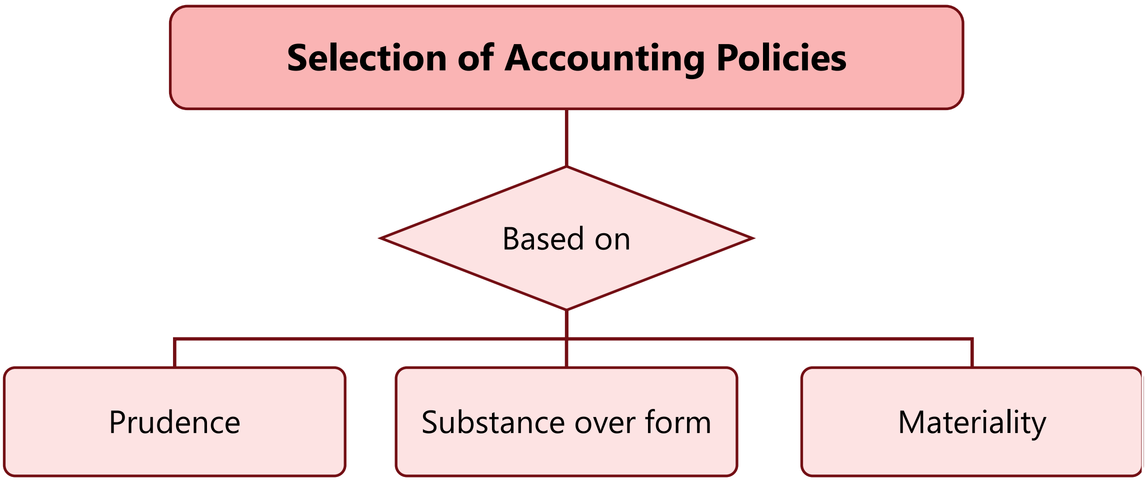
UNIT – 5 ACCOUNTING POLICIES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the meaning of 'Accounting Policies'.
- Familiarize with the situations under which selection from different accounting policies is required.
- Grasp the conditions where change in accounting policy can be made and the consequences arising from such change.

UNIT OVERVIEW



5.1 MEANING OF ACCOUNTING POLICIES

Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions that have already been explained in Unit 2 of Chapter 1. There is no single list of accounting policies, which are applicable to all enterprises in all circumstances. Enterprises operate in diverse and complex environmental situations and so they have to adopt various policies. The choice of specific accounting policy appropriate to the specific circumstances in which the enterprise is operating, calls for considerate judgement by the management. ICAI has been trying to reduce the number of acceptable accounting policies through Guidance Notes and Accounting Standards in its combined efforts with the government, other regulatory agencies and progressive managements. Already it has achieved some progress in this respect.

The areas wherein different accounting policies are frequently encountered can be given as follows:

(1) Valuation of Inventories;

(2) Valuation of Investments.

This list should not be taken as exhaustive but is only illustrative. As the course will progress, students will see the intricacies of the various accounting policies.

Suppose an enterprise holds some investments in the form of shares of a company at the end of an accounting period. For valuation of shares, the enterprise may adopt FIFO, average method etc. The method selected by that enterprise for valuation is called an accounting policy.

5.2 SELECTION OF ACCOUNTING POLICIES

Choice of accounting policy is an important policy decision which affects the performance measurement as well as financial position of the business entity. Selection of inappropriate accounting policy may lead to understatement or overstatement of performance and financial position. Thus, accounting policy should be selected with due care after considering its effect on the financial performance of the business enterprise from the angle of various users of accounts.

It is believed that no unified and exhaustive list of accounting policies can be suggested which has universal application. Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz., Prudence, Substance over form, and Materiality. The financial statements should be prepared on the basis of such accounting policies, which exhibit true and fair view of state of affairs of Balance Sheet and the Profit & Loss Account.

Examples wherein selection from a set of accounting policies is made, can be given as follows:–

1. Inventories are valued at cost except for finished goods and by-products. Finished goods are valued at lower of cost or market value and by-products are valued at net realizable value.

2. Investments (long term) are valued at their acquisition cost. Provision for permanent diminution in value has been made wherever necessary.

