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AS 1 = DISCLOSURE OF ACCOUNTING POLICIES

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This standard talks about the disclosure of significant accounting policies and fundamental accounting assumptions used in the preparation of financial statements.

Every entity should disclose all SIGNIFICANT accounting policies in **notes on accounts** of the financial statements.

1. What is an accounting policy?

Accounting Policies are specific → Accounting principles & Methods } adopted by the entity → In preparation & presentation of FS

A number of accounting policies are available for measurement of each item in financial statements.

The management of the entity should **select suitable accounting policies** considering the nature of business, legal requirements, Accounting Standards requirements, etc.

Let us see some examples where we find different policies. The below list is NOT exhaustive:

Purpose	Policies
Valuation of inventory	FIFO, Weighted average cost, Standard cost, retail cost method, etc. (AS 2)
Valuation of Property, Plant and Equipment (PPE)	Cost model or Revaluation model (AS 10)

Fair valuation of PPE	Market value method, discounted cash flow method, earning capitalisation method, etc. (AS 10)
Construction contract revenue	Surveyor method, Percentage completion method based on costs incurred, etc. (AS 7)
Treatment of Government grant directly related to PPE	Recognising as deferred government grant or reduction from cost of asset, etc. (AS 12)

For example: Reliance Industries Ltd. selected the weighted average method for inventory valuation and the same is disclosed in the financial statements (notes on accounts) in the following manner:

Extract from RIL financial statements

Inventory

"Items of inventories are measured at lower of cost and net realisable value after providing for obsolescence. Cost of inventories comprises of cost of purchase, cost of conversion and other costs including manufacturing overheads net of recoverable taxes incurred in bringing them to their respective present location and condition.

Cost of raw materials, process chemicals, stores and spares, packing materials, trading and other products are determined on weighted average basis."

Benefits of disclosure of accounting policies

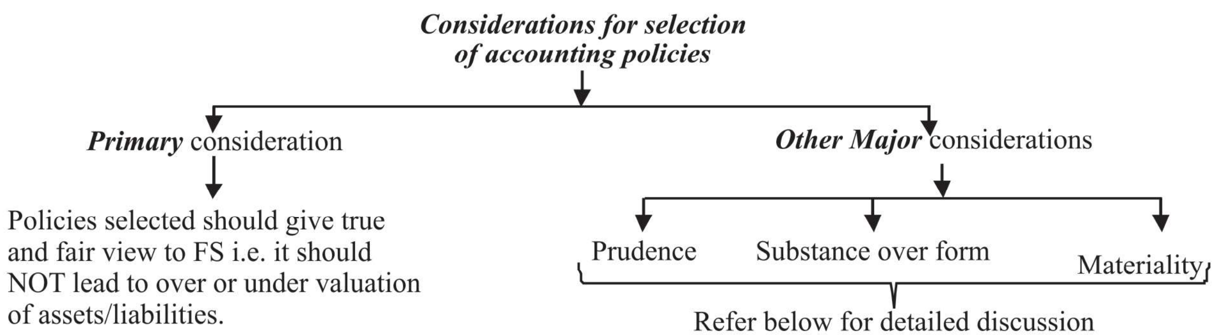
Disclosure of accounting policies helps the users;

1. in better understanding of financial statements.

2. to have a meaningful comparison of financial statements among the other entities in the industry.

2. Considerations for selection of Accounting policies

The selection of accounting policies is the **responsibility of the management** andwhile selecting the accounting policies, management should consider the following**:**



The following paragraphs explain the other major considerations in detail:

(1) Prudence

- The dictionary meaning is "*Caution with regard to practical matters*" and the word is *associated with wisdom, insight, and knowledge*.
- This means management should be **cautious and they should apply wisdom (knowledge)** while selecting accounting policies, i.e., they should consider the entity's nature of business, legal requirements, accounting standards, etc. in the selection of policies.
- In case of **revenue recognition**, it is prudent to **recognise profits only when they are realisable,** i.e., it should be recorded only when the entity establishes the right to receive revenue and it doesn't mean actual receipt of cash.
- **Provision** should be made for **all known liabilities and losses** even though the amount of loss is not certain and it should be determined by the best estimate based on the available information. You need to read and understand this sentence carefully – Provisions are recognised only when present obligation is arising from past activity and outflow of future economic benefit is probable. It DOESN'T mean next year operating expenditure or operating losses should be recognised in the current year.

Example 1

Exercise of prudence does not permit creation of hidden reserve by understating profits and assets or by overstating liabilities and losses. Suppose GST department filing a legal case for non-payment of taxes, a company should create a provision if it is probable to win the case. If the management is of the opinion that they can win the same based on the advocate's opinion they don't need to make a provision.

(2) Substance Over Form

- An entity should select the accounting policies which help to present a complete, relevant and accurate picture (Substance/Reality) of financial statements rather than legality i.e., Reality over legality.

You will understand better from the following examples:

Example 2

When assets are purchased on hire purchase, the purchaser becomes the legal owner only after the payment of last instalment. But all risks and rewards related to the asset are with the purchaser right from the beginning and the hire purchaser gets all economic benefits from the asset.

As per the definition of ***"asset"***, Asset is the one which is controlled by the entity and expected future economic benefits inflow to the entity.

Irrespective of the legality, hire purchaser should ***record the asset*** in its books of account by considering the reality over the legality.

Example 3

Company A is a ticket agent for RK tours and travels and it receives the ticket amount and commission from customers and remits the ticket amount to travels e.g. If Company A receives ₹ 1,050 (form), which includes ticket money of ₹ 1,000 and commission of ₹ 50. Even though ₹ 1,050 is received by the company, ₹ 50 of commission is the only income (Substance). Hence the entity should record revenue only to the extent of ₹ 50. The remaining ₹ 1,000 received on behalf of RK tours and travel is a liability to pay the travels.

(3) *Materiality*

- Financial statements should disclose "**all material**" items. It means that NO material item should be omitted from the financial statements.
- Information is material if its omission or misstatement could influence the economic decisions of users.
- The materiality depends on the size & nature of the item. A multi-national company may consider ₹ 1 crore as immaterial in proportion to its total activity, but ₹ 1 crore is material for a small local firm.
- At the same time, materiality is not always a matter of amount. A small amount lost by **fraudulent practices of certain employees** can indicate a serious flaw in the internal control system. In certain cases, quantitative limits of materiality are specified.
- As per the **Revised Schedule III** of the Companies Act, any item of income **or** expenditure which exceeds 1% of the revenue from operations (Sales value) **or** ₹1,00,000, whichever is higher should be disclosed separately. If any income or expense value is less than ₹ 1,00,000, can be clubbed under miscellaneous income or expenditure.
- As per the revised Schedule III – the company should disclose in Notes to Accounts, shares in the company held by each shareholder holding more than 5 % shares specifying the number of shares held.

3. Disclosure of Accounting Policies

- Accounting policies should form a part of the financial statements.
- Disclose all the policies **at one place** and it should not be spread over financial statements.
- Disclosure is NOT a REMEDY for wrong or inappropriate accounting.

Concept capsule 1

Mr. A is a chief accountant of ABC Ltd. The company is capitalising the routine repair expenditure with the fixed asset and it is disclosing the same as it is the company's accounting policy. Comment please.

Suggested answer

Routine repair expenditure is revenue expenditure and it does not increase the future economic benefits and does not satisfy the definition of Property, Plant and Equipment as per AS 10, hence such expenditure should be charged to P&L a/c as an expense in the year in which it is incurred. The current accounting treatment of the company is NOT correct and as it is said in the AS 1, disclosure is not a remedy for wrong accounting.

Concept capsule 2

Rama Ltd. follows the practice of disclosing accounting policies adopted in preparation of financial statements in the Directors' report. Comment on this practice.

Suggested answer

As per AS-1, Accounting policies should be part of financial statements. Director's report & Auditor's report are **not part** of financial statements.

Hence, the practice followed by the company is not correct. It should be disclosed as part of the financial statements.

Concept capsule 3

Lakshman Ltd has disclosed accounting policies related to fixed assets in Schedule E - Fixed assets, accounting policies relating to investments in Schedule F - Investments, and accounting policies relating to inventories in schedule G - Current assets, loans and advances and so on. Comment on this practice.

Suggested answer

As per AS-1, Accounting policies should be part of financial statements and all significant accounting policies should be disclosed **at one place** and these should **not be scattered** over various schedules.

In the given case, the accounting policies are scattered over various schedules which is **not** in accordance with AS -1. It should change the disclosure as required by the AS.

Concept capsule 4

Bharat Ltd. has not complied with AS 22 – *"Taxes on Income"* and the same is **disclosed in the notes on accounts**. Management of the entity says as non-compliance of AS is disclosed – Financial statements give a true and fair view? Comment

Suggested answer

As per AS-1, Disclosure of accounting policies is NOT a remedy for wrong accounting,. i.e., mere disclosure of errors / non-compliance will not correct the same.

In the given case, the company did not comply with AS-22, which is non-compliance of accounting standards as per Sec. 129 of the Companies Act, 2013. This non-compliance does not give a true and fair view to financial statements.

4. Fundamental Accounting Assumptions *(IPCC May 2013 & Nov 2017)*

There are certain fundamental assumptions in the preparation and presentation of financial statements. These are assumed by the users while using financial statements.

Fundamental accounting assumptions

Going concern

Consistency

Accrual

Disclosure of fundamental accounting assumptions is NOT necessary when the entity is following the assumptions. Disclosure is NECESSARY if the entity DOES NOT follow

(1) Going Concern

- It is assumed that an entity continues its business in the foreseeable future. It means the entity has *neither* intention *nor* the necessity of closing its operations or liquidating its assets in the near future.
- In general, an entity is assumed to be a going concern unless there is significant information to the contrary.
- The going concern concept is **not very clearly defined** anywhere in Accounting standards, hence we can take help of other GAAPs.

The Standard uses the words "foreseeable future", but how long management should look into the future?

- There is NO answer given in AS-1 but we can take the help of Ind AS which is followed by listed entities and other large entities in the country, as per Ind AS-1 (Indian Accounting standard) – "*In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is* ***at least twelve months from the end of the balance sheet date****. The degree of consideration depends on the facts in each case*".

If the management believes that an entity may **NO LONGER BE A GOING CONCERN –**

(1) the entity **should account** for all its assets at net realisable value ***OR*** on a liquidation basis **but not** on the historical cost basis.**Any gain or loss,** i.e., the difference **between the carrying amount and net realisable value should be transferred to P&L;** and

(2) It should **disclose the basis of preparation** of financials;

- If there is significant **uncertainty** on the going concern assumption, the management should **disclose the facts** of the situation in the financial statements.

(2) Consistency

It is assumed that, accounting policies followed during the current year are same as the previous year and there is no change in accounting policies.

- ➢ If there is any change in accounting policy, which has material effect, the entity should disclose the following in the year of change in policies:
  - ♦ Which accounting policy is changed?
  - ♦ Which item in financial statements is affected?
  - ♦ *Quantify* the effect on financial statements due to change in policy.
  - ♦ If not able to quantify the effect, wholly or partly, disclose the fact.
  - ♦ Change in accounting policy has taken place in the current year, but there is no material effect in the current year and it may probably affect materially in the future years – in such situation disclose the amount of effect in the year of change of accounting policy only.

Concept capsule 5

In the books of M/s Prashant Ltd., closing inventory as on 31.03.20X2 amounts to ₹ 1,63,000 (based on FIFO method).

The company has decided to change from FIFO method to weighted average method for ascertaining the cost of inventory from the year 20X1-X2. Based on weighted average method, closing inventory as on 31.03. 20X2 amounts to ₹ 1,47,000. Realisable value of the inventory as on 31.03.20X2 amounts to ₹ 1,95,000.

Discuss disclosure requirement of change in accounting policy as per AS-1.

Suggested answer

As per AS-1, any change in an accounting policy which has a material effect should be disclosed in the financial statements. 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.

Thus Prashant Ltd. should disclose the change in valuation method of inventory and its effect on financial statements. The company may disclose the change in accounting policy in the following manner:

"***The company values its inventory at lower of cost and net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year, i.e., 20X1-X2, the company has changed to weighted average method, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced current profit and value of inventory by ₹16,000***".

(3) *Accrual*

- Generally, it is assumed that the entity is following Accrual method of accounting the events and transactions.
- As per Accrual Concept, expenses incurred for a particular accounting period should be recorded in the same period, irrespective of payment of cash. The same holds true for revenues, i.e., revenues earned in a specific accounting period are construed as income of the same period, irrespective of its receipt.
- This concept is very important to compute the true income of a business firm for each accounting period. Let us illustrate. Suppose, a business firm has salary expense of ₹ 50 lakh per month. Due to the cash shortage, even though employees worked, the firm could not pay salary for the last two months (Feb & Mar). The salary paid is for 10 months only (₹ 50 lakh × 10 months = ₹ 500 lakh). Irrespective of the cash outflow, as per accrual concept we should recognise all 12 months' salary (₹ 50 lakh × 12 months = ₹ 600 lakh) as an expense in the CY P&L a/c.

We suggest you to try the below concept capsule after reading the entire concept at least once:

Concept capsule 6

State whether the following statements are **'True' or 'False'**. Also give reason for your answer.

(i) Certain fundamental accounting assumptions underline the preparation and presentation of financial statements. They are usually specifically stated because their acceptance and use are not assumed.

(ii) If fundamental accounting assumptions are not followed in presentation and preparation of financial statements, a specific disclosure is not required.

(iii) All significant accounting policies adopted in the preparation and presentation of financial statements should form part of the financial statements.

(iv) Any change in an accounting policy, which has a material effect should be disclosed. Where the amount by which any item in the financial statements is affected by such change is not ascertainable, wholly or in part, the facts need not to be indicated.

Suggested answer

(i) **False:** As per AS-1 "Disclosure of Accounting Policies", fundamental accounting assumptions are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

(ii) **False:** As per AS-1, if the fundamental accounting assumptions are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

(iii) **True:** 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. The disclosure of the significant accounting policies as such should form part of the financial statements and they should be disclosed in one place.

(iv) **False:** 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. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

***Note*:**

Section 128 of the Companies Act, 2013 requires that accrual basis of accounting should be followed for a true and fair view of such statements. Therefore, there is no option available to the companies to follow cash basis.