DISCLOSURE OF ACCOUNTING POLICIES

AS-1

Scope

The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users, in making economic decisions.

Financial statements portray the effect of past events and transactions. Accounting policies and methods adopted by an enterprise, in turn, influence the effect of past events and transactions. Users must be able to compare the:

- financial statements of any ***one enterprise*** through time so that trends and movements in performance and position can be identified, and
- status of ***different enterprises*** for an evaluation of relative financial position and performance.

The disclosure by an entity of its accounting policies, enable users to-

- understand the past
- extrapolate to the future

A critical qualitative characteristic of “comparability” is that users be informed of not merely the accounting principles and methods adopted by the enterprises, but the changes in such policies introduced and the monetary effect of such changes, as well.

This standard deals with the disclosure of significant accounting policies followed in preparation and presentation of financial statements. The purpose is to promote a better understanding of financial statements by establishing through an Accounting Standard (AS), a mandatory requirement that all significant accounting policies ought to be disclosed as also the manner in which such accounting policies are to be disclosed in the financial statements.

Accounting Policies

Accounting policies refer to:

a) Specific accounting principles, and

b) Methods adopted by enterprises, in applying these principles in the preparation and presentation of financial statements.

Accounting Policy Components

Principle	Method of applying principle
Providing depreciation on an asset to account for loss in value	Straight line, Written down value basis or any other appropriate method

Disclosure needs arise because accounting policies can differ

Accounting principles and methods can differ between one enterprise and another, in the areas of recognition, treatment or valuation of assets, or recognition of transactions or events. An illustrative list of examples is given below:

i. Accounting conventions followed
ii. Basis of accounting—Historical or Current cost
iii. Valuation of inventory
iv. Valuation of investments
v. Valuation of fixed assets including revaluation
vi. Policies relating to depreciation of fixed assets
vii. Translation of foreign currency transactions or items
viii. Treatment of Government grants
ix. Treatment of goodwill
x. Recognition of a liability for retirement benefits
xi. Recognition of profit on long-term contracts
xii. Absorption of costs incurred on research and development
xiii. Treatment of preliminary, or, capital issue expenses
xiv. Treatment of Lease rental income or lease rental payment
xv. Treatment of expenditure during construction
xvi. Treatment of contingent liabilities

Fundamental Accounting Concepts

AS-1 highlights three important practical rules. [The term “rules” is used consciously to focus on the fact that over time, these are capable of variation and evolve as the depth and profundity of accounting practice increases].

- ***Going Concern Concept***

  We apply this concept on the basis that the reporting entity is normally viewed to be continuing in operation **in the foreseeable future**, and without there being any intention or necessity for it to either liquidate or curtail materially its scale of business operations.

- ***Accrual Concept***

  This is relevant in the area of revenue and costs. These are accrued, i.e., recognised, as they are earned or incurred (and not as cash is received or paid). Also, they are recorded in the period to which they relate.

- ***Consistency Concept***

  There should be consistency of accounting treatment of comparable (similar) items, not only within each accounting period, but also from one period to another.

These concepts, which are fundamental to accounting, are the broad-based assumptions, underlying preparation of financial statements periodically. Financial statements are assumed to be prepared by adhering, among others, to these concepts.

Unless any contrary position is unequivocally brought to notice, the user can validly presume that these principles have been followed. Consequently, if any one of these principles is not adhered to, such a fact ought to be disclosed.

Selection of appropriate accounting policies

Financial statements (e.g., annual accounts) are internationally recognised as a "composite whole" with, Balance Sheet, Statement of Profit and Loss, Notes on accounts, and cash flow picture, as its constituent elements. Entities governed by the provisions of Companies Act, or other Statutes while complying with the detailed provisions in the relevant statues, should also ensure that the accounts do give a true and fair view of the financial position and performance. A remote possibility of a conflict between compliance with detailed provisions in the Statues and the achievement of truth and fairness cannot perhaps be taken as entirely non-existing. In such a situation, there is an overriding obligation to provide a **"true and fair view"** to users of financial statements.