Sometimes a wrong or inappropriate treatment is adopted for items in Balance Sheet, or Profit & Loss Account, or other statement. Disclosure of the treatment adopted is necessary in any case, but disclosure cannot rectify a wrong or inappropriate treatment.

5.3 CHANGE IN ACCOUNTING POLICIES

A change in accounting policies should be made in the following conditions:

(a) It is required by some statute or for compliance with an Accounting Standard

(b) Change would result in more appropriate presentation of financial statement

Change in accounting policy may have a material effect on the items of financial statements. For example, if cost formula used for inventory valuation is changed from weighted average to FIFO, or if interest is capitalized which was earlier not in practice, or if proportionate amount of interest is charged to inventory which was earlier not the practice, all these may increase or decrease the net profit. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts. Therefore, it is necessary to quantify the effect of change on financial statement items like assets, liabilities, profit/loss.

For example, Omega Enterprises revised its accounting policy relating to valuation of inventories to include applicable production overheads. It intends to do as it believes that such change would result in a more appropriate presentation of its financial statements.

SUMMARY

- Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions.

- Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz., Prudence, Substance over form, and Materiality.

- A change in accounting policies should be made in the following conditions:
  (a) It is required by some statute or for compliance with an Accounting Standard.
  (b) Change would result in more appropriate presentation of financial statement.

TEST YOUR KNOWLEDGE

True and False

1. *There is a single list of accounting policies, which are applicable to all enterprises in all circumstances.*
2. *Selection of accounting policy doesn't impact financial performance and financial position of the business*
3. *A change in accounting policies should be made as and when business like to show result as per their choice.*
4. *Choosing FIFO or weighted average method for inventory valuation is selection of accounting policy.*
5. *Selection of an inappropriate accounting policy decision will overstate the performance and financial position of a business entity every time.*

Multiple Choice Questions

1. *A change in accounting policy is justified*
   (a) To comply with accounting standard and law.
   (b) To ensure more appropriate presentation of the financial statement of the enterprise.
   (c) Both (a) and (b).
2. *Accounting policy for inventories of Xeta Enterprises states that inventories are valued at the lower of cost determined on weighted average basis or net realizable value. Which accounting principle is followed in adopting the above policy?*
   (a) Materiality.
   (b) Prudence.
   (c) Substance over form.

3. *The areas wherein different accounting policies can be adopted are*

   (a) *Providing depreciation.*

   (b) *Valuation of inventories.*

   (c) *Both the option.*

4. *Selection of an inappropriate accounting policy decision may*

   (a) *Overstate the performance and financial position of a business entity.*

   (b) *Understate/overstate the performance and financial position of a business entity.*

   (c) *Overstate the performance of a business entity.*

5. *Accounting policies refer to specific accounting*

   (a) *Principles.*

   (b) *Methods of applying those principles.*

   (c) *Both (a) and (b).*

Theoretical Questions

1. *Define Accounting Policies in brief. Identify few areas wherein different accounting policies are frequently encountered.*

2. *"Change in accounting policy may have a material effect on the items of financial statements." Explain the statement with the help of an example.*

ANSWERS/HINTS

True and False

1. False: There cannot be single list of accounting policies, which are applicable to all enterprises in all circumstances. There would always be different policies chosen by different industries under different circumstances.

2. False: Accounting policy has big impact on value of items goes under financial statements, hence it impacts financial performance and financial position of the business.

3. False: A change in accounting policies should be made in the following conditions:

   (a) It is required by some statute or for compliance with an Accounting Standard.

   (b) Change would result in more appropriate presentation of financial statement.

4. True: An enterprise may adopt FIFO or weighted average method for inventory valuation and the method selected for valuation is called an accounting policy.

5. False: It could understate/overstate the performance and financial position of a business entity.

Multiple Choice Questions

1.	**(c)**	2.	**(b)**	3.	**(b)**	4.	**(b)**	5.	**(c)**		

Theoretical Questions

1. Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. For details, refer para 5.1.

2. Change in accounting policy may have a material effect on the items of financial statements. For example, if cost formula used for inventory valuation is changed from weighted average to FIFO. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts.