DISCLOSURE OF ACCOUNTING POLICIES

AS 01

Objectives		
• *Disclosure of significant accounting policies followed in preparing and presenting financial statements.* • *Manner in which accounting policies are disclosed in financial statements*		
Accounting Policies		
Meaning	These are: → Specific accounting principles (Eg: AS 2 – Lower of Cost or NRV) and → Methods of applying those principles (Eg: AS 2 FIFO or Weighted Average) adopted by the enterprise in the preparation & presentation of financial statements.	
Notes	• There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which the enterprises operate make alternative accounting policies acceptable. • Choice of the appropriate accounting policies in these specific circumstances of each enterprise requires considerable judgement by the management of the enterprise.	
Fundamental Accounting Assumptions		
Name	Going concern	It is assumed that an enterprise will continue its operations in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations.
	Consistency	It is assumed that accounting policies are consistent from one period to another.
	Accrual	Under this basis of accounting, transactions are recognised as soon as they occur, whether or not cash or cash equivalent is actually received or paid.
Notes	• If the above said assumptions are followed in financial statements, specific disclosure is not required. • If a fundamental accounting assumption is not followed, the fact should be disclosed. • Disclosure is necessary if not followed.	
Considerations in the selection of Accounting Policies		
Primary consideration	Financial statements should present true and fair view of →The state of affairs of the enterprise as at the balance sheet date and →The profit or loss for the period ended on that date	
Secondary consideration	Prudence	While recognizing the incomes, expenses and losses the principle of prudence should be followed. The income should be recognized only when it is certain to be received. (Profits are not anticipated) The provision should be created for all the known liabilities and losses.

<table>
<tr><td rowspan="2"></td><td>Substance over form</td><td>It implies that suitable changes may be made in the legal form of presentation to disclose the substance in a true and fair manner. Example:
a) Agreement to Sell
b) Hire Purchase Transaction</td></tr>
<tr><td>Materiality</td><td>Any item of financial statements which can influence the decision of user is termed as material item & all material items should be disclosed in the financial statements.
Example: A company should disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or 1,00,000 whichever is higher. (Sch III)</td></tr>
<tr><th colspan="3">Disclosure of Accounting Policies</th></tr>
<tr><td>Points to note</td><td colspan="2">➢ All the accounting policies need to be disclosed at one place
➢ These should form an integral part of the financial statements.
➢ These are usually disclosed in “Notes to Accounts”</td></tr>
<tr><td>Examples (Areas in which different accounting policies may be adopted)</td><td colspan="2">• Valuation of Inventory
• Treatment of Goodwill
• Valuation of Investment
• Treatment of Retirement benefit
• Valuation of Fixed assets
• Treatment of Contingent liabilities.
• Treatment of Expenditure during construction
• Conversion or translation of Foreign currency items.</td></tr>
<tr><th colspan="3">Change in an Accounting Policy</th></tr>
<tr><td>When change can be done?</td><td colspan="2">Accounting policy may be changed only if
→ Required by Statute
→ For Compliance with an Accounting Standard
→ For better presentation or true and fair view of the financial statements</td></tr>
<tr><td>Points to note</td><td colspan="2">• Any change in an accounting policy 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
• The amount by which any item 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.
• Any change in policy which does not affect the current period but can have material effect in the later periods, then such fact should be disclosed.</td></tr>
<tr><td>Disclosure requirement</td><td colspan="2">• Old policy
• New policy
• Reason for change in policy
• Impact of such change</td></tr>
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ASSIGNMENT QUESTIONS

Question 1

X Limited has sold its building for ₹ 50 lakhs to the purchaser who has paid the full price. Company has given possession to the purchaser. The book value of the building is ₹ 35 lakhs. As at 31st March, 2022, documentation and legal formalities are pending. The company has not recorded the sale. It has shown the amount received as advance. Do you agree with this accounting treatment done by X Ltd.? What accounting treatment should the buyer give in its financial statements?

Solution

Although legal title has not been transferred, the economic reality & substance is that rights and beneficial interest in the immovable property have been transferred. Therefore, recording of disposal by the transferor would in substance represent the transaction entered into.
In view of this, X Ltd. should record the sales and recognize the profit of ₹ 15 lakhs in its Statement of Profit and Loss. It should remove building account from its balance sheet.
Further, in its 'Notes to Accounts', X Ltd. should disclose the following:
"Building has been sold and full consideration has been received and possession of the same has been handed over to the buyer. However, documentation and legal formalities are pending as on 31.3.2022."
The buyer should recognize the building as an asset in his balance sheet and charge depreciation on it. The buyer should disclose in his notes to account that possession has been received however documentation and legal formalities are pending.

Question 2 *(RTP May 2020) (Similar) / (ICAI Study Material)*

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 & 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.

(v) There is no single list of accounting policies which are applicable to all circumstances

Solution

(i) False; As per AS 1 "Disclosure of Accounting Policies", 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.

(ii) False; As per AS 1, if fundamental accounting assumptions; 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.

(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 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.

(v) True; As per AS 1, 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.

Question 3 *(ICAI Study Material) / (RTP May 2023) (Similar)*

In the books of M/s Prashant Ltd. closing inventory as on 31.03.2022 amounts to ₹ 1,63,000 (on the basis of FIFO method). The company decides to change from FIFO method to weighted average method for ascertaining the cost of inventory from the year 2021-22. On the basis of weighted average method, closing inventory as on 31.03.2022 amounts to ₹ 1,47,000. Realisable value of the inventory as on 31.03.2022 amounts to ₹ 1,95,000.
Discuss disclosure requirement of change in accounting policy as per AS-1.

Solution

As per AS 1 "Disclosure of Accounting Policies", 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 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. 2021-22, 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'.

Question 4 *(RTP May 2018) / (RTP May 2021) (Similar) / (ICAI Study Material)*

Jagannath Ltd. had made a rights issue of shares in 2021. In the offer document to its members, it had projected a surplus of ₹ 40 crores during the accounting year to end on 31st March, 2022. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of ₹ 10 crores. The board in consultation with the managing director, decided on the following:

(i) Value year-end inventory at works cost (₹ 50 crores) instead of the hitherto method of valuation of inventory at prime cost (₹ 30 crores).

(ii) Not to provide for "after sales expenses" during the warranty period. Till the last year, provision at 2% of sales used to be made under the concept of "matching of costs against revenue" and actual expenses used to be charged against the provision. The board now decided to account for expenses as and when actually incurred. Sales during the year total to ₹ 600 crores.

(iii) Provide for permanent fall in the value of investments - which fall had taken place over the past five years - the provision being ₹ 10 crores.

As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 2021-2022.

Solution

As per AS 1, 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.

Accordingly, the notes on accounts should properly disclose the change and its effect.
Notes on Accounts:

1) During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost as was the practice till last year. This has been done to take cognizance of the more capital intensive method of production on account of heavy capital expenditure during the year. As a result of this change, the year-end inventory has been valued at ₹ 50 crores and the profit for the year is increased by ₹ 20 crores.
2) So far, the company has been providing 2% of sales for meeting "after sales expenses during the warranty period. With the improved method of production, the probability of defects occurring in the products has reduced considerably. Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for the year is increased by ₹ 12 crores than would have been the case if the old policy were to continue.
3) The company has decided to provide ₹ 10 crores for the permanent fall in the value of investments which has taken place over the period of past five years. The provision so made has reduced the profit disclosed in the accounts by ₹ 10 crores.

Question 5 *(ICAI Study Material)*

ABC Financial Services Ltd. is engaged in the business of financial services and is undergoing tight liquidity position, since most of the assets of the company are blocked in various claims/petitions in a Special Court. ABC Financial Services Ltd. has accepted Inter Corporate Deposits (ICDs) and it is making its best efforts to settle the dues. There were claims at varied rates of interest, from lenders, from the due date of ICDs to the date of repayment. The company has provided interest, as per the terms of the contract till the due date and a note for non-provision of interest from the due date to date of repayment was mentioned in financial statements. On account of uncertainties existing regarding the determination of the amount and in the absence of any specific legal obligation at present as per the terms of contracts, the company considers that these claims are in the nature of "claims against the company not acknowledged as debt", and the same has been disclosed by way of a note in the accounts instead of making a provision in the Profit and Loss Account. State whether the treatment done by the company is correct or not as per relevant accounting Standard.

Solution

AS 1 recognizes 'prudence' as one of the major considerations governing the selection and application of accounting policies. In view of the uncertainty attached to future events, profits are not anticipated but recognized only when realized 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. Also as per AS 1, 'accrual' is one of the fundamental accounting assumptions.

Irrespective of the terms of the contract, so long as the principal amount of a loan is not repaid, the lender cannot be replaced in a disadvantageous position for non-payment of interest in respect of overdue amount. From the aforesaid, it is apparent that the company has an obligation on account of the overdue interest.

In this situation, the company should provide for the liability (since it is not waived by the lenders) at an amount estimated or on reasonable basis based on facts and circumstances of each case. However, in respect of the overdue interest amounts, which are settled, the liability should be accrued to the extent of amounts settled. Non-provision of the overdue interest liability amounts to violation of accrual basis of accounting. Therefore, the treatment, done by the company, of not providing the interest amount from due date to the date of repayment is not correct.

Question 6 *(Inter Nov 2018) (5 Marks) / (RTP May 2020) / (RTP Nov 2023) (Similar)*

HIL Ltd. was making provision for non-moving stocks based on no issues having occurred for the last 12 months upto 31.03.2021. The company now wants to make provision based on technical evaluation during the year ending 31.03.2022.

Total value of stock ₹ 120 lakhs
Provision required based on technical evaluation ₹ 3.00 lakhs.
Provision required based on 12 months no issues ₹ 4.00 lakhs.

You are requested to discuss the following points in the light of Accounting Standard (AS)-1:

(i) Does this amount to change in accounting policy?
(ii) Can the company change the method of accounting?

Solution

The decision of making provision for non-moving inventories on the basis of technical evaluation does not amount to change in accounting policy. Accounting policy of a company may require that provision for non-moving inventories should be made but the basis for making provision will not constitute accounting policy. The method of estimating the amount of provision may be changed in case a more prudent estimate can be made.

In the given case, considering the total value of inventory, the change in the amount of required provision of non-moving inventory from ₹ 4 lakhs to ₹ 3 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of HIL Ltd. for the year 2021-22 in the following manner:

"The company has provided for non-moving inventories on the basis of technical evaluation unlike preceding years. Had the same method been followed as in the previous year, the profit for the year and the value of net assets at the end of the year would have been lower by ₹ 1 lakh."

PRACTICE QUESTIONS

Question 1 *(Inter Dec 2021) (5 Marks)*

a) ABC Ltd. was previously making provision for non-moving stocks based on stocks not issued for the last 12 months up to 31.03.2020. Now, the company wants to make provisions based on technical evaluation during the year ending 31.03.2021.
Total value of stock ₹ 133.75 lakhs
Provision required based on technical evaluation ₹ 4.00 lakhs
Provision required based on 12 months not issued ₹ 5.00 lakhs.

b) In the Books of Kay Ltd., Closing stock as on 31st March, 2021 amounts to ₹ 1,24,000 (on the basis of FIFO method)
The company decides to change from FIFO method to weighted average method for ascertaining the cost of inventory from the year 2020-2021. On the basis of weighted average method, closing stock as on 31st March, 2021 amounts to ₹ 1,15,000. Realisable value of the inventory as on 31st March, 2021 amounts to ₹ 1,54,000.

Discuss Disclosure Requirements of change in accounting policy in above cases as per AS 1.

Solution

a) The decision of making provision for non-moving inventories on the basis of technical evaluation does not amount to change in accounting policy. Accounting policy of a company may require that provision for non-moving inventories should be made. The method of estimating amount of provision maybe changed in case more prudent estimate canbe made In the given case, considering the total value of inventory, the change in the amount of required provision of non-moving inventory from ₹ 5 lakhs to ₹ 4 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2020 -21:
"The company has provided for non-moving inventories on the basis of technical evaluation unlike preceding years. Had the same method been followed as in the previous year, the profit for the year and the corresponding effect on the year end net assets would have been lower by ₹ 1 lakh."

b) As per AS 1 "Disclosure of Accounting Policies", 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 company 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 inventory at lower of cost & net realizable value. Since net realizable 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. 2020-21, 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 & value of inventory by ₹ 9,000."

Question 2 *(Inter May 2022) (5 Marks)*

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

a) 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.

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

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

d) 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.

Solution

a) False: As per AS 1 "Disclosure of Accounting Policies", 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.

b) False: As per AS 1, if the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If fundamental accounting assumption is not followed, fact should be disclosed.

c) 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 significant accounting policies as such should form part of the financial statements and they should be disclosed in one place.

d) 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.

Question 3 *(ICAI Study Material)*

Give examples of areas where accounting policies adopted could be different for different enterprises. Would there be any adverse impact due to the adoption of different policies, and if yes, how does Accounting Standard 1 seek to address such issue?

Solution

There are various areas where different accounting policies could be adopted by different entities within the same industry. An entity may choose to value its inventories using FIFO method, whereas another entity may choose to value the same using Weighted Average method. While an entity is free to choose its accounting policy as long as in the financial statements reflect 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, the application of different accounting policies by different entities affects the comparability of the financial statements of such different entities by stakeholders, analysts, investors etc.

To mitigate the loss of comparability, Accounting Standard 1, Disclosure of Accounting Policies requires disclosure of significant accounting policies as a part of the financial statements. This would help users of the financial statements to understand the policies followed by different entities, particularly if they belong to the same industry, and make a correct analysis of each entity resulting in more informed decision-making.

Question 4 *(Inter May 2023) (5 Marks)*

You are required to comment on the following cases as per the provisions of Accounting Standard-1 'Disclosure of Accounting Policies'

a) Bee Limited has not complied with AS-2 "Valuation of inventories" and the same is disclosed in the Notes on Accounts. Management is of the view that the financial statements give a true and fair view as non-compliance with AS-2 is disclosed.

b) Cee Limited sold its Office Building for ₹ 10,00,000 on 1st March, 2023. The buyer has paid the full amount and taken possession of the building. The book value of the Office Building is ₹ 4,00,000. On 31st March 2023, documentation and legal formalities are pending. The company has not recorded the disposal and the amount received is shown as an advance.

c) Dee Limited has prepared its accounts on cash basis and the same is not disclosed.

d) Jee Limited disclosed significant accounting policies adopted in the preparation of financial statements, in the Directors' Report.

Solution

a) As per AS-I disclosure of accounting policies is not a remedy for wrong or inappropriate treatment in accounting. In the given case the financial statement does not give a true and fair view as they are not in compliance with AS-2.

b) Considering the substance over form as per AS-I, documentation and legal formalities represent the form of the transaction, although the legal title has not been transferred, the economic reality and substance are that the rights and beneficial interest in the Office Building have been transferred. Therefore, recording of acquisition/ disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

c) Accrual is a fundamental accounting assumption. If it is not followed by the company, the facts should be disclosed under AS-I. Hence the company should disclose the fact that the cash basis of accounting has been followed in the notes on accounts.

d) The practice followed by the company is not correct. It should be disclosed as part of financial statements (The director's report is not part of financial statements).

Question 5 *(Inter Nov 2023) (5 Marks)*

Discuss Disclosure requirements in following cases as per AS 1.

(i) Accountant of A Ltd. charges a probable loss of losing a suit in books of accounts and also disclosed the same fact in financial statements. The probability of losing the suit is 25%.

(ii) Accountant of A Ltd. capitalized all the revenue expenses of repair and maintenance during the year to Plant & Machinery and is also disclosing the same as company policy in financial statements.

(iii) A Ltd. has followed accrual basis of accounting since incorporation. The chief accountant also disclosed this fact in financial statements.

(iv) A Ltd. was providing for after sales expenses @ 2% of sales for covering expenses during the warranty period. Now A Ltd. observes that actual after sales expenses were much less as compared to provision because of better technology used in manufacturing of the products. Now, the Board of A Ltd. decides to account for these expenses as and when they occur. Sales during the period are ₹ 50 crores.