key variables, assess deviation, if any, of actual performance from expected performance and taking corrective action whenever there is any deviation from specified parameters in the context of these variables. Process control is management intervention which takes place when the process of transformation is in progress and has not been completed and the output is not yet ready. Process controls are applied to the activities and not to the end results.

Output controls

Unlike process controls which are used when the transformation process is in progress, output control is used to evaluate the results. Comparison of the actual results is made with expected results in output controls. Such types of controls are used when management feels that the employees have requisite skill, knowledge and aptitude to do the required activities in an effective and efficient manner. Further, such controls are applicable when it is easy and inexpensive to measure the output and when the elements of uncertainty are few.

Informal Control System

Informal control systems originate at the worker level. These are basically worker-initiated mechanisms that influence the behavior of individuals or groups in business units. They are not put in written form. Informal control systems are classified into three broad categories as detailed below:

Self-control

These controls are established by the employees individually own their own for themselves. Many a time employees establish their personal objectives and continuously monitoring their progress vis-a-vis attainment of their objectives. They adjust their behavior to attain the goals as and when required. These types of controls are very useful to the organization when employee preferences and goals match with organization's goals. But if the goals do not match then the performance of the employee can suffer.

Social controls

Social Controls can also be described as group controls; subgroups in the firm develop group preference and goals. These controls arise out of group values and mutual commitment towards these goals. Group informally monitors the progress and efforts put in for the achievement of goals set out by it and take corrective steps through peer pressure if there is adverse deviation. Group preferences have to match with organizational goals otherwise it can be devastating to the organization success.

Cultural controls

Cultural control is another category of informal management control system. William G Ouchi states that culture is “the broader values and normative patterns that guide worker behavior within the entire organization.” Norms of social interaction, stories, rituals and legends relating to the organization determine the nature of cultural controls.

12.4 COMPONENTS OF MANAGEMENT CONTROL SYSTEMS

Formal and Informal control systems have different components. The components of the formal and informal control systems are explained in detail below:

Formal Control Process

Formal planning and formal reporting are the two components of the formal control system. **Formal planning** in turn again has two dimensions i.e. strategic planning and operations planning. Strategic planning is long term in nature and is necessary to assist the organization in the planning and control of projects. Strategic planning is aimed at helping the organization in deciding the goals, objectives and the other key strategies. **Formal reporting** is concerned with the establishment of detailed reports which helps the organization to assess the progress of its strategic and operational planning. Weekly, fortnightly, monthly, quarterly or yearly reports help the organization to assess its performance periodically and to select the next course of action to be undertaken. Both planning and reporting should be integrated to the maximum possible extent as reporting helps in achieving the plans.

Informal Control Process

Informal Control Process consists of two subsystems i.e. Ad-hoc teams and Informal Communication System. These controls are formed on the basis of interaction among the people. Management decisions are based upon detailed formal study of the business and economic environment and on informal factors like intuition, experience and culture. One of the main sub systems of informal control is **ad-hoc teams**. These teams consist of members from cross-organizational groups which work in coordination to solve problems related to a particular client, product or market.

Informal communication systems develop because of regular interaction and work relationships amongst the employees. Developing informal communication is essential for the maintenance of effective informal controls as they are helpful in supporting the key values of the organization.

12.5 Approaches to Management Control System

Cybernetic Approach to Management Control Systems

Contingency Approach to Management Control Systems

Strategy and Control Systems

CYBERNETIC APPROACH TO MANAGEMENT CONTROL SYSTEMS

Cybernetics deals with the self-regulating principles and can be described as the study of “the entire field of control and communication theory. It covers both manmade instruments like machine or nature made elements like animals and human beings”. Cybernetics originated from Greek word ‘Kybernetes’ which stands for “steersman.” A steersman is a person who directs the movement of the ship along the planned course or direction. Due to its broad applicability in diverse fields such as language translation, automatic machine tool control, radar control, animal genetics, cryptography and deciphering, teaching machines, inferential automation, artificial intelligence and robotics, cybernetic has been popular with general systems theorists as a unifying theory of self-regulation. Cybernetic paradigm involves the goal-oriented control process which includes planning, decision-making and controls and operates through a hierarchy of control.

CONTINGENCY APPROACH TO MANAGEMENT CONTROL SYSTEMS

Contingency means dependent and therefore this theory is based on the premises that the design and use of control systems is organization specific and is dependent upon the particular organizational setting. This theory states that the suitability of different control systems depends on the business setting.

Fisher identified five contingent control variables: uncertainty; technology and interdependence; industry, firm and unit variables; competitive strategy; and mission and visibility of factors which may affect the design and use of control systems in an organization. This theory focuses on the interaction between the organization and its environment.

STRATEGY AND CONTROL SYSTEMS

Strategy helps the organization in stating the organizational goals and controls are designed to help organizations to achieve their goals. Management control systems are the tools which help in the effective implementation of strategy. Strategies can be considered at two levels in an organization i.e. corporate strategy and business unit strategy. Design and use of control system is dependent upon the strategy in use i.e. Corporate or Business Unit. Since planning and control requirements are different for different corporate strategies, they need to be designed in accordance with the corporate strategies.

12. 6 FACTORS INFLUENCING THE DESIGN OF MCS

The design and use of management control systems in organizations is affected by a number of factors. Few important factors and their effect on design of management control system is explained below:

1. Managerial Styles and the Design of Control Systems

Different styles are used by the managers in managing their employees. The choice of the design of management control system is dependent upon the managerial style being followed in the organization. A mismatch between the control systems and the managerial style may lead to conflicts in the organization. The different managerial styles that influence the design of control systems are external control, internal control and mixed control. External control works on the principle of stretching the employees by setting difficult goals for them and provision of incentives for motivating the employees. Internal control works on the premises that employees should be involved in decision making which is a motivating force. Mixed control is a mixture of strong features of external and internal control.

2. Corporate culture and control system

There is a direct link between corporate culture and control system adopted. There is a need to take corporate culture into consideration at the time of designing control system. Design of the control system must fit in the existing culture of the organization. Attention must be paid to those values

which the management wants its employees to follow. Formal control systems should be so changed as to inculcate the values which the management wants its employees to follow.

3. Decentralization and Design of Control Systems

Decentralization deals with delegation of authority. Higher the degree of decentralization in an organization, higher is the importance of control system. As the purpose of a control system is to bring together the subunits of an organization. Without a centralized control system, it would be difficult to bring this about.

4. Stakeholder Controls and Design of Control Systems

There is a wide variety of stakeholders having different objectives to be met from the business enterprise. The stakeholders of an organization may include government, regulatory bodies, industry associations investors, customers, suppliers, employees, and the public at large. It is necessary for the organization to design control process keeping in mind the different goals of different stakeholders.

5. Communication Structures and Control Process

The link between the design of the control process and communication structure is very important for the successful conduct of the control process. Organizations use both formal and informal system of communication. As control process deals with identifying the key performance areas, assessment of performance of those key areas, checking the deviation of actual performance from expected performance all this is done with the help of communication set up in place in the organization. Varied kind of information required for efficient working of control process is made available by the communication structure. Therefore, design of control process should be developed after taking into consideration the communication structure in use in the organization.

12.7 Responsibility Accounting

Responsibility accounting is one of the management control techniques. In this technique, organization is divided into various centers, resources and authority is delegated to these centers and responsibility is fixed. Responsibility accounting helps in measuring the performance of these centers by comparing actual performance of the centers with the expected performance. Different researchers have defined responsibility accounting from different angles. Few definitions given by

renowned researchers which will help the readers in proper understanding of responsibility accounting are given below:

According to Charles T. Horongren, Responsibility Accounting or profitability accounting or activity accounting which means the same thing, is a system that recognizes various decision or responsibility centers throughout the organization and traces costs (and revenue, assets and liabilities) to the individual managers who are primarily responsible for making decisions about the costs in question.

Robert Anthony defines responsibility accounting as that type of management accounting which collects and reports both planned and actual accounting information in terms of responsibility centers

In simple words we can say that responsibility accounting collects and reports on actual and planned performance of the responsibility centers in terms of inputs used and output produced. The unit of measurement of variety of input used in terms of raw material, labour etc. is reduced to common denominator and is measured in terms of money. Similarly output of goods and services is measured in terms of money. Responsibility accounting enables the manager to record the plans and performances of the centers, known as responsibility centers, entrusted to him and which falls within his responsibility area.

The measurement of the performance of responsibility centers may be made in terms of cost, profit, investment or quality i.e. according to the goal set for that department by the organization.

Types of Responsibility Centers

According to the nature of monetary inputs and outputs, responsibility centers can be classified into the following:

1. Revenue Center
2. Cost Center
3. Profit Center
4. Marketing Center

5. Investment Center

1. Revenue centers

Such a center is devoted to increasing the revenue, and assumes no responsibility for production. The output of revenue centers is measured in monetary terms. These centers are marketing organizations and they are not directly responsible for profits. The main objective of revenue centers is to maximize revenues. For example, a marketing organization is a sales revenue center.

2. Cost centers

Cost centers are basically related to costs. Cost centers have nothing to do with the revenues or assets and liabilities of the organization. It is a separate organizational unit for which separate cost allocation is done. A cost center forms the basis for building up cost records for cost measurements, budgeting and control.

3. Marketing centers

Marketing centers are responsible for marketing activities. Evaluation of marketing centers is difficult, as the marketing department has no control over economic conditions or competitors' actions. The actual results of the marketing center may be different from the expected results due to changed marketing conditions and economic environment. The main activities of marketing centers include test marketing, training sales force, advertising, sales promotion, etc.

4. Profit centers

Profit centers are responsible for profits. Their performance is measured in terms of profits. Profit is measured in terms of the numerical difference between revenues (outputs) and expenditure (inputs). A profit center is given the responsibility of earning profits. It is involved in the manufacture and sale of outputs. The profit center also determines the efficiency of the manager in charge of the center. It also helps to motivate the managers to perform well in areas they control and also encourages managers to take initiatives.

5. Investment centers

It is a responsibility center having revenues, expenses, and an appropriate investment base. It has control over sales revenues and operating costs, and the assets used to generate profit. An investment unit manager must be in a position to influence the size of the investment and profit variables. The objective of this center is to maximize profit, given the amount of investment required to generate the profit.

Objectives of Responsibility Accounting

Responsibility accounting is a technique of management which helps the organization in achieving its goals by dividing the organization into sub-units. Following are the specific objectives of responsibility accounting:

1. To help the management in improving its performance of managing the company by following the approach of Management by exception. This is done by responsibility accounting by bringing to light the poor performing responsibility centers.
2. To help the management in bringing synchronization between organizational objectives and activities of the responsibility centers.
3. To determine the contribution that a division/center as a sub-unit makes to the total organization.
4. To provide a basis for evaluating the performance of the divisional managers.
5. To act as motivational tool for the divisional/center managers whose performance is up to the mark.

Process of Responsibility Accounting

The process of responsibility accounting consists of six steps, which are detailed below:

1. Organization is divided into Responsibility Centers

This is the first step in responsibility accounting. Whole of the organization is divided into responsibility centers. These centers may take the form of cost centers, profit centers or investment center. Efforts are made to fix specific responsibility of each employee.

2. Determination the objective of each department

This is the second step in responsibility accounting. The task of the organization is bifurcated into sub-goals and these sub-goals are assigned to each department/division/responsibility center in the organization. This allocation of assignments to the individual departments helps the management in fixing the accountability and checking the performance of each division.

3. Measurement of Actual Performance

At third step efforts are made to measure actual performance of each division/responsibility center. The performance of each responsibility center is measured in terms of its assigned responsibility i.e. the performance of cost centers is measured in terms of cost incurred, the performance of profit centers is measured in terms of profits earned and the performance of investment centers is measured in terms of investments made.

4. Comparison of Actual Performance with Planned Performance

At this stage actual performance of divisions is compared with the planned performance. The idea of this comparison is to identify the weak organizational areas so that necessary steps can be taken for their improvement.

5. Calculate the value of Variance

At this stage, company calculate the value of variance i.e. deviations of employee's/divisions/centers actual performance from standard performance. The variance may be favorable, if actual performance is better than the target which is fixed by company.

6. Corrective Measures

This is the last step in responsibility accounting process. After identifying the poor performing departments/divisions/centers/employees and the reasons for adverse deviations, corrective measures are taken at this stage to ensure that this adverse

deviation does not repeat in future. In case adverse deviation is due to the negligence at the level of an employee, it may invite the ire of management in terms of demotion, transfer, cancellation of pay increments etc.

Significance of Responsibility Accounting

Responsibility accounting has emerged as an effective management control technique. This technique is widely practiced because of the following advantages attached to it:

1. Easy Identification

Since responsibility accounting is based on the concept of splitting the organization into sub-units and then fixing the accountability on sub-unit basis. It makes the identification of individual managers responsible for satisfactory or unsatisfactory performance easy.

2. Data Availability

Since management is always interested in conducting performance analysis to identify weak areas, responsibility accounting helps the management in doing that by making data easily available. Responsibility accounting is a mechanism for presenting performance data. A framework of managerial performance appraisal system can be established on that basis, besides motivating managers to act in the best interests of the enterprise.

3. Planning and Decision Making

Responsibility accounting helps not only in control but in planning and decision making too.

4. Provide Check on the use of Delegated Authority

Large scale business organizations work through delegation of authority. Whether the delegates are making proper use of the authority given or not, can be assessed with the help of responsibility accounting.

5. Acts as Motivating Mechanism

Responsibility accounting also helps in motivating the employees by pinpointing the good and poor performers. Management can use this for rewarding the good performers and punishing the poor performers.

12.8 Transfer Pricing

A transfer price is used for the evaluation of profit centers; it is a price which is used to measure the value of goods and services provided by a profit centre to other responsibility centers within a company. The assessment of profit in a profit centre is a bit difficult because of the problem of transfer prices. Transfer price is a source of revenue for the selling division and an element of cost for the buying/receiving division. The methods of fixing transfer price will therefore, have a significant bearing on the revenues, costs and therefore, profits of responsibility centers. Hence, determination of correct transfer prices is of utmost importance. There are several methods for the determination of transfer prices. The types of transfer pricing methods include Cost based and Market based methods. Based on cost and market prices there are five basic methods of transfer price i.e. Cost Method, Cost plus a normal mark-up, Incremental cost, Market price, and Negotiated price.

12.9 Summary

Management control system is a technique of management which helps in bringing synchronization between organizational efforts and organizational goals. Management control system helps to improve the organizational performance by setting standards and checking and correcting adverse deviations, if any, in performance. The management control techniques used in the organization can be categorized into formal and informal categories. On the other hand, responsibility accounting is a technique of management control which helps to improve the performance of the organization by dividing the organization into profit, cost, investment and market centers and fixing the responsibility.

12.10 Glossary

Profit centre : Profit centre is the part of company that is treated as a separate business unit, responsible for both generating revenue and managing cost, with the goal of making profits.

Transfer Price: Transfer price is a source of revenue for the selling division and an element of cost for the buying/receiving division

12.11 SELF-ASSESSMENT QUESTIONS

TRUE/FALSE

1. Management Style does not affect the design the management control system.
2. Management control systems can be divided into formal and informal categories.
3. There are three approached to management control system
4. Cybernetic has its origin in greek work “kebernectic”.
5. Ad-hoc team is a category of formal types of controls.

FILL IN THE BLANKS

6. There aresteps involved in Responsibility accounting.
7. Responsibility accounting works by dividing the organization into.....
8. Profit centre is responsible for.....
9. Transfer price concept is relevant to.....centers only
10. There are mainlycategories of transfer price methods.

12.12 ANSWER TO SELF-ASSESSMENT QUESTIONS

1. False
2. True
3. True
4. True
5. False
6. Six
7. Centers
8. Profit
9. Profit
10. Two

12.13 Terminal Questions

1. Explain the advantages of Management Control System.
2. “Management control system helps in bringing synchronization in organizational efforts and organizational goals.” Explain this statement.
3. How far management control systems are relevant for small scale enterprises? Explain with the help of live example.
4. “Responsibility accounting has no link with management control system.” Explain this statement.

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UNIT-13 CORPORATE SOCIAL ACCOUNTING

STRUCTURE

- 13.1 Introduction
- 13.2 Meaning of Corporate Social Accounting
- 13.3 Objectives of Corporate Social Accounting
- 13.4 Need for Corporate Social Accounting
- 13.5 Uses of Corporate Social Responsibility Accounting
- 13.6 Scope of Corporate Social Accounting
- 13.7 Social Benefits and Social Costs
- 13.8 Measurement of Social Costs and Benefits
- 13.9 Approaches in Corporate Social Accounting
- 13.10 Benefits of Corporate Social Reporting
- 13.11 Limitations of Corporate Social Reporting
- 13.12 Corporate Social Disclosure Practices in India
- 13.13 Summary
- 13.14 Glossary
- 13.15 Check Your Progress
- 13.16 Answers to Check Your Progress
- 13.17 Terminal Questions
- 13.18 Reference Books

OBJECTIVES

After reading this unit, you should be able to:

- Define corporate social accounting and explain its need and objectives.
- Discuss the scope and approaches in corporate social accounting.
- Describe the approaches for measurement of social costs and benefits.

13.1 INTRODUCTION

Conventional financial accounting primarily focuses on the measurement and reporting of business transactions between two or more business firms. Financial statements prepared under financial accounting are basically meant to serve the needs of shareholders and potential investors in making sound economic decisions. Exchanges between a firm and its social environment are practically ignored. The conventional financial reporting system is designed to gather, process and report financial results and operating statistics with no regard to social performance information of business enterprises. This nature of financial accounting has led to, in recent years, a serious debate that business activity should conform to socially, desirable ends, e.g., that products should not be harmful to users, the pursuit of profit should be constrained by social considerations; the environment should be protected from industrial malpractices in the form of pollution of every kind; and employees should have a right to security of employment. As business enterprises respond to pressures of new dimension—social, human and environmental—they may not necessarily change their basic (business) goals, but they will alter them to reflect the new constraints to be satisfied.

American Accounting Association Committee on Measurement of Social Costs has emphasized on operational objectives for the corporate enterprises such as increase in annual profit by 8 per cent, an increase in sales by 20 per cent, a reduction in pollution levels by 30 per cent and an employee mix that reflects the mix of minorities in communities where plants are located. Recently a study conducted by Spicer concludes that the most profitable, larger companies, in general, were judged by investors to be less risky in terms of both total and systematic risk. In addition, these companies were awarded generally higher price-earnings ratios than those with poorer pollution-control records. Social accounting is based on the following hypothesis:

“The technology of an economic system imposes a structure on its society which not only determines its economic activities but also influences its social relationships and well-being. Therefore, a measure limited to economic consequences is inadequate as an appraisal of the cause-effect relationships of the total system; it neglects the social effects.”

13.2 MEANING OF CORPORATE SOCIAL ACCOUNTING

The term ‘social accounting’ is of recent origin and many other terms like, ‘social audit’, ‘socio-economic accounting’, ‘social cost benefit analysis’, ‘report on corporate social policies’, ‘social information system’, ‘corporate social accounting’, ‘social responsibility accounting’ etc. are often interchangeably used for this. Now-a-days it is being realized that commercial evaluation of business units is not sufficient to justify commitment of funds to a business unit. Rather evaluation will be complete only if it takes into consideration social cost and benefits associated with them.

In order to gain understanding of the term social accounting, various points of view given by some eminent accounting authorities are reproduced below:

Ralph Eates defines the term as “The measurement and reporting, internal and external, of information concerning the impact of an entity and its activities on society”.

Elliot uses the term social responsibility accounting which, according to him, “is a systematic assessment of and reporting on those parts of a company’s activities that have a social impact. Social responsibility accounting, therefore; describes the impact of corporate decisions on environment pollution, the consumption of non-renewable resources, and ecological factors; on the rights of individuals and groups; on the maintenance of public services; on public safety; on health and education and many other such social concerns.”

