FINANCIAL ACCOUNTING

(Elements of Financial Accounting Paper - I)

Rajiv Mishra
Asif Baig
Shraddha M. Bhome

Himalaya Publishing House
ISO 9001:2008 CERTIFIED

Financial Accounting

(Elements of Financial Accounting Paper - I)

(As Per the Revised Syllabus 2016-17 of Mumbai University for F.Y. BAF, Semester I)

Rajiv Mishra
M.Com., MBA, M.Phil., UGC-NET, Ph.D. (Pursuing)
Recognised UG Professor by University of Mumbai.
Assistant Professor in BBI & Co-ordinator, M.Com.,
N.E.S. Ratnam College of Arts, Science and Commerce,
Bhandup (W), Mumbai - 400 078.
Visiting Faculty at N.G. Acharya, D.K. Marathe, V.K. Menon College, Pragati College,
Chandrabham Sharma College, Dnyansadhana College and Vikas College
for M.Com., BBI, BMS, BFM and BAF

Asif Baig
M.Com., B.Ed., M.Phil., MBA, NET
HOD, Accounts at Gurukul College, Ghatkopar &
Visiting Faculty at NES Ratnam College for M.Com.

Dr. Shraddha Mayuresh Bhome
M.Com, M.Phil. (Gold Medalist), Professional MBA,
Ph.D. in Commerce,
Pursuing D.Litt. in Commerce,
Assistant Professor and Coordinator
(Accounting and Finance),
Satish Pradhan Dnyanasadhana College, Thane.

Himalaya Publishing House
ISO 9001:2008 CERTIFIED

First Edition : 2016
Edition : 2017
Second Revised Edition : 2018

Published by	:	Mrs. Meena Pandey for **Himalaya Publishing House Pvt. Ltd.,** "Ramdoot", Dr. Bhalerao Marg, Girgaon, Mumbai - 400 004. **Phone:** 022-23860170, 23863863; **Fax:** 022-23877178 **E-mail:** himpub@vsnl.com; **Website:** www.himpub.com
Branch Offices	:	
New Delhi	:	"Pooja Apartments", 4-B, Murari Lal Street, Ansari Road, Darya Ganj, New Delhi - 110 002. Phone: 011-23270392, 23278631; Fax: 011-23256286
Nagpur	:	Kundanlal Chandak Industrial Estate, Ghat Road, Nagpur - 440 018. Phone: 0712-2738731, 3296733; Telefax: 0712-2721216
Bengaluru	:	Plot No. 91-33, 2nd Main Road, Seshadripuram, Behind Nataraja Theatre, Bengaluru - 560 020. Phone: 080-41138821; Mobile: 09379847017, 09379847005
Hyderabad	:	No. 3-4-184, Lingampally, Besides Raghavendra Swamy Matham, Kachiguda, Hyderabad - 500 027. Phone: 040-27560041, 27550139
Chennai	:	New No. 48/2, Old No. 28/2, Ground Floor, Sarangapani Street, T. Nagar, Chennai - 600 012. Mobile: 09380460419
Pune	:	"Laksha" Apartment, First Floor, No. 527, Mehunpura, Shaniwarpeth (Near Prabhat Theatre), Pune - 411 030. Phone: 020-24496323, 24496333; Mobile: 09370579333
Lucknow	:	House No. 731, Shekhupura Colony, Near B.D. Convent School, Aliganj, Lucknow - 226 022. Phone: 0522-4012353; Mobile: 09307501549
Ahmedabad	:	114, "SHAIL", 1st Floor, Opp. Madhu Sudan House, C.G. Road, Navrang Pura, Ahmedabad - 380 009. Phone: 079-26560126; Mobile: 09377088847
Ernakulam	:	39/176 (New No. 60/251), 1st Floor, Karikkamuri Road, Ernakulam, Kochi - 682 011. Phone: 0484-2378012, 2378016; Mobile: 09387122121
Bhubaneswar	:	Plot No. 214/1342, Budheswari Colony, Behind Durga Mandap, Bhubaneswar - 751 006. Phone: 0674-2575129; Mobile: 09338746007
Kolkata	:	108/4, Beliaghata Main Road, Near ID Hospital, Opp. SBI Bank, Kolkata - 700 010. Phone: 033-32449649; Mobile: 07439040301
DTP by	:	Rakhi
Printed at	:	Rose Fine Arts, Mumbai. On behalf of HPH.

