FINANCIAL ACCOUNTING I

UNIT-3
INTRODUCTION TO ACCOUNTING THEORY
&
INTRODUCTION TO ACCOUNTING STANDARD

SYLLABUS

- *Concept of Accounting Theory, relation with practice*
- *GAAP [Generally Accepted Accounting Principles]*
- *Capital- Capital Maintenance concepts*
- *Limitation of Historic Cost Accounting*
- *Introduction to Fair Value Accounting*
- *Financial accounting standards : concept, benefits, procedure for issuing accounting standard in India.*
- *Need for a global standard. IFRS (concept only)*

GAAP [Generally Accepted Accounting Principles]

- Generally Accepted Accounting Principles (GAAP) are basic accounting principles and guidelines which provide the framework for more detailed and comprehensive accounting rules, standards and other industry-specific accounting practices. For example, the Financial Accounting Standards Board (FASB) uses these principles as a base to frame their own accounting standards.

GAAP encompasses:-

✔Basic accounting principles/guidelines

✔Accounting Standards usually issued by the premier accounting body of the country

✔Industry-specific accounting practices to cover unusual scenarios

✔**Principle of consistency:** This principle ensures that consistent standards are followed in financial reporting from period to period.

✔**Principle of permanent methods:** Closely related to the previous principle is that of consistent procedures and practices being applied in accounting and financial reporting to allow comparison.

✔**Principle of non-compensation**: This principle states that all aspects of an organization's performance, whether positive or negative, are to be reported. In other words, it should not compensate (offset) a debt with an asset.

✔**Principle of prudence**: All reporting of financial data is to be factual, reasonable, and not speculative.

✔**Principle of regularity**: This principle means that all accountants are to consistently abide by the GAAP.

- ✔**Principle of sincerity**: Accountants should perform and report with basic honesty and accuracy.

- ✔**Principle of good faith**: Similar to the previous principle, this principle asserts that anyone involved in financial reporting is expected to be acting honestly and in good faith.

- ✔**Principle of materiality**: All financial reporting should clearly disclose the organization's genuine financial position.

- ✔**Principle of continuity**: This principle states that all asset valuations in financial reporting are based on the assumption that the business or other entity will continue to operate going forward.

- ✔**Principle of periodicity**: This principle refers to entities abiding by commonly accepted financial reporting periods, such as quarterly or annually.

Concepts of Capital Maintenance

✔Financial Capital Maintenance

Financial or money capital maintenance pertains to the original cash invested by the shareholders in the business enterprise. According to this concept periodic income should be measured after recovering or maintaining the shareholders' equity intact.

Income under this concept is the difference between opening and closing shareholders' equity. It is this amount which may be distributed as income without encroaching upon the financial capital of the firm.

✔Operating Capital Maintenance.

Operating Capital Maintenance can be measured in a variety of different ways, generally seeks to ensure that the business's physical operating capacity is maintained.

Limitations of Historical Accounting

1. Changes in the price level are not taken into account.
2. Fixed assets are shown in the position statement at the cost at which they were acquired.
3. Depreciation is charged on the historical cost of the asset.
4. Financial statements contain non-comparable figures because of inflation.
5. Tax is levied on money profits.
6. Balance Sheet consists of monetary as well as non-monetary items.

Fair Value Accounting

Definition: Fair Value is defined in IAS 39 as "the amount for which asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."

Features:

1. Fair Value incorporates market information into the financial statement.
2. It focusses on the fair value of assets and liabilities.
3. Fair value of Balance Sheet based.
4. Fair value accounting meets the conceptual framework criteria in terms of qualitative characteristic of accounting information.

INTRODUCTION TO ACCOUNTING STANDARDS

- Accounting standards are accounting rules and procedure relating to measurement, valuation and disclosure issued by the Council of The Institute of Chartered Accountants of India. Accounting standards are stated to be the norms of accounting policies and practices by way of guidelines that should be followed while preparing accounts and disclosed in the annual financial statement. The accounting standards are intended to apply only to items which are material.
- Accounting standards are regarded as a mechanism for resolving the conflicts of interest among various preparations and users of accounting information.
- Accounting standards are generally appropriate to the normal conduct of business and are in conformity with local conditions.
- Accounting standards serve public interest and are based on a conceptual framework of accounting.
- Necessarily, the utility of accounting standards results in a consequential improvement in the quality of preparation of financial statements.

NATURE

- *Mandatory in nature*
- *Applicable to published accounts of limited companies*
- *In case of sole proprietorships or partnerships*
- *Financial statement are statutorily required to be audited.*
- *Accounting standard could be national, international or both. Every national institute frames its own accounting standards, which generally are in keeping with the international norms. In effect, the development of accounting standards in India has been contemporaneous with that of the international accounting standards, which are formulated by global organisation of accounting bodies. As such, there is not much difference among the parameters of these standards.*

PROCEDURE FOR ISSUING ACCOUNTING STANDARDS

1. Determination of the broad areas in which AS need to be formulated

2. Formulation of Study Groups.

The study groups will help Accounting Standard Board (ASB) in the preparation of the AS

At the time of formulation of study groups, provisions will be made for wide participation by the members of the institute and others.

3. Holding of dialogue by ASB with the representatives of the government, public sector undertakings, industry and the other organisations for ascertaining their views.

4. Preparation and publication of an exposure draft of the proposed standard for comments by members of the institute and the public at large. An exposure draft is prepared on the basis of the work of the study groups and the dialogue with the different parties as mentioned above.

5. Circulation of the draft so revised among the council members of ICAI, Securities and Exchange Board of India (SEBI), Comptroller & Auditor General (CAG), Dept. of Company Affairs and others seeking their comments.

6. Discussion with the representatives of the council members and specified outside bodies seeking their views on the draft accounting standard.

7. Finalization of the Exposure Draft of the proposed accounting standard with the help of comments arises and results of the discussions with the representatives of specified outside bodies.

8. Circulation of the Exposure Draft inviting Public comments.

9. Consideration of the comments received on the exposure draft of the accounting standard and making revision and modification of the same, if needed.

10. Submission of the Final Draft of the accounting standard to the council of the Institute of Chartered Accountants of India.

11. Issuance of the Accounting Standard by the Council of the Institute of Chartered Accountants of India.

Adoption of IFRS

It has already been stated that many countries of the world have already accepted IFRS and some are trying to implements the IFRS as early as possible (e.g. all European Union, Hong Kong, Australia Malaysia, Pakistan, Russia, South Africa, Singapore, Turkey etc.).

Many countries require IFRS reporting for all domestic listed companies. The United States of America is also progressing towards IFRS. For this purpose, they are shifting from US GAAP to accept IFRS. General acceptance of IFRS will, no doubt help the investors as well as the other users of financial statements.

It will improve and increase the quality of information and will also reduce the cost of comparing alternative investments. Since the investors will be more interested to provide financing, companies are also expected to take the advantage of adequate financing.

IFRS and Convergence with AS

Benefits of Convergence

1] Beneficial to the Economy

If the accounting standards are converged it will promote international business and increase the influx of capital into the country. This will help India's economy grow and expand. International investing will also mean more capital for domestic companies as well.

2] Beneficial to Investors

Convergence is a boon for investors who wish to invest in foreign markets or economies. It makes it much easier for them to study and compare the financial statements of foreign companies. Since the financial statements are made using the same set of standards it is also easier for the investors to understand and analyze them.

3] Beneficial to the Industry

With globally accepted standards the industry can also surge ahead. So convergence is important for the industry as well. It will allow the industry to lower the cost of foreign capital. If companies are not burned by adopting two different sets of standards it will allow them easier entry into the market.

4] More Transparency

Convergence will benefit the users of the financial statements as well. It will make it easier for them to understand the financial statements. And this will generate better transparency and raise the confidence of the investors to invest funds.

5] Cost Saving

Firstly it will exempt companies from maintaining separate accounting books according to separate standards. This will save a lot of work hours and money for the finance department. And also planning and executing auditing will also become easier.

It will be especially helpful for those companies that have subsidiaries in many countries. And the cost of capital will also reduce since capital would be more accessible and easily available.

BASIS FOR COMPARISON	GAAP	IFRS
Acronym	Generally Accepted Accounting Principles	International Financial Reporting Standard
Meaning	A set of accounting guidelines and procedures, used by the companies to prepare their financial statements is known as GAAP.	IFRS is the universal business language followed by the companies while reporting financial statements.
Developed by	Financial Accounting Standard Board (FASB).	International Accounting Standard Board (IASB).
Based on	Rules	Principles
Inventory valuation	FIFO, LIFO and Weighted Average Method.	FIFO and Weighted Average Method.
Extraordinary items	Shown below.	Not segregated in the income statement.
Development cost	Treated as an expense	Capitalized, only if certain conditions are satisfied.
Reversal of Inventory	Prohibited	Permissible, if specified conditions are met.

THANK YOU