According to G.C. Maheshwari, social accounting is “identification, measurement, recording and reporting of corporate activities which may permit informed decision-making with respect to social activities of the firm having direct or indirect effect on the very fabric of the society at large, while ‘social audit’ would mean enquiry into the corporate social accounting records by an outside agency that can opine with a view to attestation and authentication of such records and reports.”

It can be said that social accounting is rational assessment of and reporting on some meaningful, definable domain of a business enterprise's activities that have social impact.

13.3 OBJECTIVES OF CORPORATE SOCIAL ACCOUNTING

The objective of corporate social accounting is to inform the general public about social welfare measures taken by the enterprise, and their effects on the society. How far the enterprise is successful in fulfilling the social obligations, also comes to light through social accounting. The eminent objectives of corporate social accounting are as follows:

- ❑ To know the contribution of individual firms towards the society.
- ❑ Through social accounting, firms strategies and practices, that directly affect relative resources can be determined.
- ❑ Relevant information on firm's goals and policies is made available to general public.
- ❑ Social accounting aims at development of models of quantification and proper presentation of social costs and benefits of an enterprise.

13.4 NEED FOR CORPORATE SOCIAL ACCOUNTING

The practice of corporate social accounting is followed only by a handful of enterprises in public sector. There is a greater need for social accounting in a developing economy is needed for the following reasons:

- ❑ The management fulfils its social obligations and informs its members, the government and the general public.
- ❑ The management responds through social accounting to the criticisms leveled by hostile media and voluntary social organisations.
- ❑ There are certain legal obligations that have to be fulfilled by the business, such as social security obligations and welfare measures etc. The management informs the public and government about its efforts in this regard through social accounting.

- ❑ The management gets feedback on its efforts and policies aimed at the welfare of the society.
- ❑ Corporate social accounting is necessary from the view point of public interest groups, social organisations and government bodies.
- ❑ Through corporate social accounting the company proves itself that it is not a society unethical in view of moral cultures and environment degradation.

13.5 USES OF CORPORATE SOCIAL RESPONSIBILITY ACCOUNTING

Social responsibility information about business enterprises is mainly useful to internal users (management), external users (shareholders and other investors), and in influencing the share prices of a company.

(a) Internal Users

Within a company, the greatest need and the greatest demand for social responsibility information comes from top management, or board of directors. Top management, especially the chief executive officer, needs social performance information to respond to a critical press, to answer shareholders' questions, and to ensure that company policies are followed. Corporate directors, especially because of their growing legal liability, need to know in some detail what sort of social programmes the company is having, and what result it is getting. Directors also need complete information about the effects of the company on society; it is probably more important that they be fully informed as to negative effects, since this is where the criticism will be directed and this is where the directors may have to defend themselves. Labor unions can also be expected to seek social performance information about their companies.

(b) External Users

The external users' demand for social accounting information is even more diverse. Corporate social accounting and reporting are needed by present and potential investors, by large institutions and individuals. Some studies conducted in this area show the impact of social disclosure on investment decisions. In a survey of institutional investors, Longstreth and

Rosenbloom found that 57 per cent of the respondents indicated that they considered social factors in addition to economic factors when making investment decision.

(c) Impact on Share Prices

The disclosure of social information helps investors in studying the negative effects of social awareness expenditures on earnings per share along with any compensating positive effects that reduce risk or create greater interest from a particular investment. Between firms competing in the capital markets those perceived to have the highest expected future earnings in combination with the lowest expected risk from environmental and other factors will be most successful at attracting long term funds. Others believe that 'ethical investors' form a clientele that responds to demonstrations of corporate social concern. Investors of this type would like to avoid particular investments entirely for ethical reasons and would prefer to favour socially responsible companies in their investment decisions.

13.6 SCOPE OF CORPORATE SOCIAL ACCOUNTING

Brummet has identified five possible areas in which corporate social objectives may be found:

1. Net income contribution
2. Human resource contribution
3. Public contribution
4. Environmental contribution
5. Product or service contribution

1. Net Income Contribution

The term 'contribution' includes both benefits and costs associated with an organization's activities. Implicit in this definition of the scope of corporate social responsibility are a variety of users having different purposes in using accounting information.

The growing attention which other social objectives are receiving does not reduce the importance of the income objective. A business organisation can not survive without an adequate financial surplus. The recognition of the importance of other social objectives does not diminish the importance of the income objectives. On the contrary, it adds meaning to the significance of corporate net income by drawing attention to the circumstances under which it has been produced. In this sense, there is a clear correlation between income and other objectives. The failure to recognize a social responsibility may well affect the organization's income performance either in the short term or the long term. Thus, excessive hours of work under bad working conditions may damage the ability of workers to maintain the level of output. Failure to pay adequate attention to the quality of the products and customer's reactions to poor product quality may ultimately affect sales and income. For this reasons, many would argue that the income objective is the complete test of business efficiency, both as regards financial and social goals.

2. Human resource contribution

This contribution reflects the impact of organizational activities on the people who constitute the human resources of the organisation. These activities include; recruiting practices; training programmes; experience building; job rotation; job enrichment; wage and salary levels; fringe benefit plans; management-union relations; employee skills; employee knowledge; employee attitudes; employee self-actualization; congruence of employee and organizational goals; mutual trust and confidence; job security, stability of work force, lay-off and recall practices; transfer and promotion policies; occupational health; freedom from undue stress; on-the-job physical environment, and on-the-job safety.

3. Public contribution

This area considers the impact of organizational activities on individuals generally outside the organisation. For example, general philanthropy—contributions to educational, cultural, or charitable organisations; financial or manpower support for public transportation; health services, urban housing, day-care centres, minority business, community problem solving, minority group programmes and general volunteer community activities; equal opportunity employment practices; training and employment of handicapped persons; and taxes paid.

The contribution which corporate enterprise may make towards the public good are generally overlooked in the debate on social accounting. It should be noted, for example, that the creation of jobs and the provision of employment are important public contributions, as well as the development of local services which often accompanies corporate expansion into a community. The training and employment of the handicapped is an important corporate social contribution.

4. Environmental contribution

This area involves the environmental aspects of production, covering the use of resources, the production process and the product itself, including recycling and other positive environmental activities. Attention has been drawn in recent years to the negative aspects of organizational activities such as the pollution of air and water, noise, and spoiling of the environment. Moreover, industrial activities lead to a net use of irreplaceable resources and a net production of solid wastes.

Corporate social objectives are to be found in the abatement of these negative external social effects of industrial production, and in adopting more efficient technologies to minimize the use of irreplaceable resources and the production of waste.

5. Product or service contribution

This area concerns the qualitative aspects of the organization's product or service, for example, product utility, product life-durability, product safety, serviceability as well as the welfare role of the product or service. Moreover, it includes customer satisfaction, truthfulness in advertising, completeness and clarity of labeling and packaging. Many of these considerations are important already from a marketing point of view. It is clear, however, that the social responsibility aspect of the product contribution extends beyond what is advantageous from a marketing angle.

13.7 SOCIAL BENEFITS AND SOCIAL COSTS

Corporate social accounting and reporting focuses, primarily, on the measurement and reporting of social benefits and costs arising due to social responsibilities and activities of

business enterprises. It is necessary to know what social benefits and costs are associated with such social responsibilities and activities.

Social benefits

Generally speaking, the term ‘social benefits’ includes the following benefits:

1. Products and services provided – Business enterprises generally provide products and services; these are purchased by customers, which provides prima facie evidence of benefit to society. The starting point for valuing such benefits is the exchange prices usually arrived at in response to demand and supply factors. In other words, an automobile that sells for Rs. 1,00,000, presumably, is expected to provide to the purchaser, one element of social, benefit having a present value of at least Rs. 1,00,000. Included in this category of benefits are facilities, equipment, and space provided to other elements of society, for which rent is received.

Care must be exercised, however, to value only direct effects from the products and services provided. Suppose that the automobile referred to above provided the purchaser utility having an estimated present value of Rs. 1,20,000, and that in turn used the auto to provide free transportation to and from work for several neighbors, resulting in additional benefits to the neighbors (but not to the owner) estimated to Rs. 15,000. The amount to be reported by the selling firm, including Rs. 20,000 in consumer surplus, would be Rs. 1,20,000 not Rs. 1,00,000 or Rs. 1,35,000 (the automobile owner could report social benefits provided of Rs. 15,000). Significant indirect effects should be reported in footnotes, but not integrated into the model, since they are not actually provided by the reporting entity.

2. Payments to other elements of society – Companies render benefits to various elements of society as they pay for goods and services used. The value of employment provided should be separately disclosed; that is, payments to employees represent a social benefit in the amount of money transmitted to such employees and made available for their use. Since the value of human services used is separately reported as a social cost, compensation that is less than the value of services used results in a lower net social surplus (or greater social deficit).

Other significant payments included in this section include loans, contributions, dividends, interests, taxes, and assessments. It should be noted that the benefit provided by a firm

disbursing money is the money itself; what the recipient entity does with that money should be credited to that separate entity. In this case significant indirect effects might be reported in a footnote but should not be integrated into the model.

3. Additional direct employee benefits – The value of most fringe benefits should be reported in this category, e.g., the value of experience provided, training programmes, special opportunities provided, and rewarding work that provides utility to the employee over and above the monetary remuneration.

4. Staff, equipment, and facility services donated – When business firms make available their officers and employees to other organisations, benefits are provided separate from the compensation paid to the employees. These benefits might be estimated at the cost that would have been incurred by the outside organisation if it had hired persons with the qualifications required.

5. Environmental Improvements – When companies provide clean areas, plant trees, landscape eroded terrain, and clean polluted lakes, benefits accrue to society. The company is charged for the social costs of environmental damage done, hence it should receive credit for benefits provided through restoration of a previously damaged environment. Valuation is difficult for these benefits and is, probably, not accurately reflected by the amount of outlay. Community survey, shadow pricing, and economic studies might be used to develop suitable estimates.

6. Other benefits – Companies may provide to society benefits not falling within the above categories. These would include such programmes as free day-care centers, special assistance to minority enterprises, and sponsorship of public interest television programmes at a cost exceeding the advertising value.

Social costs

‘Social costs’, generally, include the following costs:

1. Goods and materials acquired – Raw materials acquired by an entity represent a sacrifice to society to the extent of the value in alternative use.

2. Building and equipment purchases – When the reporting entity acquires a building or piece of equipment, the utility from that item is lost to the rest of society for as long as it is held by the entity. This cost to society should be approximated by the exchange price, adjusted downward for producers' surplus. In fact, in this approach, there is no cost to society as the fixed assets are used by their owner. The full cost occurs at the moment of transfer from the rest of society to the reporting entity, and is measured by the discounted present value of the future stream or benefits that the seller would have received had they not been sacrificed in the exchange.

3. Labour and services used – The cost to society of human services used is the sacrifice in time and effort made by the employees (as elements of society); this can, probably, be approximated by the benefits that they could obtain in alternative employment and other activities. This raises difficult measurement problems. When the measurements involve excessive subjectivity, it may be reasonable to value employee services at the amount paid for them, with some adjustment for underutilization, nepotism, favouritism, producers' surplus and the like.

4. Discrimination – Entities may engage in two forms of discrimination: external discrimination, or discrimination in hiring, and internal discrimination, or discrimination in placement, advancement, and training. External discrimination imposes direct cost on those women and minorities (or any other targets of discrimination, for that matter) who would otherwise have been hired by the company. Their social cost is the present value of income lost and the value of experience forgone.

The social cost of internal discrimination is the present value of lifetime scarified income and experience caused by a delay in advancement of one year (continuing discrimination in succeeding years would be charged in the social reports of those years). Internal discrimination should be easier to value, since a limited number of specifically identifiable individuals are involved.

5. Work-related injuries and illness – Any injury and/or illness attributed to the entity and its activities should be reported as a social costs. The cost of an injury or illness might be estimated as the present value of lost income plus an increment for discomfort, frustration, and

delayed experience. This cost can, of course, be reduced by installation of safety devices, elimination of unhealthy conditions, health monitoring and similar efforts.

6. Public service and facilities used – This category includes the reporting entity's share of police and fire protection, the legislative and judicial system, and government activities at all levels. Many of these services are so pervasive as to make estimation of one entity's share exceptionally difficult. The amount of taxes paid might be used as a starting point. In addition, industry studies might be undertaken to produce guidelines or adjustment factors for firms within the industry.

7. Environmental damage – The entity imposes damage on the environment most noticeably through the production and waste disposal processes, but damage is also done by delivery trucks, salesmen's automobiles, construction, and some advertising. The damage comes in several forms – air and water pollution, noise, plant-life destruction, terrain damage, trash and litter, and even visual pollution. In measuring environmental damage, the objective is to estimate the utility lost to society through the entity's activities or omissions. In the case of water pollution, estimates may be sought for lost recreational utility, value of fish and plant life destroyed, increased treatment cost down-stream, and impairment of living conditions proximate to the waterway. Air pollution may require estimates of lost utility due to pollution-related illness (medical costs, lost productivity, shortened life span, and discomfort), damage to exterior finishes, impairment of living conditions, and plant-life damaged or destroyed.

8. Payments for other elements of society – Customers, lenders, investors, and others make payments to the reporting entity; in so doing they are sacrificing the utility that such purchasing power could command. This sacrifice is a cost to society vis-à-vis the reporting entity. Payments from customers might be netted against the value of the products and services provided, but the proposed gross disclosure would be more informative especially when market imperfections result in a significant difference between the value of products or services and the amount paid.

13.8 MEASUREMENT OF SOCIAL COSTS AND BENEFITS

The greatest problem in social accounting and reporting is an apparent lack of valid and reliable measurement technique. Social measurement often requires valuation of goods, services and effects that have not been exchanged in the market and consequently do not have recorded exchange or market prices. Exchange prices are considered to be the foundation of business accounting. However, exchange prices are often not available and are not very good indicators of social value. Therefore, some other measures of social benefits and costs need to be developed. Social measurement requires the estimation of benefits or utility provided by an entity, and the costs or sacrifices imposed on elements of society. Several approaches for social measurements can be used.

1. Surrogate Valuation

When a desired value cannot be directly determined, a surrogate value needs to be estimated, that is, some item or phenomenon that is logically expected to involve approximately the same utility or sacrifice as the item in question. For example, assume that we want to estimate the value of building facilities loaned by a company to some community groups. In this case, a surrogate valuation can be obtained by determining the amount of rent such groups would have to pay if they rented commercial facilities having the same utility. Surrogate valuation has weaknesses; a wrong thing could be measured or a surrogate may be selected which is not sufficiently related in value to the item under consideration. In spite of this drawback, surrogate valuation is one of the most useful tools available in corporate social accounting.

2. Survey Techniques

Survey techniques involve obtaining information from those affected – elements of society who make the sacrifice or who receive the utility – for measurement of social cost and benefits. In this, a simple approach is to ask individuals directly what something is worth to them. In this direct inquiry method, several criteria must be fulfilled:

- (a) The user of affected individual must have a clear appreciation of the impact on him of the item under consideration.

- (b) He must be able to relate this impact to monetary units, either directly or through the use of surrogates.
- (c) He must be willing to give a truthful answer or at least must have no discernible reason for lying.

3. Restoration or Avoidance Cost

Certain social costs may be valued by estimating the monetary outlay necessary to undo or prevent the damage. Some social effects can not be undone and, in such cases, the restoration cost estimate is supplemented with estimates of such additional damage. An example would be the damage to automobiles and vehicles from streets and roads during rainy season. This damage can be prevented if proper care is taken. Suppose the damage to a car amounted to Rs. 3,000 , but the cost of preventive measures would have been only Rs. 1,500. Therefore, Rs. 1,500 is the proper value to be assigned to this social cost.

4. Appraisals

Independent appraisals may be useful for valuing certain goods, buildings, and land. These will often reflect nothing more than an expert estimate of market value and are, thus, analogous to surrogate valuation performed by an outside expert. When appraisals are used, it is necessary that we understand the basis for them and interpret the results accordingly.

5. Analysis

Many times an economic and statistical analysis of available data produces a valid and reliable measure of value. Estimates of the increased earnings value of education have relied on present value analysis of comparative earnings rates and life expectancies.

The above measurement approaches generally provide an adequate set of choice for virtually any social measurement problem. They must be used, however, with care and proper understanding in full recognition of their respective weaknesses and especially with careful attention to the attributes that are ultimately intended to be measured. The Sachar Committee Report has suggested that company social report needs to be developed both in quantity and monetary terms.

13.9 Approaches in Corporate Social Accounting

Many different approaches are used in corporate social accounting. However, no one approach is widely recognized as the most appropriate for social accounting. Some of these approaches in social accounting are as follows:-

- (i) Cost-Benefit Analysis approach
- (ii) Socio-Economic Operating Statement Approach
- (iii) Integral Welfare Theoretical Approach
- (iv) Descriptive or Narrative Approach
- (v) Goal Oriented Approach
- (vi) Value Added Approach
- (vii) Pictorial Approach
- (viii) Regulatory Requirements

(i) Cost-Benefit Analysis Approach

This approach has been developed and used by Abt Associates in the United States. Under this approach presentation of social information in a quantitative form is made. It consists two parts viz., (i) Social Income Statement and (ii) Social Balance Sheet. The objective of this approach is to determine the full impact of corporate activities on different constituents.

The Social Income Statement part provides social benefits and social costs to staff, local community and general public. The Social Balance Sheet part depicts the social investment of capital nature on the assets side such as township, water supply, roads, buildings, hospital, ambulances, school, club etc. and shows organisation equity and social equity on the liabilities side.

The main objective of this approach is to determine the full impact of corporate activities on different social aspects. The format of Social Income Statement is given in Table 21.1. It explains (i) Social benefits and costs to staff, (ii) Social benefits and costs to community and (iii)

Social benefits and costs to the general public. Ultimately, it discloses net social income to staff, community and general public.

The Social Income Statement provides monetary quantification for the firm's social benefits. These benefits are defined as resources generated by the company operations having a positive impact, or increasing the society's resources. The social costs are resources used in the company's operations at a 'cost sacrifice'. The net social income is social gain or loss to the society's resources due to the firms operations.

The format of Social Balance Sheet is given in Table 21.2. The balance sheet part of social accounting contains information on social assets and social liabilities. The utility of this approach lies in the presentation of information in quantitative information is provided. Any other additional information is provided in footnotes.

TABLE 21.1

Social Income Statement of XYZ Ltd. for the year ended 31st March,

Particulars	Amount
(I) Social Benefits and Costs to Staff	
(a) Social Benefits to Staff	
1. Medical and Hospital facilities	x x x
2. Educational facilities	x x x
3. Canteen facilities	x x x
4. Recreation, Entertainment and Cultural activities	x x x
5. Housing and Township facilities	x x x
(b) Social Cost to Staff	
1. Layoff and Voluntary termination	x x x
2. Extra hours worked by Executives but not paid	x x x

Net Social Benefits to Staff	x x x

(II) Social Benefits and Costs to Community	
(a) Social Benefits to Community	
1. Local Taxes paid to Panchayat/Municipality	x x x
2. Environmental Improvements	x x x
3. Generation of Job Potential	x x x
4. Generation of Business	x x x
(b) Social Costs to Community	

1. Increase in cost of living in the vicinity on account of Company's plants	x x x
Net Social Benefits to Community	x x x
(III) Social Benefits and Costs to General Public	
(a) Social Benefits to General Public	
1. Taxes and Duties paid to State Governments	x x x
2. Taxes and Duties paid to Central Governments	x x x
(b) Social Costs to General Public	
1. State Services consumed – Electricity service	x x x
2. Central Services consumed – Telephone, Telegrams, Postal services and Banking	x x x
Net Social Benefits to General Public	x x x
Net Social Income (I) + (II) + (III)	x x x

TABLE 21.2

Social Balance Sheet of XYZ Ltd. as on 31st March,.....

Liabilities	Amount	Assets	Amount
I. Organisation Equity	x x x	I. Social Capital Investment	
II. Social Equity Contribution by Staff	x x x	Township Land	x x x
		Building	
		(i) Township (Residential & Welfare Buildings)	x x x
		(ii) Canteen Buildings	x x x
		Township Water Supply & Sewerage	x x x
		Township Roads	x x x
		Township Electrification	x x x
		II. Other Social Assets	
		Hospital Equipments	x x x
		Hospital Vehicles and Ambulances	x x x
		School Equipments	x x x
		Club Equipments	x x x
		Playground/Park	x x x
		School Buses	x x x
		Others	x x x
		III. Human Assets	x x x
	x x x		x x x

(ii) Socio-Economic Operating Statement Approach

This approach was suggested by David Linowes and Ralph W. Estes. Linowes proposes the development of a 'Socio-Economic Operating Statement' for social reporting which aims at focusing on 'what corporation has done for society' on one hand and 'what it has failed to do' on the other.

He suggested that a firm should prepare a social statement periodically along with the Corporate Balance Sheet and Income Statement. It would include a tabulation of the corporation's voluntary expenditures to benefit its employees, public or environment, offset against the cost of programmes which were not undertaken but which would have resulted in improvement.

Estes proposed a comprehensive model to report and permitting the disclosure of all direct benefits and costs of an entity in terms of its net contribution to society. The main assumption under this approach is that, a firm gives something to the society and uses something of society and this interaction be presented in a statement format which is called the 'Socio-Economic Operating Statement (SEOS)'. According to this approach, the firm presents the positive and negative aspects of its social activities. The positive aspects are termed as 'social benefits' and negative aspects as 'social costs'.

The net social contribution of a firm is represented by the difference between social benefits and social costs. This approach suggests that a firm should prepare a social statement periodically showing the expenditure made for 'improvement in social areas, offset the cost of programmes which were not undertaken but which would have resulted in improvements'.

Typical basic guidelines for the preparation of SEOS are:

- If a socially beneficial action is required by enforceable law or union regulations, it is not included in the SEOS.

- If a socially beneficial action is required by law but is ignored, the cost of such item is a 'detriment' for the year. The same treatment is given to an item if postponed, even with government approval.
- A prorated portion of salaries and related expenses of personnel who spend time in socially beneficial actions or with social organisations is included.
- Cash and product contributions to social institutions are included. The cost of setting up facilities for the general good of employees or the public, if done voluntarily without union or government mandate, is included.
- Expenditure made voluntarily for the installation of safety devices on the premises or in products and not required by law or other contract are included.
- The cost of voluntarily building a playground or nursery facility for employees and / or neighbors is included. Operating costs of the unit are also included for each succeeding year applicable.
- Extra costs of designing and building business facilities to upgrade health, beauty or safety standards are included.

The format of Social Economic Operating Statement is given in Table 21.3. Further Lee Seidler developed another approach for Social Accounting and reporting and suggested two Income Statement formats, one for a profit seeking organization and another for a non-profit seeking organization the result of which is a net social profit or loss reflecting the net contribution of the entity to the society.

TABLE 21.3

Socio Economic Operating Statement of XYZ Ltd. for the year ended 31st March, 2012

(I) Social actions – People related	
(a) Improvements	
Minority enterprise technical assistance programme	4,000
Emergency flood relief	3,000
Training programme for handicapped workers	8,000

Executive time – hospital trusteeship	5,000
Minority hiring programme – extra training and turnover costs	6,000
Day-care center for children of employees setup and maintenance cost – voluntarily established	11,000

	37,000
(b) Less: Detriments	
Postponed installation of hydraulic safety control system-cost of unit	16,000

	16,000

Net Improvements for the year	21,000
 (II) Social actions – Environment related	
(a) Improvements	
Cost of installing water quality monitoring system to control pollution	22,000
Cost of clearing landscaping company-owned ravaged area and dump	41,000
Executive time-free consulting service to state environmental protection agency	4,000

	67,000
(b) Less: Detriments	
Deferral of liquid waste treatment facility	60,000
Postponed installation of higher smoke stacks to reduce air pollution	19,000

	79,000

Net Deficit for the year	12,000
 (III) Social actions – Product related	
(a) Improvements	
Voluntary discontinued product judged unsafe for home use-Projected annual net income.	23,000
Salary of safety engineer on loan to government product safety committee.	21,000

	44,000

(b) Less: Detriments	
Cost of process redesign to reduce manufacturing hazard – recommended by Safety Council, but implementation deferred	36,000

Net Improvement for the year	36,000
Total Socio-economic improvements during the year 2011-12	-----

Add: Net cumulative Socio-Economic Improvements as at 1.4.2011	8,000
Net Socio-Economic Improvements upto 31st March, 2012	17,000
	1,76,000

	1,93,000

(iii) Integral Welfare Theoretical Approach

This approach deals with all activities which are expected to be undertaken by business enterprises. The conceptual approach of this school of thought is well summarized by Eichhorn (1974) in his book on 'Social Accounting'. It intends to develop an integral assessment of all activities on the part of business corporations from the view point of society.

This school of thought involves the preparation of a social report comprising social benefits and social costs. These social costs and social benefits are presented in Table 21.4, from which it is understood that corporate social accounting framework includes social costs such as labour, material, fixed assets and capital costs.

In the same manner social benefits are provided in the form of qualitative products, safety of products, rational prices and regular supply of products. It also prevents value of negative external effects and value of positive external effects on the part of business corporations.

TABLE 21.4: SOCIAL STATEMENT

Social Costs	Rs.	Social Benefits	Rs.
(I) Producers' Surplus for:		(I) Consumers' Surplus for:	
1. Labour Performance	x x x	1. Product A	x x x
2. Fixed Assets	x x x	2. Product B	x x x
3. Materials	x x x	3. Product C	x x x
4. Capital	x x x	4. Product D	x x x
5. Entrepreneurial Performance	x x x		
6. Performance paid in advance	x x x		
	-----		-----
	x x x	(II) Consumers' Surplus for:	x x x
(II) Value of Negative external effects on:	-----	1. Employees	-----
1. Employees		2. Population	
2. Population	x x x	3. Companies	x x x
3. Companies	x x x	4. Public Entites	x x x
4. Public Entites	x x x		x x x

Net Social Benefits	x x x	Net Social Costs	-----
	-----		x x x
	x x x		-----
	-----		x x x
	x x x		x x x

(iv) Descriptive or Narrative Approach

The American Accounting Association's Committee on 'Environmental Effects of Organizational Behavior' has proposed this method to include certain environmental disclosures. The nature of such type of narrative disclosure is non-quantitative. These disclosures would be attached to the annual financial statements. Under this approach, a firm highlights the positive aspects of its social activities. The Committee recommended that the present reporting model be more fully utilized to:

- (a) Display environmental control expenses on a separate line in the Income Statement.
- (b) Disclose separately total environmental control expenditures in the Funds Statement.
- (c) Classify separately environmental control facilities in the Balance Sheet.
- (d) Use accrual accounting for Environmental Liabilities.

The Committee further recommended that the present reporting system should help to identify the environmental problems facing the organisation and the disclosure of material environmental effects on financial position, earnings and business activities of the corporations.

Under this method, the schedules representing employees benefit and services, social overheads, township maintenance, etc., are prepared and shown as part of annexure in the Annual Report. Social overhead includes medical, education, canteen, transportation facilities etc. Schedules of township maintenance contains expenditure on building, water, sewerage etc. It consists of quantitative measurements on the social involvement of the firms. This is to be included as an additional footnote in the financial statement section of the annual report.

(v) Goal Oriented Approach

It is based on the recognition of the fact that companies usually have elaborate goals and purposes describing the economic and social objectives which they have set for themselves. Therefore, it involves two aspects:

- (a) The selection of social goals, and
- (b) The reporting and assessment of company's performance according to these goals.

Compared to the other social approaches, this concept has the advantage because indicators to be used to report on company's achievements are not arbitrarily selected but are derived from the specific goals and objectives under consideration. The detailed activities are measured and analyzed in pursuit of these goals. It also has the advantage of integrating traditional financial reporting and social reporting.

(vi) Value Added Approach

Under the Value added Accounting, the income accruing to the enterprise after external payments is taken into account. It represents the value added to goods and services, required by the enterprises as a result of the efforts of management and employees.

(vii) Pictorial Approach

Under this approach, photographs of health care center, school and hospital etc. run by the firm are presented in annual reports.

(viii) Regulatory Requirements

The reporting is done by other methods also which include mention of social activities by an enterprise in the Chairman's Report, Director's Report or Auditor's Report. This approach is followed by many public and private sector enterprises, because it is simple to present.

The Companies (Disclosure of Particulars in the Report of Board of Directors) Rules, 1988 require information regarding Conservation of energy, Technology absorption and Foreign

earnings and outgo. Disclosures requirement under this rule has covered some aspects of social reporting.

Indian economy is based on the principle to democracy and socialism and as such the social audit has greater importance for our country. For this reason an order for social audit was issued by the Government of India by amending Section 227(4A) of the Companies Act, 1956 and by passing the Manufacturing and Other Companies (Audit Report) order, 1988.

13.10 BENEFITS OF CORPORATE SOCIAL REPORTING

Several benefits may be realized by an organisation by the publication of a social statement. These may include:

- Presentation of a complete picture to the society and the management to enable everybody to form correct opinions.
- Assist management in formulating appropriate policies and priorities.
- Avoidance of adverse publicity.
- Improved image leading to greater support from government and public.
- Help in marketing and greater customer support.
- Evidence of social commitment.
- Improved employee motivation.
- Better business relations with all concerned e.g. banks, insurance, government.
- Resolution of social problems can assist in long term growth of the organisation.
- Attracting and retaining high quality staff.
- Obtaining feedback from the public as to the changes required in the focus.
- Improve confidence of shareholders or members.

- Several companies are realizing that being a socially responsible organisation can be good for productivity, morale and loyalty amongst employees.

In addition to the benefits derived by the individual organisation, various other interested parties like government agencies, consumer council, shareholders associations, trade associations, news media etc. also benefit because of ready availability of the information.

13.11 LIMITATIONS OF CORPORATE SOCIAL REPORTING

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

- **Not Mandatory:** Disclosure of social responsibility information is not mandatory for private sector units. In the case of public sector units also 'order for social overheads schedule' does not at all fulfill the requirements of social audit.
- **No Standard format:** There are no well established concepts, conventions, postulates and axioms to guide the Social Accountant in drafting his accounts and reporting.
- **Lack of clear cut definition of social reporting:** Every enterprise adopts different methods for measuring, reporting and evaluating social responsibility as there is no clear cut definition and procedure for social reporting.
- **No cadre of social auditors:** There is no separate cadre of social auditors and it is not clear how and who will conduct such audit.
- **Auditing social cost and benefit is an intricate function:** It is highly doubtful if only accountancy scholars would be able to perform the stupendous task of identifying and documenting the many sided social effects of business behavior and auditing social costs and benefits.

13.12 CORPORATE SOCIAL DISCLOSURE PRACTICES 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 a report under section 227 to members (shareholders) and express an opinion whether the company's balance sheet and 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 in 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 recommended the inclusion of the following, inter alia, in the director's 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 report on the future plans of the company towards the discharge of its social responsibilities and duties.”

In 1981, The Institute of Chartered Accountants of India after making a survey found that 123 out of 202 companies provided some information in their directors reports about company contribution in social responsibility areas.

The TISCO performed the first social audit (the company has used the term audit) ever undertaken by any company, public or private, in India. The purpose of the audit was to examine and report whether, and the extent to which the company had fulfilled objectives regarding its social and moral responsibilities to the consumers, employees, shareholders, society and the local community. In its 65 page report, the Audit committee has given the background of the idea (social audit) and explained the company's responses (action and inaction) towards Jameshedpur, pollution, employer-employee relations, consumers, shareholders, community development and social welfare programme, rural development programme, etc. The report about social audit performed by the company is very descriptive and not structured and accounting-oriented.

Some Indian Companies have made attempts to provide information on their social responsibility activities in published annual reports. Some such companies have been given

social income statements and social balance sheet in their annual reports; some have preferred to give narrative disclosures on social responsibility actions. Also, social reporting policy of Indian Companies has not been consistent. Some Indian Companies, after giving social responsibility reports for a few years, have discontinued it without stating any reasons in this regard.

13.13 SUMMARY

The conceptual thinking about corporate social accounting has grown at a rate faster than what has been done in practice. The social accounting information about business enterprises are not only important for external users, public interest groups, government, etc., but also for managements in planning and decision-making areas. In pursuance of their basic goals, all organizations have a social commitment. The debate on a suitable corporate social reporting model is continuing. At present, the primary objectives for business enterprises should be to provide disclosure about their society related activities. If a business enterprise decide to wait for a perfect model, completely reliable measures, generally accepted reporting standards, and qualitative characteristics applicable to social information, it would be failing in its responsibilities as a stable and forward looking employer and a good citizen. Business enterprises should be ready to accept growing challenged emerging in social accounting and reporting area.

13.14 GLOSSARY

Social Accounting: It is rational assessment of and reporting on some meaningful, definable domain of a business enterprise's activities that have social impact.

Net Social Income: The net social income is social gain or loss to the society's resources due to the firms operations.

Net Social Contribution: The net social contribution of a firm is represented by the difference between social benefits and social costs.

13.15 Check Your Progress

Fill in the blanks:

- a. The external users' demand for social accounting information is even _____ diverse.
- b. The failure to recognize a social responsibility may well affect the organization's _____ performance either in the short term or the long term.
- c. The social cost of _____ discrimination is the present value of lifetime scarified income and experience caused by a delay in advancement of one year.
- d. _____ appraisals may be useful for valuing certain goods, buildings, and land.

State whether the following statements are True or False:

- a. Goal Oriented Approach is based on the recognition of the fact that companies usually have elaborate goals and purposes describing the economic and social objectives which they have set for themselves.
- b. The income accruing to the enterprise after external payments is taken into account in Pictorial Approach.
- c. TISCO performed the first social audit (the company has used the term audit) ever undertaken by any company, public or private, in India.
- d. Socio- Economic Operating Statement Approach was suggested by David Linowes and Ralph W. Estes.

13.16 ANSWERS TO CHECK YOUR PROGRESS

Fill in the blanks

- a. More
- b. Income
- c. Internal
- d. Independent

True and False

- a. True

- b. False
- c. True
- d. True

13.17 TERMINAL AND MODEL QUESTIONS

1. What do you mean by Social Accounting ? Discuss the objectives and need for social accounting.
2. Explain the various methods of measurement of social costs and social benefits.
3. How should social accounting information be reported in published annual reports? Which method of disclosure, do you think, will be most appropriate ?
4. Discuss the effect of social disclosures on the share prices of a company. Explain the limitations of social reporting also.

13.18 SUGGESTED READINGS

1. A Belkaoui, Socio- Economic Accounting, Quorum Books, Westport.
2. Longstreth and Rosenbloom, Corporate social reporting and the institutional investor, Praeger, New York
3. M C Shukla and T S Grewal, Advanced Accounting, S Chand & Sons, New Delhi.
4. K V Ramanathan, Towards a theory of corporate social accounting, Accounting Review
5. Sachar Committee Report of the High-Powered Expert committee on companies and MRTP Acts, Ministry of Law, Justice and Company Affairs, New Delhi
6. R L Gupta, Advanced Accounting, Sultan Chand and Sons, New Delhi

UNIT -14 HUMAN RESOURCE MEASUREMENT

STRUCTURE

- 14.1 Introduction
- 14.2 Concept of Human Resource Accounting
- 14.3 Objectives of HRA
- 14.4 Need for HRA
- 14.5 Assumption of HRA
- 14.6 Benefits of Human Resource Accounting
- 14.7 Methods of Accounting for Human Resources
 - 14.7.1 Cost Methods
 - 14.7.2 Present Value Methods
- 14.8 Requirements under the Companies Act
- 14.9 Recording and Disclosure in Finance Statements
- 14.10 Problems and Limitation of HRA
- 14.11 Summary
- 14.12 Glossary
- 14.13 Check Your Progress
- 14.14 Answers to Check Your Progress
- 14.15 Terminal Questions
- 14.16 References

OBJECTIVES

After reading this unit, you should be able to

- Explain the meaning and concept of human resource accounting
- Understand the objectives and advantages of human resource accounting

- Explain the various methods of human resource accounting
- Discuss the recording and disclosure practices of human resource accounting in Finance Statements

14.1 INTRODUCTION

It is widely recognized that human resources are no lesser important than other productive resources. However the recognition of importance of people in organisations as productive resources by the accountants is a recent origin. In conventional accounting practices, human work force, a core element, did not find its place. The expenses incurred in respect of acquisition, selection, layoff, training, promotion and development etc. of employee are treated as revenue expenditure which yield benefits to an enterprise in the form of service rendered by the manpower and such expenditure should be quantified as well as capitalized and shown in the Balance Sheet. But the managers failed to recognize and treat them as an asset in the financial statements.

It was in 1960's, the behavioral scientists attacked the conventional accounting practice for its failure to value the human resources of the organization along with other productive resources and pointed out that this was a serious handicap for effective management. As a consequence, valuation of human resources has received widespread recognition. In the course of time a number of accounting models have been developed to value and report human resources of an organization. In the management terminology this is called “Human Resource Accounting” (HRA).

Human resources have certain distinct characteristics from other physical assets, like personality, self control, devotion, quality, skill, talents, loyalty and imitateness. An organization's basic need of present time is to improve productivity, that can be improved by the human force. Hence to encourage, it is necessary to take progressive decisions for them. Advocates of HRA stresses on the importance of the human element in organisations and the failure of conventional accounting in dealing with it as an asset. In its simplest form, HRA involves the identification of the costs of recruitment, training, and maintenance of an entity's human assets.

The basic premise underlying the theory of HRA are:

- ❖ People are valuable resources of an enterprise.
- ❖ The usefulness of manpower as an organizational resources is determined by the way in which it is managed.
- ❖ Information on investment and value of human resources is useful for decision- making in the enterprise.

Just like financial capital structure, which consists of various types of capital, the human capital structure consists of various types of employees employed in an organization. The type of employees may be executives, supervisory, artisans, clerical and skilled staff or semi-skilled staff. The composition and proportion of various types of employees play an important role in development of an organization. The human capital structure is highly related with HRA and the techniques to value human resource.

14.2 CONCEPT OF HUMAN RESOURCE ACCOUNTING

Human resource accounting is the process of measuring and reporting the human resources of an organization. It is the process of providing information about individuals and groups of individuals, within an organization to decision-makers both inside and outside the organization. The American Accounting Association's Committee on Human Resource Accounting (1973) defines HRA as "the process of identifying and measuring data about human resources and communicating this information to interested parties". According to Flamholtz "Human resource accounting may be defined as the measurement and reporting of the cost and value of people as organizational resources. It involves accounting for investments in people and their replacement cost. It also involves accounting for the economic value of people to an organisation."

According to Davidson and Weil "It is the process of measuring and reporting the human dynamics of an organisation. It is the assessment of the condition of human resources within an organisation and the measurement of the change in the condition through time."

From the above definitions, the requirements of HRA are as follows:

- ❖ Valuation of human resources.
- ❖ Recording of human resources as per accounting principles.

- ❖ Disclosure of human resource information in the financial statements.

HRA is the measurement of cost value of people for organisation. HRA is the systematic recording of the transactions relating the value of human resource. The importance of people in the organization as productive resource was ignored by the management, but now a days it has received increasing attention and widespread interest in developing the system of HRA.

The productivity of a company's investment is known for the rate of return, which is calculated on the basis of physical assets investment only. There is need to find out productivity of investment on human beings in any organization. It is an effective tool for decision making.

Human resources have certain distinct characteristics from the physical assets like personality, self control, devotion, quality, skill, talent, loyalty, imitativeness etc. It is a basic need of present time to improve productivity, that can be improved by the human force. Hence to encourage, it is necessary to account them and to take progressive decisions for them.

14.3 OBJECTIVES OF HRA

HRA is basically adopted to treat human resources as assets, to generate human data about human resources, to assign value to human resources and to present human assets in the balance sheet. The following are the main objectives of an HRA system:

- (a) To furnish cost value information for making management decisions about acquiring, allocating, developing and maintaining human resources in order to attain cost effective organisation objectives.
- (b) To allow management personnel to monitor effectively the use of human resources.
- (c) To provide a determination of asset control i.e., whether human assets are conserved, depleted or appreciated.
- (d) To aid in the development of management principles by classifying the financial consequences of various practices.
- (e) To recognize the nature of all resources used or cultivated by a firm and improvement of the management of human resources so that the quality and quantity of goods and services are increased.
- (f) To facilitate the effective and efficient management of human resources.

- (g) To evaluate the return on investment in human resources.

14.4 NEED FOR HRA

HRA is required to be implemented in the organization for the following reasons:

- (a) The Balance Sheet and Profit and Loss Account of a firm cannot show true and fair view of its affairs unless all resources and assets including human resources are properly shown.
- (b) The expenditure on hiring, training and acquiring experience and efficiency on the human element is huge amount in these days. Firms spend large amount on the training and development of the skilled workers, the technical personnel, the accountants and the managers. It is essential that the true position regarding the nature of this expenditure and its role is prominently highlighted for the benefit of all concerned.
- (c) Management is required to take important decisions regarding the appointment, promotion, training, internal transfers, work distribution, merit rating, job evaluation, layoff, discharge etc. in respect of its personnel. In the absence of proper accounting data, sometimes the decisions are faulty and the organization suffers on this account.
- (d) Employee also is well informed about the investment made by the employer on him and his true value to the organisation, so that he adopts and enlightened attitude when faced with certain important decisions regarding himself and react properly.
- (e) Strikes, lockouts, go slow, work to rule, absenteeism, high labour turnover rate etc. which plague industry are natural in a system where the human resource are not properly valued and prominently shown in the books. Wastage of human resource and time due to the above would be checked to a large extent if its cost to the different parties is calculated. Such information could also form the basis of wage agreements.
- (f) Comprehensive manpower inventory is also essential for manpower planning projections regarding the future requirements of manpower and their development within the organization or hiring from outside will be possible only if proper records are maintained.

- (g) In the context of the country as a whole, while there is no scarcity of unskilled workers and the inter-firm mobility is also low, there is relative scarcity of skilled and technical manpower like the technicians and engineers, the accountants, the managers etc. Precise estimates of the value of these scarce human resources is essential for their systematic development.

14.5 ASSUMPTIONS OF HRA

The following assumptions which underlie HRA:

- (a) Human resources provide benefits to an organisation in a fashion similar to the manner in which financial and physical resources provide benefits.
- (b) The benefits associated with both conventional assets and human resources have value to the organisation because these benefits contribute in some way to the accomplishment of the organizational goals.
- (c) The acquisition of human resources typically involved an economic cost and the benefits associated with such resources can personally be expected to contribute to the economic effectiveness. It follows, therefore, that these benefits are essentially economic in nature and are subject to measurement in financial terms.
- (d) Since the usual accounting definition of an asset involves the right to receive economic benefits in future, human assets are appropriately classified as accounting assets.
- (e) It is theoretically possible to identify and measure human resource costs and benefits within an organization.
- (f) Information with respect to human resource costs and benefits should be useful in the process of planning, controlling, evaluating and predicting organizational performance.

14.6 BENEFITS OF HUMAN RESOURCE ACCOUNTING

The concept of human resource accounting covers the people who constitute a valuable resource of an enterprise and information on the investment and value of such resources is useful for internal and external decision-making. Such accounting is of paramount importance to the nation and also to individual organizations. The following are the main benefits of Human Resource Accounting:

- (a) **Helpful in proper interpretation of Return on Capital Employed:** The human resource accounting will disclose the value of human resources. This will help in proper interpretation of return on capital employed. Such information will give long-term perspective of the business performance which could be more reliable than the return on capital employed based on net profit only.
- (b) **Improves managerial decision-making:** The maintenance of detailed records relating to internal human resources (i.e. employees), will improve managerial decision-making specially in situations like direct recruitment versus promotion, transfer versus retention, retrenchment or relieving versus retention, utility of cost reduction programme in view of its possible impact on human relations and impact of budgetary control on human relations and organizational behavior and decision on relocating plants, closing down existing units, developing overseas subsidiaries etc. Thus, the use of HRA will definitely improve the quality of management.
- (c) **Serves social purpose:** It will serve social purpose by identification of human resource as a valuable asset which will help in prevention of misuse and under use due to thoughtless or rather reckless transfers, demotions, lay offs and day to day maltreatment by supervisors and other superiors in the administrative hierarchy; efficient allocation of resources in the economy; effecting economy and efficiency in the use of human resources and proper understanding of the evil effects of avoidable labour unrest/disputes on the quality of the internal human resources.
- (d) **Increase productivity:** It will have the way for increasing productivity of the human resources because, the fact that a monetary value is attached to human resources, and that human talent, devotion and skill considered as valuable assets and allotted a place in the financial statements of the organization, would boost the morale, loyalty and initiative of the employees, creating in their mind a sense of belonging towards the organization and would act as a great incentive, giving rise to increased productivity.
- (e) **Invaluable contribution to humanity.** HRA will be an invaluable contribution for accounting to humanity and it will lead to improve human efficiency while preserving human dignity and honor. For this, a basic change in individual behavior, attitude and thinking is required. HRA will help in realizing the value of human resources and, thus, will influence the individual behavior, attitude and thinking in the desired direction.

- (f) **Essential where the human element is the prime factor.** HRA is absolutely essential in such organizations where human element is the prime factor, e.g., a professional accounting firm, a drama company, a solicitor and attorney firm, an educational institution.
- (g) **Completes MIS.** Human resource data would create a more complete management information system as it can provide information of vital importance for both short-term and long-term decision-making as well as performance measurement. It will provide adequate basis for decision on allocation of resources e.g., budgeting, capital expenditure decisions and better measurement of resources of an organization. Performance measurement helps in assessing the strengths and shortcomings of an organization and helps in making better promotion policies.
- (h) **For successful operation of an organisation.** The success of an organisation very much depends on the build up of quality work force at all levels. The success stories of BHEL, ITC, Hindustan Lever, Larsen & Toubro and several other enterprises are largely due to the emphasis on human resource development. If this vital asset is not shown in the balance sheet, to that extent the public and investors are handicapped.

14.7 METHODS OF ACCOUNTING FOR HUMAN RESOURCES

Traditional accounting system treats human resources as current cost and charge such cost as of revenue nature. On the basis of contractual obligation, the organisation, pays only salaries, wages and related fringe benefits for human resources, i.e. what the organisation pays in under normal methods of accounting chargeable to revenue only and no human resource is carried over as asset in the Balance Sheet. The latest thinking on HRA considers such resources as capital items and involving human resources. The following are relevant:

- They render future service that have economic value,
- The value would depend upon how the resources are utilized.

Various management actions such as training, development and technological advances have the effect of conserving, enhancing and depleting the value of human resources. Like the accounting for any other assets, HRA involves:

- Capitalizing the human resources and recording them as investments.

- Recording the routine expiration of the resources on the basis of amortization.
- Record the loss of resources due to obsolescence and labour turnover.
- Valuation of the human resources after adjustments.

From time to time many methods have been suggested for the valuation of human resources. These methods can broadly be classified into Cost Methods and Present Value Methods.

COST METHODS

The HRA methods based upon cost involve computation of cost of human resources to the organisation. The HRA models based upon cost are described as under:

1. Historical Cost Model
2. Replacement Cost Model
3. Opportunity Cost Model
4. Standard Cost Model

1. Historical or Acquisition Cost Model

This model is also known as 'Acquisition Cost Model'. This model of accounting of human resources was first initiated by Rensis Likert at R.G. Bary Corporation in Ohio Columbia (USA) in 1967. This model involves capitalization of the actual cost incurred on developing the human resources of the organisation. This historical cost consists of recruitment, selection, hiring training and development etc.

Again historical cost may be categorized into two namely Acquisition cost and Learning costs. Recruitment cost, selection cost, hiring cost and placement costs are the examples of acquisition cost. Training and development costs are examples of learning costs. The sum of such costs for all the employees of the organisation represents the value of the human resources of the organisation.

This value is amortized over the expected length of service of individual employees. The unexpired cost is considered to be the investment in human resources. If an employee leaves the organisation due to resignation, death, dismissal etc., whole of the amount not written off is charged to the current revenue.

Under this method, the actual cost of recruiting, selection, training, developing of an employee are capitalized and written off over the his length of service. If an employee expires or leaves the organisation within his tenure of service the remaining value is charged off against revenue.

Advantages: Historical costs based HRA have several advantages. Because they use primarily accounting techniques which have been in common use for many years, this method is relatively easy to develop and apply. In addition management would have little difficulty in understanding the meaning of the information supplied by cost-based systems since the underlying concepts are consistent with those of the conventional (historical) accounting data which management often rely upon. Another important advantage is that the accumulation of the cost of human resources investments in individuals is a much simpler process than attempts to measure the value of these individuals. Thus, historical cost-based approaches avoid some of the behavioral problems which are found in HRA.

Historical cost based HRA would be useful to business managers interested in personnel control, evaluation, and lower labour turnover. The availability of human resource costs bring home to managers the sums of money invested in personnel of the relevant department, and the likely costs of replacing staff by persons of similar competence. This approach can be used in personnel cost control where departments are required to operate under a budgetary system.

Disadvantages : Historical cost based HRA has the following disadvantages:

- (i) The principal shortcoming of historical cost approaches relates to the limitations inherent in any accounting system based on historical costs, viz., past costs are not particularly relevant to decisions about the present and the future. Historically cost-based accounting for human resources has serious limitations for decision-making purposes just as it does for financial or physical resources. It can be argued that a balance sheet should reflect the economic value of an organization's assets and claims thereon, and income measurement should assess the changes in these economic values for specific time periods.
- (ii) The measurement problems in historical cost approaches to HRA can be summarized as follows. *First*, it is necessary to define and identify those items which are, in fact, human resource costs. A *second* measurement problem involves distinguishing between those costs which are to be capitalized and those costs which are to be treated as expenses of

the period in which they are incurred. An *additional* measurement difficulty relates to the selection of reasonable procedures for the amortization of capitalized human resource costs. Although the significance of the measurement problems associated with cost-based systems should not be underestimated, these problems appear to be solvable at least for practical purposes.

- (iii) Historical cost data must always be interpreted carefully keeping in mind the scope and function of the measurement system which has generated the data.

2. Replacement Cost Model

This method of valuation of human resources was developed by Eric G. Flamholty on the basis of concept of replacement cost suggested by Rensis Likert. Replacement cost refers to the sacrifice that would have to be incurred to replace resources presently owned or employed. It is the measure of the cost to replace a firm's existing human assets. These costs consist the cost of selecting, recruiting, hiring, training, placing and developing new employees to reach the level of competence of the existing employees.

It has the advantage of adjusting the employee value to the current market value. This approach is regarded as, “a good surrogate for the economic value of the asset in the sense that, market considerations are essential in reaching a final figure. Such a final figure is also generally intended to be conceptually equivalent to a notion of a person's economic value.”

This method is based on current value or replacement cost. Under this system, an organization values an employee at the estimated cost of replacement with a new employee of equivalent ability. The application of such a method, however, is made difficult by the problems of defining and measuring replacement costs.

In the context of human resources, it refers to the cost that would have to be incurred to replace human resources presently employed. Flamholty has referred to two different concepts of replacement cost viz., Individual replacement cost and Positional replacement cost.

(a) Individual Replacement Cost: The replacement cost of individuals in an organisation as conceptualised by Flamholty comprises of:

- (i) The present estimated cost of hiring, training and developing individuals upto the normal level of productivity of the existing individuals, i.e. it includes the basic cost elements like:

- Recruiting outlay cost
 - Acquisition cost
 - Formal training and orientation cost
 - Informal training cost
 - Efficiency recovery cost
 - Extra supervision cost
 - Familiarization cost
 - Cost of lost productivity during training
 - Investment building experience cost
 - Development cost
 - Others
- (ii) Costs associated with moving the existing position holders either out of the organisation or to new positions within the organisation, i.e.
- The cost of carrying a vacancy until a suitable replacement can fill it i.e. likely cost of contribution during the period when vacancies remain unfilled.
 - Cost of moving and displacement.
 - Loss of productivity of the employees and their co-workers prior to their separation.
 - The effect of a vacant position on other employees.

(b) Positional Replacement Cost: Besides the assessment of replacement cost of individuals, such a cost item may be estimated with reference to different positions in an organisation rather than specific individuals to be referred to as positional replacement cost. It may be difficult to identify a suitable replacement of an individual employee in an organization. One good design engineer may be produced from a batch of thirty graduate trainee engineers after twenty years. Recognizing this fact, Flamholtz has introduced the concept of marginal value of replacement cost and full replacement cost.

The marginal value replacement cost has been defined as the summation of:

- (i) The cost to recruit one person at the entry level.
- (ii) The cost to select one person at the entry level.
- (iii) The cost to develop one person at each intermediate level.
- (iv) The separation cost for one person at the critical level.

The full replacement cost refers to the summation of all such cost elements not for only one person but for number of persons as needed so as to make available the replacement for one individual.

Limitations: The following are the limitations of Replacement Cost Models:

- This model claims to incorporate the current value of company's human resources in its annual accounts at the year end. However its utility in actual practice is limited as it is very difficult to find exact replacements for individuals as no two human beings are alike in terms of abilities.
- The estimation of the replacement cost of individuals or the rebuilding cost of human organization would be based on the best judgment of the managers rather than facts and figures, thus being subjective in nature, may not be acceptable to the traditional accountants.
- The replacement cost of individuals may affect their behavior significantly and might feel themselves indispensable, leading to subsequent increase in the cost of retaining them.
- Decrease in the rebuilding cost of human organisation may also be cause of concern for the employees.
- Market imperfections may make the replacement of an individual having specific skill more costly. Moreover, costs are escalated due to inflationary conditions and other influencing factors like union agreements, government legislations and external labour market situations.
- An increase in the capitalized value due to increase in replacement/rebuilding cost may reflect spurious organizational profit primarily attributable to the operational inefficiency, the effects of inflation, external factors and constraints whereas a decrease in the cost reflect apparent loss due to operational efficiency and better management of the human resource.

3. Opportunity Cost Model

This model of HRA seeks to measure the value of human resources on the basis of economic concept of opportunity cost. This model was proposed by Hekimian and Jones to

overcome the limitations of replacement cost model. This model is also known as ‘Competitive Bidding Model’.

It attempts to estimate the value of human resources by establishing an internal labour market in an organisation through the process of competitive bidding. Under this model, all managers of profit centres are encouraged to bid for any scarce employee they want. This is largely artificial method involving the concept of the competitive bidding process.

In competitive bidding process, the opportunity cost of an employee or group of employees in one department is calculated on the basis of the bids (offers) by other departments for those employees. Thus the value of human resource is determined on the basis of the value of an individual employee in alternative use.

Under this system, profit center managers are encouraged to bid for scarce employees, the successful bid being included in the organization’s human investment calculations. Employee abilities are related to profit generation, and may lead to a more efficient allocation of human resources. The employee is allotted to the highest bidder among the divisional managers and the bid price is included in that division’s investment base. The maximum bid price may go to the extent of the capitalized value of extra profits likely to be generated by the ability and competence of the executives.

Example I: XYZ Ltd. has a capital base of Rs.10,00,000 and it earned profits of Rs.1,00,000. The return on investment of the same group of firms is 12%. If the services of a particular Engineer are required, it is expected that the profits will raise by Rs.30,000 over and above the target profit.

Capitalised value of Rs.30,000 at 12% rate of return	$= 30,000 \times 100/12$	$= \text{Rs.}2,50,000$
Limit upto which the company may bid for an Engineer		$= \text{Rs.}2,50,000$
New Capital base	$= 10,00,000 + 2,50,000$	$= \text{Rs.}12,50,000$
Required rate of return on new capital base	$= 12,50,000 \times 12/100$	$= \text{Rs.}1,50,000$
Profit generated at old capital base		$= \text{Rs.}1,00,000$
Additional profit generated by the Engineer	$= 1,50,000 - 1,00,000$	$= \text{Rs.}50,000$

Therefore, the maximum bid can go upto the capitalized value of additional profit of Rs. 4,16,667 (i.e. $50,000 \times 100/12$).

Advantages : The advocates of this approach claim that this bidding process is helpful in:

- More optimal allocation of human resources, and
- Planning, developing and evaluating human resources of a business as it provides a quantitative base for decision making.

Limitations: The following are the limitations of Opportunity Cost Model:

- It excludes the value of employees who can be readily hired. In other words, it does not consider those employees as an asset who are not scarce.
- A person specialized in one type of work and having no alternative work may get zero valuation.
- It would mislead the information collected on the basis of whole organization.

4. **Standard Cost Method**

This approach was given by David Watson. In this method the standard cost of recruiting, hiring, training and development is accumulated every year for each grade of employees. However, this method is found to be suitable for control purposes and variance analysis, it has also the disadvantage of amortization etc.

PRESENT VALUE MODELS

The present value models use capital budgeting techniques to assess human resources, the argument being that the value of firm's employees is their discounted future earnings. Present Value methods try to measure economic value rather than simply record investment in human resources at historic or replacement cost.

Present value models seek to measure the value of human resources on the basis of present value of the services to be generated by the employees of an organisation in future. The following two approaches have been suggested for this purpose:

- By discounting the future salaries and employee related capital costs (such as cost incurred on recruiting, training and developing employees) by a certain rate of discount, and

- By discounting the future earning of an organization at a certain date by a suitable rate and allocating a part of such present value to human resources.

Based upon these premises the following HRA models have been developed:

1. Lev and Schwartz Model
2. Hermanson's Models
3. Stochastic Rewards Valuation Model
4. Jaagi and Lau Model
5. Morse Model
6. Chakraborty Model
7. Dasgupta Model

I. Lev and Schwartz Model

This model has been developed by Brauch Lev and Aha Schwartz in 1971. They are of the opinion that determination of the total value of a firm's labour force is a straight forward extension of the measurement procedure of an individual value to the organisation. This model is also known as 'Present Value of Future Earning Model'. The model is a salary based model. It is based on certain assumption. One of the most important assumption is that the employee will not leave the organisation till retirement. The aggregate present value of different groups represents the capitalized future earnings of the firm as a whole. They have advocated the use of cost of capital rate for the purpose of capitalizing the present value of the future earning of the employees. According to them, the value of human capital represented by a person of age 'X' is the present value of his remaining future earnings from his employment. They have given the following formula for calculating the value of an individual:

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

Where	V_r	=	the value of an individual r years old
	$I(t)$	=	the individual's annual earnings upto the retirement
	t	=	retirement age
	R	=	discount rate

However, the model suffers from the following limitations:

- (i) A person's value to an organisation is not determined entirely by the person's inherent qualities, traits and skills but also by the organizational role in which the individual is placed. Moreover, the individual's skill and knowledge are not valuable to an organisation in an abstract form. They are valuable only when such qualities serve as a means to achieve the organizational goals.
- (ii) The model ignores the possibility and probability of an individual leaving the organisation for reasons other than death or retirement. People may leave the organisations for a variety of reasons.
- (iii) It fails to correctly evaluate the team work involved. Team work is something more than the sum of the values of individuals. The valuation does not reflect the contribution of the team as a whole.
- (iv) This model ignores security, bargaining capacity, skill and experience etc. which may affect the payment of higher or lower salaries. Again salaries paid to the employees may not reflect the real worth of the employees to the organization.

2. Hermanson's Models

Roger H. Hermanson has suggested two models for the measurement of human resources: (i) Unpurchased Goodwill Model, and (ii) Adjusted Discounted Future Wages Model.

(i) Unpurchased Goodwill Model

Under the model, it is argued that super normal profits in a firm are the indicators of presence of human resources. The model requires computation of the ratio of net income after taxes (EAT) to total assets (excluding human assets) of each firm. This in turn is compared with the ratio for the industry as a whole. The value of human resources of a firm is then measured with the help of differential rates.

In this the value of human assets of an organisation may be calculated by capitalizing earnings in excess of normal earnings for the industry or the group of companies of which the firm is a part. It has been assumed that the excess profit earned by the concern is due to the extra ability of employees.

Example 2: The investment made in ABC Ltd. is Rs.5,00,000. The normal earnings are 10%. The company is earning at the rate of 15%.

Company's actual earnings	(5,00,000 x 15/100)	Rs. 75,000
Less: Normal earnings	(5,00,000 x 10/100)	Rs. 50,000
Excess earnings		Rs. 25,000
Capitalised value of excess earnings	(25,000 x 100/15)	Rs. 1,66,667

Therefore, the capitalized value of excess earnings i.e. Rs.1,66,667 is the value of human assets under this model.

(ii) Adjusted Discounted Future Wages Model

This model uses compensation as a surrogate measure of a person's value to the firm. Compensation means the present value of future stream of wages and salaries to employees of the firm. The discounted future wages stream is adjusted by an 'efficiency ratio' which is weighted average of the ratio of the return on investment of the given firm to all the firms in the economy for a specified period, usually the current year and the preceding four years. The weights are assigned in the reverse order i.e., 5 to the current year and 1 to the proceeding fourth year. The following formula is used:

$$\text{Efficiency Ratio} = 5 \frac{RF(0)}{RE(0)} + 4 \frac{RF(1)}{RE(1)} + 3 \frac{RF(2)}{RE(2)} + 2 \frac{RF(3)}{RE(3)} + \frac{RF(4)}{RE(4)}$$

Where,

RF(0) = Rate of accounting income on owned assets of the firm for the current year.

RE(0) = Rate of accounting income on owned assets of all the firms in the economy for the current year.

RF(4) = Rate of accounting income on owned assets of the firm for the fourth previous year.

RE(4) = Rate of accounting income on owned assets of all the firms in the economy for the fourth previous year.

The efficiency ratio measures the rate of effectiveness of the human resources operating in the given entity over a five year period. A ratio greater than one implies that the rate of return

of the firm is above the average rate of return for all firms in the economy. The efficiency ratio has been criticized by certain authors as subjective because of arbitrary weighting scheme and restricting the valuation period to five years only.

The main drawback of the approach is the subjectivity in the method of calculation of efficiency ratio. While calculating the efficiency ratio, Hermanson assumed that the performance of the firm was entirely due to the efforts of employees and not due to any other extraneous cause.

3. Stochastic Rewards Valuation Model

This model has been suggested by Flamholtz. It identifies the major variables that determine an individual's value to an organisation, i.e., his expected realizable value. The expected realizable value of an individual is the present worth of future services expected to be provided during the period he is expected to remain in the organisation. The model is based on the presumption that a person's value to an organisation depends upon the positions to be occupied by him in the organisation. The movement of people from one organizational role to another is stochastic process with rewards. As people move and occupy different organizational roles, they render services (i.e., rewards) to the organisation. However, the roles they will occupy in future will have to be determined probabilistically for each individual. The model suggests a five steps approach for assessing the value of an individual to the organization:

- (a) Forecasting the period a person will remain the organisation i.e., his expected service life.
- (b) Identifying the services states, i.e., the roles that he might occupy including, of course, the time at which he will leave organisation.
- (c) Estimating the value derived by the organisation when a person occupies a particular position for a specified time period.
- (d) Estimation of the probability of occupying each possible mutually exclusive service state at specified future times.
- (e) Discounting the value at a predetermined rate to get the present value of human resources.

4. Jaggi and Lau Model

The model suggested by Jaggi and Lau is based on valuation of groups rather than individuals. A group implies homogeneous employees who may or may not belong to the same department or division. It might be difficult to predict an individual's expected service tenure in the organisation or at a particular level or position, but on a group basis it is easier to ascertain the percentage of people in a particular group likely either to leave the firm during each of the forthcoming period, or to be promoted to higher levels.

In order to consider the role movements of employees within the organisation a Markov Chain representation can be used. The model required the determination of Rank Transitional Matrix and the expected quantities of services for each rank of service. The matrix can be prepared from the historical personnel records of the employees available in the organisation. For the purpose of measurement of quantities of services, a certain service or performance criteria is used.

The value of the services an organization's current employee render in a future period is computed by multiplying the estimated number of current employees that will be in each service state in that period, by the value of the services an employee in each state (i.e. rank) renders to the organisation.

The equation for the computation of value of human resources of an organization using Jaggi and Lau model is given below:-

$$TV = (N)^r n (T)^n (V)$$

Where,

TV = Column vector indicating the current value of all current employees in each rank.

(N) = Column vector indicating the number of employees currently in each rank.

n = Time period

r = Discount rate

(T) = Rank transitional matrix indicating the probability that an employee will be in each rank within the organisation or terminated in the next period given his current rank.

(V) = Column vector indicating the economic value of an employee of rank 1 during each period.

The model given by Jaggi and Lau tries to simplify the calculations of the value of human resources by taking groups of employees as valuation base. However this method is also difficult to apply in practice because of difficulty in obtaining reliable data.

This model suggests valuation of human assets on a group basis rather than on an individual basis. In this model 'group' means a homogeneous group of employees who may not necessarily be working in the same department. It is difficult to estimate the future period of stay and chances of promotion on an individual basis.

5. **Morse Model**

Under it the value of human resources is equivalent to the present value of the net benefits derived by the enterprise from the service of its employees. The following steps are involved under this approach:

- a) The gross value of the services to be rendered in future by the employees in their individual and collective capacity.
- b) The value of direct and indirect future payments to the employees is determined.
- c) The excess of the value of future human resources (as per (a) above) over the value of future payments (as per (b) above) is ascertained. This represents the net benefit to the enterprise because of human resources.
- d) By applying a predetermined discount rate (usually the cost of capital) to the net benefit, the present value is determined. This amount represents the value of human resources to the enterprise.

6. **Chakraborty Model**

This model also known as Aggregate Payment Model has been suggested by Prof. S.K. Chakraborty, the first Indian to suggest a model on human resources of an enterprise. In his model, he has valued the human resources in aggregate and not on an individual basis. However, managerial and non-managerial manpower can be evaluated separately. The value of human resources on a group basis can be found out by multiplying the average salary of the group with the average tenure of employment in that group. The average annual salary payments for next few years could be found out by salary structure and promotion schemes of the organization.

He has further suggested that the recruitment, hiring, selection, development and training cost of each employee can be recorded separately. These could be treated as deferred revenue expenditure to be written off over the expected average stay of the employee in the organisation. The deferred portion should be shown in the position statement of the organisation. If there is a permanent exit on account of death, retrenchment etc. then the balance on deferred revenue expenditure for that year attributable to that person should be written off against the income in the year of exit itself.

The discount rate for the purpose of ascertaining the present value of estimated payments in the future should be taken as the expected average after tax return on capital employed over the average tenure period. He suggested the adoption of such a long-term rate to avoid fluctuations in human asset valuation from year to year simply due to changing rates of return.

7. Dasgupta Model

Prof N. Dasgupta (1978) suggested this approach. The various approaches (discussed in the previous pages) take into account only those persons who are employed and ignore those who are unemployed. According to him both employed and unemployed persons should be brought in its purview for determination of the value of human resources of the nation. Thus, for the preparation of the balance sheet of the nation, the system should be such so that it fits and shows the human resources not only a firm but also of the whole nation.

According to him, the total cost incurred by the individual up to that position in the organisation should be taken as the value of a person which is further adjusted by his intelligence level. It will include not only all expenses incurred by the individual for his education and training but also by the organization on recruitment, training, familiarizing and development human beings employed in the organization. The valuation can be done group-wise, if the number of employees is large. The value thus, determined should be further adjusted at the end of each year by organization on the basis of his age, seniority, status, performance, experience, leadership, managerial capabilities etc. The psychologists and other concerned experts will be helpful for such measurement. The revised value would be the value of the employee at the end of the year.

Theoretically this model may be sound but its practical application may be difficult as it will involve a number of factors which may not be capable of being expressed precisely and objectively in monetary terms.

Human resources valued according to this model should be shown both on the assets and 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 by the amount at which it has been shown on the assets side against the value of individuals. This will be more clear from the following example.

Example 3: A firm has started its business with a capital of Rs. 5,00,000. It has purchased fixed assets worth Rs. 2,50,000 in cash. It has kept Rs. 1,30,000 as working capital and incurred Rs. 1,20,000 on recruitment, training and developing the engineers and a few workers. The value of engineers and workers is assessed as Rs. 4,00,000. Show these items in the Balance Sheet.

BALANCE SHEET

(including Human Resources)

Liabilities	Rs.	Assets	Rs.
Capital	5,00,000	Fixed Assets	2,50,000
Human Assets	4,00,000	Human Assets:	
		(i) Individual Value	4,00,000
		(ii) Value of Firm's Investment	1,20,000
		Current Assets	
		Less: Current Liabilities	1,30,000
	9,00,000		9,00,000

14.8 REQUIREMENTS UNDER THE COMPANIES ACT

At present, companies in India are expected to furnish information relating to their employees such as name, age, qualification, designation and nature of duties, remuneration, data of commencement of employment, experience as per Section 217(2A) of the Indian Companies Act, 1956, read with the Companies (Particulars of Employees) Amendment Rules, 1988 forming part of the Director's Report.

The particulars provided by companies relating to their employees are only specific in nature. In other words, details of remuneration drawn by the managerial employees alone are shown in the annual reports and the details of remuneration of non-managerial personnel are not shown.

The provisions includes only those employees whose remuneration falls within certain specified limits. Moreover, only those companies who have their employees drawing remuneration in excess of the specified limits had to give an account of such details as required under section 217(2A) of the Companies Act, 1956.

14.9 RECORDING AND DISCLOSURE IN FINANCIAL STATEMENTS

The various models dealing with the mode of valuation of human resources as an asset have been explained. In India Human Resource Accounting has not been included so far as a system. India Companies Act, 1956 does not provide any scope for furnishing any significant information about human resources in financial statements. Beyond it, there is no rigid instruction on behalf of the Companies Act, 1956 to attach information about the value of human resources and the results of their performance during the accounting year in notes and schedules. In India, a growing trend towards the measurement and reporting of human assets, particularly in the public sector, is noticeable during the past few years. There are about twelve companies in India which have adopted the concept of human resource accounting so far. The data of only four companies is compatible for comparison. The companies are:

- (i) **Bharat Heavy Electrical Limited (BHEL)**, which is the first Indian company to publish human resource accounts from 1974-75 onwards and is one of the FORTUNE 500 companies listed outside U.S.A.
- (ii) **Steel Authority of India Ltd. (SAIL)**, which is a holding company consisting of five integrated steel plants and two alloy steel units in the public sector.
- (iii) **Minerals and Metals Trading Corporation (MMTC)**, which is the biggest trading organisation in India.
- (iv) **Southern Petrochemical Industries Corporation Ltd. (SPIC)**, which is one of the biggest diversified organisations in the Joint Sector, producing fertilizers, chemical, electronic etc.

Most of the Indian enterprises observed Lev and Schwartz model in the sense that they have computed the present value of future direct and indirect payment to their employees as the basic frame work of human resource valuation.

14.10 PROBLEMS AND LIMITATIONS OF HRA

No doubt HRA can provide valuable information both for management and outsiders, yet its development and application in different industries and organisations has not been very encouraging. This accounting concept is not popular like social accounting because it may not result in providing immediate and tangible benefits and on account of the fact of lack of consensus among accountants and other concerned about the basis of measurement of the value of human resources. The reluctance on the part of the organisation to introduce the HRA system can be attributed to the following:

- (a) There are no specific and clear-cut guidelines for finding cost and value of human resources of an organisation. The existing valuation system suffers from many drawbacks.
- (b) The life of human resources is uncertain and therefore, valuing them under uncertainty seems unrealistic.
- (c) There is a possibility that HRA may lead to dehumanizing and manipulations in employees. For example, a person having a low value may feel discouraged and thus, in itself, may affect his competency in work.
- (d) The much needed empirical evidence is yet to be found to support the hypothesis that HRA, as a managerial tool, facilitates better and effective management of human resources.
- (e) Human resources, unlike physical assets, are not capable of being owned, retained and utilized at the pleasure of the organization. Hence, treating them as 'asset' in the strict sense of the term, could not be appropriate.
- (f) There is a constant fear of opposition from the trade unions. Placing the value on employees would prompt them to seek rewards and compensation based on such valuation.

- (g) Tax laws do not recognize human beings as assets. So human resource accounting has been reduced to a merely theoretical concept.

14.11 SUMMARY

Human resource accounting (HRA) is the art of valuing recording and presenting systematically the work of human resources in the books of accounts of an organization. The objectives of HRA is to inform the general public about human capital measures taken by the enterprises and their effect on the human resources. HRA is helpful in proper interpretation of return on capital employed, improves managerial decision making increase productivity, serves social purpose, helps in investment decisions, creates a complete management information system and leads to improve human efficiency several methods for valuation of human resources have been developed and can be broadly classified into cost models and Present Value Models. HRA models based upon cost methods involve computation of cost of human resources to the organization while present value methods use capital budgeting techniques to assess human resources. Sourer companies in India have adopted these models after modifications to suit Indian conditions. The absence of general acceptance of the measurement criteria for valuation of human resources would prove to be an impediment towards its wider adoption. However, as more experience is gathered in the use of various models, it is expected that in the year to come corporate reporting practices will ascribe greater importance to this emerging diversion of accounting.

14.12 GLOSSARY

Human Resource Accounting: The process of identifying and measuring data about human resources and communicating this information to interested parties.

Acquisition Cost: The cost incurred upto the stage of reporting for duty of employees are called acquisition costs.

Labour Turnover: It is the movement of people into and out of the organization.

14.13 Check Your Progress

1. The composition and proportion of various types of employees play an important role in _____ of an organization.
2. Human resources provide benefits to an organization in a fashion similar to the manner in which _____ resources provide benefits.
3. Traditional accounting system treats human resources as current cost and charge such cost as of nature.
4. In _____, all managers of profit centres are encouraged to bid for any scarce employee they want
5. The present value models use _____ techniques to assess human resources.
6. The aggregate present value of different groups represents the capitalized _____ of the firm as a whole.
7. Adjusted Discounted Future Wages Model uses _____ as a surrogate measure of a person's value to the firm.
8. In Morse Model, the value of human resources is equivalent to the _____ of the net benefits derived by the enterprise from the service of its employees.
9. Human resources, unlike physical assets, are not capable of being owned, retained and utilized at the _____ of the organization.

14.14 ANSWERS TO CHECK YOUR PROGRESS

1. Development
 2. Financial and physical
 3. Revenue
 4. Opportunity Cost Model
 5. Capital budgeting
 6. Future earnings
 7. Compensation
 8. Present value
 9. Pleasure
-

14.15 TERMINAL QUESTIONS

1. What do you mean by Human Resource Accounting ? Give the objectives of this system.
2. Discuss the different methods of Human Resource Accounting. Which one of them will you recommend for adoption in India under the prevailing circumstances ? Give reasons.
3. In what way HRA information would be useful to management ?

4. Give the main problems and limitations of Human Resource Accounting.
5. Compare Lev and Schwartz model with Flamholtz model of measuring human resources. Discuss their shortcomings.

14.16 REFERENCES

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UNIT-15 ACCOUNTING FOR INTANGIBLES

Structure

- 15.1 Introduction
- 15.2 Intangible Assets
 - 15.2.1 Patents
 - 15.2.2 Design
 - 15.2.3 Trademarks
 - 15.2.4 Copyrights
 - 15.2.5 Technical Know-how
 - 15.2.6 Franchises
 - 15.2.7 Fictitious Assets
 - 15.2.8 Goodwill
- 15.3 Useful Life of Intangible Asset
- 15.4 Valuation of Goodwill
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 - 15.4.2 Capitalization of Expected returns Method
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- 15.8 Glossary
- 15.9 Answer to Check Your Progress
- 15.10 Reference/ Bibliography
- 15.11 Suggested Readings
- 15.12 Terminal and Model Questions

OBJECTIVES

After reading this unit, you should be able to

- ✦ Understand the concept of intangible assets and explain the common examples of intangible assets.
- ✦ Explain the useful life of intangible assets.
- ✦ Make the valuation and accounting treatment of goodwill.
- ✦ Appreciate the Indian experiences of intangible assets.

15.1 INTRODUCTION

The word “asset” generally triggers the mind to perceive an object that can be seen, felt, possessed, used and parted with. Land, building, plant, machinery, equipment, vehicles instruments are all assets in this sense. We usually associate assets with things that have physical existence. However, the views of an economist as to what an asset is are quite different from that of an accountant. He considers all expenditures that contribute to the earning of revenue by a business over a period longer than a year as assets. Whether the expenditure has resulted in the creation of physically recognizable objects, which directly generate income or obtaining special rights, claims or privileges, which indirectly contribute to earning is irrelevant to him as long as they generate income. The former group of physically identifiable expenditures is termed as *tangible assets*, while the latter group is known as *intangible assets*.

15.2 INTANGIBLE ASSETS

Intangible assets are, to repeat, expenditures that result in the acquisition of special rights, claims and privileges, which indirectly contribute to the earning of the business over its useful life. As intangible assets are abstract, they are governed, as to their character, nature, usefulness and tenure by legislations specially enacted. These regulations provide for rights and responsibilities of the users of the rights, claims and privileges. Common examples of intangible assets are patents, designs, trademarks, copyrights, technical know-how, franchises and goodwill.

15.2.1 Patents

Patent is a monopoly right granted to a person who had invented a new and useful article or an improvement of an existing article or a new process of making an article for commercial exploitation either by the inventor himself or his assignee. It is an exclusive right for a limited period to benefit the inventor for his efforts. Indian Patents Act, 1970, governs law relating to patents. The period of validity of the right has been limited to 7 years for food processes and 14

years for drugs, from the date of patenting. The right can be renewed for further periods. If not renewed, anyone can make use of the invention after the lapse of the period. Patents are to be registered with the Controller of Patents by payment of specified fees. Anyone who infringes on the patented process is liable for legal prosecution.

15.2.2 Designs

Designs are shapes, configurations, patterns or imitations applied to any article by an industrial process, which, in the finished article, appeals to the eye and judged solely by the eye. This right protects the owners of novel or original designs from infringement. The interested person has to get his or her design registered with the Controller General of designs, under the Indian Patents & Designs Act, 1911.

15.2.3 Trademarks

Trademark is a visual symbol in the form of a word, device, name, letter, brand, heading, signature or label used to indicate the connection of the goods with the registered owner of the trademark. The purpose of trade marking is to distinguish the trademarked goods from similar goods, thereby appealing to the specific demands of consumers. Trademarks were to be registered with the Register of Trademarks in terms of Trade and Merchandise Mark Act, 1958 till 2003. Under the Act only 34 classes of goods were registered. Service marks were not registered. As service sector started playing a lead role in the economy after globalization, a new Act “Trademark Act of 1999” was passed. The Act came into force from 2003. In terms of the Act, marks of 10 classes of services are allowed to be registered. Service marks for the purpose of registration are defined, as marks used in any service business, where actual tangible goods are under that mark are not traded. The groups of services eligible are advertising, insurance, real estate, building construction, telecommunication, transport, education, entertainment, sporting and cultural activities, scientific and technological services, research, design, development of computer hardware, software, legal, medical and security services.

15.2.4 Copyrights

Copy rights are privileges allowed to producers of intellectual and artistic works for their exclusive use. It prevents the appropriation, by others, of the fruits of labour of authors in

literacy, dramatic, musical or artistic work or skill, without consent. Writers and artists can get their works copyrighted with the Register of Copyrights, under the Copyrights Act, 1954. The registration gives the writers and artists and their heirs, legal representatives and assign exclusive ownership of their work during the lifetime of the authors or artists and up to 60 years after their death.

15.2.5 Technical Know-how

Research and Development is an important corporate function in these days of rapid change. Products have a life cycle comprising the stages of development, growth, saturation and decline. Hence corporate continue to improve existing product lines and introduce new product ranges to be in the reckoning. The current axiom is that creative enterprises should *introduce new products and make their own products obsolete, otherwise competitors will do that*. It is common knowledge that technical know-how developed in the process is the exclusive right of the concerned organization. Such know-how generates income to the inventor companies during their effective life and is their intangible asset. Sometimes, the inventor shares his know-how with others, usually in different market segments, on his own terms and conditions, under a *collaboration agreement*, for a price. The price is an ad-hoc one-time payment known as *technical know-how fee* and a recurrent annual payment called *royalties* for an agreed period. Royalties are charged, at certain percentage, on the sales, production or profit of the recipient corporate.

15.2.6 Franchises

Franchises are rights obtained by enterprises from the technical know-how developers, for exploitation of the process, product or service in specific areas for an agreed period. The nature of franchise closely resembles that of know-how arrangements, except that in case of franchises, the franchisee is always given the right to use the brand name of the innovator. This may not be so in the case of collaboration agreements, where the right to use the brand name is at the discretion of the know-how supplier and the user normally mentions that the product is made in collaboration with so and so company. Secondly, in franchise, the increasing practice is to supply the know-how with the requisite equipment to be installed at the site of the franchise.

Franchise charges would, then include the rental for the equipment in addition to royalty for the use of technology.

Intangible assets, like tangible assets, are to be written off during their effective life. The closing adjustment entry for writing off of intangible assets is given in Table 1.

Table 1
Journal Proper of Gosamy Corporation Ltd.

Particulars	LF	Dr.	Cr.
P&L A/c Dr.		50,000	
To Patents A/c			25,000
To Copyright A/c			15,000
To Franchise A/c			10,000

In addition to the intangible assets discussed above, we also come across a few expenses incurred in a particular accounting period, which do not directly contribute to the earning of revenue. These are clubbed together as deferred revenue expenses and the commonly known items are capital issue expenses, preliminary expenses, carried forward loss balances and deferred advertisement expenses. *Capital issue expenses* are those that a company incurs at the time of issuing share capital or loan capital, such as bonds, debentures and deposits. Presently, issue expenses are about 15 to 25% of large mega issues and above 25% in case of medium sized issues. Where issue expenses are heavy and are expected to contribute to earning revenue over a longer period, it would be unfair to charge the entire expense in the year of occurrence. Hence, these expenses are not written off in a single year, but are deferred and written off during the period over which these are useful. For example, the issue expenses on 5-year bonds may be written off over 5 years. In case of share capital, which is used by the business as long as the company exists, a reasonable period may be assumed for writing off the expenses. Preliminary expenses, a detailed discussion on which had been made in an earlier chart, are statutorily to be written off over 10 years in equal installments. In case of mega budget advertisements, whose benefit is expected to be spread over more than the year of advertising, the expenses are treated as deferred revenue expenses and written off during the period the advertisement is presumed to be effective.

15.2.7 Fictitious Assets

The assets side of the balance sheet also contains the carry forward balances of losses, suffered by the business during the previous years. Loss balances carried forward are intangibles, but are not assets, as they do not contribute to the earning of revenue either directly or indirectly. These are considered as *fictitious assets*, although the suffix assets are a misnomer. We can simply call them as *intangibles*. Generally, these balances are adjusted against capital and reserves of the business, before arriving at the owner's capital, also called net worth. Annually, a portion is written off from the profit and loss account, through an adjustment entry as in Table 2.

Table 2
Journal Proper of Annie Anchor Ltd.

Particulars	LF	Dr.	Cr.
Profit & Loss A/c Dr.		11,500	
To Deferred Revenue Expenses			6,250
To Preliminary Expenses			5,250

Carried forward loss balances are primarily to be recovered from the future revenue of the business within 8 years. In case it is not absorbed within the stipulated period, the balance has to be adjusted against the equity of the owners. The justification for writing off the loss balance from future profits of the business is to allow for the fluctuating opportunities of the business. But if the business is not capable of adjusting the deferred cost within the stipulated eight years, the owners of the business have to bear the loss as a penalty for their inefficiency.

15.2.8 Goodwill

Goodwill is an important intangible asset of an enterprise. Although a number of business enterprises deal in the same or similar goods or services, with quality, price, after sales service etc. remaining same, consumers show preference to a particular product of an enterprise over that of others. This preference leads to the reputation of the enterprise and is termed as goodwill. As a result of this special attachment of customers the concerned enterprise is able to reap abnormal profits. The additional profit accruing to the business on account of this loyalty of customers is

goodwill. Goodwill is thus defined as *“the value of reputation of a business in respect of profits expected in future, over and above normal level of profits earned by other undertakings belonging to the same class of business”*. Prof. Dicksee in his book on “Goodwill and its treatment in accounts” describes goodwill as an aid in profit making. According to him, payment for goodwill is justified *“when a man pays for something which places him in the position of being able to earn more money than he would be able to do by his own unaided efforts”*.

From the above definitions, it transpires that goodwill is the quantified value of the reputation of the business to earn extra profit over and above what its tangible assets would have earned. The reputation, based on the preference of the customers, might have been caused by one more of the following special features, such as its location, the personal touch of the businessman, the real or imaginary product differentiation, dependability of supply and the ability of the businessman to keep his competitors at bay. Goodwill usually creates brand equity.

Intangible assets are either created or acquired from those who had created them initially. Research, development and innovation create intangible assets. The cost of intangible asset is the resources utilized by the business in its creation. In case intangibles are acquired, their value is the purchase consideration paid for such acquisition. Purchase consideration is based on the expected contribution of the intangible to the earning of revenue over its useful life. Whenever the cost of creation or acquisition is insignificant, it is treated as revenue expense of the period of incidence and charged to the profitability of the business of that period. On the other hand, should the cost be substantial, loading the entire cost to the profitability of the period of incidence would distort the operational results of the period. Therefore, the cost is capitalized and booked as an asset, to be written off during its effective life, in assumed proportion to its contribution to the earning of revenue.

15.3 USEFUL LIFE OF INTANGIBLE ASSET

The maximum useful lives of intangibles assets are restricted by the regulations that govern them. For example, patents have a useful life of 14 years. Hence the cost of patent should be written off within 14 years. The period of 14 years commences from the time of its registration. Thus, if a patent is acquired by another business after 4 years of its registration, the useful residual life is 10 years for the acquire. In the event of the ability of the patent to generate

income is lost during its useful life, due to development of better products or processes, it becomes obsolete and the entire amount outstanding has to be written off in that year itself.

15.4 VALUATION OF GOODWILL

The valuation of goodwill is on a different footing than other intangible assets. Discernible resources are not expended in developing goodwill. Goodwill is the quantification of the entrepreneurial excellence and it is highly subjective. Goodwill remains dormant and its value is not presented in the books of the business till any change in the structure of the business is anticipated. In the case of sole trading business, it is brought into the books at the time of change in ownership of the business. When the sole trader sells his business to another or when he admits another as a partner into the business, he wants to crystallize the efforts he had taken in the past to create the name for the business. He, therefore, values the goodwill and takes it as part of his capital. In this respect, goodwill reflects the valuation of the qualitative inputs of the businessman to shape the business to its present status. Goodwill thus par takes the role of *sweat capital* of individuals. In the case of a corporate, goodwill is created when the pattern of share holding is about to undergo change. This may be before the issue of fresh shares to the public. But usually it is at the time of takeover of the company by another. If Vasu desires to take Girish and Ilkya as partners and she desired to create goodwill of Rs.2,50,000, the journal entry required is at Table 3.

Table 3
Journal Proper of Vasu & Co.

Particulars	LF	Dr.	Cr.
Goodwill A/c Dr. To Vasu's Capital		2,50,000	2,50,000

The valuation of goodwill is not an easy task. There are varieties of causes for the creation of name for the business and each business may have to adopt a different norm for the valuation of goodwill. As the value of goodwill that has to be raised should be acceptable to the buyer, the decision is really ticklish. Usually, goodwill is valued as the difference between the price paid for the enterprise as a whole less the net of assets over liabilities. Suppose a business

has net assets (both of fixed and current) of Rs.27.50 lakhs and total liabilities (including share capital and reserves of Rs.11.50 lakhs) and the purchase consideration for the business is Rs.33.5 lakhs, the value of goodwill will be Rs.17.50 lakhs.

The value of goodwill, being subjective, depends upon the negotiated price. Hence it reflects the relative strength of bargaining of the parties. The valuation tends to be arbitrary in nature. Therefore, prior to arriving at an agreed price for goodwill, both the buyer and seller of the business do calculate the expected value of goodwill based on any one or more of the following methods, namely

- *Certain multiples of the average profits / or turnover over a number of past years.*
- *The capitalization of expected future returns over a specified number of years or*
- *The present value of the super profits likely to be earned by the business.*

15.4.1 Multiples of Profit/Turnover Method

This is based on the historic data of the performance of the business. Under this, the average net profit or turnover for the past five to seven years is calculated and the value of goodwill is estimated as certain multiples thereof. For example, if the average net profit of Hari's business for the past five years were Rs.2,75,000 and goodwill is to be estimated as a multiple of three years, then the value of goodwill will be Rs.8,25,000. In case of certain service industries, like that of the lawyers or doctors, the multiple will be on the basis of average turnover and not average profit.

15.4.2 Capitalization of Expected Returns Method

Under this method, the stream of expected cash inflows, over a period (usually over the residual life of the major assets) is estimated. The cash flow is discounted with the desired rate of return of the buyer. From the summation of the discounted cash flows, the current book value of the assets is subtracted. The excess, if any, is considered the value of goodwill. For example, the current book value of the assets of Humayun was Rs.51 lakhs. The residual life of his major assets is 6 years. The expected annual cash inflows during the useful life of major assets are Rs.25 lakhs, Rs.27 lakhs, Rs.24 lakhs, Rs.20 lakhs and Rs.18 lakhs respectively. The desired rate of return of the buyer is 18%. The present value of the future incomes for six years would

$$\begin{aligned} & \Sigma 25/1.18 + 27/1.18^2 + 24/1.18^3 + 22/1.18^4 + 220/1.18^5 + 18/1.18^6 \\ & = 81.88 \text{ lakhs} \end{aligned}$$

The present value could also be worked out by using the discount tables, given as annexure. From the present value thus arrived at, current book value of assets at Rs.51 lakhs is deducted, leaving a residual value of Rs.30.88 lakhs, which is the value of goodwill under the capitalization of expected return method.

15.4.3 PV of Super Profit Method

The next method of valuation is based on the hypothesis that the value of goodwill should roughly correspond to the present value of the abnormal profits or super profits the business is likely to earn over the next few years. As the utility of goodwill as an earning asset is subject to changes in the taste and preference of customers, technological upgradation of the competitors etc., the buyer would normally prefer to evaluate super profits for as short a period as possible, say three to four years. The summation of the discounted cash flows of the expected super profits of the business will be considered as a fair value of goodwill. For example, Ramdas' expected cash flows from super profits for the next 3 years were Rs.47 lakhs, Rs.45 lakhs, and Rs.43 lakhs respectively. The market rate of capitalization for similar industries is 25%. The sum total of discounted cash flows for the 3 years would be Rs.88.4 lakhs, which is the value of goodwill under this method.

15.5 TREATMENT OF GOODWILL

Once goodwill is created, it will be shown as an intangible asset. As a portion of assets is written off annually, notionally representing their contribution to the earning of revenue of that year, it is logical that goodwill too has to be written off. However, there is a difference between other assets (both tangible and intangible) and goodwill. Other assets have a cost, either cost of development by the business or by the seller. But, goodwill is created by the business without incurring any monetary cost. Hence, tax authorities do not allow the writing off of goodwill as an allowable cost. Goodwill has, therefore, to be adjusted against the distributable profits of the owners. Or in other words, it will reduce the wealth of the owners, who had purchased the business. However, once it has been treated as an intangible asset, it has to be amortized. As

regards the methods of amortization of goodwill, the accepted accounting conventions setup by the Accounting Principle Board of US, has prescribed the following alternative:

- *To retain the goodwill at its full value till a reduction or amortization is desired,*
- *To retain the cost as an asset and to amortize a portion over an assumed life period. (Goodwill can be written off within forty years of its creation)*
- *To reduce the value of goodwill from the equity of the owners.*

The third method, namely to reduce goodwill from the equity (accumulated reserves and surplus of the business) during the year of its creation itself, is an ideal choice, provided the retained earnings of the company are quite substantial to absorb the amount of goodwill. In that case, the following journal entry has to be passed.

Table 4
Journal Proper of X

Date	Particulars	LF	Dr.	Cr.
	Reserves & Surplus A/c Dr. To Goodwill A/c		7,50,000	7,50,000

15.6 FEW MODERN BREEDS OF INTANGIBLES

Global competition and the resultant consumer domination have widened the horizon of intangible assets. Businessmen all over the world are increasingly realizing that apart from the tangible assets and conventional intangibles, discussed in the foregoing paragraphs, a few non-conventional intangibles also contribute significantly to the revenue earning capacity of business. Eminent researchers have attempted to identify and quantify these intangibles. We may consider a few important modern concepts on intangibles.

(a) Intellectual Capital

The first that gives an overall assessment of the non-conventional intangibles is the concept of intellectual capital. Stewart has described intellectual capital as “*intellectual material, comprising knowledge, information, intellectual property and experience that can be put to use*

to create wealth". It is the collective brain power and not attributable to any single segment of human resource, structural advantages and customer capital. It is the synergy created by all these factors collectively. NRI Research, Evanston, Illinois, has evaluated the concept. They have developed a technique named calculated intangible value model (CIVM) to measure the ability of the intellectual capital to outperform other business in the industry, with similar tangible assets. CIVM is a simple application of the industrial return on assets (ROA), to the tangible assets of a business, to arrive at normal industry return on assets of the business. The return so arrived at is deducted from the actual profit of the business. This excess return is attributable to the *intellectual capital*. When the excess return is discounted at the cost of capital of the business, the value of intellectual capital emerges. For example Zealot Enterprises has an average operating profit of Rs.46.20 crores for the last three years. Its assets (for three years) averaged Rs.378.12 crores. The average industry return on assets is 10%. The cost of capital of Zealot is 15%. Applying CIVM to the information of Zealot, its intellectual capital is valued at Rs.56 crores, as in Table 5 below:

Table 5
Zealot enterprises
Assessment of Intellectual Capital (Rs. Crores)

1. Average tangible assets of Zealot	378.12
2. Average ROA of the industry	10%
3. Expected profit applying industry norm (1*2)	37.8
4. Actual profit of Zealot	46.2
5. Profit attributable to intellectual capital (4 – 3)	8.4
6. Cost of Capital	15%
7. Capitalization intellectual capital of Zealot (5/6)	56.0

(b) Human Resource as an Asset

A number of factors contribute to the creation of intellectual capital. Among these, the single largest contribution comes from human resources. Management Guru, Peter Ducker has been for quite some time, emphasizing on *knowledge workers* and their twin contribution – in their capacity as owners of companies and as employees. Measurement of human capital has been attempted by a number of economists, among whom Lew and Schwatz stand out unique.

Their model, names after them, assumes the annual remuneration of employees till their termination as cost to the company and is the human capital of the business. Major IT companies in India have included the valuation in their reports. The process was, however, started long ago by public sector companies like Steel Authority of India and Bharat Heavy Electricals Ltd.

Broadly, there are two approaches to human capital valuation – cost-based and economic approach. The cost-based approach is further classified into three – historical cost, replacement cost and opportunity cost. The L&S model along with other methods like Likert, Flamboltz and Jaggi is part of the economic approach. Though there is little clarity on which of the various human capital valuation models is effective, the Lew and Schwartz model seems to have an edge over others in India. HR consultants say it gives an opportunity to benchmark the efficiency of their human resources as quite a few Indian companies have adopted this system. Second, the valuation is less subjective as it makes limited assumptions.

(c) Brand Names

Brand names do contribute to the earning of revenues over and above tangible assets. The earning capacity of brands had been so acclaimed that brands are equated with equity and the phrase brand equity is in common usage. Brands are treated as intangible assets and are valued by using earning multiple approaches. Under this approach, brand strength of a company is determined on the basis of seven factors, namely, leadership, stability, market, internationality, trend, support and protection, is worked out. These factors are suitably weighted according to the importance of their contribution in creating brand equity. The cumulative weighted average will be the value of the brand. As the degree of the contribution by each of the factors is assumed to vary from company to company, the valuation of brands are highly subjective. No uniform norm could therefore be adopted in valuing brand equity.

15.7 INDIAN EXPERIENCE

It is heartening to note that Indian corporate is also veering slowly towards the recognition of these intangibles. A few blue chip companies such as Infosys, Satyam Computers and Dr. Reddy's Lab., besides the public sector giant BHEL have made attempts to assess these intangible assets. In their latest annual reports, they had evaluated intangible assets like

intellectual capital, market value addition, brand valuation, human resources capital and economic value addition.

Infosys has adopted the Lew & Schwartz model to compute the value of human resources. Infosys has valued its 36,750 employees at Rs.28,334 crores (\$6.4-billion). In its annual report for 2004-05, the company has reported a software delivery staff of 34,747 valued at Rs.26,550- crores and 2003 support staff value at Rs.1,784 crores. In the previous year, Infosys had valued its human capital at Rs.21,139 crores. It then had 25,634 employees, comprising of 24,110 software staff and 1,524 support personnel. Infosys revenue from software in 2005 was Rs.7129.65 crores, while its total employees cost was Rs.3539.11 crores.

Infosys had adopted the generic brand earnings-multiple model to value its corporate brand, the company said. The concept finds mention in “Valuation of Trademarks and Brand Names” by Mr. Michael Birkin in “Brand Valuation”, edited by Mr. John Murphy.

Using the brand earnings-multiple model, Infosys based its valuation on the assumptions, among others, of the total revenues excluding other income after adjusting the cost of earnings, the annual inflation at five per cent and five per cent of the average capital employed used for purposes other than promotion of the brand and a tax rate of 33.66 per cent.

Infosys annual report said it had used various models for evaluating assets off the balance sheet to bring certain advances in financial reporting. “Such an exercise also helps the Infosys management in understanding the components that make up goodwill. The aim of such modeling is to lead a debate on the balance sheet of the next millennium,’ it added.

Corporate attributes including core competency, market leadership, copyrights, trademarks, brands, superior earning power, excellence in management outstanding workforce, competition, longevity were built into this concept, the annual report said. Infosys believes the client base was its most valuable intangible asset. Marquee clients or image enhancing clients accounted for 48 per cent of Infosys’ total revenues. “Marquee clients give stability to our revenues and also reduce our marketing cost,” Infosys said.

A word of caution may here be added. These valuation are not entered in the books of accounts, but are presented as supplemental information to the final accounts of the corporates.

These intangible assets, no doubt, create and strengthen the goodwill of the business in the long run.

15.8 SUMMARY

This is the concluding chapter on the steps a business has to take, before actually undertaking the preparation of final accounts. Most of the intangible assets, although do not have physical existence, are created or purchased by utilizing the resources of the business. They represent expenditures, which contribute to the earning of the business during their useful life. These expenditures are treated on par with tangible assets in balance sheet. Patents, designs, trademarks, technical know-how, copyrights, franchises and goodwill are all examples of intangible assets that contribute directly or indirectly to the earning of the business. Besides, deferred revenue expenditure on account of capital issues, advertisements etc., also contribute indirectly to the earning of the business and hence are intangible assets. There are a few other intangibles, erroneously called fictitious assets, such as preliminary expenses and carried forward loss balances, which neither contribute directly nor indirectly to the revenue generating capacity of the business, but are incidental to the operations of the business. Still, they are presented on the assets side of the balance sheet and are written off periodically. Specific legislations for the intangible assets stipulate the effective life and the period over which intangibles assets are to be amortized. Whatever may be the effective life of the intangible assets, once they become obsolete, their entire outstanding value has to be written off in the year in which they had become useless. The write off is allowed as a cost in profit and loss account, except goodwill, for the creation of which resources of the business are not used up. Thus, goodwill has to be adjusted against the equity of the owners of the business.

Intangible assets are valued at the cost at which they are created or acquired. Should the cost of creation or acquisition be insignificant, they are written off as revenue expenses in the year in which the cost was incurred. However, when the amount spent is quite large and the writing off the entire expenditure in the year of occurrence will distort the operational results of the business, these expenditures are capitalized and written off according to assumed proportion of their contribution to the earning capacity of the business. Modern concepts of intangible assets have transgressed the conventional ideas. Intellectual capital, human resources capital and brand

equity are considered as intangible assets capable of contributing to the earning of the business, over and above tangible assets.

15.9 Glossary

Intangible Assets: These are expenditures that result in the acquisition of special rights, claims and privileges, which indirectly contribute to the earning of the business over its useful life.

Patent: It is a monopoly right granted to a person who had invented a new and useful article or an improvement of an existing article or a new process of making an article for commercial exploitation either by the inventor himself or his assignee.

Trademark: This is a visual symbol in the form of a word, device, name, letter, brand, heading, signature or label used to indicate the connection of the goods with the registered owner of the trademark.

Copy rights: These are privileges allowed to producers of intellectual and artistic works for their exclusive use.

Franchises: Franchises are rights obtained by enterprises from the technical know-how developers, for exploitation of the process, product or service in specific areas for an agreed period.

Goodwill: It is defined as the value of reputation of a business in respect of profits expected in future, over and above normal level of profits earned by other undertakings belonging to the same class of business.

Intellectual capital: Means intellectual material, comprising knowledge, information, intellectual property and experience that can be put to use to create wealth.

15.10 Check Your Progress

Whether the following statements are True or False:

- (a) Patents are to be registered with the Controller of Patents by payment of specified fees.
- (b) Goodwill is the quantified value of the reputation of the business to earn extra profit over and above what its tangible assets would have earned.
- (c) CIVM is a simple application of the industrial return on assets (ROA), to the tangible assets of a business, to arrive at normal industry return on assets of the business.

- (d) The maximum useful lives of intangibles assets are restricted by the regulations that govern them.
- (e) Goodwill is created by the business with incurring any monetary cost.
- (f) Intangible assets, like tangible assets, are not to be written off during their effective life.
- (g) It is common knowledge that technical know-how developed in the process is the exclusive right of the every organization.
- (h) The purpose of trade marking is to distinguish the trademarked goods from similar goods, thereby appealing to the specific demands of consumers.

15.11 Answer to Check Your Progress

- (a) True
- (b) True
- (c) True
- (d) True
- (e) False
- (f) False
- (g) False
- (h) True

15.12 Terminal Questions

1. What is meant by intangible assets? Explain the common examples of intangible assets.
2. Make a critical evaluation of different methods of valuation of goodwill.
3. Is there any useful life of intangible assets in India? Explain.
4. How treatment of goodwill is done in the books of accounts/ Explain.
5. Write a note on the Indian experiences on intangible assets.

15.13 Reference

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UNIT-16 BEHAVIORAL ASPECTS OF PERFORMANCE EVALUATION

Structure

- 16.1 Introduction
- 16.2 Concept of Performance and Performance Evaluation
- 16.3 Importance of Performance Evaluation
- 16.4 Techniques of Performance Evaluation
 - 16.4.1 Responsibility Accounting
 - 16.4.2 Budgetary Control and Reporting
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- 16.5 Summary
- 16.6 Glossary
- 16.7 Check Your Progress
- 16.8 Answer to Check Your Progress
- 16.9 Terminal and Model Questions
- 16.10 Suggested Readings

OBJECTIVES

After reading this lesson, you should be able to

- Know the concept and significance of performance evaluation
- Describe the technique of responsibility accounting.
- Understand the method of Budgetary Control and Reporting
- Explain different measures of financial performance
- Identify non-financial measures of performance

16.1 INTRODUCTION

For the long range planning and management controls, a company establishes its overall goals. Such goals are developed by the top management and they are usually consist of general statements or a series of statements in general terms stating what the company expects to achieve. Sometimes, the goal set may be stated in such broad terms as it is goal of the company is to achieve profits with a high level of manufacturing efficiency, to be a leader in technology in the industry. For the purpose of measuring performance and control, it is necessary to set objectives or goals in more precise terms. The goals are usually in quantitative terms and are set within time framework. Measurement of the results of a decision, and the feedback of those results into future decision making, perhaps via reconsideration of objectives or targets, is the last stage of decision making process. As such measuring performance is an essential tool for management control. The question of how to measure results thereof arises, and in answering this question it is necessary to return to the issue of corporate objectives. If it is accepted that the primary objective is maximization of profit, then the basis of measurement must be in terms of profit. If the objectives differ, then the criteria of judgment must differ significantly.

16.2 CONCEPT OF PERFORMANCE AND PERFORMANCE EVALUATION

A management accountant is involved in four key areas namely planning, control, decision-making and performance evaluation. While the first three areas have been discussed in previous units, the present unit gives an overview of tools and techniques used in performance evaluation. One of the most difficult tasks facing the management accountant is the evaluation of performance, more often of his own organization, but sometimes that of another organization. The term '*performance*' can be understood as 'to do, what is to be done'. Consequently, performance evaluation would mean judging whether something has been done as it was expected to be done. In the context of industrial management, performance evaluation thus means to find out whether or not an organization has fulfilled its objectives. This implies that performance evaluation as an exercise has three elements namely, expected performance, actual performance and a mechanism through which a comparative analysis is made of expectations and actual. Such a mechanism, in essence

involves fixing up performance criteria, obtaining actual performance data, in addition to a system of feedback to the concerned people who in turn can initiate action towards performance improvements.

Looking from this perspective, performance evaluation as an exercise is similar to budgeting and budgetary control exercise. However, budgeting and budgetary control are essentially planning and control tools, rather than performance evaluation tools though the results of budgetary control exercise can sometimes be used for managerial performance evaluation. Further, there are both accounting and non-accounting measures of performance and a management accountant should be conversant with all important measures and be capable of applying appropriate measures while evaluating performance.

16.3 IMPORTANCE OF PERFORMANCE EVALUATION

Performance evaluation is the basis of a management control system. Periodic comparisons of the actual costs, revenues and investments with the budgeted costs, revenues and investments can help management in taking decisions about future allocations. Performance evaluation should be done in respect of all responsibility centres (i.e., cost centres, profit centres and investment centres) to ascertain their level of performance. The best way to encourage managers to achieve the desired level of performance is to measure their performance in comparison to budgeted results. Performance evaluation of employees is used in taking decision about their salaries, promotions and training required for future assignments.

Performance evaluation is to be made of a cost centre, profit centre or investment centre. It will, therefore, be appropriate to give a brief idea of these before coming to the discussion of the various techniques of performance evaluation.

1. Cost Centre

A cost centre is the smallest segment of activity or area or responsibility for which costs are accumulated. Typically cost centres are departments but in some instances, a department may contain several cost centres. These cost centres are the departments or sub-department may organization with reference to which cost is collected for cost ascertainment and cost control. For example, although an assembly department may be supervised by one foreman, it may contain several assembly lines. Sometimes each assembly line is regarded as

a separate cost centre with its own assistant foreman. A cost centre can be a location, i.e., an area such as department or sales area or an item of equipment, e.g., lathe machine, delivery vehicle or a person, e.g., salesman, foreman.

The determination of a suitable cost centre is very important for ascertainment and control of cost. The manager incharge of a cost centre is held responsible for control of cost of his cost centre. It enables the accumulation of all such costs at one place for which a common base of recovery may be used.

Types of Cost Centres

Cost centres may be classified as under:

(i) ***Personal and impersonal cost centres.*** Personal cost centre is one which consists of a person or a group of persons. On the other hand, impersonal cost centre consists of a machine, a department or plant.

(ii) ***Operation and process cost centres.*** Operation cost centre consists of those persons and/or machines carrying out the same kind of operation. On the other hand a centre which has a continuous sequence of operations is called process cost centre.

(iii) ***Product and service cost centres.*** Product centre refers to a centre through which a product passes and generally corresponds to a product department. In such centres, raw materials are converted into finished goods. Service centre is a department or centre which incurs direct and indirect costs but does not work directly on products. Maintenance department and general factory office are examples of such centre.

2. Profit Centre

A profit centre is that segment of activity of a business which is responsible for both revenue and expense and discloses the profit of a particular segment of activity. Profit centres are created to delegate responsibility to individuals and measure their performance. Profit centre is different from cost centre. The following are the main points of difference between a cost centre and profit centre:

(i) Cost centre is the smallest unit of activity or area of responsibility for which costs are collected whereas a profit centre is the segment of activity of a business which is responsible for both revenue and expenses.

- (ii) Cost centres are created for accounting conveniences of costs and their control whereas a profit centre is created because of decentralization of operations i.e., to delegate responsibility to individuals who have greater knowledge of local conditions etc.
- (iii) Cost centres are not autonomous whereas profit centres are autonomous.
- (iv) A cost centre does not have target costs but efforts are made to minimize costs, but each profit centre has a profit target and enjoys authority to adopt such policies as are necessary to achieve its targets.
- (v) There may be a number of cost centres in a profit centre as production or service cost centres or personal or impersonal but a profit centre may be a subsidiary company within a group or division in a company.

3. Investment Centre

It is a centre in which a manager can control not only revenues and costs but also investments. The manager of such centre is made responsible for properly utilizing the assets used in his centre. He is expected to earn a requisite return on the amount employed in assets in his centre. Return on investment is used as a basis of judging and evaluating performance of an investment centre. Many large firms in U.S.A. like General Motors etc. follow this system of management control.

Performance of an investment centre is assessed not by profit alone; rather profit is related to investment employed in the centre. The manager of an investment centre is required to earn a satisfactory return on capital employed in the centre.

Performance report of an investment centre in absolute money terms would be like a performance report of a profit centre, but in addition the report would also mention the amount of investment employed in the investment centre. Return on capital employed in the investment centre along with desired rate of return should also be given in the performance report.

An investment centre may be treated as a separate centre of business where the manager has overall responsibility of managing inputs (i.e. expenses or costs), outputs (i.e. revenues) and investment. Managers of subsidiary companies can be treated as investment centre managers, accountable for costs, profits and capital employed.

16.4 TECHNIQUES OF PERFORMANCE EVALUATION

The following financial measures can be used for the evaluation of the performance of cost centres, profit centres and investment centres:

16.4.1 Responsibility Accounting

Responsibility accounting involves accumulating and reporting costs on the basis of individual manager who has authority to make day-to-day decisions. Under responsibility accounting, the evaluation of manager's performance is based only on matters directly under the manager's control. It is also termed as profitability accounting. In this system, the accountability is established according to the responsibility delegated to various levels of management and they are made responsible to give adequate feedback in terms of delegated responsibility. The basic idea behind responsibility accounting is that each manager's performance should be judged by how he or she manages those items and only those items under his/her control. The best way to encourage managers to achieve the desired level of performance is to measure their performance in comparison to budgeted results. Periodic comparisons of the actual costs, revenues and investments with the budgeted costs, revenues and investments relating to individual managers can help management in ascertaining their performance.

Responsibility accounting fixes responsibility for cost control purposes. Responsibility accounting is a method of accounting in which costs and revenues are identified with persons who are responsible for their control rather than with products or functions. This method of accounting classifies costs and revenues according to the responsibility centres that are responsible for incurring the costs and revenues according to the responsibility centres that are responsible for responsibility centres. The responsibility centres represent the sphere of authority decision points in an organization. A large firm is generally divided into meaningful segments, departments or divisions in order to have effective control. These segments, departments or divisions of an organization are called responsibility centres. Thus a responsibility centre is a specific unit of an organization assigned to a manager who is held responsible for its operations. In the words of *Anthony and Reece*, "Responsibility centre is like an engine in that it has inputs, which are physical quantities of material, hours of various types of labour and a variety of services; it works with these resources usually; working capital and fixed assets are also required. As a result of this

work, it produces outputs which are classified either as goods, if they are tangible or as services, if they are intangible. These goods or services go either to other responsibility centres within the company or to customers in the outside world”.

Responsibility accounting is used to measure both inputs and outputs of the responsibility centre in monetary terms, wherever feasible. The total of various inputs is called cost whereas the total of outputs is called revenue. Where monetary measurement of output is not possible (as services rendered by the accounting department to the organization), then it may be measured in terms of total cost of goods or services transferred, or as a number of units of output.

Essential Features of Responsibility Accounting

The features of responsibility accounting are as follows:

1. Information for both output and input of resources, i.e., based on cost and revenue data for financial information.
2. Information for planned and actual performance.
3. Identification of responsibility centre.
4. Transfer pricing policy.
5. Performance reporting.
6. To report reasons for deviation from original plan and to what extent.

Advantages of Responsibility Accounting

Following are the main advantages of responsibility accounting:

- (i) It establishes a *sound system of control* because it enables top management to delegate authority to responsibility centres while retaining overall control with itself.
- (ii) It forces the management to consider the organizational structure to result in effective delegation of authority and placement of responsibility. It will be difficult for individual manager to pass back unfavorable results. Thus, *it facilitates decentralization of decision making*.
- (iii) *It encourages budgeting for comparison* of actual achievements with the budgeted figures. It compels management to set realistic budget.
- (iv) *It increases interest and awareness among the supervisory staff* as they are called upon to explain about the deviations for which they are responsible.

- (v) It *simplifies the structure of reports and facilitates the prompt reporting* because of exclusion of those items which are beyond the scope of individual responsibility.
- (vi) It is helpful in following *management by exception* because emphasis is laid on reporting exceptional matters to top management and consequently top management is not burdened with all kinds of routine matters.

Major Difficulties Encountered in Introducing Responsibility Accounting

Following are the major difficulties encountered in introducing a system of responsibility accounting:

- (i) *Generally the prerequisites for a successful responsibility accounting scheme i.e., a well defined organization structure, proper delegation of work and responsibility, proper allocation of costs, a proper system of reporting are absent and makes it difficult to have a responsibility accounting.*
- (ii) *It becomes difficult to have a further analysis of expenses than provided by traditional classification of expenses. For example, wages of workman is controllable but fringe benefits included in it have to be paid under law or as per agreement with the workers' union.*
- (iii) While introducing the system supervisory staff may require additional clarification especially in the responsibility reports. They must be explained properly the purpose and benefits of the new system.

16.4.2 Budgetary Control and Reporting

Preparation of the budget is the first step in the budgetary control system. Implementation of budgets is the second phase which needs continuous reporting of budget performance at short intervals. Preparation of budgets alone will not achieve much unless a comparison is made regularly between the actual performance and the budgeted performance. Thus proper reporting is an essential element in budgetary control. The daily/week/monthly reports depending on the nature of operations involved in the results of various functions are regularly submitted to the management and follow up action has to be taken immediately. In this respect, budget reports showing the following information will prove useful:

- (a) Budgeted level of activity and budgeted cost of the same.
- (b) Budgeted cost of actual level of activities.
- (c) Actual cost of actual activity.
- (d) Variance between budgeted figures and actual figures.
- (e) Reasons of variance.

The importance of reporting lies in the fact that it brings into light the areas which need management attention. It will help in taking timely action for taking corrective measures. Thus, reporting will disclose the persons who are responsible for the variance. It is also possible that variance may not be due to employees but may be due to external factors (i.e., change in wage rates, prices of materials, slack market etc.) which are uncontrollable for which no operative or executive can be held responsible.

Budget reports to top management should explain the difference between the profit in the profit plan stating the factors involved in quantitative and financial terms show the flow of funds and projections in this regard and provide feedback about the achievement of goals and objective of the firm.

Various budget reports such as sales budget report, production budget report, purchases budget report, labour budget report, expenses budget report, cash budget report, capital expenditure budget report, research and development budget report etc., can be prepared to highlight the activities of various functional budgets.

16.4.3 Balanced Scorecard

This is an approach that links both the financial and non-financial measures of performance. This approach helps to provide a lot of information to the management that will assist them in strategic policy formulation and achievement. Balanced Scorecard, thus, addresses all areas of performance in an objective and unbiased fashion and gives top management a very fast and comprehensive view of the organization.

Different Perspectives of Balance Scorecard

The various perspective's of Balanced Scorecard that allows the manager to look at the business by seeking to provide answers are discussed below:

- (i) ***The Customer Perspective (How do customers see us?).*** In this perspective, managers should identify the customers and the market segment in which the business unit will compete. This perspective typically includes several core or genetic measures that relate to customer loyalty and the result of the strategy in the targeted segment. They include market share, customer retention, new customer acquisition, customer satisfaction and customer profitability.
- (ii) ***The Internal Business Perspective (What must we excel at?).*** In the internal business process perspective, managers identify the critical internal processes for which the organization must excel in implementing its strategy. The principal internal business processes include the following:
 - (a) Innovation processes for exploring the needs of the customer.
 - (b) Operation processes with a view to providing efficient management consistent and timely delivery product/service.
 - (c) Post service sales processes.
- (iii) ***The learning and Growth Perspective (can we continues to improve and create value?).*** It identifies the infrastructure that the business must build to create long term growth and improvement. There will be focus on factors like employee capability, employee productivity, employee satisfaction, employee retention. Under the existing business scenario, company will need on excellent information system.
- (iv) ***The financial perspective (How do we look to the shareholders?).*** Under this perspective the focus will be on financial measures like operating profit, ROI, Residual income, economic value added concept, revenue growth, cost reduction, asset utilization, etc. These financial measures will provide feedback on whether improved operational performance is being translated into improved financial performance.

16.4.4 Variance Analysis

Control is very important function of management. Through control management ensures that performance of the organization conforms to its plans and objectives. Analysis of variances is very helpful in controlling the performance and achieving the profits that have been planned.

The difference between the standard cost of profit or sales and actual cost or profit or sales is known as variance and the process by which the total difference between standard cost or sales and actual cost or sales is broken down into its different parts is known as variance analysis. When actual cost is less than standard cost or actual profit is better than standard profit, it is known as favorable variance and such a variance is usually a sign of efficiency of the organization. On the other hand, when actual cost or standard profit or standard sales is more than standard cost or actual profit or sales, it is called unfavorable or adverse variance and is an indicator of inefficiency of the organization. The favorable and unfavorable variances are also known as credit and debit variances respectively. Variances of different items or cost provide the key to cost control because they disclose whether and to what extent standard set have been achieved.

Another way of classifying the variances may be controllable and uncontrollable or random variances. When the variance is due to efficiency of a cost centre (i.e., individual or department) it is said to be controllable variance. Such a variance can be corrected by taking a suitable action. For example, if actual quantity of material used is more than the standard quantity, the foreman concerned would be responsible for it. But if excessive use is due to defective supply of materials or wrong setting of standards, the Purchasing Department or Cost Accounting Department would be responsible for it. On the other hand, an uncontrollable or random variance does not relate to an individual or department but it arises due to external reasons like increase in prices of materials. This type of variance is not controllable and no particular individual can be held responsible for it.

There are a number of reasons which give rise to variances and the analysis of variances will help to locate the reason and person or department responsible for a particular variance. The management needs not pay attention two items or departments proceedings according to standard laid down. It is only in case of unfavorable items that they have to exercise control. This type of management technique is known as 'management by

exception'. This type of technique is considered as an efficient way of exercising control because management cannot devote their limited time to every item.

The deviation of total actual cost from total standard cost is known as total cost variance. It is a net variance which is the aggregate of all variances relating to various elements of cost, both favorable and unfavorable.

Analysis of variances may be done in respect of each element of cost and sales viz.:

- a. Direct Material Variances,
- b. Direct Labour Variances,
- c. Overhead Variances,
- d. Sales Variances.

16.4.5 Contribution Margin

Contribution margin can be defined as the difference between the sales and the variable cost of those sales. It contributes towards fixed expenses and profit. A profit centre or investment centre giving more contribution is preferred because it will give higher figure of profit taking fixed expenses as constant. It is a very good device for optimizing the use of scarce resources.

Contribution is different from the profit which is net gain in activity and remains after deducting fixed expenses from the total contribution. Contribution margin is a good technique of performance measurement as it helps to find out the profitability of a product, department or division, to have better product mix, for profit planning and to maximize the profit of a firm.

The main drawback of this technique as a measure of performance is that it does not give due consideration to fixed expenses. With the development of technology, fixed expenses have increased and their impact on production is much more than that of variable expenses. Therefore, a technique of performance evaluation which ignores fixed expenses is less effective because a significant portion of the cost representing fixed expenses is not taken care of.

Another important limitation of contribution margin approach is that firms in a competition industry might be induced to sell at prices which cover variable costs and give contribution but fail to earn an adequate return on investment in fixed assets. A technique of

performance evaluation should lay emphasis on the need for making an adequate return on capital employed in a division or department.

In the technique of contribution margin, time taken for the completion of jobs is not given due attention because marginal cost excludes fixed expenses which are connected with time. Fixed expenses should be considered if the suitable comparison of two jobs is to be made.

ILLUSTRATION 1

A company has two divisions, A and B. The Division A is currently operating at full capacity. It has been asked to supply its product to division B. Division A sells its product to its regular customers for Rs.30 each. Division B (currently operating at 50% capacity) is willing to pay Rs.20 each for the component produced by division A (this represents the full absorption cost per component at division A).

The components will be used by Division B in supplementing its main product to conform to the need of special order. As per the contract terms of sales, the buyer calls for reimbursement of full cost to Division B plus 10%.

Division A has a variable cost of Rs.17 per component. The cost per unit of Division B subsequent to the buying part from division A is estimated as follows:

	Rs.
Purchased parts – outside vendors	90
Purchased part – Division A	20
Other variable costs	50
Fixed overheads and administration	40
	<hr/>
	200
	<hr/>

The company uses contribution margin technique for evaluation of divisional performance.

Required

- (a) As manager of Division A, would you recommend sales of your output to Division B at the stipulated price of Rs.20

- (b) Would it be in the overall interest of the company for Division A to sell its output to Division B?

SOLUTION

Computation of Contribution per Unit on Output of Division A if Output is Sold

Externally

	Rs.
Selling price per unit of output of Division A	90
Purchased part – Division A	20
Contribution per unit	<u>13</u>

Contribution if Output is Transferred to Division B

	Rs.
Transfer Price per unit of output of Division A to B	20
Less Variable cost per unit	17
Contribution per unit	<u>03</u>

As Manager of Division A, sale at Rs.20 per unit to B, should not be recommended because contribution per unit will reduce from Rs.13 to Rs.10. Division A is already operating at its full capacity and market is absorbing all its output at Rs.30 per unit. The internal transfer made to Division B would reduce contribution and profit of Division A by Rs.10 per unit.

(b)

	<i>Sold Externally</i>	<i>Transferred To Division B</i>
	Rs.	Rs.
Selling per unit of output of Division A	30	220
Selling price per unit of division (Rs.200 cost as given + 10% of Rs.200)		157
Less Variable cost per unit (Relevant incremental cost)	17	(17+90+50)
Contribution per unit	<u>13</u>	<u>63</u>

It will be in the overall interest of the company that the transfer takes place as it would increase the firm's contribution by Rs.50 per unit.

16.4.6 Return on Capital Employed (ROCE) or Return on Investment (ROI)

Return on capital employed or return on investment is an indicator of the earning capacity of the capital employed in the business. Return on investment gives an idea of the efficiency or otherwise of an investment centre as the ratio is calculated for a particular investment centre. Measuring the performance of an investment centre requires a comparison of the profit that has been earned with capital employed in the investment centre. Return on investment is calculated is given below:

$$\begin{aligned}
 (1) \quad \text{ROI} &= \frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100 \\
 \text{or} \\
 \text{ROI} &= \frac{\text{Operating Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Capital Employed}} \times 100
 \end{aligned}$$

The alternative method of calculating ratio of ROI gives better idea of the operating efficiency of capital employed as compared to the first way of calculating ROI because it throws light on operating profit margin and assets turnover. The ratio of operating profit to sales is the result of firm's pricing policy and its cost control. The ratio will be higher if strict control is exercised on various elements of cost and or higher selling prices are realized by providing quality goods to customers. If profit margin ratio is lower, it will give an idea of increased cost and/or lower selling prices. Assets turnover or capital turnover ratio shows the amount of sales generated by the assets available or capital employed and gives an idea whether assets are being utilized properly or not. The higher the capital turnover ration, the better it is for the firm.

ROI is considered to be the most important ration because it reflects the overall efficiency with which capital is used. This ratio is a helpful tool for making investment decisions. A project yielding higher return on investment is favored. ROI can be improved by any of the following factors, all other factors being held constant:

- (i) A decrease in operating costs.
- (ii) An increase in selling price.
- (iii) An increase in sales volume.
- (iv) A reduction in amount of capital employed.

In considering the suitability of return on capital employed for measuring performance, operating profit and capital employed should be clearly defined for getting comparable results of operating performance of different division or years.

$$\begin{aligned}\text{Operating Profit} &= \text{Profit before interest on long term borrowings and tax} \\ \text{Capital Employed} &= \text{Equity Share Capital} + \text{Preference Share Capital} \\ &\quad + \text{Undistributed Profit} + \text{Reserves and Surplus} + \text{Long-Term Liabilities} - \text{Fictitious Assets} - \text{Non-business Assets} \\ \text{Alternatively} &\quad \text{Tangible Fixed and Intangible Assets} + \text{Current Assets} \\ &\quad - \text{Current Liabilities}\end{aligned}$$

Limitations of ROI

Following are the limitations of ROI:

1. Satisfactory definitions of profit and capital employed may not be available. Profit has many concepts such as profit before interest and tax, profit after interest but before tax, profit after interest and tax, profit before deducting fixed expenses etc. Similarly, capital employed may be taken as gross capital employed (total of all funds long-term and short-term invested in a firm), net capital employed (only long-term funds invested in a firm), assets including or excluding intangible assets, assets taken at their book value or at their current cost etc.
2. ROI of different firms for making an analysis of their comparable performance may not serve the purpose if they follow different accounting policies and methods in respect of valuation of fixed assets, valuation of stock, apportionment and absorption of overheads etc.
3. ROI may not be suitable for making analysis of short term performances. In the initial years, a new investment may give a very small ROI which may mislead the management and a wrong decision of not making the investment may be taken. It is possible that ROI may improve in course of time when the initial obstacles are overcome.
4. It is quite possible that ROI may influence a divisional manager to select only those investments which give higher rates of return to achieve his target ROI. Other investments that reduce his division's ROI but could increase the value of the firm may be rejected by the divisional manager.

16.4.7 Residual Income (RI)

The General Electric Company of US developed the concept of Residual Income (RI) as an alternative to Return on investment (ROI).

Residual Income is defined as income remaining out of profit before taxes after making provision for the expected return on investment. The expected return is considered as the capital (imputed interest) charge. The idea is that the division bears a charge for the assets provided by the organization to the division for use.

$$\begin{aligned}\text{RI} &= \text{Profit} - \text{Capital Charge} \\ &= \text{Profit} - (\text{Required Rate of Return} \times \text{Investment})\end{aligned}$$

It is used to assess divisional performance.

Here, capital (imputed interest) charge represents interest forgone as a result of funds tied up in the business. In other words, imputed interest is the opportunity cost of the funds invested in the business. Evaluation of the performance of a firm or division of a firm will be made by the size of the residual income. The objective of a firm should be to maximize its residual income. As long as the firm or the division earns a rate of income in excess of the imputed interest charge for the investments made in the firm or the division, the firm or division should expand.

ROI may induce a divisional manager to select only those investments which give high rates of return that are in line or above his target ROI. Other investments that reduce division's target ROI but could increase the overall value of the firm may be rejected by the divisional manager. But it will not be the case if the residual income is made a criterion for evaluating the performance of a divisional manager. Objective of overall increase in the value of the firm is more likely to be achieved by using residual income rather than ROI as a divisional manager's performance measure.

Advantages of the Residual Income

The advantages of the Residual Income are as follows:

1. It maximizes the overall value and growth of the firm and increases shareholders' wealth by accepting investments which give a rate of return in excess of the cost of capital.

2. Divisional managers become aware of the opportunity cost of funds and they accept those investments which give a higher rate of return than the rate of imputed interest.
3. It avoids taking sub-optimal decision because investments are not rejected by divisional managers merely because they lower their target ROI.
4. Goal congruence (overall objective of the firm) is more likely to be achieved by using residual income rather than ROI as a technique of performance evaluation.

Weaknesses (or Limitations) of RI

1. It is difficult to have satisfactory definition of income and investment.
2. It may be difficult to get the rate of imputed interest because it depends on factors like risk, demand and supply of capital etc.
3. Residual income is an absolute measure of performance because it is expressed in rupees. It will not provide a proper basis for evaluation of organizational performance which is affected by the size of the organization. ROI being relative measure expressed in percentage is a better technique of organizational performance as compared to the residual income.

According to *Horngren, Foster and Datar*, “Both ROI and residual income represent the results for a single time period (such as a year). Managers can take actions that cause short-run increases in ROI or residual income but are in conflict with the long-run interests of the organization. For example, managers may curtail research and development and plant maintenance in the last three months of a fiscal year to achieve a target level of annual operating income”.

ILLUSTRATION 2

The following information relates a profit centre P_1 of a manufacturing company:

	Rs.
Sales	2,00,00,000
Less Total Cost	1,90,00,000
Profit	<hr/> 10,00,000

The amount of capital employed in profit centre P_1 is Rs.75,00,000 and the cost of capital is 15%. You are required to calculate : (i) ROI and (ii) RI. Give your comments.

SOLUTION

$$\begin{aligned}
 \text{(i) ROI} &= \frac{\text{Rs.10,00,000 (Profit)}}{\text{Rs.75,00,000 (Capital Employed)}} \times 100 = 13.33\% \\
 \text{(ii) RI} &= \text{Profit} - \text{Cost of Capital} \\
 &= \text{Rs.10,00,000} - 15\% \text{ of Rs.75,00,000} \\
 &= \text{Rs.10,00,000} - \text{Rs.11,25,000} = \text{Rs.1,25,000 (Negative)}
 \end{aligned}$$

Comments

Desired rate of return is 15% but profit centre P_1 gives ROI 13.33%. Residual income is negative figure of Rs.1,25,000 because cost of capital of Rs.11,25,000 is more than profit of Rs.10,00,000. Hence performance of profit centre P_1 is not satisfactory at all.

16.4.8 Value Added

Value added is the change in market value resulting from an alternation in the form, location or availability of a product or service excluding the cost of bought-in-material and services. It is the excess of sales revenue plus income from services over the cost of bought in goods and services purchased from outsiders. It can also be defined as the wealth the organization has created by people working in the business, by providers of capital and by the Government which has a responsibility for the social and economic environment within which the business operates. In this sense it will be calculated by taking the total of employees' costs (i.e., wages, salaries and cost of other benefits given to employees), interest on loans, dividend, Government takes, depreciation and retained profits.

Value added differs from the conventional profit depicted by Profit and Loss Account because conventional profit's calculations deduct all costs from sales and other incomes whereas value added is obtained by deducting the cost of bought-in-material and services from sales and other incomes.

Every effort should be made to increase the value of products produced or services provided by a firm so that these may be more addition to the wealth of the organization. The figure of value added is more important to measure, evaluate and judge the performance of an enterprise than the figure of profit because it excludes those costs over which the firm has either no control or at best a little control. An organization may survive without earning profit but cannot survive without adding value. Any business which is not making profit shall

become risk but any business not generating value would be an evil and not desirable at all from the society's point of view.

16.4.9 Bench Marking

The increased global competition calls for special competence of increased cost efficiency for a company for its very survival. Bench marking is a technique which will help a company to achieve this comparative cost efficiency.

Bench marking may be defined as a continuous information sharing process, adopted by an organization internally and externally to identify its strong or weak points against the toughest competitors, to improve the activities carried out and services provided by it. Companies choose to bench mark excellent companies whose business process is similar to their own.

A bench mark amount is the best level of performance that can be found inside or outside the organization. The bench mark exercise has six essential steps as given below:

- (i) Identifying key variables for bench marking.
- (ii) Selecting comparative companies (i.e., excellent companies)
- (iii) Gathering required data.
- (iv) Increased budget for idea generation and training.
- (v) Evaluating and interpreting the performance gap.
- (vi) Improving the performance to achieve world class operations.

Bench marking is to be treated as a continuous learning process and it should result in innovations. In order to effectively bench mark, it is vital to determine the real difference between our firm and business process leader to be copied or imitated and comparison must be made in at least in the following essential areas:

- (i) Cost of product/service
- (ii) Productivity
- (iii) Standard of performances achieved
- (iv) Attitudes/features

Pro-active bench marking is the need of the hour which will monitor that the input costs do not blunt the competitive edge thereby makes a company fit to be a global player, to beat the best competitor in the world.

Davit T. Kearns, the former chief executive of Xerox, has rightly defined bench marking as “Bench marking is the continuous process of measuring products, services and business practices through the comparison with the strongest competitors or with companies, that are recognized as industry leaders.” It is a continuous search for superior competitive performance.

Advantages of Bench Marking

1. Bench marking is a continuous search for better ways to make improvement in the performance of the organization. This results in better processes of production and managing business and leads to higher profits.
2. It helps in reduction of cost and improvement of quality of the products.
3. It leads to higher customer satisfaction levels because efforts are made to follows the practices of business leaders.

16.4.10 Non-Financial Quality Performance Measures

Profitability alone is inadequate to measure the performance of various centres. There is no denying the fact that financial measures are important measures for evaluating the performance of cost centres, profit centres and investment centres. But these measures are not fully adequate measures for performance evaluation. Further these measures are short-term benefits by using these techniques at the expense of long-term benefit of the firm. Therefore, it is desirable to use non-financial measures for evaluating the performance besides using financial measures. The following non-financial measures should also be considered along with financial measures for evaluation of the performance:

- (i) Market Share for each major product.
- (ii) Product leadership.
- (iii) Product or service quality.
- (iv) Delivery reliability.
- (v) Productivity
- (vi) Personnel turnover popularly known as labour turnover.
- (vii) Personnel development.
- (viii) Personnel satisfaction.
- (ix) Customers' after sale service.

- (x) Customer satisfaction (ultimate measure of quality).
- (xi) Employment opportunities.
- (xii) Minimization of wastages and losses.
- (xiii) Social responsibilities etc.

Non-financial measures are very important for the overall success of a firm. Financial measures alone may not measure the overall performance of a firm. It is slightly claimed that any financial measures like ROI and RI have drawbacks while evaluating divisional performance, since it is virtually impossible to capture in one financial measure all the variables that measure the success of a division.

For example, two divisional managers having equal amounts of investments in their respective divisions may also have some rate of return on investment. However, this does not mean that their performances are also equal. It is possible that one division might have provided excellent after sale service and thereby has enhanced the reputation of the firm. On the other hand the other division might not have taken any care of after sale service.

Earlier, little attention was given to non-financial performance measures when there was sellers' market. But now-a-days when there is acute competition and there is wide choice for buyers, it is desirable to give due attention to non-financial measures for evaluating the performance of managers so that they may become aware of providing facilities to customers to have a hold on the market.

From the above discussion of all performance measures it is clear that an effective performance evaluation system should emphasize both financial and non-financial measures.

16.5 SUMMARY

Performance evaluation is the basis of a management control system. Periodic comparisons of the actual costs, revenues and investments with the budgeted costs, revenues and investments can help management in taking decisions about future allocations. Performance evaluation should be done in respect of all responsibility centres (i.e., cost centres, profit centres and investment centres) to ascertain their level of performance. There are various techniques for the evaluation of cost centres, profit centres and investment centres. Under responsibility accounting, the evaluation of manager's performance is based only on matters directly under the manager's control. Responsibility accounting fixes

responsibility for cost control purposes. Budget reports to top management should explain the difference between the profit in the profit plan stating the factors involved in quantitative and financial terms show the flow of funds and projections in this regard and provide feedback about the achievement of goals and objective of the firm. Balanced Scorecard addresses all areas of performance in an objective and unbiased fashion and gives top management a very fast and comprehensive view of the organization. Analysis of variances is very helpful in controlling the performance and achieving the profits that have been planned. The deviation of total actual cost from total standard cost is known as total cost variance. Contribution margin is a good technique of performance measurement as it helps to find out the profitability of a product, department or division, to have better product mix, for profit planning and to maximize the profit of a firm. Return on investment gives an idea of the efficiency or otherwise of an investment centre as the ratio is calculated for a particular investment centre. Objective of overall increase in the value of the firm is more likely to be achieved by using residual income rather than ROI as a divisional manager's performance measure. Value added is the excess of sales revenue plus income from services over the cost of bought in goods and services purchased from outsiders. A bench mark amount is the best level of performance that can be found inside or outside the organization. it is desirable to use non-financial measures for evaluating the performance besides using financial measures

16.6 Glossary

Performance Evaluation: Judging whether or not an organization has fulfilled its objectives.

Cost Centre: A cost centre is the smallest segment of activity or area or responsibility for which costs are accumulated.

Profit Centre: It is that segment of activity of a business which is responsible for both revenue and expense and discloses the profit of a particular segment of activity.

Investment Centre: It is a centre in which a manager can control not only revenues and costs but also investments.

Responsibility Accounting: It refers to the accounting process that reports how well managers have fulfilled their responsibilities.

Balanced Scorecard: This addresses all areas of performance in an objective and unbiased fashion and gives top management a very fast and comprehensive view of the organization.

Variance Analysis: The process by which the total difference between standard cost or sales and actual cost or sales is broken down into its different parts is known as variance analysis.

Contribution Margin: It is defined as the difference between the sales and the variable cost of those sales.

Return on Capital Employed: It is an indicator of the earning capacity of the capital employed in the business.

Residual Income: This is defined as income remaining out of profit before taxes after making provision for the expected return on investment.

Value Added: Value added is the change in market value resulting from an alternation in the form, location or availability of a product or service excluding the cost of bought-in-material and services.

Bench Marking: A continuous information sharing process, adopted by an organization internally and externally to identify its strong or weak points against the toughest competitors.

16.7 Check Your Progress

1. As such measuring performance is an essential tool for _____.
2. The best way to encourage managers to achieve the desired level of performance is to measure their performance in comparison to _____ results.
3. A cost centre can be a location or an item of equipment or a _____.
4. The manager of an investment centre is required to earn a satisfactory _____ in the centre.
5. Balance Scorecard is an approach that links _____ of performance.
6. When actual cost is less than standard cost or actual profit is better than standard profit, it is known as _____ variance.
7. _____ is a good technique of performance measurement as it helps to find out the profitability of a product, department, to have better product mix, for profit planning and to maximize the profit of a firm.
8. The ratio of operating profit to sales is the result of firm's _____ and its cost control.
9. Every effort should be made to increase the value of products produced or services provided by a firm so that these may be more addition to the _____ of the organization.

10. Bench marking is to be treated as a continuous learning process and it should result in _____.

16.8 Answers to Check Your Progress

1. Management Control.
2. Budgeted
3. Person
4. Return on capital employed
5. Both the financial and non-financial measures
6. Favorable
7. Contribution margin
8. Pricing policy
9. Wealth
10. Innovations

16.9 Terminal and Model Questions

1. Distinguish between a cost centre, profit centre and an investment centre.
2. How is performance generally measure in cost centre, profit centre and investment centre.
3. How is residual income defined? What is the advantage of using residual income in performance evaluation versus ROI?
4. “The ROI measure may be based in favor of divisions with older plant and equipment”. Explain.
5. Explain the various Non-Financial Quality Performance Measures.
6. What is the rationale of using Bench Marking while measuring the performance?
7. Discuss the features, advantages and limitations of responsibility accounting.

16.10 Reference/ Bibliography

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