Preface

It is a matter of great pleasure to present the second revised edition of this book on **Financial Accounting** to the students and teachers of First Year Bachelor of Commerce – Accounting and Finance (F.Y. BAF), Semester I course started by University of Mumbai.

We have tried to make and present the book in simple language and precise. We are hoping that the diagrams and step-by-step answers put up will be helpful to understand the subject clearly.

We are thankful to our all family members for constant support and motivation. We are also grateful to our Principal, Vice-Principal, Co-ordinator, Colleagues, Library Staff and our dear students and friends for encouraging us to write the book. Special thanks to Himalaya Publishing House Pvt. Ltd. for publishing our book.

Any constructive suggestions from the students and teachers for improving the text in future are welcome.

Authors

Syllabus

<table>
<tr><th>Sr. No.</th><th>Modules/Units</th></tr>
<tr><td>1</td><td>Financial Accounting (Elements of Financial Accounting - I)
● Accounting Standards
Concepts, benefits, procedures for issue of accounting standards
Various AS:
AS – 1: Disclosure of Accounting Policies
Purpose, Areas of Policies, Disclosure of Policies, Disclosure of Change in Policies, Illustrations.
AS – 2: Valuation of Inventories (Stock)
Meaning, Definition, Applicability, Measurement of Inventory, Disclosure in Final Account, Explanation with Illustrations.
AS – 9: Revenue Recognition
Meaning and Scope, Transactions Excluded, Sale of Goods, Rendering of Services, Effects of Uncertainties, Disclosure, Illustrations.
● Inventory Valuation
Meaning of Inventories, Cost for Inventory Valuation, Inventory Systems: Periodic Inventory System and Perpetual Inventory System, Valuation: Meaning and importance.
Methods of Stock Valuation as per AS – 2: FIFO and Weighted Average Method, Computation of Valuation of Inventory as on Balance Sheet Date: If inventory is taken on a date after the balance sheet or before the balance sheet</td></tr>
<tr><td>2</td><td>Final Accounts
● Expenditure: Capital, Revenue
● Receipts: Capital, Revenue
● Adjustment and Closing Entries
● Final Accounts of Manufacturing Concerns (Proprietary Firm)</td></tr>
<tr><td>3</td><td>Departmental Accounts
● Meaning
● Basis of Allocation of Expenses and Incomes/Receipts
● Inter Departmental Transfer: at Cost Price and Invoice Price Stock Reserve
● Departmental Trading and Profit & Loss Account and Balance Sheet</td></tr>
<tr><td>4</td><td>Accounting for Hire Purchase
● Meaning
● Calculation of interest
● Accounting for hire purchase transactions by asset purchase method based on full cash price
● Journal entries, ledger accounts and disclosure in balance sheet for hirer and vendor (excluding default, repossession and calculation of cash price)</td></tr>
</table>

Question Paper Pattern

Maximum Marks: 75 **Duration: 2 ½ Hrs.**

All Questions are Compulsory Carrying 15 Marks each. **Questions to be set: 05**

Question No.	Particular	Marks
Q.1	Objective Questions (A) Sub-questions to be asked (10) and to be answered any 08 (B) Sub-questions to be asked (10) and to be answered any 07 (*Multiple Choice/True or False/Match the Columns/Fill in the Blanks)	15 Marks
Q.2 Q.2	Full Length Question OR Full Length Question	15 Marks 15 Marks
Q.3 Q.3	Full Length Question OR Full Length Question	15 Marks 15 Marks
Q.4 Q.4	Full Length Question OR Full Length Question	15 Marks 15 Marks
Q.5 Q.5	(A) Theory questions (B) Theory questions OR Short Notes To be asked (05) To be answered (03)	08 Marks 07 Marks 15 Marks

Note: Full length questions of 15 marks may be divided into two sub-questions of 7/8 and 10/5 marks.