It is this overriding obligation that constitutes the **"major consideration"** in the determination and selection of accounting policies that are appropriate to an entity, event or transaction. Rightly, therefore, AS-1 lays emphasis on true and fair view being kept in primary focus for adoption of any accounting policy.

Consider an entity using projector lights, the useful life of which is governed by the number of hours it is in use. The basis for an appropriate accounting policy for depreciating such an asset would be the actual number of hours such an asset is put to use. Selection of a straight-line method, allowing for a five-year life would apparently be inappropriate. Consider another case of usage of a machinery wear and tear of which is higher in initial years, relative to later years. Selection of written down value method of depreciation would be appropriate in this case, as opposed to a straight-line method. Viewed in this backdrop, true and fair principle would get vitiated if the accounting policy selected is inappropriate.

An enterprise has, therefore, to exercise scrupulous care in the selection and application of accounting principles and methods. Such a selection is guided by "three major considerations".

(a) Prudence

Prudence is the inclusion of a degree of caution in the exercise of judgements needed in making estimates required under conditions of uncertainty.

By exercising prudence, an enterprise does not recognise profits on the basis of anticipation. These are recognised only when realised **though not necessarily in cash**. However, all known losses are anticipated and provided for.

For example, in determining the carrying amount of inventory, the profit margins are ignored and yet, the realisable value if less than cost is taken cognizance of.

(b) Substance over form

If information is to represent faithfully the transactions or events, it is essential that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

For example, where rights and interests in a property stands transferred while legal documentation for the transfer is yet to be completed, the transaction should be recorded as a sale in the books of transferor and acquisition in the books of transferee. While distinguishing an amalgamation in the nature of merger, from one that of purchase, we do look at the substance of the transaction (i.e. whether the shareholders come together in a substantially equal partnership to share risks and benefits), over its form. Under AS-7(R) Construction Contracts, this concept of substance over form has been fittingly adopted in the determination of "what constitutes a single contract" for recognition of costs and revenues,

(c) Materiality

The relevance of information is affected by its materiality. Information is material if its misstatement, i.e. omission or erroneous statement, could influence the economic decisions taken by the user, based on such financial statements. Accordingly, financial statements should disclose all material items, i.e., knowledge of which might influence the decision of the user of financial statements.

Three major considerations in selecting accounting policies are highlighted in the Standard. Other qualitative characteristics of accounting information, such as (i) relevance, (ii) neutrality, (iii) completeness, and (iv) reliability are equally critical to users in order that financial statements are meaningful. In the selection and adoption of accounting policies these aspects should also be kept in view.

Disclosure of Accounting Policies

All significant policies adopted in the preparation and presentation of financial statements should be disclosed at one place and should form part of the financial statements.

It is customary to furnish a summary of the accounting policies in respect of the following areas:

- Accounting Convention
- Basis of Accounting
- Fixed Assets
- Depreciation
- Revaluation of Assets
- Investments
- Inventories
- Revenue Recognition
- Investment Income
- Borrowing Cost
- Proposed Dividend
- Retirement Benefits
- Lease Rentals (Lease Income)
- Research and Development Costs
- Taxes on income
- Foreign currency translation
- Claims
- Segment Reporting
- Financial and Management Information Systems
- Intangible assets

Changes in the Accounting Policies - Dealt with in AS- 5

a) An enterprise is free to change its accounting policies, unless it violates any statutory provisions, or codes laid down in a mandatory Accounting Standard, and provided of course such a change leads to better and more meaningful presentation of accounting information. If, however, such a change may have a material effect on the financial statements of the current accounting period or later periods, such changes should be disclosed.

b) Where a change in the accounting policies carries with it a material impact on the performance and operations in the current period, the amount by which any item in the financial statement is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable wholly or partly, the fact should be indicated. If a change in the accounting policy has material effect only on the financial statements of a subsequent period, the fact of such change should be appropriately disclosed in the period in which the change is adopted.