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Financial Reporting

Frequently Asked Questions (FAQs)

Prepared by
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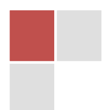


Financial Reporting (FR) – FAQs

Prepared by

1) Introduction to Business and Financial Accounting – Tejashree Wagh

2) Framework for Preparation and Presentation of Financial Statements – Aditya Suvarna

3) Measuring Accounting Income and Assets – Md. Aftab Alam

4) Financial Reporting Standards – Tejashree Wagh, Md. Aftab Alam, Manav Joshi, and Sadhika Nimbutkar

5) Preparation of Financial Statements – Laxmikant Behera

6) Measuring and Reporting of Inventories – Aditya Singh

7) Measuring and Reporting of Long-Lived Assets – Sadhika Nimbutkar

8) Measuring and Reporting of Income Taxes – Manav Joshi

Introduction to Business and Financial Accounting

- ***BY TEJASHREE WAGH***

1) What is Accounting?

American Institute of Certified Public Accountants (AICPA) formulated the following definition of accounting in 1961 – "Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof"

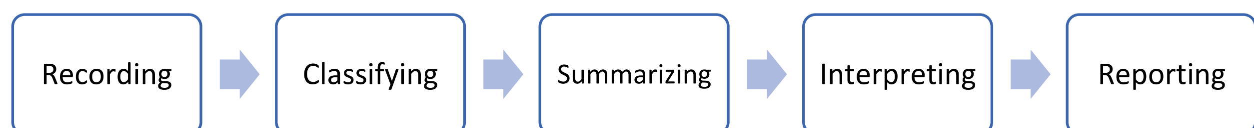
As per the ICAI, Accounting is simply an art of record keeping**.** The aim of accounting is to meet the information needs of rational and sound decision-makers. Hence, it is called the **language of business**.

Thus, Accounting, in the simplest form, is the process of systematically recording, summarizing, classifying, analyzing, and reporting financial transactions.

Following are the four types of Accounting –

1) Financial Accounting
2) Cost Accounting
3) Tax Accounting
4) Management Accounting

Accounting is an art of



business transactions in terms of money.

2) How does Accounting Information help in making decisions?

Accounting information plays a crucial role in making decisions. It helps in making a decision for the selection of the best available information on the basis of various facts and information. Also, it evaluates all the activities in order to reach the best conclusions.

All decision-makers predict future cash flow. Hence, the Cash Flow Statement helps in getting core information to forecast future cash flow. If a firm is not making a profit, by analyzing the Profit and Loss Account, the firm will get a clear picture of expenses and incomes of the firm; this will help in cut down their expenses.

Hence, Accounting Information helps in the formulation of plans by providing useful information and it plays a key role in the establishment of a budget.

3) Why Should an Investor Understand Accounting Information?

An Investor should understand Accounting Information because Investors can get benefit from these statements to gain information used in credit analysis and valuation of organizations. For fundamental analysis, Investor relies on the company's financial statements i.e. Balance Sheet, Income Statements, and Cash Flow Statement. It enables us to know the company's categorization of its assets, liabilities, financing sources, and the methods of valuation. Also, it assists in understanding the efficiency and profitability of the business. This makes it crucial to calculate financial ratios that help in estimating a company's liquidity and allows it to identify core risk areas. Hence, it plays a key role in decision making.

Hence, the knowledge of accounting helps investors to obtain critical information about the company's financial position and performance and helps in assessing the growth potentials of business.

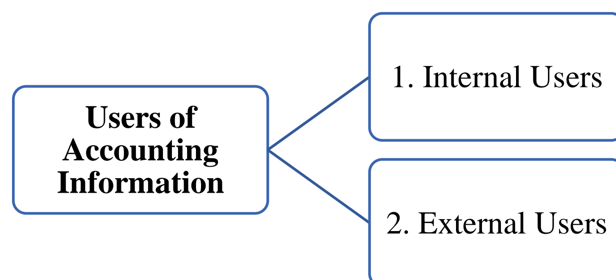
4) How does limited liability encourage entrepreneurship?

"Limited liability is a legal status where a person's financial liability is limited to a fixed sum, most commonly the value of a person's investment in a company or partnership" – Wikipedia.

It encourages entrepreneurship because the liability of an entrepreneur is limited to the capital invested by him and his personal property will not be liable for the debts of the company. As he is not legally responsible for the debts and liabilities, he can put his efforts to achieve goals without having fear which results in the growth and development of the business.

A separate entity is formed for the firm itself by selecting a limited liability. Hence, individuals can put their skills and knowledge in business because their personal property will not liable for any loss. So, they can put their best attempts to maximize profit.

5) Who are the users of Accounting Information? Why do they need information?



1) Internal Users -

a. Shareholders/Owners - To get the financial performance and financial position of the business.
b. Employees – To know about the profitability of the business made because their salaries and bonuses rely on the position and performance of the business.
c. Management- To make business decisions and to compare performance with past performance to achieve a goal.

2) *External Users* -

a. Investors – To know about the safety of investment and to see the progress of the business.
b. Government – To understand the earnings with the motive of imposing taxes and regulations
c. Creditors and Financial Institutions - To analyze the company's financial position and liquidity before making a loan to the company. To make sure about the future creditworthiness of the business.
d. Customers - To know the Current position of business, profitability, and liquidity.
e. Regulatory Agencies - To ensure that the firm is following all rules & regulations, accounting principles, and accounting standards.

6) Why is the accounting equation necessary?

"The relationship of assets with that of liabilities and owners' equity in the equation form is known as accounting equation" – ICAI

Accounting equation formula -

Assets = Liability + Owner's equity

This accounting equation comes into the picture when sum total of capital liabilities equalizes assets, where assets are what the business owns and capital and liabilities are what the business owes. This accounting equation has great value in the process of accounting. Financial reports are made on the basis of this accounting equation. Also, this equation helps to understand the double-entry system on which the accounting system is based. At the time of preparing financial statements, this equation enables us to track debits and credits. It is also useful in maintaining accuracy.

Hence, as the accounting equation is based on all accounting transactions, we should not underestimate its importance.

Framework for Preparation and Presentation of Financial Statements

- *BY* **ADITYA SUVARNA**

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1) What are the Institutions that regulate and influence financial reporting in India?

Firstly, financial reporting uses financial statements to disclose financial data that is an indication of the financial strength and health of the company over a specified period of time. The objective of financial reporting is to track analyze and report a business' income among other disclosure requirements.

Now, there are various institutions and regulatory boards that influence different nuances of Financial Reporting in India. The **"National Financial Reporting Authority (NFRA)"** is the most recent of inclusions as an overseer of auditing profession and accounting standards in India.

Other important regulators include:

- **Ministry of Corporate Affairs (MCA):** It administers the Companies Act, 2013. MCA articulates the government's view on financial reporting and accounting requirements.
- **Securities and Exchange Board of India (SEBI):** They are responsible for the regulation of the companies listed on the stock exchanges in India. SEBI prescribes the type and amount of information provided in company prospectuses for the issue of securities. SEBI introduced Cash Flow Statements.
- **Institute of Chartered Accountants of India (ICAI):** ICAI has been holding an advisory role to the government on accounting and auditing but lately it has been relieved of duty in this context. They mainly regulate Chartered Accountants.
- Among other regulatory authorities are the Ministry of Finance, the Reserve Bank of India, the Insurance Regulatory and Development Authority of India, the Comptroller and Auditor General of India.
- There are international organizations and boards that have an influence as well such as the **International Accounting Standards Board**, the International Federation of Accountants, and the International Organization of Securities Commissions.

2) What is GAAP?

- "Generally Accepted Accounting Principles (GAAP) are a common set of accounting principles, standards, and procedures issued by the Financial Accounting Standards Board."
- GAAP in Indian accounting is a commonly accepted standard of accounting that has stated the ways of recording, analyzing, and reporting accounting information. It has as its purpose to improve the clarity, consistency, and comparability of the communication of financial information.
- The purpose of GAAP is to create a uniform standard for financial reporting. The primary purpose of financial information is to help investors and other stakeholders to make important decisions with the right knowledge at their disposal. They should be able to easily assess the financial position of the company before decision making.
- **In the case of organizations that don't work for profit such as NGOs or Government entities, the main objective of GAAP is to ensure complete transparency and clarity of the reporting entity's activities. Information provided under GAAP needs to be clear, comprehensive, and easily interpreted. Also, it should be verifiable by related third parties or auditors.**

3) Why is GAAP so important?

- Without GAAP the companies and any entity in the finance sector would have its functioning put to a halt. This is because the GAAP is to finance what the Bible is to Christianity.

- GAAP allows its stakeholders to easily evaluate companies by assessing their financial statements. When an investor is in two minds about two companies in the same sector, he can compare the financial statements of those companies to come to a decision for investment.

- GAAP also helps companies gain key insights into their own practices and performances. Moreover, it helps minimize the risk of errors in financial reporting by having checks and safeguards at multiple levels while preparation of financial statements.

4) Why is the periodic income measurement necessary?

- Business activity is expected to perpetual and continuous. But, for purposes of measuring performance, it is necessary to draw a line in the sand of time. A periodicity assumption is made that business activity can be divided into measurement intervals, such as months, quarters, and years. A periodicity assumption helps to "draw a line in the sand" and also helps to gauge the performance of the business.
- It is important to assign revenues and expenses appropriately to their respective time periods for accurate presentation of financial statements. This works in favor of all the stakeholders in the business since the periodicity concept helps in proper determination and allocation of transactions to the right time period.
- Correctly assigning revenues and expenses to time periods is pivotal in the determination of income. It goes without saying that reported income is of great concern to investors and creditors, and its proper determination is crucial. Measurement issues can become complex.
- The following explanation helps simplify the concept. Why would companies try and get their financial statements prepared at regular intervals instead of employing resources to engage in their business operations? Had it not been an important principle would the company really use the periodicity concept of measurement of its transactions? The answer is YES. Periodicity assumption doesn't just help provide intervals for recording transactions; it becomes useful for investors to understand how the business is functioning and also the managers to look for areas to improve. **A business without periodicity is more like students without examinations. Both feel they are better off without the former to add to their responsibility but we know what is best for them.**

5) What is the money measurement assumption?

"The money measurement concept states that a business is to record every such event or transaction that can be measured in terms of money. Those transactions which cannot be expressed in monetary terms is not recorded in the monetary terms." This implies that all transactions that can be seen as quantified information come under the purview of this assumption.

6) What is the drawback of the money measurement concept? or How realistic is the money measurement assumption?

The qualitative aspects of the business failed to be considered often due to the limitation of the scope of this concept. A lot of companies boast of their qualitative USPs and for some, it is abundantly clear but they cannot be recorded in accounting simply because they cannot be quantified. A few of such exemptions are a competent workforce, employee working conditions, product durability, expected resale value of a patent, quality customer support or field service, and many more.

There are not many accounting tools to accurately quantify most of the transactions stated above. Although some companies boast of these traits and are known to have such characteristics, it is not measurable. Hence, it is a common notion that the money measurement concept is less realistic and its relevance is restricted to a certain extent.

7) What are the underlying Assumptions for preparation and presentation of Financial Statements?

Separate Reporting Entity: It is the subject of set of financial statements. Accountants treat a business as separate from its owners and other related firms. The reporting entity defines the scope of the activities to be included in the financial statements. It may be (i) a business, (ii) a legal entity, (iii) a group or (iv) a segment.

Going Concern: The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Accrual Basis: In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid).

8) What are the qualitative characteristics of Financial Statements?

a) **Understandability**: An essential quality of the information provided in financial statements is that it is readily understandable by users.

b) **Relevance:** To be useful, information must be relevant to the decision-making needs of users.

   Materiality: The relevance of information is affected by its nature and materiality. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

c) **Reliability:** To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

   i. ***Faithful representation***: To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent.

   ii. ***Substance over form:*** If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

   iii. ***Neutrality***: To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Prudence: Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.

   iv. ***Completeness:*** To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

d) **Comparability:** Users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and cash flows.

9) What is Forensic Accounting?

Forensic accounting as a career option has never been more enticing than it is now. It utilizes concepts of accounting, auditing, and investigation methodology to a detailed examination of the finances and dealings of an individual or a business. Forensic accounting provides an accounting analysis that aids investigating officials to obtain material information for legal proceedings. Forensic accountants undergo training in order to find out possible loopholes in the accounting transactions and other business aspects. It is being increasingly used in fraud and embezzlement cases to give clarification on the nature and extent of the financial crime in court.

Forensic accountants, analyze, interpret, and summarize complex financial and business matters. The employers include insurance, companies, banks, police forces, government agencies, or public accounting firms. Their modus operandi includes a compilation of financial evidence and discrepancies, developing software to help manage the collected evidence, and to communicate the conclusive findings in the form of reports or presentations.

Along with testifying in the court of law, forensic accountants are also asked to prepare formats of the evidence that are easily comprehensible for the smooth proceedings of the case. Investigative accounting methods employed by forensic accountants can be tracing the fund’s trail, asset identification, asset recovery, and due diligence reviews. Forensic accountants may pursue additional preparation in alternative dispute resolution (ADR) due to their high levels of involvement in legal matters and familiarity with the judicial system.

Measuring Accounting Income and Assets

- *BY MD AFTAB ALAM*

1) What is the Cash system of Accounting?

Cash accounting is a methodology under which transactions are recorded only when cash moves in or moves out. For example, income will be recorded when a firm receives cash, and expenses are recorded when cash is paid by the firm.

2) What are the Benefits of cash accounting?

- It is beneficial for small companies and for companies that have complex organizational structures accrual accounting is better.
- It is fairly easy to use cash system methodology because cash accounting is a system where revenues as well as expenses are realized when they are received or paid out in case of an expense.

3) What is the Accrual system of accounting?

Accrual accounting is an accounting method that recognizes financial events when they occur, regardless of when payment is made. It states that "revenue is recognized when it is earned and expense is recognized when incurred". Accruals are required to tackle the timing differences between the cash movement and accounting recognition of revenue and expense.

4) What are the Types of Accruals?

There are four types of accruals enumerated below:

1. Prepaid expense: Prepaid expense is a type of expenditure which is paid in advance. This accrual is a type of expense that has not yet been recorded by a company as an expense but has been paid in advance. On the other side, it is recorded in the balance sheet; prepaid expenses are first recorded as an asset. After the benefits of the assets are realized over time, the amount is then recorded as an expense.

2. Accrued Expenses: The accrued expense is a type of expenditure that is already incurred but has not yet been paid. In the Balance sheet, it is shown as a current liability because it represents a company's obligation.

3. Unearned revenue: Money received by an individual or company for a service or product that has yet to be provided or delivered. It can be thought of as a

4. Accrued or unbilled revenue: Accrued revenue is revenue that is recognized but is not yet realized. In other words, it is the revenue earned/recognized by a business for which the invoice is yet to be billed to the customer. It is also known as unbilled revenue.

The actual cash movement of the accruals are shown below with the help of the following chart:

Accruals	Cash movement
Prepaid expense	Earlier
Unearned revenue	Earlier
Accrued expense	Later
Accrued or unbilled revenue	Later

5) What is the Income measurement principle?

Realization principle: According to the recognition or realization principle revenue is recognized when they are realized, realizable, and are earned. Now revenue is the cash inflow for a business arising from the different sale of goods or services. And we assume that this revenue is realized only when it legally arises to be received. So, in simpler terms, the profit earned will be recorded when it is actually earned.

Matching principle: The matching principle states that the related revenues and expenses must be matched in the same period. This is done in order to link the costs of an asset or revenue to its benefits. In practice, the matching principle combines accrual accounting (wherein revenues and expenses are recorded as they are incurred, no matter when cash is received) with the revenue recognition principle (which states that revenues should be recognized when they are earned or realized, no matter when cash is received).

6) How does the Income measurement mechanism work?

Accrual: When transactions are recorded in the books of accounts as they occur even if the payment for that particular product or service has not been received or made, it is known as accrual-based accounting. This method is more appropriate in assessing the health of the organization in financial terms. Accrual refers to an entry made in the books of accounts related to the recording of revenue or expense paid without any exchange of cash. The use of accrual accounting is typically useful in businesses where there are a lot of credit transactions or the goods and services are sold on credit, which simply means that there was no exchange of cash.

Deferrals: Deferral accounts for expenses that have been prepaid or early receipt of revenues. In other words, it is the payment made or payment received for products or services not yet provided. In deferrals, the expense or revenue to be later reflected on the financial statements in the same time period the product or service was delivered.

7) What are the components of the income statement?

The components of Income statements are divided into two sections

- **Top-line:** The top line is a record of a company's income or revenue earnings that reflect the value of goods sold to consumers within the statement period. It is shown at the top of the income statement which includes revenue from the operation, income from other sources, and Gross profit.
- **Bottom line:** The bottom line is a company's income after deducting operation costs from Gross Profit. It consists of EBITDA, EBIT, PBT, and PAT.

8) What are the Top-line components?

- **Revenue from the operation** – It is defined as the income generated by the company from its core operation.
- **Gross profit** – Gross of the company is the total sale of the firm after deducting the total cost of goods sold.

Gross Profit = Total sales – Cost of Goods Sold

9) What are the Bottom-line components?

- **Operating expenses** - They are the expenses incurred in running the businesses. They are normally separated by function. It consists of Selling and distribution expenses and administration expenses**.**

Operation Expenses = Selling and distribution expenses + Administrative Expenses

- **EBITDA** – It is Earning before Income, Tax, Depreciation, and Amortisation. It is an accounting measure calculated using a company's earnings before interest, tax, depreciation, and amortization.

EBITDA = Gross Profit – Operating Expenses

- **EBIT** - It is Earning Before Interest and Tax. It is a measure of a company's profit that includes all income and expenses except interest expenses and tax expenses.

EBIT = EBITDA - Depreciation - Amortisation

- **PBT** – It is Profit Before Tax. It is a measure of the company's profitability which looks at the profit made before any tax paid.
- Non-operating Expenses are the expenses that are incurred from activities unrelated to the core activities of the business.
- Non-operating income is the income that is earned from activities unrelated to the core activities of the business.

PBT = EBIT + Non-operating Income – Non-operating expenses

- **PAT** – It is Profit After Tax. It is an earning of the company after deducting income tax.

PAT = Profit Before Tax– Income Tax

10) Describe the adjusting process of depreciation?

Depreciation: Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. It is allocating the cost of an asset to the periods that are expected to benefit from the asset's use and gradual conversion of cost into the expense. It is necessary to charge depreciation even if the market value of an asset has appreciated because depreciation is a process of cost allocation, not asset valuation. It continues even when the asset becomes idle or is retired from active use unless the asset is fully depreciated.

Example: if a 150,000 rupees car with a 3-year life was purchased and depreciation expense would be rupees 50,000 per year then (150,000/3 = 50,000). This expense of 50,000 rupees would be reported on each year's income statement.

The journal entry of the expense is enumerated below:

Particulars	Dr. Amount	Cr Amount
Depreciation Expense A/c	50,000	
To Accumulated Depreciation A/C		50,000

Steps to find depreciation

- Recognition of Depreciable Asset
- Establishing the depreciable amount
- Estimating the useful life
- Choosing an appropriate cost allocation method

Step1- Recognition of Depreciable Asset

Step2-Establishing the depreciable amount

Step3-Estimating the useful life

Step4-Choosing an appropriate cost allocation method

There are three methods which are enumerated below:

- Straight-line method (SLM)
- Written-down-value (WDV) method
- Production-Units method

11) What are the real accounts and nominal accounts?

Real accounts are those accounts that are recorded in the balance sheet. These accounts show the summary of the assets, liabilities, and owners' equities of a business.

Example- Plant, property, equipment, goodwill, cash, etc.

Nominal accounts are those accounts that are recorded in the income statement. These accounts show the summary of the expenses, losses, income, and gains of a business for a period of time.

Example-Salary A/c, Rent A/c, Wages A/c, Commission A/c, Utilities Expenses A/c, etc.

12) What are the measurement bases for different types of Assets?

Measurement bases:

Historical cost

- Coast at which asset was actually purchased
- Historical cost is highly reliable but its relevance to an analyst declines as value change.

Fair value

- Cost at which an asset can be purchased now.
- Fair value is more relevant to an analyst but is less reliable compared to historical cost because it involves some level of judgment.

Financial Reporting Standards

by Tejashree Wagh, Md. Aftab Alam, Manav Joshi, and Sadhika Nimbutkar

1) What is an Accounting Standard?

An accounting standard is a principle and procedure that provides a framework for companies to follow while making financial statements. It is set up by specific governing bodies in order to withhold a company's management from manipulating their statements for personal gains or false representation. Accounting standards not only improve the transparency of financial reporting but also facilitates financial accountability. Some examples of accounting standards are enumerated below

- Goodwill accounting.
- Depreciation Methods.
- Mergers and acquisitions.
- Revenue recognition.

2) Why do we need accounting standards?

Objectives of Accounting Standards are

1. Enhance Reliability -The first objective of accounting standards is to enhance the reliability of financial statements.
2. Allows making comparisons – Accounting standards allow to make comparisons to examine the progress and performance of the company.
3. Uniformity in accounting methods – Provides one set of standard accounting policies which contains valuation norms and disclosure requirements.
4. It helps to prevent fraud, allows eliminating confusion, and attains reliability.

Hence, It enables to improve the quality of financial reporting by assisting comparability, consistency, and transparency.

3) What is the need for convergence towards Global Accounting Standards (IFRS)?

- Every country makes its own rules and regulations for accounting and financial reporting. In such a case, the multi-national companies have to abide by the rules of all the nations it wants to run its businesses. Hence in this period of rapid globalization, there is a strong requirement to bring uniformity, rationalization, comparability, transparency, and adaptability in the financial statements. Having a multiplicity of accounting standards globally is against the public interest because international analysts and investors prefer comparing financial statements based on uniform accounting standards.
- The convergence of financial reporting and accounting standards is a valuable process that contributes to the free flow of global investment. It facilitates the investors to compare investment at a global level and also lowers the risk of errors of judgment. Hence this convergence holds high significance in today's era.

4) What is IND AS?

IND AS stands for Indian Accounting Standards, which are IFRS converged standards issued by the Central Government of India under the supervision and control of the Accounting Standards Board (ASB) of ICAI and in consultation with NFRA.

In India IND AS was made compulsory to follow from the 1st April 2016. Earlier there were 29 IND AS but now it has narrowed down to 27 IND AS.

5) IND AS VS IFRS

- IFRS stands for International Financial Reporting Standards which is a single set of accounting standards for businesses around the world and is issued by the International Accounting Standards Board.

  Indian Accounting Standards (Ind AS) are IFRS converged standards issued by the Central Government of India under the supervision and control of the Accounting Standards Board (ASB) of ICAI and in consultation with NFRA.

- Indian Accounting Standards largely follow historical cost whereas IFRS follows the fair value measurement basis.
- International Financial Reporting Standards (IFRSs) are considered a "principles-based" set of standards. While IND AS was not directly taken from IFRS. It was been modified making necessary changes according to the economic condition of the country (India).
- At present, there are 16 IFRS and 27 IND AS.

6) What are Accounting policies?

Accounting policies are the principles and procedures according to which the companies prepare financial statements. The principles and procedures include accounting methods, measurement systems, and procedures for presenting disclosures.

An entity shall select and apply its accounting policies consistently for similar transactions, other events, and conditions, unless a standard or an interpretation specifically requires so, in order to make the financial statements more relevant and reliable.

7) What are Accounting concepts?

While preparing accounts and recording business transactions, there are some assumptions made and principles followed in order to maintain uniformity and consistency in maintaining records. These are known as accounting concepts; which form the basis of accounting.

Following are various accounting concepts: -

- **Entity concept:**

  The entity concept says that the business organization has a separate identity apart from its owner. the business and the owner should be treated distinctly. Hence according to the concept, the business entity is liable for the capital invested by the owner.

- **Money measurement concept:**

  This concept says that only the transactions measurable in terms of money are recorded. The transactions which affect the business results but do not have monetary value are not recorded in the books.

- **Going concern concept:**

It is an assumption that a business is a going concern and will continue to operate its activities for the foreseeable future. Hence the business has no intent or needs to dissolve or liquidate or put an end to its business activities.

- **Accounting period concept:**

After going concern concept comes into the picture, it becomes difficult to measure performance in the ordinary course of business. So, we choose a specific period of time to measure performance. In India, the accounting period is for one year starting from 1st April of the current calendar year to 31st March of the next calendar year.

- **Historical cost concept:**

According to this concept, the value of an asset should be recorded on the basis of historical cost/amount at which the asset was acquired or purchased (cost of acquisition of an asset). The market value of an asset may vary across periods hence it becomes difficult to value the asset in such a case. The historical cost concept provides solutions for this difficulty.

- **Dual aspect concept:**

Every business transaction has two effects; a debit and a credit effect. It is the base of the double-entry bookkeeping system. It also gives us the accounting equation i.e.

Assets = Liabilities + Equity.

- **Realization concept:**

Realization refers to inflows of cash or claims arising from the sale of goods or services. It helps to find out what amount should be recognized as revenue. The realization concept states that the amount recognized as revenue is the amount that is reasonably certain to be realized.

- **Accrual concept:**

It states that revenue is recognized when it is earned and expense is recognized when incurred regardless of when payment is made.

- **Matching concept:**

This concept says that all the expenses of an accounting period should match the income for that accounting period.

8) What are accounting conventions?

Accounting conventions are the set of principles that one follows while preparing financial accounts. There are four main accounting conventions as follows:

i. Consistency

According to this convention, accounting practices should remain unchanged from one period to another. This is necessary for the purpose of comparison. The lack of consistency will result in distorting the profit and making them uncompilable with each other.

ii. Full Disclosure

Transparency is one of the most important aspects of corporate governance. Financial statements are prepared with the objective of disclosing a true and fair view of the affairs of the company.

iii. Conservatism

Conservatism concept in accounting is also called the doctrine of prudence, it says that anticipate the future losses and expenses but not gains and incomes. Conservatism states that the accountant should not anticipate income and should provide for all possible losses.

iv. Materiality

On contrary to the full disclosure principle, materiality says that the events or transactions which do not have a significant effect on the business can be ignored and not disclosed in the financial statements.

Preparation of Financial Statements –

-BY LAXMIKANT BEHERA

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1) What are the Financial Statements?

Financial statements are the statements that present an actual view of the financial performance of an organization at the end of a financial year. It represents a formal record of financial transactions taking place in an organization. These statements help the users of the information in determining the financial position, liquidity, and performance of the organization.

Financial statements reflect the impact of the financial effects of the transactions on the organization. The preparation of financial statements is done by both profit and non-profit organizations. It forms a crucial part of the annual report of any organization.

Financial statements are used by different stakeholders of an organization which includes shareholders, staff, customers, investors, suppliers, stock exchanges, government authority, and other related stakeholders.

Types of Financial Statements

There are five types of financial statements that are required to be prepared by an entity. These statements are: -

1. Income statement,
2. Balance Sheet or Statement of financial position,
3. Statement of change in equity,
4. Statement of cash flow,
5. Noted (disclosure) to financial statements.

Let us discuss these statements in detail now

I. Income statement

The income statement of an organization or business entity is the financial statement that contains financial information about the three important components, which are revenues, profit or loss, and expenses incurred during the accounting period.

It is sometimes called as the statement of financial position performance as this statement helps users of financial information in determining the financial performance of an organization from one accounting period to another of the same business or with that of the competitors.

The three components of the income statement are explained as follows:

- **Revenues:** It refers to the sales of goods and services that the business generates during the current accounting period. Revenues can be obtained from both cash and credit sales.
- **Profit or Loss:** Profit or loss is the net income which is obtained by deducting the expenses from the revenues. Profit will happen if revenues are more than expenses and loss will occur if expenses are more than revenue.
- **Expenses:** Expenses are the cost of operations that an organization incurs for running day to day operations. They can be administrative expenses like salaries, depreciation, etc.

II. Balance sheet

A balance sheet is known as a statement of financial position as it shows the position of assets, liabilities, and equity at the end of an accounting period. The net worth of a business can be determined by deducting the liabilities from the assets.

If the users of financial information are looking for information regarding the financial position of the company, a balance sheet is the most appropriate statement which will present the necessary information.

Components of a balance sheet are assets, liabilities, and equity. These are described below:

A) Assets: Assets are resources that are owned by the company both legally and economically. There are two main classes of assets. They are current and non-current assets.

Current assets are short-term assets that can be converted in the current accounting period, and these include cash in hand, raw materials, petty cash, etc.

Non-current assets comprise tangible and intangible assets, and these include machinery, building, land, computer equipment, vehicles, etc. Assets are equal to the sum of liabilities and equity of the organization.

B) **Liabilities:** Liabilities are obligations of a company which they owe to other businesses or individuals. It includes interests payable, loans, taxes, etc. Liabilities are of two categories current liabilities and non-current liabilities.

Current liabilities are due within a year that means the organization has to pay the dues within that accounting year only. Non-current liabilities, on the other hand, are obligations that have a longer period of repayment, which is more than twelve months. For example, a long-term lease which is due in more than twelve months.

C) **Equity:** Equity is defined as the difference between assets and liabilities. The examples of equity are retained earnings, share capital. Equity can be calculated by subtracting assets from liabilities.

III. **Statement of changes in equity**

This type of financial statement shows the contributions of shareholders, the movement of equity, and the balance of equity at the end of an accounting period. It shows all the changes in equity that take place during the accounting period. It includes the issue or purchase of shares, issuing of dividends, etc.

IV. **Statement of Cash Flow**

The cash flow statement reveals the movement of cash in an organization. It comprises cash inflows and outflows. Cash flow can be classified into three activities which are operating activities, investing activities, and financing activities.

V. **Notes to financial statements**

This is the fifth type of statement that is considered in accounting. It is mandatory to disclose information regarding the preparation of financial statements. It contains information on the valuation method used. Also, it includes the disclosures related to compliance with accounting standards. It is an important statement that must be included by the organization.

2) For whom financial statements are prepared?

Financial statements are prepared to provide information that suits the common needs of all users. Users of financial statements could be any of the following:

- Investors
- Employees
- Lenders
- Suppliers and other trade creditors
- Customers
- Government and their agencies
- Public

3) COMPONENTS OF SHAREHOLDER EQUITY?

Shareholders' equity is the amount of money a company could return to shareholders if all its assets were converted to cash and all its debts were paid off.
The things which are included in shareholders' equity.

- **Authorised Capital**: Authorised capital is the amount of the share capital in which a company is allowed to issue its Memorandum of Association. The company is not supposed to raise more than the amount of capital as mentioned in the Memorandum of Association. It is also known as Registered or Nominal capital. The authorised capital can be either decreased or increased as per the process furnished in the Companies Act. It should be understood that the company need not issue the complete authorised capital for public subscription at one time. Relying upon its necessity, it may circulate share capital but, in any scenario, it should not cross more than the amount of authorised capital.

- **Issued Capital**: It is that portion of the authorised capital which is usually circulated to the public for subscription comprising the shares assigned to the merchants and the endorsers to the enterprise's memorandum. The authorised capital which is not proffered for public consent is called as 'unissued capital'.

- **Subscribed Capital**: It is that chunk of the issued capital which is subscribed and contributed by the public. When the shares offered for public subscription are contributed entirely by the public, however, subscribed capital and the issued capital would be similar. Ultimately, the issued capital and subscribed capital are similar because if the total number of shares that is subscribed is less than what is offered, the company allocate only those number of shares for which the subscription has been received.

- **Called up Capital**: It is that chunk of the subscribed capital which is called upon the shares. The company may ascertain to call the complete amount or just a chunk of the shares' face value.

- **Outstanding Shares: -** The number of outstanding shares is an integral part of shareholders' equity. It is the amount of company stock that has been sold to investors and not repurchased by the company. It represents the total amount of stock the company has issued to public investors, company officers, and company insiders, including restricted shares.

- **Additional Paid-in Capital: -** Shareholders' equity also includes the amount of money paid for shares of stock above the stated par value, known as additional paid-in capital (APIC). This figure is derived from the difference between the par value of common and preferred stock and the price each has sold for, as well as shares that were newly sold.
- **Retained Earnings: -** When a company retains income instead of paying it out as a dividend to stockholders, a positive balance in the company's retained earnings account is created. A company often uses retained earnings to pay off debt or reinvest in the business.

This figure is included in shareholders' equity and is typically the largest line item in this calculation. You can find a company's retained earnings on its balance sheet under shareholders' equity or in a separate statement of retained earnings. A company may refer to its retained earnings as its "retention ratio" or its "retained surplus. You want to describe or define free reserves here.

4) WHAT IS THE DIFFERENCE BETWEEN CURRENT ASSETS VS NON-CURRENT ASSETS?

Current Assets

- Equal to cash or will be converted into cash within a year
- Used to fund immediate or current needs
- Items like cash and cash equivalents, short term investments, accounts receivables, inventories
- Valued at market prices
- Tax implications: Selling current assets results in the profit from trading activities
- Current assets generally not subject to revaluation—though in certain cases, inventories subject to revaluation give an illustration in the Indian context.

USES:

- Current Assets can be used as clear regular payments and bills.
- It gives an insight into the company's cash and liquid position
- Investors and Creditors analyse the company's current assets closely to understand the risk or benefits involved in the operation.

EXAMPLE: -

- Cash and cash equivalent
- Inventory
- Pre-paid expenses
- Account receivable
- Marketable securities

Noncurrent Assets

- Will not be converted into cash within one year
- Used to fund long-term or future needs
- Items like long term investments, PP&E, goodwill, depreciation and amortization, long-term deferred taxes assets
- Valued at cost less depreciation
- Tax implications: Selling assets results in capital gains and capital gains tax are applied

- Common revaluation of PP&E—for instance, when the market value of a tangible asset decreases compared to the book value, a firm needs to revalue that asset give illustrations in the Indian context

Noncurrent assets consist of both tangible assets and intangible assets: -

A). Tangible asset: - A tangible asset is an asset that has a physical form. Tangible assets include both fixed assets, such as machinery, buildings, and land, and current assets, such as inventory. The opposite of a tangible asset is an intangible asset. **Example**- land and building plant and machinery

B). Intangible Assets: This asset does not have a physical appearance and can be intellectual properties. It is considered as a non-current asset because it cannot be liquidated to cash with 12 months of the investment. Some examples are:

- Patent
- Trademark
- Copyright

Important things to know how to classify assets: -

- Non-current assets are categorized on the balance sheet under the heading of investment, property, plant, equipment, intangible assets, etc.,
- The assets are classified according to the segment of the balance sheet
- Investments are always labelled as a non-current asset only if the total expected return is not expected within the next 12 months of the balance sheet
- Property, plant, land, buildings, and machinery including vehicles are fixed asset
- Intangible assets are goods that have no physical presence
- Intangible assets may also arise from the sale or purchase of a business unit

5) PROVISIONS VS RESERVES?

Provisions

- Provisions are charged on profits.
- The creation of provision does not depend on profit. They have to be created even if there are inadequate profits or heavy losses.
- They are created to meet a known liability
- The creation of provision is necessary as per law.
- Provisions are recorded on the debit side of the Profit and Loss Account.
- Provision may appear on either side of the balance sheet by way of deduction from the concerned asset or separately on the liabilities side.
- Provision can never be invested outside the business
- Provision can never be distributed as profit unless actual liability is less than the amount provided for.
- Provision reduces net profit.

The provision refers to an amount that is kept aside from a company's profit in order to cover probable expenses arising in the future or a possible reduction in the value of an asset.

Provisions are important for a business as they address certain expenses in business and payments made for them. Provisions should not be regarded as savings as these are created to meet expenses for an anticipated liability in the future.

WHERE RECORDED- It appears in the income statement in the form of expenses and is recorded as a current liability in the balance sheet.

Example: - you have a motorcycle that is on the verge of a breakdown. You know about it but use it to ride to work every day. The repair costs are too high for you to make the payment in one go. In this case, you set aside a portion of your allowance /salary, towards the hiring of a taxi to go to work (or) towards the expected sum of repair. When the motorcycle actually breaks down, you have a certain sum of money squirreled away to meet those expenses

Reserves:

- Reserves are an appropriation of profits.
- Reserves depend upon profit. In the absence of adequate profits, reserves cannot be created.
- Reserves are created to strengthen the liquid resources of the business enterprise.
- Maintenance of reserves is not necessary because they are created as per financial prudence.
- Reserves are recorded on the debit side of the Profit and Loss Appropriation Account.
- Reserves are always shown on the liabilities side.
- Reserves can be invested outside the business and known as the Reserve Fund.
- Reserves, other than capital reserves, can be distributed as profit.
- Reserves reduce divisible profits.

There are two types of reserves in an organization

- Capital Reserve
- Revenue Reserve

The capital reserve is created from the capital profits and is not available for distribution to shareholders in the form of dividends. Therefore, it cannot be created from the profits earned from the core operations of a company.

Revenue reserve is created from the profits earned from the core operations of a company or organization. A profit and loss appropriation account needs to be made for creating a Revenue reserve.

It can be used for the following purposes.

- Paying dividend to shareholders
- Expanding the business
- Stabilizing the dividend rate

Further Revenue reserve can be classified as: -

Both general and specific reserves are created out of profit earned in the normal course of business, yet the following differences are observed between general and specific reserves.

General Reserve: -

- General reserve is created not for a specific purpose. It is created to strengthen the financial position of the business
- It can be utilized for any purpose.
- A dividend can be paid out of it if needed.

Specific Reserve: -

- It is created for some specific purpose. For example, a debenture sinking fund is created for the purpose of repaying loans on account of the debenture.
- It can be utilized only for the purpose for which it has been created. It cannot be utilized for other purposes.
- The dividend cannot be paid out of it. But on fulfilment of the objective for which a fund has been created the fund will no longer be required, when dividends may be paid out of it.

  For example, on repayment of the loan on account of debenture the debenture sinking fund is not required. Then it is transferred to the general reserve fund. In other words, the fund money is distributable as dividends. Example – dividend equalization reserve, investment fluctuation reserves

6) WHAT ARE INTANGIBLE ASSETS AND TYPES?

An intangible asset is an asset that is not physical in nature. Goodwill, brand recognition, and intellectual property, such as patents, trademarks, and copyrights, are all intangible assets. Intangible assets exist in opposition to tangible assets, which include land, vehicles, equipment, and inventory.

Such an asset is identifiable when it is separable, or when it arises from contractual or other legal rights. Separable assets can be sold, transferred, licensed, etc. Examples of intangible assets include computer software, licences, trademarks, patents, films, copyrights, and import quotas.

TYPES: -

Goodwill is an intangible asset that is associated with the purchase of one company by another. Specifically, goodwill is the portion of the purchase price that is higher than the sum of the net fair value of all of the assets purchased in the acquisition and the liabilities assumed in the process. The value of a company's brand name, solid customer base, good customer relations, good employee relations, and proprietary technology represents some reasons why goodwill exists.

Trademarks: The term trademark refers to a recognizable insignia, phrase, word, or symbol that denotes a specific product and legally differentiates it from all other products of its kind. A trademark exclusively identifies a product as belonging to a specific company and recognizes the company's ownership of the brand. Trademarks are generally considered a form of intellectual property and may or may not be registered.

Copyrights: Copyrights protect "original works of authorship," such as writings, art, architecture, and music. For as long as the copyright is in effect, the copyright owner has the sole right to display, share, perform, or license the material. One notable exception is the "fair use" doctrine, which allows some degree of distribution of copyrighted material for scholarly, educational or news-reporting purposes.

Patents: A patent safeguards an original invention for a certain period of time and is granted by the United States Patent and Trademark Office (USPTO). By granting the right to produce a product without fear of competition for the duration of the patent, an incentive is provided for companies or individuals to continue developing innovative new products or services.

7) WHAT IS INVESTMENT PROPERTY?

An investment property is real estate property purchased with the intention of earning a return on the investment either through rental income, the future resale of the property, or both. The property may be held by an individual investor, a group of investors, or a corporation.

An investment property can be a long-term endeavour or a short-term investment. With the latter, investors will often engage in flipping, where real estate is bought, remodelled or renovated, and sold at a profit within a short time frame.

The term investment property may also be used to describe other assets an investor purchases for the sake of future appreciation such as art, securities, land, or other collectibles.

Types: Residential, Commercial, and Mixed

The following are examples of investment property:

a) Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.
b) Land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)
c) A building owned by the entity (or a right-of-use asset relating to a building held by the entity) and leased out under one or more operating leases.
d) A building that is vacant but is held to be leased out under one or more operating leases.
e) Property that is being constructed or developed for future use as an investment property.

The following are examples of items that are not investment property and are therefore outside the scope of this Standard:

a) property intended for sale in the ordinary course of business or in the process of construction or development for such sale (see Ind AS 2, Inventories), for example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale.
b) owner-occupied property (see Ind AS 16 and Ind AS 116), including property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal.
c) property leased to another entity under a finance lease.

Measuring and Reporting of Inventories –

- ***BY ADITYA SINGH***

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1) What are Inventory and its types?

Indian Accounting Standard 2(Ind AS 2) defines inventories as assets which are:

- held for the sale in the normal course of business,
- in the process of production for such sale, or
- in the form of supplies or material to be consumed in the production process or rendering of services

Ind AS 2 doesn't allow for the capitalization of:

- the abnormal cost of waste,
- storage costs where the storage is not part of the production process,
- administrative costs,
- selling costs.

Inventory refers to all those goods that are in different stages of the production process including:

- Finished goods (available for sale)
- Work in process (in the of being made)
- Raw materials (processed to make the final product)

Precisely, Inventory is referring to goods available for sale and raw materials which are the process to make finished goods.

Types of inventory-

Raw material

Raw materials consist of all the items which are processed to make the final product. For example, the Flour is the raw material for the company producing Pizza and Crude Oil is the raw material for an oil refinery.

Work in progress (WIP)

Work in progress is also commonly known as semi-finished goods. Raw Materials have been undergoing the process of their conversion into the final goods or products. Which are partly processed or have not been converted into the final good or product than this stage is known as work in progress. For example, in process of making Pizza, the dough of the Flour is work in process.

Finished goods

Finished goods are the final goods or products that are ready for sale. The goods, which have passed through all stages of production and quality checking. For example, Pizza is the final product for a company that sells pizza.

2) What do you mean by the Cost of goods sold (COGS)?

The cost of inventory comprises all the costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition **(Ind AS 2.10)**

The cost of goods sold is referred to all the direct expenses incurred to produce the goods or services sold by a company. The direct expense includes material cost, direct labour cost, and direct factory overheads.

The cost of goods sold is often the second line item appearing on the income statement.

The cost of goods sold does not include selling expenses, general expenses, and administrative expenses such as advertisement expenses and salaries.

For the computation of COGS, the opening annual inventory amount, add net purchases and then subtract the closing inventory for the period from that total.

COGS = Beginning Inventory + Net Purchases during the Period – Ending Inventory

Example-

XYZ Ltd. has an opening inventory of $8,000, makes purchases valued at $5,000, and is left with a closing inventory of $1,000. Use the COGS formula.

COGS = Opening Inventory + Net Purchases during the Period – Closing Inventory

COGS = $8,000 + $5,000 – $1,000

COGS = $12,000

3) What Is Gross Profit?

Gross profit, the profit a company makes after deducting the costs of goods sold and sales return/ from revenue or total sales revenue.

The formula of gross profit is:

Gross Profit= Net sales (Sales Revenue) – Cost of Goods Sold

Sales Revenue

Sales Revenue or net sales is the monetary amount obtained from selling goods and services to customer minus sales returned /allowances/discounts.

Example-

A business had sold 100 units of the product, for the revenue of $10,000 and the cost of goods sold was $5,000 for the year, also there was a sales return of $1,000. Calculate the Gross Profit.

Gross Profit = Net sales – COGS

Net Sales = Sales – sales return/allowance

Net Sales = $10,000 -$1,000

= $9,000

Gross Profit = $9,000 - $5,000

=$4,000

4) What do you mean by goods in transit?

According to **Ind AS 2** Inventories, How and when to determine the Ownership of the Goods:

Goods in Transit- At end of the year, any goods which are in transit from the seller to buyer may properly be includable in one and only one, of those parties' inventories, based on the terms and conditions of the sale.

- FOB stands for "free on board ", If goods are shipped to FOB destination, transportation costs are paid by the seller and the title doesn't pass until the carrier delivers the goods to the buyer, thus these goods are part of the seller's inventory while in transit.

- In case goods of FOB shipping point, the transportation costs, which are paid by the buyer and title passes when the carrier takes possession, thus these goods are part of the buyer's inventory while transiting.

5) What are the different methods of valuation of inventory?

International Financial Reporting Standards (IFRS) and **Generally Accepted Principles (GAAP)** allow firms to use the following methods of inventory valuation: Specific identification, first-in, first-out (FIFO), and Weighted average cost. Also, GAAP allows the firms to use an additional method: -Last-in, first-out (LIFO).

- **The Specific Identification Method**

The Specific identification method is applied for the inventory that isn't generally interchangeable and for goods that have been produced and segregated for specific projects. It is also commonly used for expensive goods that are uniquely identifiable, like precious gemstones. With this method, the cost of sales and the cost of closing inventory reflect the actual costs incurred to purchase (or manufacture) the items specifically identified as sold and the items specifically identified as remaining in inventory. That is why; this method matches the physical flow of the specific items sold and remaining in inventory to their actual cost.

- **Last In, First Out (LIFO):**

LIFO is allowed only under US GAAP. This method states that the newest goods purchased (or manufactured) are sold first and the oldest goods purchased (or manufactured), including beginning inventory, remain in ending inventory. For example, the last units included in the inventory are assumed to be the first units sold from inventory.

The cost of sales reflects the cost of goods purchased (or manufactured) more recently, and the value of closing inventory reflects the cost of older goods. In periods of increasing prices, the costs assigned to the units in ending inventory are lower than the costs assigned to the units sold. In periods of falling prices, the costs assigned to the units in ending inventory are higher than the costs assigned to the units sold.

- **First In, First out (FIFO):**

FIFO assumes that the oldest goods purchased (or manufactured) are sold first and therefore the newest goods purchased (or manufactured) remain in ending inventory. In other words, the primary units included in the inventory are assumed to be the primary units sold from inventory.

The cost of sales shows, the cost of goods in opening inventory plus the cost of items purchased (or manufactured) earliest in the accounting period, and the value of ending inventory reflect the prices of products purchased (or manufactured) more recently. In periods of increasing prices, the costs assigned to the units in ending inventory are higher than the costs assigned to the units sold. Whereas, in periods of falling prices, the prices assigned to the units in ending inventory are less than the prices assigned to the units sold.

- **Weighted Average Cost:**

Weighted average cost, it assigns the average cost of the goods which are ready for a sale (Opening inventory plus purchase, production, and other costs) during the accounting period to the units that are sold and also the units in ending inventory. In an accounting period, the weighted average cost per unit is calculated by the total cost of

the units ready(available) for sale divided by the total number of units ready for sale in the period (Total cost of goods available for sale/Total units available for sale).

Weighted Average Cost vs. FIFO vs. LIFO examples –

Example: Suppose you have a furniture store and you purchase 400 tables for $10 per unit. The next month, you buy another 600 tables for $20 per unit. At the end of an accounting period, let's assume you sold 200 total tables. The application of the weighted average costs, using both FIFO and LIFO are as follows:

- 400 tables at $10 per tables= $4,000.
- 600 tables at $20 per tables = $12,000
- Total number of tables = 1,000

Weighted Average Cost

- Cost of a tables: $16,000 divided by 1,000 = $16/tables
- Cost of Goods Sold: $16 x 200 = $3,200
- Remaining Inventory: $16 x 800 = $12,800

First In, First out Cost

- Cost of goods sold: 200 tables sold x $10 = $2,000.
- Remaining Inventory: (200 tables x $10) + (600 tables x $20) = $14,000

Last In, First Out Cost

- Cost of goods sold: 200 tables sold x $20 = $4,000
- Remaining Inventory: (400 tables x $10) + (400 tables x $20) = $12,000

Measuring and Reporting of Long-Lived Assets

- *BY SADHIKA NIMBUTKAR*

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1) What are the long-lived assets?

Long-lived assets are assets that are expected to provide economic benefits over a future period of time, typically greater than one year. Long-lived assets are also referred to as non-current assets or long-term assets. Long-lived assets may be tangible or intangible.

Examples- property, plant, equipment, land, buildings, machinery, equipment, vehicles, furniture & fixtures.

2) What are tangible and intangible assets?

Tangible assets

Tangible assets are physical assets with a clear purchase value that are used by a business to produce goods and services. They are also known as hard assets. Examples- plant, property, equipment, etc. physical items

Intangible assets

Intangible assets are assets lacking physical substance. Under IFRS, identifiable intangible assets must meet three definitional criteria. They must be
(1) identifiable,
(2) under the control of the company, and
(3) expected to generate future economic benefits.
In addition, two recognition criteria must be met:
(1) It is probable that the expected future economic benefits of the asset will flow to the company, and
(2) the cost of the asset can be reliably measured. Goodwill, which is not considered an identifiable intangible asset, arises when one company purchases another and the acquisition price exceeds the fair value of the net identifiable assets.
Examples- patents, trademarks, copyrights, etc.

3) Why do firms revalue property, plant, and equipment?

Property, plant, and equipment are tangible fixed assets that are held by an organization and are used in the production or supply of goods & services to others. These assets are used frequently which helps to produce goods or services that in turn generate revenue or profit for the firm. Due to the continuous use of plants and equipment, it may incur some expenses due to wear and tear. Therefore, it may depreciate in value. Also due to continuous and high inflation, there is a difference between the historical cost and current market value of the assets. This gap between historical cost and current market value of the assets makes it necessary for a firm to revalue the assets. As it may appreciate or depreciate. So, the value does not remain the same and therefore the firms have to revalue the property, plant, and equipment in order to know the true value of the same.

A firm may revalue its assets with the aim of lifting its stock price by informing investors of its current value. A rise in the stock price would make a company a less attractive takeover target.

4) Why is the useful life of an asset often less than its physical life?

The useful life of an asset is the period over which an asset is expected to be available for use. Physical life is the period of time that an asset remains functional. The useful life of an asset often less than its physical life because of the following factors-

- New technology in the market results in suppression of the assets currently in use.
- Changes in product markets may make an asset outdated.
- New regulation given by regulators specifies limits on assets' lives for environmental and safety reasons.
- Contractual terms constrain the use of an asset.
- Companies voluntarily replace assets on safety and operating cost consideration.

For example, a computer's useful life is approximately 4 years or less while the physical life is 40 years. However, this is because newer and more efficient computers with high technology will cause companies to replace computers before the end of their physical life.

5) What does depreciation mean?

Concept of Depreciation

In the process of revenue generation, we consume or use the economic potential of long-term assets. After some time, these assets will become useless and then they are disposed of or replaced. The economic potential so consumed represents the expired cost of these assets and they must be recovered from the revenue of the business in order to determine the income earned by the business. Therefore, for this purpose depreciation is used. The term depreciation is used only in the case of fixed assets or long-term assets.

For example – Suppose we have a Tours & Transportation business for which we purchase a new car for a particular value say 10,00,000. So, now after 5 years, you want to sell it. But you will not be able to sell it at the same price at which you bought. This is because the value of the car decreases as a car requires maintenance due to wear and tear say 10,000 each year. Thus, the value of the car got reduced or depreciated by 10,000 at the end of each year. This concept is called Depreciation and the value is said to be depreciated.

In accounting, depreciation is used to denote a decrease in the book value of fixed assets. A company or an organization doesn't pay the depreciation amount to the outsider rather it is been paid to the company itself and is treated as an Internal expense of a company.

6) Is land depreciated? Why or Why not?

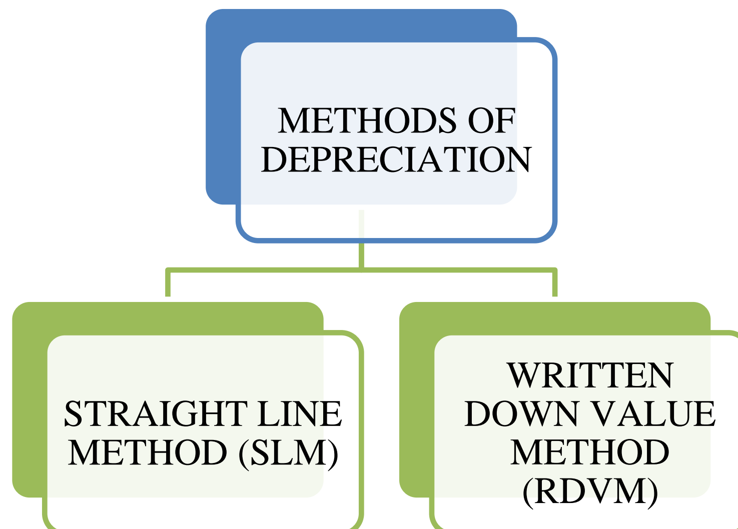
No, the **Land** is **not depreciated** as its use is considered indefinite

For example-

Imagine there was a small piece of land and there was a small fishing village on it. It was surrounded by green trees all around. But after some time, these trees were cut for farming. Over a period of time due to electricity coal-based thermal power plants were set up. On the same piece of land, new houses can be built. Thus, a single piece of land can have multiple uses and can be used for multiple years, unlike other assets.

Therefore, it can be concluded that land is not depreciated. because the land is assumed to have an **unlimited useful life**.

7) What two popular methods of Depreciation?



- **STRAIGHT LINE METHOD (SLM)**

SLM is the most popular method because of its simplicity and consistency. This method is also called as Equal Instalment Method or Fixed Percentage or Original Cost Method.

In this method, the **fixed amount** of the original cost is charged as depreciation every year.

Formula:

Depreciation (SLM) = Original cost of Fixed Asset (+) Installation charges (–) Estimated Scrap Value / Useful life of the Asset

For example – Suppose ABC company ltd purchased a second-hand machine for rupees 80,000 and spent 20,000 on its repairs and installation. The scrap value is 40,000. The useful life is 4 years. Calculate depreciation through SLM.

Depreciation = (80,000 + 20,000 - 40,000)/4 = 15000

Therefore, the depreciation charged at the end of every year is Rs 15,000.

Characteristics

- The method is simple to understand and to apply.
- Under this method, the value of the asset can be reduced to zero.
- This method does not take into account the effective utilization of the assets.

WRITTEN DOWN VALUE METHOD (RDVM)

This method of charging depreciation is also known as Diminishing Balance Method or Reducing Balance Method. Here this method assumes that the rate of allocation should be constant through time. This method is the only method acceptable for tax purposes.

In this method, the rate of depreciation remains constant whereas the amount of depreciation goes on decreasing.

For example –

The ABC company purchased machinery at rupees 50,000. The company decided to charge depreciation on machinery at 10% per annum by the Written Down Value Method for 2 years.

Cost Price	(A)	50,000
Depreciation amount (50,000*10%)	(B)	5,000
Value at the end of the 1st year	(A)-(B)=(C)	45,000
Depreciation amount (45,000*10%)	(D)	4,500
Value at the end of the 2nd year	(C)-(D)=(E)	40,500

Characteristics

- The depreciation amount goes on decreasing year by year.
- The only method is acceptable for tax purposes.

- Suitable for the assets that have a high rate of obsolescence.

8) What is Amortisation and Depletion?

- Amortisation is a decline in the value of intangible assets like goodwill, copyright, patent, etc. Amortisation is the term used for depreciation of intangible assets.
- Depletion is a gradual degradation of natural resources reserves. Depletion is the act of recovering the natural resources available, such as mining coal or pumping out of oil. It also means the allocation of the cost of a natural resource to the units extracted in the period.

Measuring and Reporting of Income Tax

- ***BY MANAV JOSHI***

1) What is Tax?

Tax is a sum of money that has to be paid to the government by an individual or an entity so that it can provide services to the public/residents/citizens/entities.

Tax is a source of income for any government in order to run itself as well as provide services to its people and incur various public expenditures to ensure the growth and development of the country.

There are two types of taxes.

a) Indirect Tax.

Any tax or a fee charged by the government at the manufacturing level is an indirect tax. This tax is then added to the cost of goods or services provided by the manufacturer and then collected from the consumer. Since the burden of tax is shifted, the consumer is ultimately the bearer of the tax. For e.g. GST, Excise Duty, Export/Import Duty, etc.

b) Direct Tax.

Direct taxes are taxes that an individual or an entity pays directly to the government. Unlike Indirect Tax, the tax burden is not shifted in Direct Tax. For e.g. Income Tax, Corporate Tax, Property Tax, etc.

2) What is the Income Tax?

Income tax is a tax paid by individuals/companies according to the slab of earnings or gains during a financial year. It is a type of Direct Tax. In India, the Government of India decides the tax rates.

3) How do companies calculate their Income Tax?

Companies calculate their tax liabilities based on the profit made by them from their businesses throughout a financial year. Companies calculate their tax liability on the basis of accounting profit, but they have to pay tax as per income tax laws, taking Taxable Profit as the base for calculation of tax payable.

4) What are Accounting Profit and Taxable Profit?

Accounting Profit is the profit or loss for a given period incurred by the company before deducting income tax expense. It is calculated by applying accounting standards and principles determined by the company whereas;

Taxable profit is the profit or loss for a defined time which is determined with respect to the rules set up by the taxation authorities upon whom income tax is payable or recoverable. For e.g. Tax laws mandate the WDV method, while SLM is commonly used in accounting.

5) What is Tax expense?

As defined in IND AS 12, "Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax". In other words, Tax Expense is the amount of tax that is computed on accounting profit.

6) What is Current Tax?

According to IND AS 12, "Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period". We can say that the current tax is the amount that a company or an individual is required to pay as income tax.

7) What are Advance Tax and Deferred Tax Asset/Liability?

When a part or whole of the Current Tax is paid before the end of the financial year (31st March), it is known as advanced tax. In this case, the Tax expense is estimated by the company and advance tax is paid accordingly. In India, advanced tax payment is necessary for all individuals or companies whose income tax liability is above Rs. 10,000. It is also called 'pay as you earn tax'.

Deferred Tax Asset is the difference amount between advance tax and current tax. Since there is an excess about paid by the taxpayer, the IT Department refunds the difference amount to the taxpayer and hence it as an asset.

Deferred Tax Liability is the amount of tax which an individual or a company is liable to pay after paying advance tax based on the taxable profit.

8) What is the Minimum Alternative Tax (MAT)?

Minimum Alternative Tax (MAT) is a tax calculated on accounting profit. A company must pay the higher normal tax and MAT. Companies with the help of several exemptions and loop-holes try to avoid paying income tax. MAT is a way introduced by the Income Tax department to ensure that companies pay a minimum amount of tax.

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