Contents

1 Accounting Standards

Chapter

WHAT IS AN 'ACCOUNTING STANDARD'

An accounting standard is a principle that guides and standardises accounting practices. The Generally Accepted Accounting Principles (GAAP) is a group of accounting standards widely accepted as appropriate to the field of accounting necessary so financial statements are meaningful across a wide variety of businesses and industries. An accounting standard is a guideline for financial accounting, such as how a firm prepares and presents its business income, expenses, assets and liabilities, and may be in accordance to standards set by the International Accounting Standards Board (IASB). However, in india all the accouting principle and standards are framed by ICAI Institute of Chartered Accountant of India.

BREAKING DOWN 'ACCOUNTING STANDARD'

Accounting standards specify when and how economic events are to be recognised, measured and displayed. External entities such as banks, investors and regulatory agencies rely on accounting standards to ensure relevant and accurate information is provided about the entity. Accounting standards relate to all aspects of an entity's finances including assets, liabilities, revenue, expenditures and equity. Specific examples of an accounting standard include revenue recognition, asset classification, allowable methods for depreciation, what is considered depreciable, lease classifications and outstanding share measurement.

History of Accounting Standards

The first accounting standards were developed in the 1930s. They were established for public entities and included in multiple securities acts that followed the Great Depression. The initial regulations established were included in the Securities Act of 1933 and the Securities Exchange Act of 1934. These technical pronouncements have ensured transparency in reporting and set the boundaries for financial reporting measures.

Financial Statement Comparability

Accounting standards ensure the financial statements from multiple companies are comparable. This is because all entities follow the same rules. Without accounting standards, there is little consistency as to the reporting of financial information. Accounting standards make the financial statements credible and allow for more economic decisions based on accurate and concise information.

Overseeing Bodies

The American Institute of Certified Public Accountants (AICPA) developed, managed and enacted the first set of accounting standards. In 1973, these responsibilities were given to the Financial Accounting Standards Board (FASB). As of May 2016, the Financial Accounting Standards Board still maintains regulation and administration on accounting standards.

Various Standards/Principles

Generally Accepted Accounting Principles are heavily used among public and private entities in the United States. The rest of the world primarily uses International Reporting Financial Standards (IFRS). These standards are required to be used for multinational entities. Accounting standards have also been established by the Governmental Accounting Standards Board (GASB) for accounting principles for all state and local governments.

Disclosure of Accounting Policies AS-1

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

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

Introduction

(A) This statement deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements.

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

1 Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

2 It may be noted that this Accounting Standard is now mandatory. Reference may be made to the section titled 'Announcements of the Council regarding status of various documents issued by the Institute of Chartered Accountants of India' appearing at the beginning of this Compendium for a detailed discussion on the implications of the mandatory status of an accounting standard.

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

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

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

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

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

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

Explanation

Fundamental Accounting Assumptions

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

10. The following have been generally accepted as fundamental accounting assumptions:—

(a) Going Concern

The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

(b) Consistency

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

(c) Accrual

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

Nature of Accounting Policies

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

12. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise.

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

Areas in Which Differing Accounting Policies are Encountered

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

- Methods of depreciation, depletion and amortisation
- Treatment of expenditure during construction
- Conversion or translation of foreign currency items
- Valuation of inventories
- Treatment of goodwill

- Valuation of investments
- Treatment of retirement benefits
- Recognition of profit on long-term contracts
- Valuation of fixed assets
- Treatment of contingent liabilities.

15. The above list of examples is not intended to be exhaustive. Considerations in the Selection of Accounting Policies.

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

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

    (a) Prudence

    In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

    (b) Substance over Form

    The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.

    (c) Materiality

    Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements.

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

19. Such disclosure should form part of the financial statements.

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

21. Examples of matters in respect of which disclosure of accounting policies adopted will be required are contained in paragraph 14. This list of examples is not, however, intended to be exhaustive.

22. Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

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

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

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

26. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

27. If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

ACCOUNTING STANDARD (AS) 2

(This Accounting Standard includes paragraphs set in bold italic type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the General Instructions contained in part A of the Annexure to the Notification.)

Objective

A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognised. This Standard deals with the determination of such value, including the ascertainment of cost of inventories and any write-down thereof to net realisable value.

Scope

1. This Standard should be applied in accounting for inventories other than:

   (a) work in progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7, Construction Contracts);

   (b) work in progress arising in the ordinary course of business of service providers;

   (c) shares, debentures and other financial instruments held as stock-in-trade; and

   (d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

2. The inventories referred to in paragraph 1 (d) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Standard.

Definitions

3. The following terms are used in this Standard with the meanings specified:

   3.1 Inventories are assets:

      (a) held for sale in the ordinary course of business; (b) in the process of production for such sale; or

      (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

   3.2 Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

Measurement of Inventories

5. Inventories should be valued at the lower of cost and net realisable value.

   Cost of Inventories

6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Costs of Purchase

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Costs of Conversion

8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials.

9. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.

10. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative

sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products as well as scrap or waste materials, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other Costs

11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

12. Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

Exclusions from the Cost of Inventories

13. In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

    (a) abnormal amounts of wasted materials, labour, or other production costs;

    (b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

    (c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

    (d) selling and distribution costs.

Cost Formulas

14 . The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

15. Specific identification of cost means that specific costs are attributed to identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced. However, when there are large numbers of items of inventory which are ordinarily interchangeable, specific identification of costs is inappropriate since, in such circumstances, an enterprise could obtain predetermined effects on the net profit or loss for the period by selecting.

16. The cost of inventories, other than those dealt with in paragraph should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

17. A variety of cost formulas is used to determine the cost of inventories other than those for which specific identification of individual costs is appropriate. The formula used in determining the cost of an item of inventory needs to be selected with a view to providing the fairest possible approximation to the cost incurred in bringing the item to its present location and condition. The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the enterprise.

Techniques for the Measurement of Cost

18. Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

19. The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used.

Net Realisable Value

20. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs necessary to make the sale have increased. The practice of writing down inventories below cost to net realisable value is consistent with the view that assets should not be.

21. Inventories are usually written down to net realisable value on an item-by-item basis. In some circumstances, however, it may be appropriate to group similar or related

items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a classification of inventory, for example, finished goods, or all the inventories in a particular business segment.

22. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

23. Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance with the principles enunciated in Accounting standard (AS), Contingencies and events Occurring After the Balance Sheet Date.

24. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

25. An assessment is made of net realisable value as at each balance sheet date.

Disclosure

26. The financial statements should disclose:

    (a) the accounting policies adopted in measuring inventories, including the cost formula used; and

    (b) the total carrying amount of inventories and its classification appropriate to the enterprise.

27. Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are raw materials and components, work in progress, finished goods, stores and spares, and loose tools.

ACCOUNTING STANDARD (AS) 9

Revenue Recognition

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

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

Introduction

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

   (a) Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

   (b) It is reiterated that this Accounting Standard (as is the case of other accounting standards) assumes that the three fundamental accounting assumptions i.e., going concern, consistency and accrual have been followed in the preparation and presentation of financial statements.

   (c) It may be noted that this Accounting Standard is now mandatory. Reference may be made to the section titled 'Announcements of the Council regarding status of various documents issued by the Institute of Chartered Accountants of India' appearing at the beginning of this Compendium for a detailed discussion on the implications of the mandatory status of an accounting standard.

   (d) See also revised Accounting Standards Interpretation (ASI) 14, which is published elsewhere in this Compendium.

   — the rendering of services, and

   — the use by others of enterprise resources yielding interest, royalties and dividends.

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

   (i) Revenue arising from construction contracts;

   (ii) Revenue arising from hire-purchase, lease agreements;

   (iii) Revenue arising from government grants and other similar subsidies;

   (iv) Revenue of insurance companies arising from insurance contracts.

3. Examples of items not included within the definition of "revenue" for the purpose of this Statement are:

   (i) Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;

   (ii) Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;

   (iii) Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

   (iv) Realised gains resulting from the discharge of an obligation at less than its carrying amount;

   (v) Unrealised gains resulting from the restatement of the carrying amount of an obligation.

   Refer to AS 7 on 'Accounting for Construction Contracts'. AS 7 (issued 1983) has been revised in 2002 and titled as 'Construction Contracts'. The revised AS 7 is published elsewhere in this Compendium.

Definitions

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

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

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

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

Explanation

5. Revenue recognition is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the

transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

6. The Institute has issued an Announcement in 2005 titled 'Treatment of Inter-divisional Transfers' (published in 'The Chartered Accountant' May 2005, pp. 1531). As per the Announcement, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with Accounting Standard 9. [For full text of the Announcement reference may be made to the section titled 'Announcements of the Council regarding status of various documents issued by the Institute of Chartered Accountants of India' appearing at the beginning of this Compendium.]

7. Sale of Goods

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

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

8. Rendering of Services

8.1 Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

(i) Proportionate completion method—Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

(ii) Completed service contract method—Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.

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

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

(i) interest—charges for the use of cash resources or amounts due to the enterprise;

(ii) royalties—charges for the use of such assets as know-how, patents, trade marks and copyrights;

(iii) dividends—rewards from the holding of investments in shares.

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

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

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

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

10. Effect of Uncertainties on Revenue Recognition

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

10.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

10.3 When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

10.4 An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

10.5 When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.

11. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

12. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

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

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

   (i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable.

   (ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement.

   (iii) Dividends from Share: when the owner's right to receive payment investments in is established.

Disclosure

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

APPENDIX

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

A. Sale of Goods

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

   Revenue should be recognised notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

2. Delivered subject to conditions

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

   Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. In some cases, however, the installation process may be so simple in nature that it may be appropriate to recognise the sale notwithstanding that installation is not yet completed (e.g. installation of a factory-tested television receiver normally only requires unpacking and connecting of power and antennae).

(b) on approval

Revenue should not be recognised until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

(c) guaranteed sales i.e. delivery is made giving the buyer an unlimited right of return of the agreement. In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment, in which case it should be treated as indicated below.

(d) consignment sales i.e. a delivery is made whereby the recipient undertakes to sell the goods on behalf of the consignor

Revenue should not be recognised until the goods are sold to a third party.

(e) cash on delivery sales Revenue should not be recognised until cash is received by the seller or his agent.

3. Sales where the purchaser makes a series of instalment payments to the seller, and the seller delivers the goods only when the final payment is received.

Revenue from such sales should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.

4. Special order and shipments i.e. where payment (or partial payment) is received for goods not presently held in stock e.g. the stock is still to be manufactured or is to be delivered directly to the customer from a third party.

Revenue from such sales should not be recognised until goods are manufactured, identified and ready for delivery to the buyer by the third party.

5. Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date. For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognised as revenue.

6. Sales to intermediate parties i.e. where goods are sold to distributors, dealers or others for resale. Revenue from such sales can generally be recognised if significant risks of ownership have passed; however in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

7. Subscriptions for publications

   Revenue received or billed should be deferred and recognised either on a straight line basis over time or, where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

8. Instalment sales

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

9. Trade discounts and volume rebates

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

B. Rendering of Services

1. Installation Fees

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

2. Advertising and insurance agency commissions

   Revenue should be recognised when the service is completed. For advertising agencies, media commissions will normally be recognised when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission, which will be recognised when the project is completed. Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

3. Financial service commissions

   A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made or added to a loan or other account and settled in stages. The recognition of such revenue should, therefore, have regard to:

   (a) whether the service has been provided "once and for all" or is on a "continuing" basis;

   (b) the incidence of the costs relating to the service;

(c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

4. Admission fees

   Revenue from artistic performances, banquets and other special events should be recognised when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

5. Tuition fees

   Revenue should be recognised over the period of instruction.

6. Entrance and membership fees

   Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally capitalised. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided.