Managerial Accounting
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Module - 4
Lecture - 7
Accounting Concepts, Standards, IFRS

In our last session, we have started discussion on accounting standards GAAP I F R S and so on to begin with we will talk about accounting principles. And then will go ahead with the new concepts last time we have done 56 concepts will go ahead with the new concepts. So, what do you understand by accounting principles? All the accounting is based on certain theoretical understanding and that is known as accounting principle. Accounting will present a true and fair view only when it is properly backed by systematically laid down principles. They are those rules of conduct and procedures which are adopted by accountants to ensure that there is uniformity and to ensure that there is fairness in the reporting. Now, this concepts are basic to the process of accounting hence they are known as accounting concepts. Some of the important concepts are business entity, going concern conservatism and so on.

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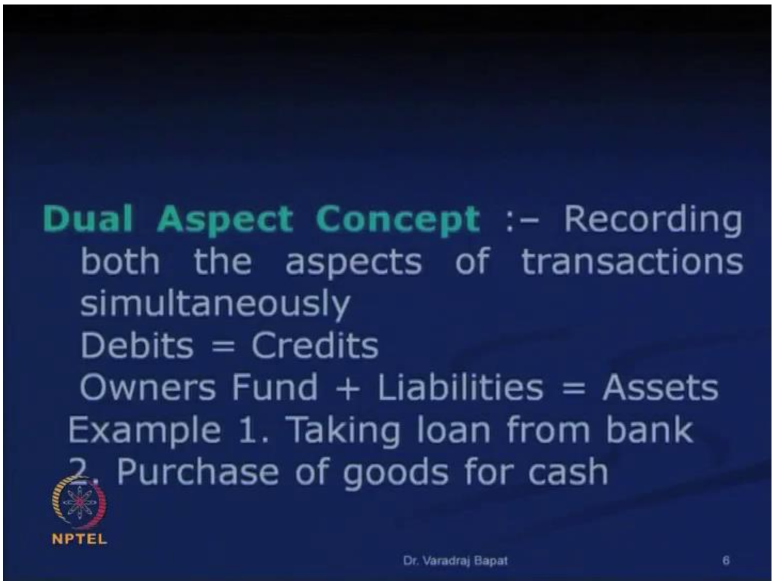

Now, let us see a business entity concept, which we have already discussed last time that the owner is different from the business that is why we make entries for capital invested.

The next is dual aspect concept in dual aspect concept both aspects of transactions are recorded separately in accounting terminology, they are known as debits and credits. So, debit should be equal to credits, we have also seen there is a balance sheet equation, where in owners fund plus liabilities is equal to assets. So, let us see 2 examples first when we take loan from bank, can you imagine what will be the entry which accounts are affected; obviously, when we get money our bank account balance increases and our liability for loan also increases.

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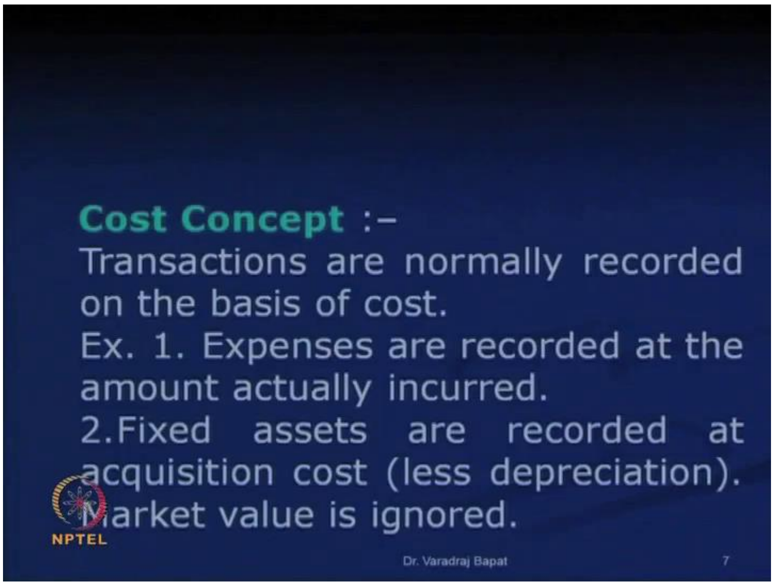

So, on one hand asset increases on the other hand liability increases, we have already seen this earlier this comes, because of business entity concept. The second one is purchase of goods for cash here in we are giving cash. So, cash balance falls and as cash balance falls our inventory balance arises. So, again because of dual aspect the balance sheet equation is maintained. Cost concept; it says that the transactions are normally recorded on the basis of cost expenses are recorded at an amount, which is actually incurred. And fixed assets are recorded at acquisition cost less depreciation, we do not consider the market price, this is because of the cost concept.

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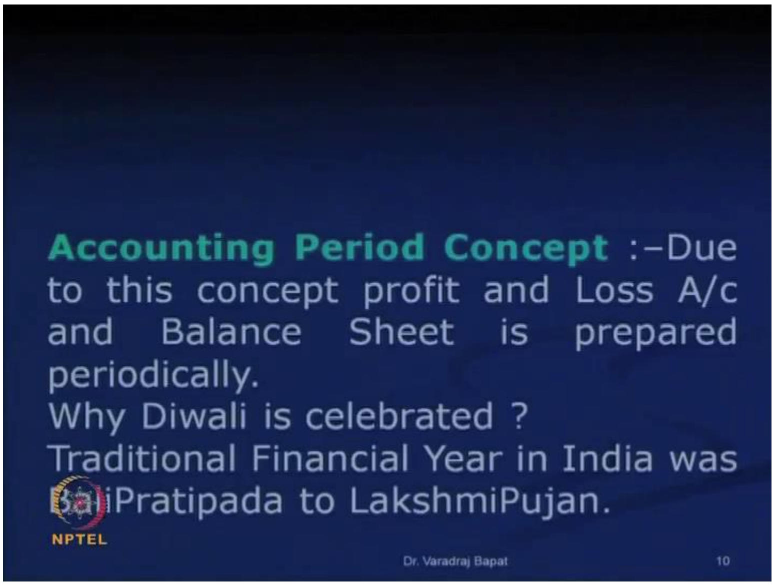

Next concept which we are discussing, which we have already discussed is going concern. Now, here it is assumed that business entity has a pretty long life; it is going to continue in the forcible future. And because of this concept we depreciate fixed assets over their useful life. We do not assume that depreciation fixed assets have to be written off immediately. Next is accounting period concept, which again we have discussed at link last time that the whole business cycle is divided into fixed periods. And the financial statements are prepared at the end of this period, due to this concept the profit and loss account and balance sheet is prepared and reported periodically. We have also seen that traditionally the Diwali has been the financial year, which was followed in India.

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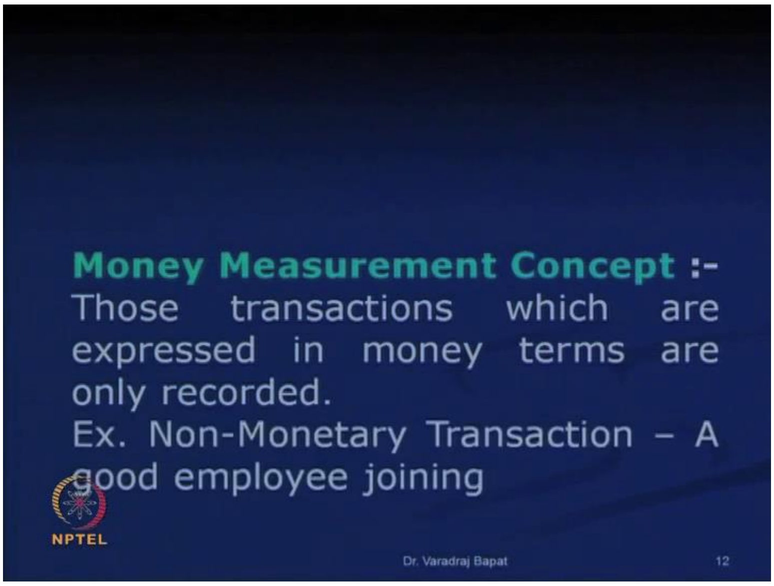

Currently the financial year, which is followed, is from first April to thirty first March in US, it is from January to thirty first December and so on. In different countries different accounting periods are used this is a new concept. I think first time we are dealing with that is money measurement concept. It says that the transactions, which are expressed in money term alone, are recorded. Now, can you imagine a nonmonetary transaction for example, a very good employee joins the company.

Now, if the employee joins the company, it adds lot of value to the company the enterprise value has actually increased. But that cannot be recorded, because it is not the monetary transaction. What accounting system will record is expenses incurred for let us say recruitment selection etcetera. But cannot really record the value of person coming in, I can give you one more example suppose we are able to have a very good business contact the contact is really valuable. But since no transaction has been incurred, just a contract is developed it cannot be recorded in the books of accounts, that is because of the money measurement concept. Next is realization concept, in realization concept the revenue is recognized only when, an agreement is reached or the sale is made. In other words just because the stock value has increased, we will not be able to show the value has it has increased; only when the sale is made will recognize.

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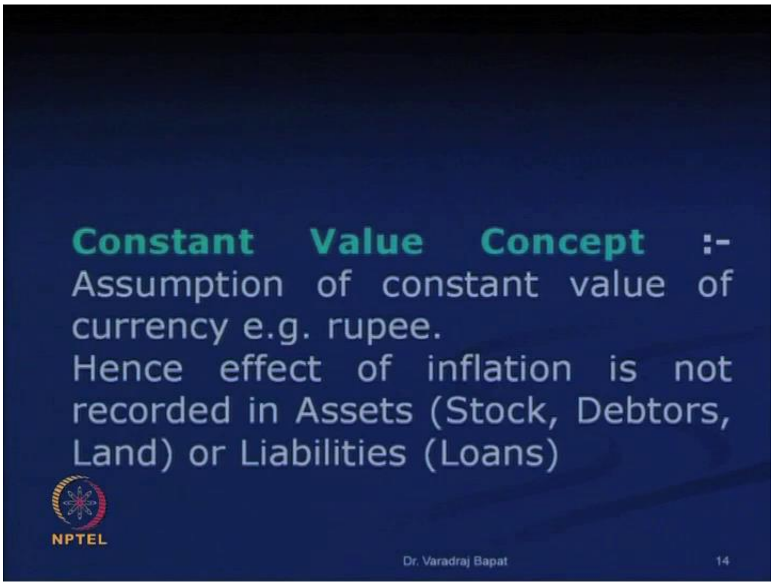

So, all revenues unless they are realized they are not supposed to be recorded in the accounting system. Next is a constant value concept now, in constant value concept the assumption of constant value of currency that is in case of India say rupee is assumed. So, the value of currency may change, especially because of inflation. So, what may happen is we are holding some stock the value of stock is raising, because of inflation. But we will not record it in case of debtors certain amounts are receivable, the value of money is actually falling. So, the amount of money which will recover from debtors is same.

But it is true value may have fallen, but we will not record those rises and falls same thing you find with land generally the land prices rise, but we cannot record them. In case of liabilities, what happens is if you have taken loan then the value of loan as you repay in absolute term remains same. But the amount is actually lower, but we cannot show that lower value, so we have to show the value as is in absolute terms, it is not in terms of constant value. The next is accrual concept now, let us go for accrual concept by accrual concept, what we mean is the effect of transactions are recorded on mercantile basis. That is when they occur we record we do not wait till the cash is received or paid for example, credit sale. So, if a transaction is entered the goods are sold. So, the transaction has happened, but the cash is yet to be received.

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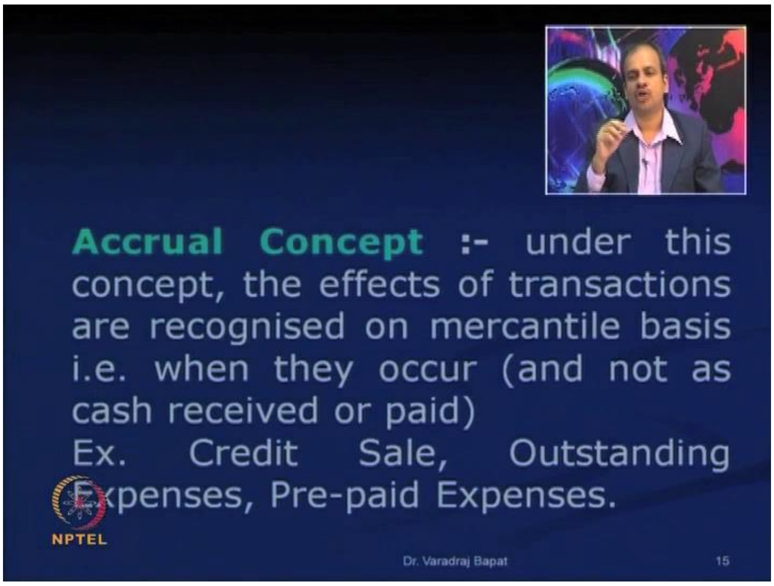

We do not wait till the cash is received as soon as the sale has happened, it gets record then you have to recognize the outstanding expenses. So, it might have happened that salary for this month is not paid at the end of the month. It will be paid only in the next month; however, at the end of the month the outstanding salary will get recorded again. Because of the accrual concept same thing happens with pre-paid expenses, suppose insurance is paid in advance we will record the insurance. Because even if it is for the next period and it has been paid now, we will treat we will show it as a prepaid expense.

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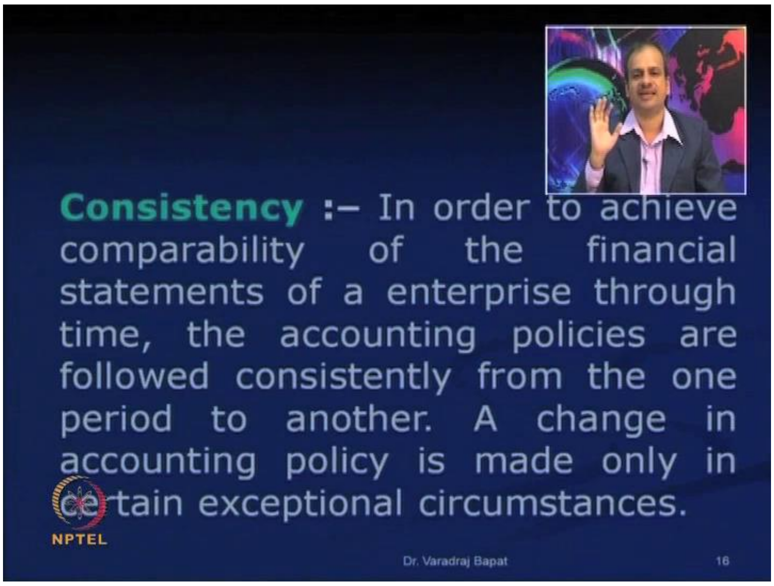

So, we do not actually wait for cash received and paid in case of prepaid expense. What will happen is whatever is insurance for the current period will be transferred to profit and loss of this period whatever is paid for future will be recognized as prepaid will not be charge for this period. So, accounting system recognizes the expenses as and when they occur same thing is true for income or any other transaction. It is not based on receipt or payment of cash and that happens, because of the accrual concept next is consistency. Now, it is very important that whatever the accounting concept of principles, which we are following they need to be consistently followed. If we change them frequently the accounting statements will not be comparable across the periods.

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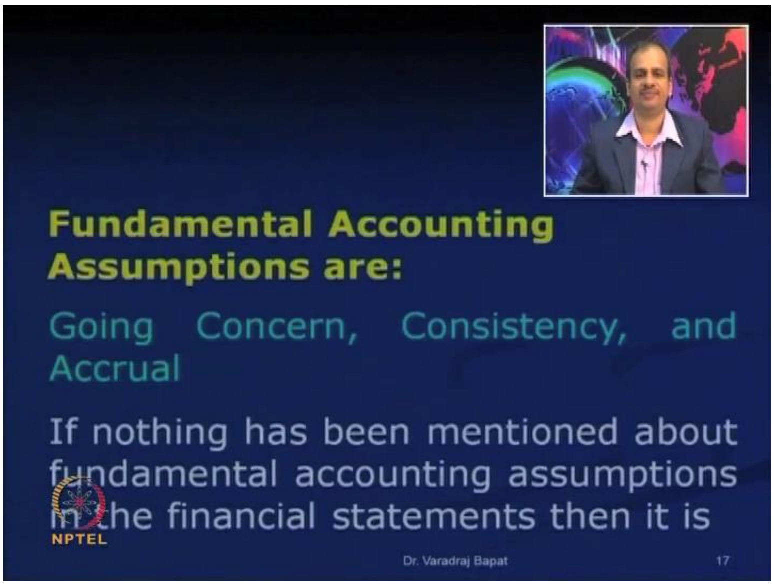

For example, suppose the depreciation is being charged at twenty percent this year and next year we charge it at ten percent. Then the books will not remain comparable, it is required by the standard setting authorities. That you must follow the same accounting policies across all the periods, only in the exceptional circumstances the changes are allowed. And at that time the proper disclosure is required this happens, because of the consistency principle now, let us understand fundamental accounting assumptions. Now, some of the accounting assumptions, though we have seen many concepts. And all of them are important certain concepts are deemed to be fundamental accounting assumptions, why they are called fundamental assumptions.

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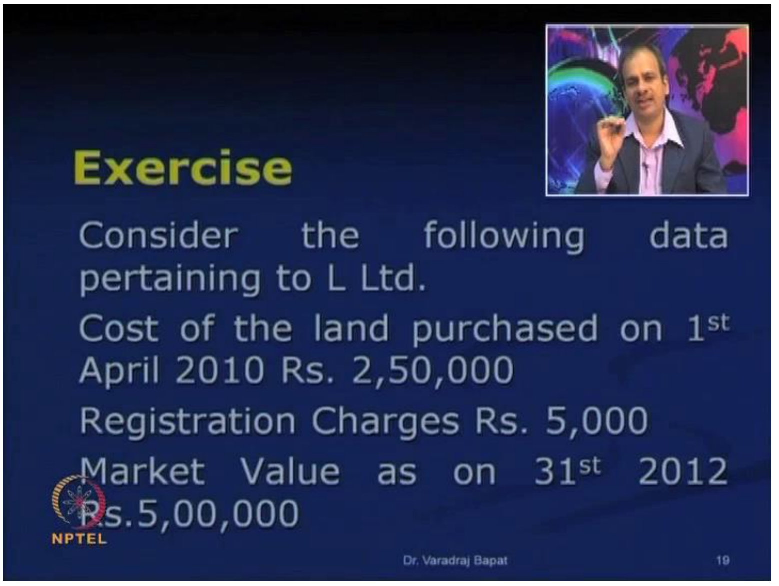

Because even if it is not disclose, it is deemed that these assumptions have been made while making the financial statements. If they are not followed, then the disclosure is required, if they are followed no separate disclosure is needed. There are 3 assumptions first is going concern we already discussed it, second is consistency and third is accrual. So, these 3 concepts or these 3 funds as should always be followed and any deviation from them will need to be separately disclosed and reported. Now, let us do one small exercise suppose the land is purchased on first April 2010 and a cost of land is 250000. Registration charges paid there on 5000 as of thirty first March 2012 the market value of the land is estimated to be 500000.

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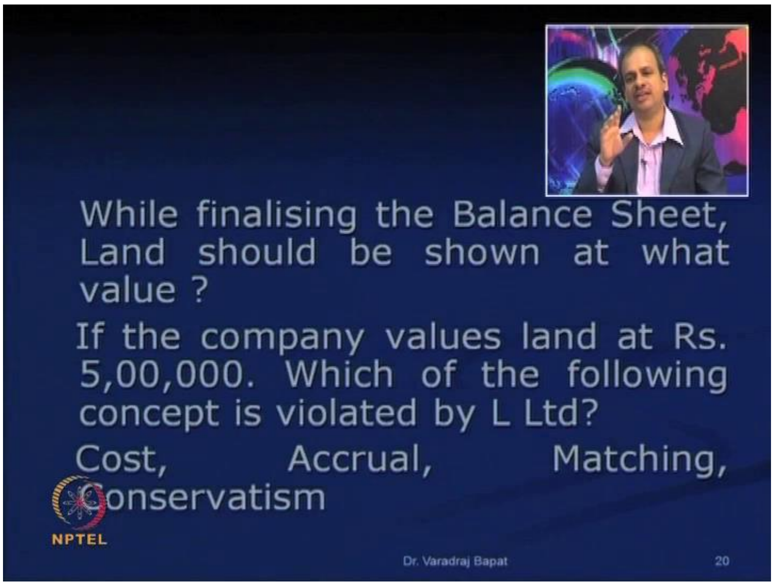

.Now, what is a value that should be shown in the balance sheet as on thirty first March 2012. That is question number one just think over will that be 200050 will it be at 200055 will it be at 500000. What is a value shown? That is question number 1, are you able to guess? Just have a look at data once again. Now, suppose management decides to value it at 500000 is it a correct decision and if not, which are the concepts which they have violated. They have if at all they value it at 500000, it is not a correct position, they have violated number of concepts the first concept violated is cost concept. We have already seen that all transactions need to be recorded at cost here the cost of land is 255000; if you record it at 500000 the cost concept is violated. Secondly accrual concept is also violated, because the cost of 5000, which was a registration charge, which is a onetime cost.

So, it should be added to the cost of land, if that is not followed accrual concept and matching concept both are violated. And the concept of conservatism is also violated, because conservatism says that we cannot show the profits unless they are realized. Now, there is a appreciation in the value of land from 255000 to 500000, but we cannot show that appreciation unless this sale transaction is realized. So, there are 4 concepts just think over and tell me actually which concept or which concepts are violated are all 4 violated or which 1 are violated? The major violation is towards conservatism; because conservatism does not permit you to value the land at selling price then its cost price is 255000. Other concept also there is slight deviation, but major violation is towards concept of conservatism. So, what will the correct value should it be 250 or 255, it should be 255000. Because 5000 which is a registration charge, it should be added to the cost of land, it cannot be charges the expense of that year it will violate matching concept. So, it needs to be added to the cost of land and land will be shown at 255000 that is considered as the cost of land is it fine.

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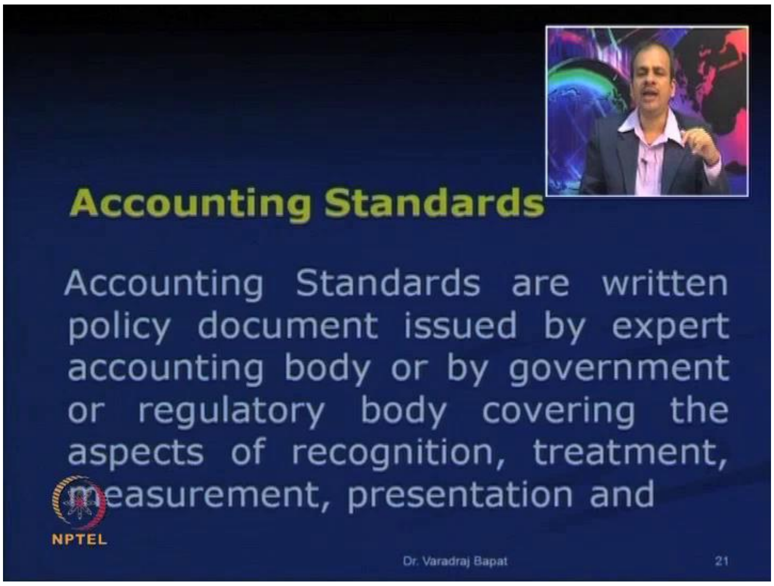

Now, let us go to something which is known as accounting standards. Now, we have seen that there are some accounting fundamentals, which are known as accounting concepts, which should be kept in mind based on the accounting concept the accounting policies are wrong. Now, are companies free to choose any concepts they like or any policies they like it is not? So, because it is companies follow some concepts, if they do not follow some concepts or if their policies are matching with some concepts. And not matching with some concepts, it will create lot of problems. Because as users of statements, when we read balance sheet and we see that say land is shown at 255000, we know that this must be at cost. If some other company shows, it was 500000 and if they have accounting policy to value the land at market price, it will be improper representation. So, it is necessary that there should be some laid down rules there should be some standardize, which all companies must follows. And those practices are known as accounting standards as you can see here. They are written policy documents issued by the expert body or by government or by regulatory authority, which cover the aspect of recognition treatment measurement presentation, and disclosure of accounting transactions and events in the financial statements.

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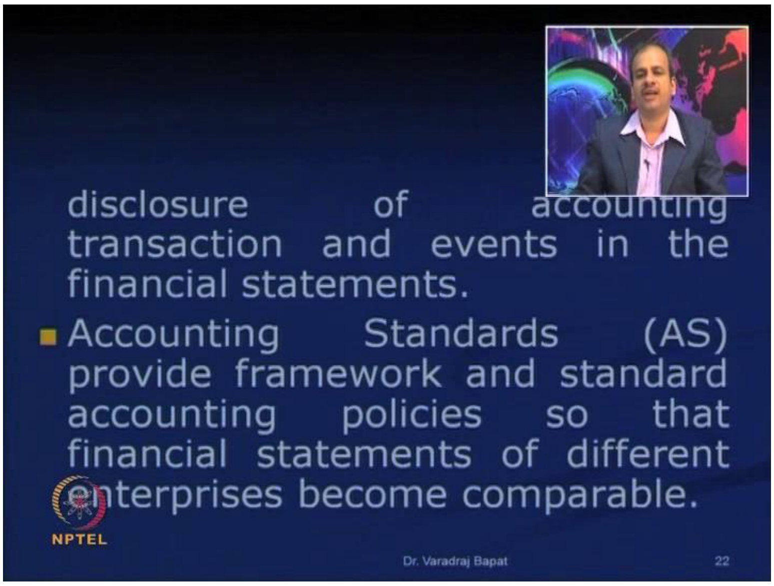

So, some standardization in the policies are made then it is called as accounting standards. Now, they provide a frame work, so that different companies follow the same pattern and their balance sheets or their financial statements are comparable.

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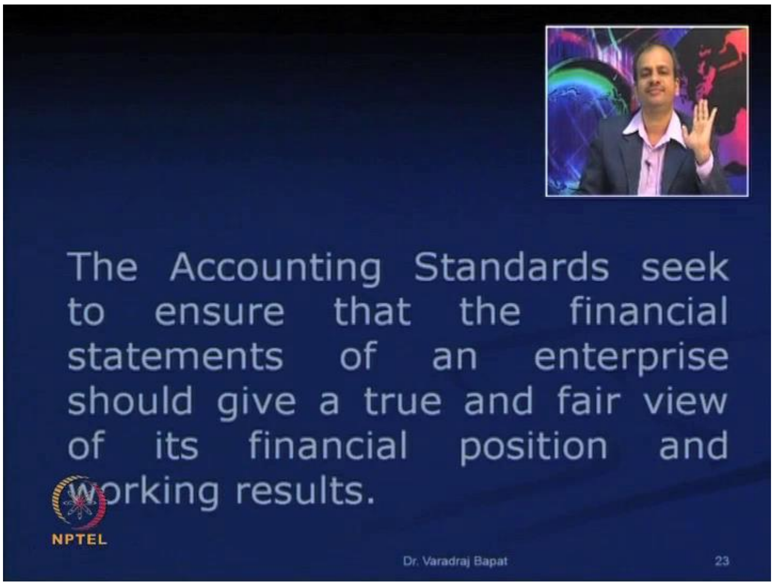

And they also ensure that you follow correct principles. So, that the true and fair view is disclosed both in terms of financial statements position and also the working results.

Now, accounting concepts do not necessarily forced a particular policy, because there may be different business conditions, there may be different business scenarios. So, they do not laid down that all the time you must follow this; however, apart from laying down some concepts or some principles, they ensure that there is more transparency and market discipline.

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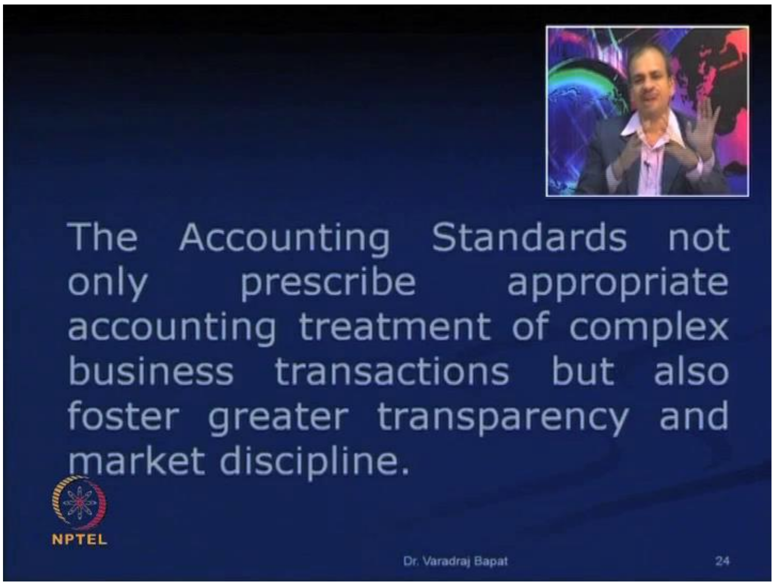

So, they do give some leave sometimes that companies may follow policy a or policy b within the prescribed permitted deviation. So, that you follow the correct principle at the same time, they faster greater transparency. And market discipline, why greater transparency, because they make it mandatory that certain disclosures must be made. So, that user is aware and they get lot of info. Secondly, market discipline, because all the companies are forced to follow a particular pattern. These are the 4 things, which accounting standards typically promote, they promote uniformity rationalization comparability and transparency; I hope these terms are clear to you.

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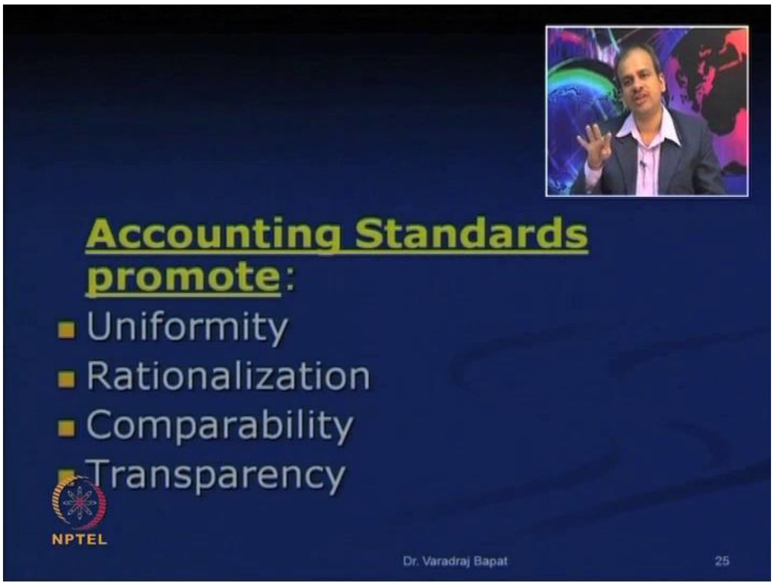

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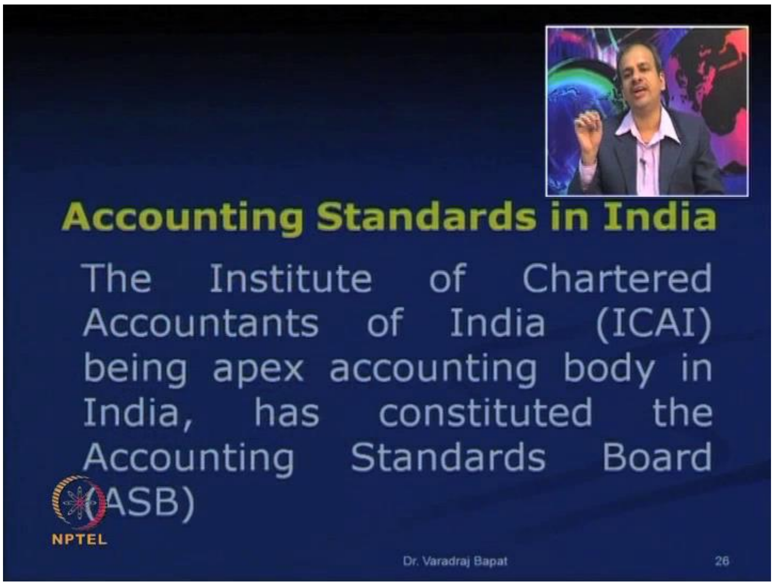

Now, let us come to Indian accounting standards, we have already seen that accounting standards are the standardize norms for accounting, which are laid down by regulatory bodies. In case of India I C A I institute of charted accountants of India is the apex accounting body. So, they have constituted a board, which is known as accounting standard board, which has the basic responsibility of laying down the accounting standards in India. The board was constituted on twenty first April 1977 with the same purpose that there should be harmonization of policies and to formulate the standard. While formulating the standards, it is not just the accounting requirements A S B also looks at the applicable laws, customs, usages and the business environment as prevailing in India.

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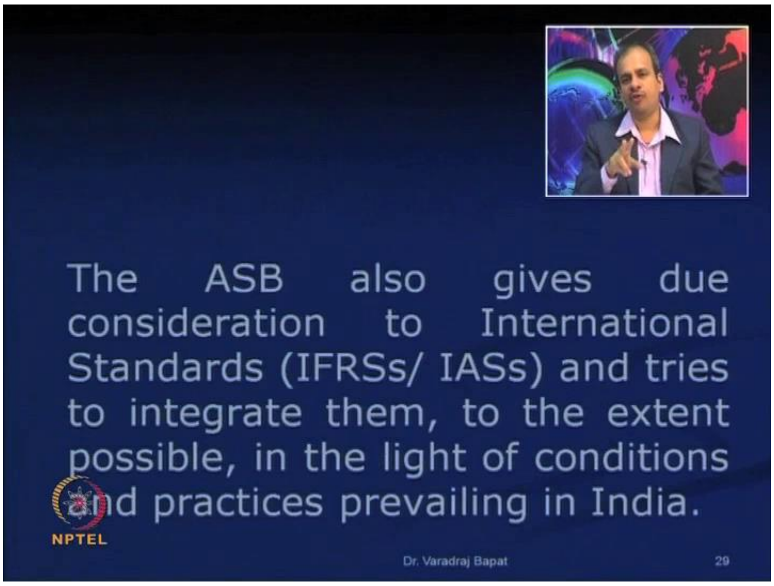

Apart from these things, as you may be aware, currently there is lot of need from the companies, that you should have uniform standards across the globe. Because there are lots of cross broad transactions, there are investors, investing from one country to another there is export import rise of global trade. So, it is necessary that at international level also the transactions are recorded in fairly the same manner. That is why A S B gives due consideration to international standards like I F R S and I A S and tries to integrate Indian standards to those standards. We are going to discuss those I F R S and I A S in detail in some more time like. Now, A S B till October 2011 has issued 34 accounting standards, since now, there is a need to converge Indian standards with the international standards.

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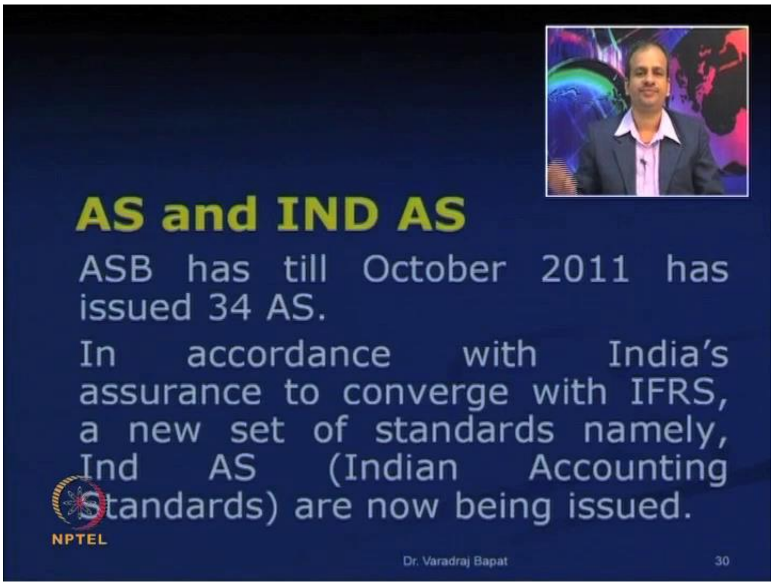

ASB is coming out with new set of standards, which are closer to international standards and they are known as Ind A S. So, currently India has 2 standards one are A S, which are the existing accounting standards and there is Ind A S, which are newest of Indian standards, but which are closer to international standards. Let us have a look at Ind A S now, the ministry of corporate affairs has also notified this Ind A S as on 21 February 2011; however, new set of standards that is Ind A S is not mandatory to all the companies from day one, they are being implemented in phased manner. So, currently all the business entities all entities are following A S. But the larger corporate or those companies, which are listed abroad and required to use Ind A S in the first phase, gradually more and more companies will be covered by Ind A S.

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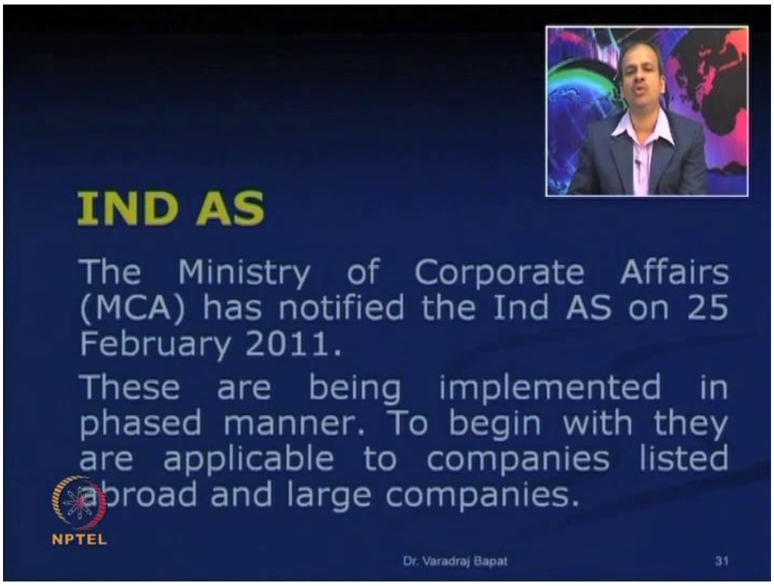

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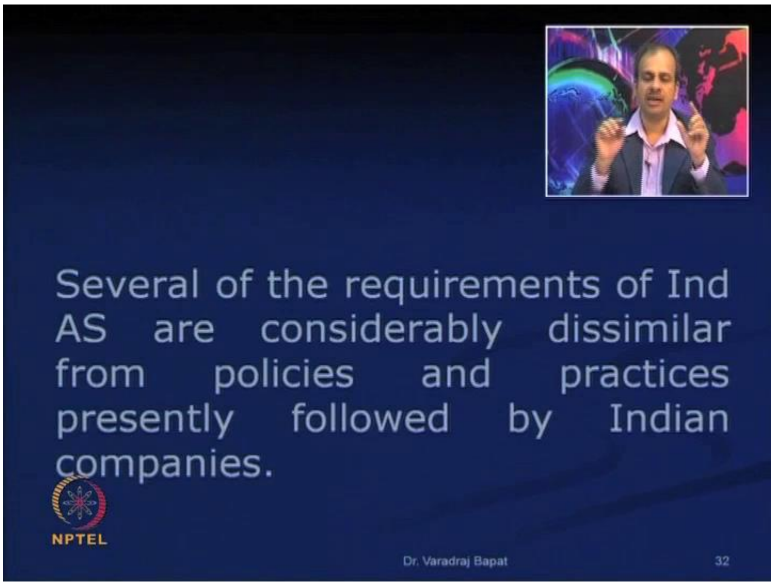

There are some requirements of Ind A S, which are dissimilar with the current practices, because Ind A S is more closer to international standards. So, there is some difference between Ind A S and current A S. So, sometime is given to companies to shift from A S to Ind A S. Now, what standard setters have done for formulating Ind A S is 1 is their looked at individual I F R S and they have also seen the conditions as in India. So, make those standards suitable to India that is why there are some differences, which are known as carve outs difference between Indian A S and parallel I F R S. Let us look at this thing now; in detail first I will look at a list of various accounting standards, which are very similar to I F R S their numbers are like this.

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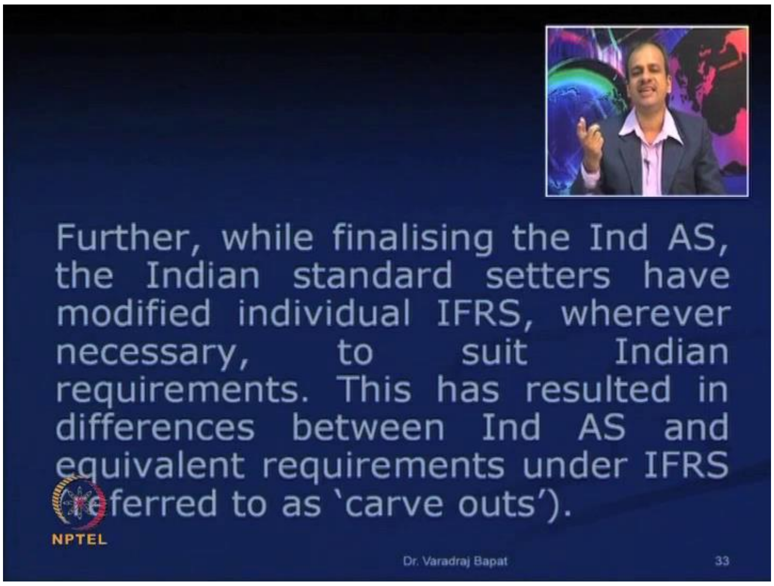

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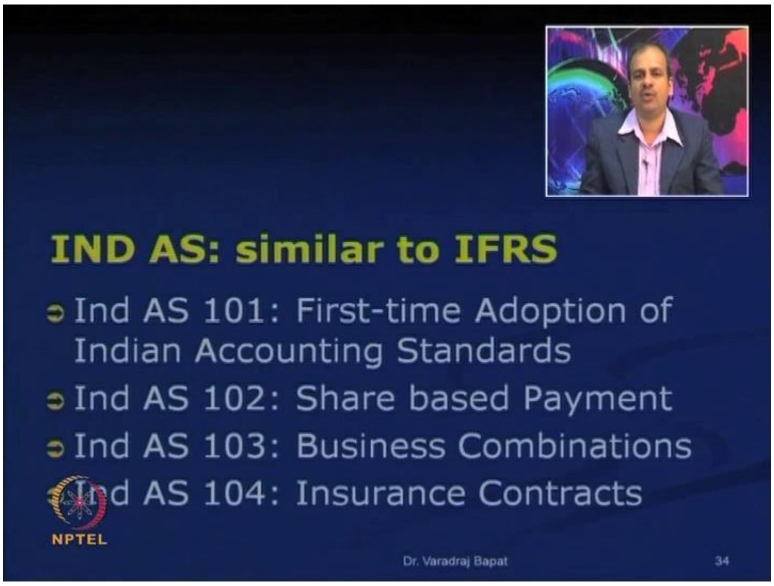

Ind A S 101 is for first time adoption of Indian accounting standards. Then Ind A S 1 0 2 it takes care of share based payments, Ind A S 1 0 3 about business combinations.

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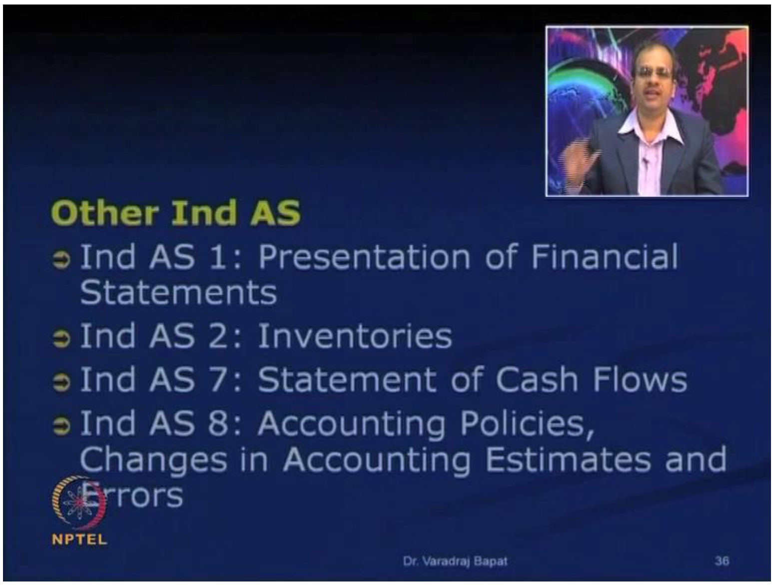

1 0 4 is about insurance contracts, 1 0 5 noncurrent assets held for sale and discontinued operation and so on. 1 0 8 is operating segments these 8 standards from 1 0 1 to 1 0 8 match closely with I F R S 1 to 8 that is why their names are being 1 0 1 to 1 0 8. Then there are some other standards, which are closer to I A S international accounting standards. We will discuss them I F R S and I A S in sometime, but those standards are named as Ind A S 1, Ind A S 2 and so on. You can see on the screen Ind A S 1 is presentation of financial statement. Ind A S 2 is about inventories then Ind A S 7 is statement of cash flows, Ind A S 2 is accounting policies changes in accounting estimates and errors and so on.

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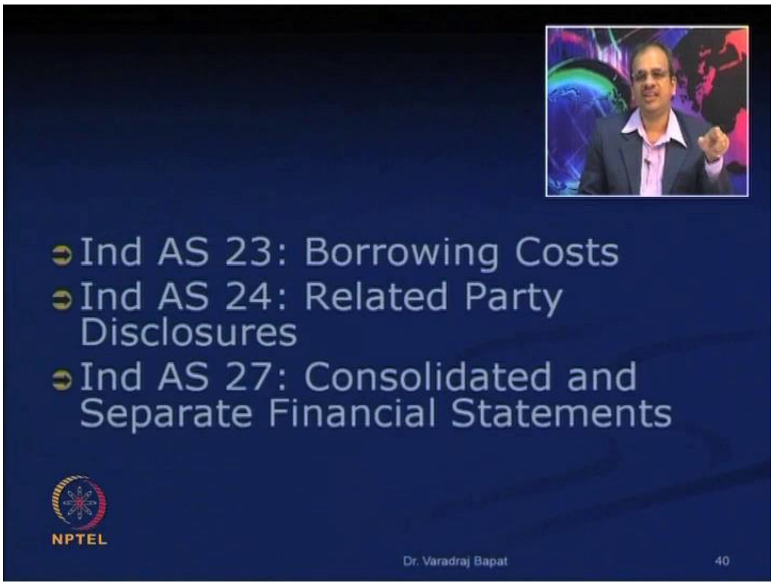

So, you can see they are not actually numbered as 1 2 3 4 it is 1 2 then 78, because these standards have exact matching with the corresponding I A S. That is international accounting standard; their numbers are also kept in that way. So, next is Ind A S 10 for events after reporting period, Ind A S 11 for construction contracts, Ind A S 12 for income tax. Then Ind A S 16, 17, 18, 19 Ind A S 20 is about government grants 21 is about foreign exchange rates, 23 about borrowing costs related party disclosures 27 is for consolidation.

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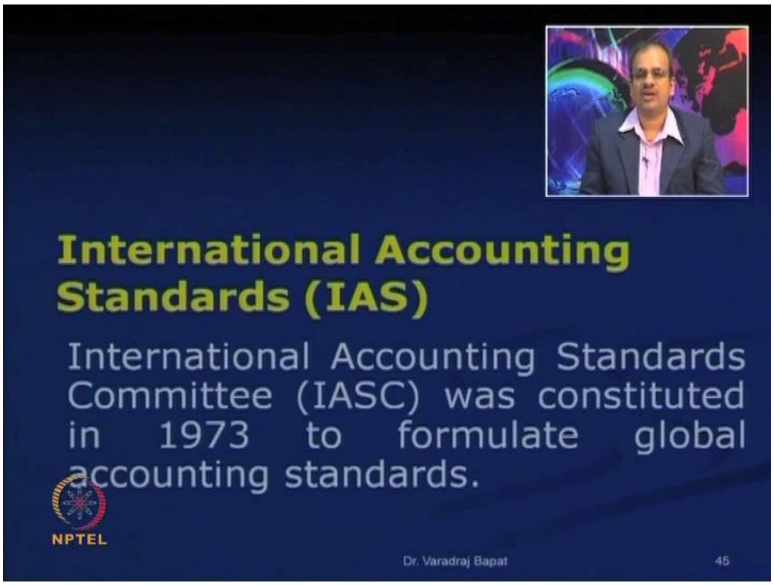

So, you can glance through, so Ind A S 40 that is investment property is a last in this series. Let us have a look again, so if you go back to current A S. You can see that Ind A S first is Ind A S 108 to 1 0 1, 1 0 1 to 1 0 8 is are 8 standards, which are in close correspondence with I F R S. Then you have other set of standards, which are Ind A S 1 to Ind A S 40 of course, they are not 40 in number. But they are numbered from 1 to 40 there are gaps in between, which correspond to I A S. Now, let us understand what is actually this I A S and I F R S. Now, an international accounting standard, to there was a need as we saw from the business community from the accountants from the investing community that there should be harmonization at international levels.

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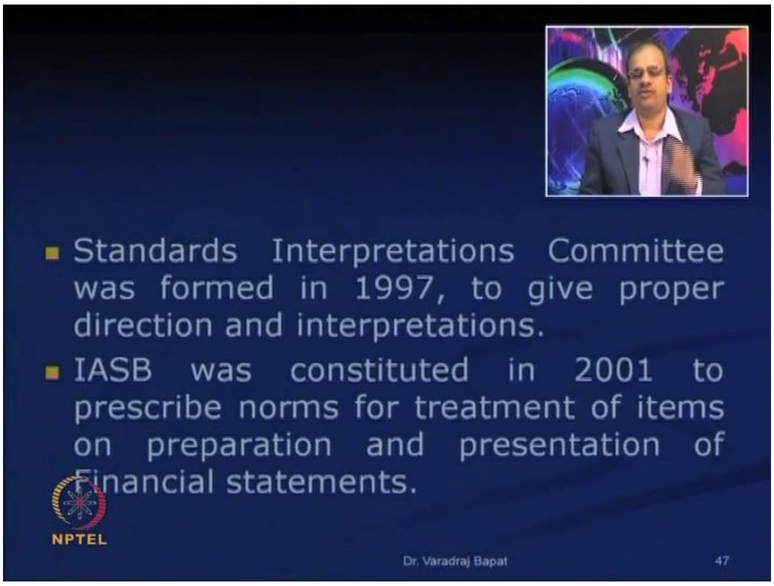

So, you need some global accounting norms and you cannot have A Situation where one countries balance sheet are not compared with other countries balance sheet. Because with rising international trade and rising cross border investments. There was a need to have some common practices that is why a body known as international accounting standard committee was constituted in 1973. That was a first effort to have global accounting standards. Now, the standards which are issued by this I A C are more or less followed by or they are being closely link to their local standards by most of the countries. But country is like Canada Japan and U S have still not accepted this standards U S accounting body which is known as F A S B.

Financial accounting standard board is in the process of eliminating the differences. So, that the standards are U S standards are very close to international standards. Now, followed by this 1973 formation by of I A S C 1 more committee known as standard interpretation committee was formed in 1997. Because number of standards need to be properly understood and interpreted. Now, as a next step I A S B international accounting standards board was created in 2001 to prescribe norms for items on preparation. And presentation of financial statements now, this was a major step for making new set of standards, which are mandatory for all the global entities.

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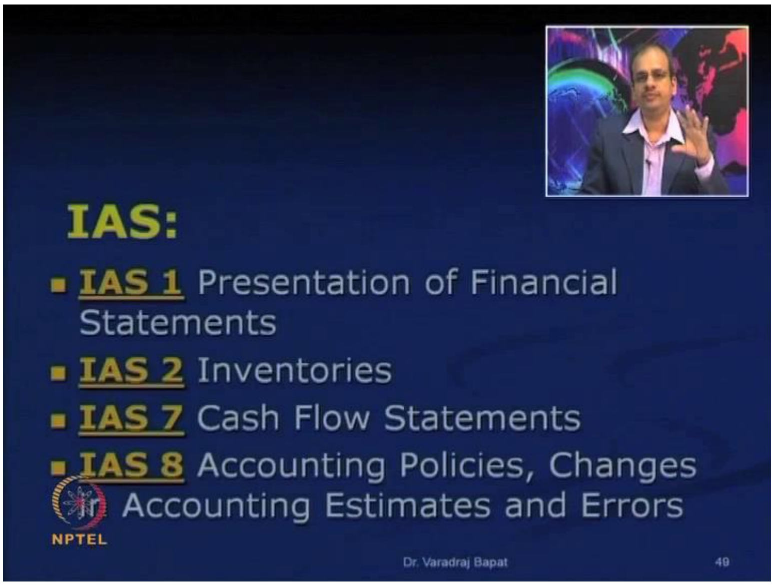

Now, I A S B has adopted all the 41 standards, which are issued by I A S C that is the international accounting standard committee. And this are now, known as I A S international accounting standards, then I A S B has also come out with new set of standards, which are known as I F R S international financial reporting standards. So, now, at a international level there are 2 set of standards one are I A S, which are old standards, but which are now, adopted by I A S B. And then there are new standards, which are called as I F R S, let us have a look at the list of I A S, I A S 1 is presentation of financial statements I A S 2 is inventories I A S 7 is cash flow.

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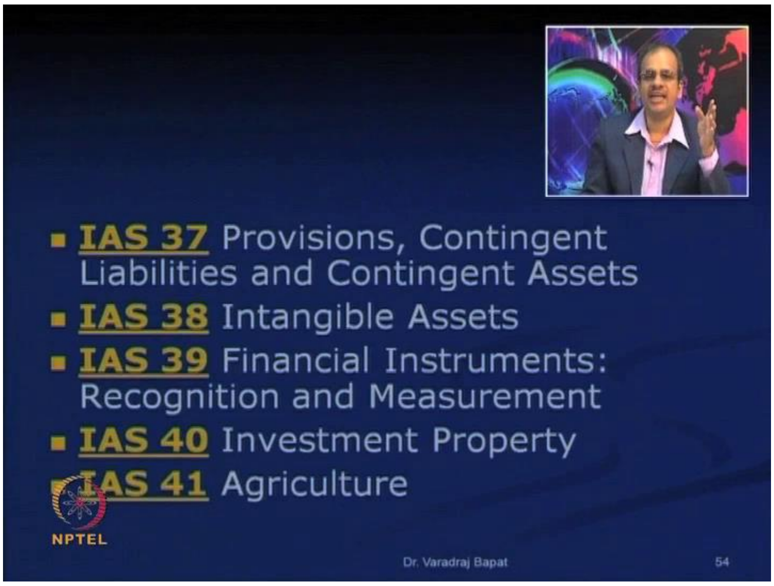

Now, you can remember that we had this Ind A S 1, Ind A S 2, Ind A S 3 sorry Ind A S 7, which actually correspond to the concern I A S. So, have a look at the list I do not think, I have to read everything, you can yourself see this list. So, currently we have got up to I A S 41 agriculture list of standards, which are issued by earst while I A S c now, adopted by I A S B that is international accounting standard board. Now, I A S c has also come out with new standards of its own, which are known as international financial reporting standards. I have not shown the list; because you have already seen this ind A S 1 0 1 to 1 0 8 they are same as concerned I F R S.

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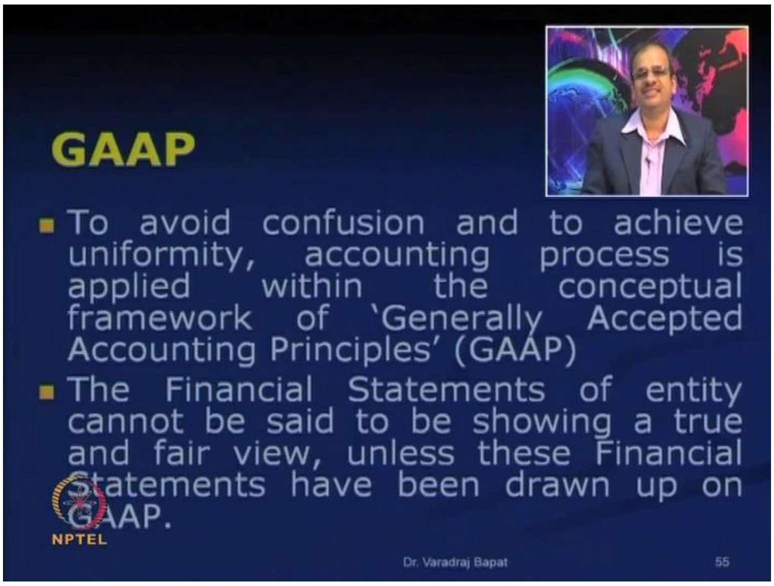

So, I F R S 1 is actually first time adaptation of Indian standards I F R S 2 is first time adoption of I F R S is I F R S 1, I F R S 2 is for share based payment I F R S 3 is for business combination and so on. So, there are 8 standards and Indian A S 1 0 1to 1 0 8 actually correspond to those respective I F R S. Now, many times you might have heard the term known as GAAP. Now, what is this GAAP? This is the term which is slightly wider than accounting standard the purpose is same that we should have a certain conceptual framework to ensure uniformity and proper recording by the accounting system.

So, that framework is known as generally accepted accounting principles or GAAP GAAP in short. Now, financial statements of the entity cannot be shown to have shown to be considered to be showing a true and fair view unless they are drawn up as per the GAAP. Now, GAAP actually has 4 components the first are requirement of law. So, if there is any particular legal provision that certain items are to be recorded in certain way. They will be a part of GAAP, I will give you an example in case of banking regulation act certain format for balance sheet of bank is prescribed.

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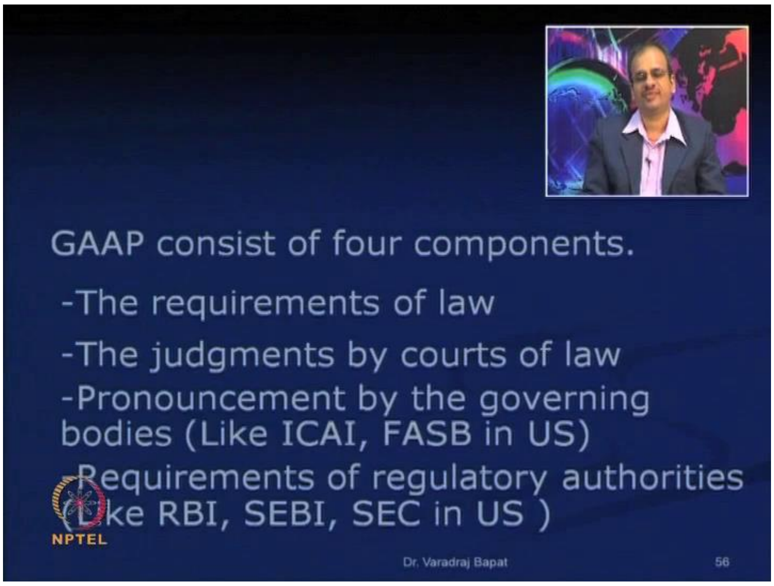

So, it is a form of it is a part of GAAP as far India is concerned same way companies act. We have already seen that there is A Schedule 6, which lays down the balance sheet format. So, it is a part of Indian GAAP though it is not a part of standard, but company losses has prescribed format for balance sheet. It is a part of law the second one the judgment by the courts of law. So, in certain cases court give certain judgment that a particular item must be recorded in a particular way. So, that way also becomes a part of GAAP, the third is the pronouncement by governing bodies say I C A I in India. We have already discussed that I C A I comes out with Indian accounting standards. And they are mandatory in India and they are a part of Indian GAAP in case of U S we have a body known as F A S B that is financial accounting standard board. So, the pronouncement by F A S B become a part of GAAP, the last 1 is the requirement of regulatory authorities for examples R B I is a regulatory authority for all the banks.

Now, R B I is stipulated norms for recognizing nonperforming assets properly known as M P S. So, what item should be recognize as N P A, how much provision should be made how you should record interest received from N P A all these things are laid down by R B I. So, they become a part of Indian GAAP same way some time sebi lays down certain disclosure norms. They also are part of R B I in case of U S there is a body known as S E C securities exchange commission their requirements also become part of GAAP. So, over all GAAP consist of legal requirements regulatory requirements and of course, the main component is the accounting standards. As you can easily imagine each country has its own GAAP since laws are different. So, Indian GAAP will be naturally governed by Indian accounting standards and Indian laws. So, there is a requirement I mean there is A Set of guidelines, which are in together known as Indian GAAP.

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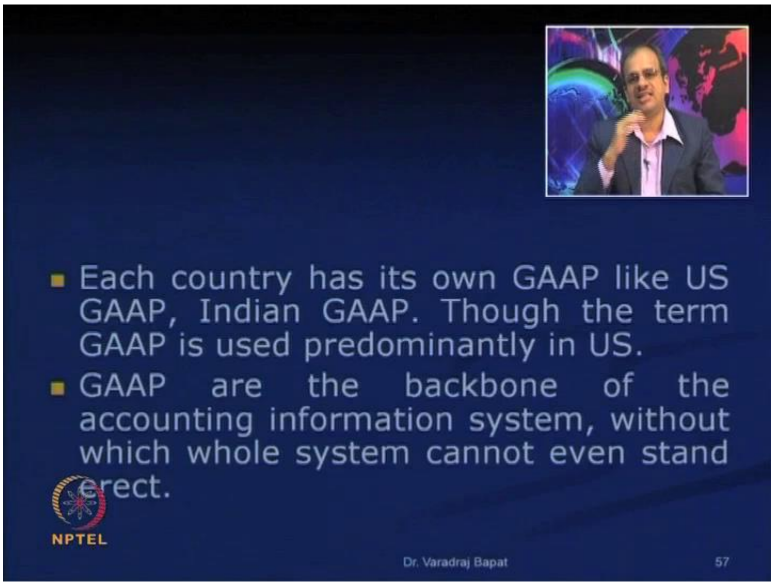

In U S again there is certain set of requirements, which are known as U S GAAP. This GAAP forms the back bone of all the accounting information system without GAAP it will be senseless and it will be un-comparable it will be meaningless. That is why it is considered as a backbone of the accounting system. This term GAAP is predominantly used in U S, because U S authorities make it mandatory for all the companies to follow U S GAAP. It if they want to list their securities in U S and so on. So, U S GAAP is the term which is commonly used, but actually there is a GAAP for each country. So, with the current effort of harmonization in accounting standards, what we can hope is in times to come say around by 2015. Most of the countries will converge their accounting standards with the global standards that is maybe I A S or I F R S etcetera.

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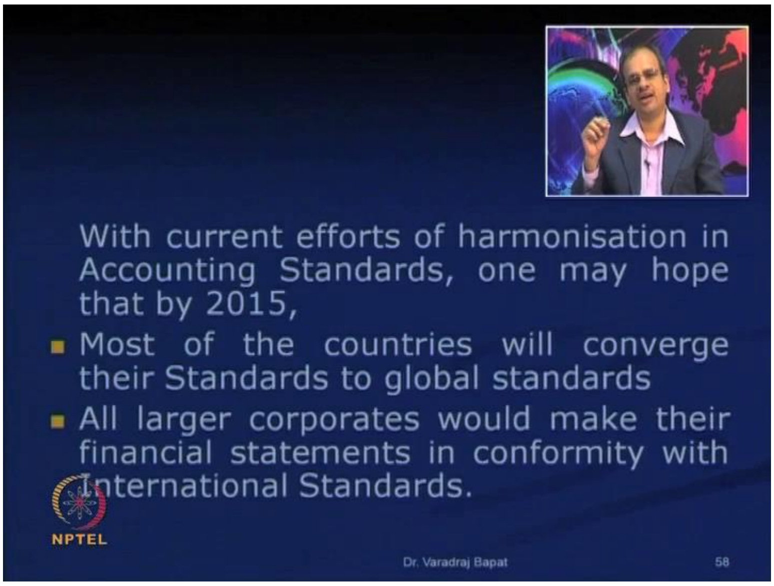

And all the larger business entities will make their financial statements, which are in conformity with international standards. Now, the benefit of these internationalization is suppose we are studying the balance sheet of say reliance industries. And we want to compare them with a U S company axon both are in petroleum business. If the GAAPs are different then their balance sheets are not comparable. But if both Indian and U S companies follow similar accounting norms their balance sheets become comparable. Same way suppose an Indian company let us say wants to invest in china. So, it is looking for a trading partner and it ask for the financial statement of a Chinese company.

If the accounting norms are completely different then Indian decision makers will not be able to understand and read that Chinese financial statements carefully; however, when the accounting norms are standardize it becomes far more simple to understand the financial statements of each other. So, these are the benefits of internationalization. So, I hope you have more or less understood the fundamentals of accounting in the form of accounting standard I A S GAAP I F R S. And the accounting concepts, which form the base of all these regulatory requirements is it fine. Let us go to the next module in this module we are going to discuss about depreciation and inventory in any balance sheet depreciation and inventory are very important things to understand.

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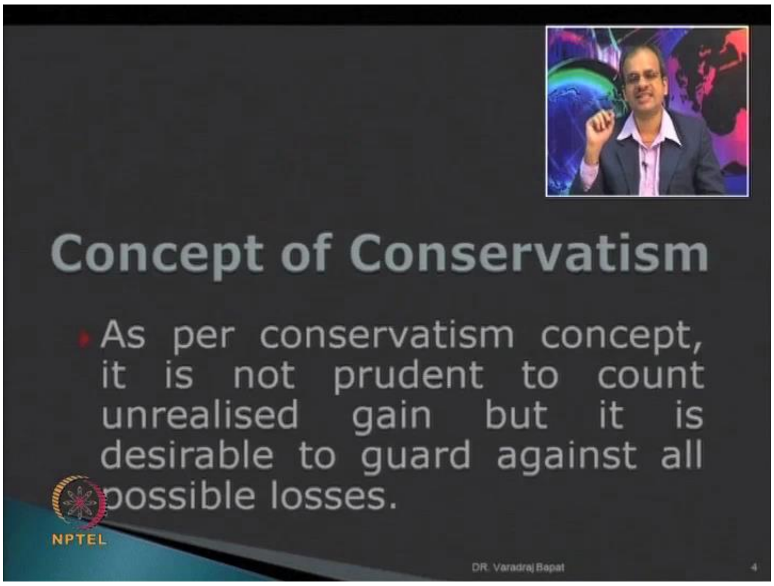

You must be knowing that in this particular thing we are going to discuss this 2 things will start with the concept of conservatism and then will look at depreciation and other provisions. We have seen some of the concepts where in we also seen that conservatism is a important concept let us deal with little more detail in here. So, conservatism states that accountant should not anticipate any income, but should provide for all possible losses. As per this concept it is not would not to count unrealized gain, but it is necessary to guard against all possible losses. Now, what does it mean suppose I have purchased inventory for 500000 and the current value of inventory goes up to 700000.

So, in my financial statements it is at 500000 that is my purchase spice current value has gone up to 700000 at what rate I should record the inventory at 500000 or at 700000.

The answer is I should record it only at 500000, because you know there is a cost concept I cannot record the unrealized profits. So, it is in violation of cost as well as realization concept. Now, suppose the cost of the stock is 500000, but its current market value falls to 420000 now, should I record 500000 or 420. Now, I will not record 500000 I will record it at 420, why now, I do not mind giving up the cost concept, because concept of conservatism actually over writes the cost concept.

So, here since it is desirable to guard against possible laws my cost is 500000, when the market price increases I do not record unrealized profit. But when the market price falls say from 500000 to 420, there is a very high probability that I will be able to sell the stock only at 420000, which is less than the market price. That is why I should record this loss as soon as it is anticipated, are you getting? So, because of the concept of conservatism I do not record unrealized profits, which is in tune with realization concept. But I do record losses even when they are yet to be realized I immediately show reduction in the value. It also says that when there are various methods to value the stock accountant should prefer the method which shows lesser value.

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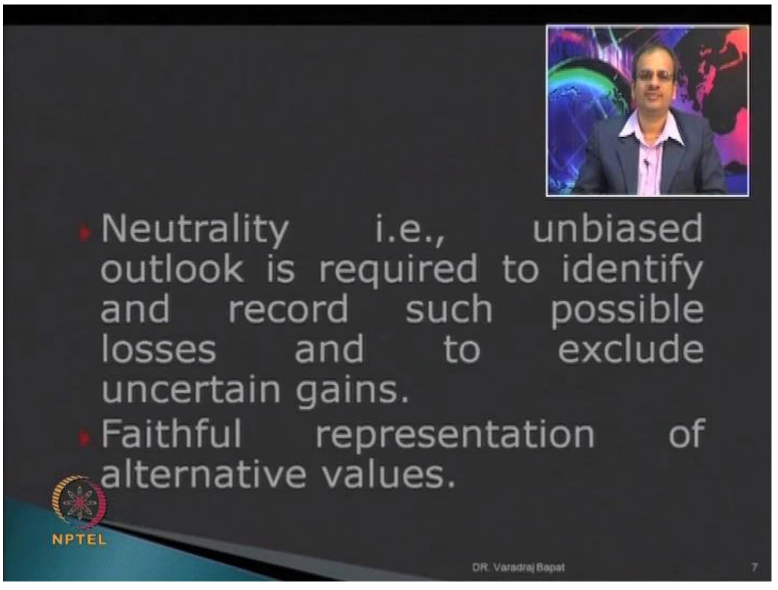

Because that is a more conservative approach instead of showing asset an inflated rate it is better to show it rather at a lower rate. There are 3 important qualitative characteristics of the concept of conservatism, first is known as prudence. That is we should make judgment about possible losses, which are to be guarded as well as gains, which are uncertain. So, there should be a fair judgment the next is neutrality accountant is required to have an unbiased outlook to identify. And record the possible losses and at the same time exclude the uncertain gains. Here you can understand that person in charge let us say c e o of the company may be interested in showing more gains and he will also be interested in not showing or not recording certain losses.

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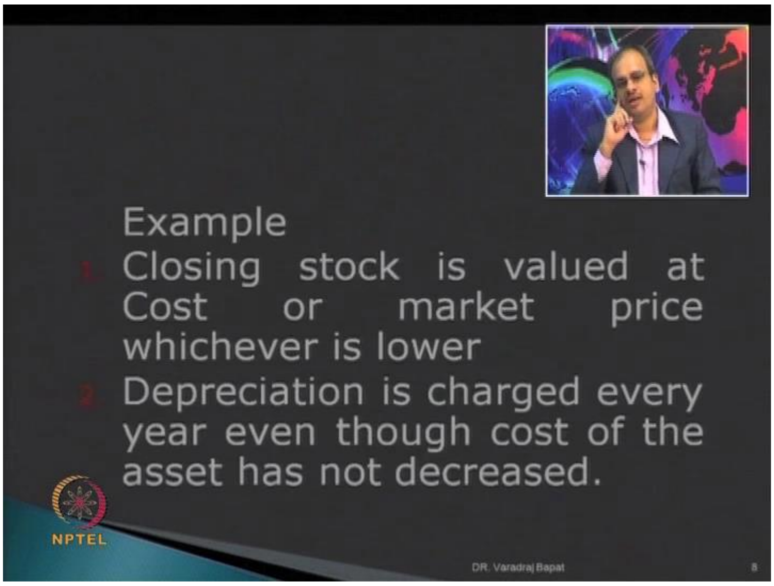

Because it will give a slightly higher profit position, but as far as the accountant is concerned accountant is required to be neutral. And he should see that the losses are properly identified and recorded whereas, whenever the gains are being recorded they should not be uncertain in nature. The third is alternative value should be faithfully represented. So, these are the 2 examples 1 we have already seen that the closing stock is required to be valued at cost or market value whichever is lower. The second example is about depreciation now, many times what happens is I might have purchased a new land new machinery for 100000 it has a useful life of 5 years.

Now, at the end of 1 year the machinery remains almost as would as new, because I have maintained it properly shall I show it at 100000 or I need to charge depreciation on it. The answer is you need to charge depreciation, because useful life of the machinery is 5 years. So, 100000 needs to be written off over the period of 5 years let us say 20000 each year. So, from 100000 I will reduce 200000 and at the end of the year the value of machinery will be shown at 80000. Methods of depreciation can vary, but it is necessary that assets should be shown at a depreciated value and depreciation should be charge every year along the useful life of the asset.

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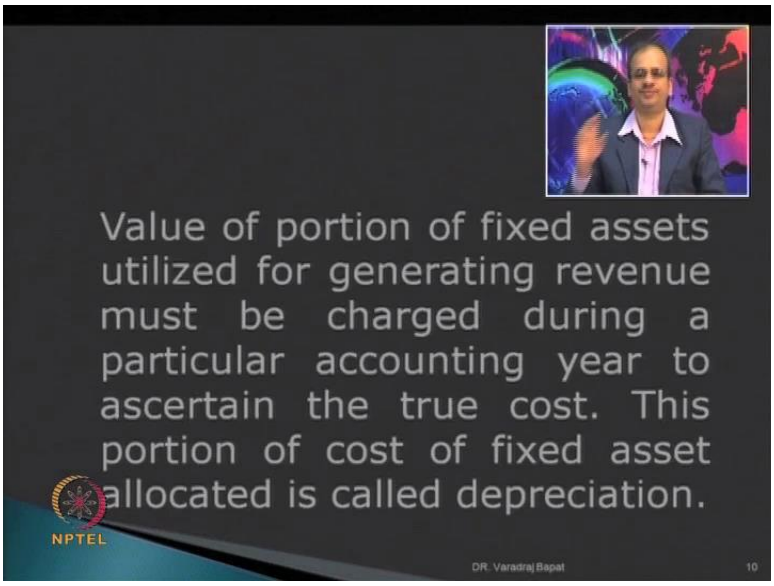

Now, this need to charge depreciation comes, because of concept of conservatism that is why before learning about the depreciation and inventory we have started with the concept of conservatism. Now, let us understand the depreciation little more in depth now, what do you understand by depreciation? You know that the fixed assets like plant and machinery as and when they are used the value of such assets is bound to decrease. And assets have certain useful life they are not there forever, so it is necessary that the value of the asset or the cost of asset is gradually reduced and completely shown I mean broad down to the scrap value at the end of its useful life. So, value of portion of fixed asset which is used for generating revenue, it charge during a particular year and this portion of the cost is known as depreciation.

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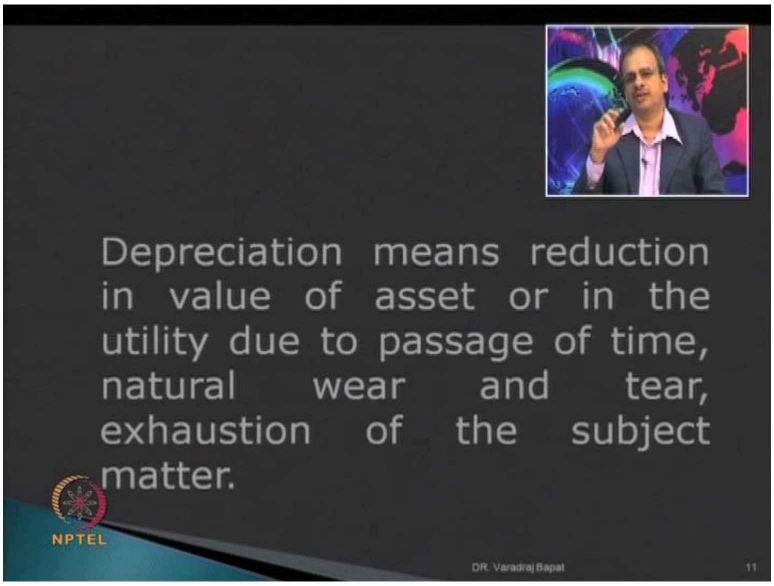

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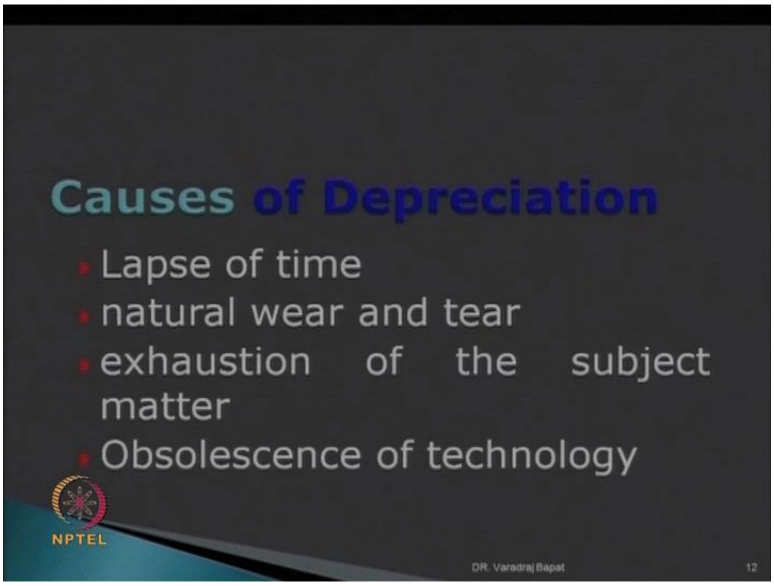

This is another definition of depreciation the depreciation means reduction in the value of asset or in the utility due to passage of time natural wear and tear and exhaustion, you got it. So, due to any of this causes the value of asset keeps on following sometimes the value of asset also falls, because of obsolescence that is also part of depreciation. Now, though in the example I have talked about plant and machinery, you should understand that the depreciation is also applicable for intangible assets. Say goodwill or software’s because of the improvements in the technology the value of software may fall; we will need to record it.

So, here the causes of depreciation are shown, that is lapse of time, natural wear and tear exhaustion of subject matter and obsolescence. Usually in case of tangible assets like say plant the natural wear and tear is a very important cause and also the time is a important cause. While the items like software there is no question of wear and tear. But the obsolescence and the lapse of time become important causes in case of assets like mines the exhaustion is a important cause. Now, why do we need to provide depreciation? What are the objectives? First is to ascertain the true value of the operations to reserves of the operation, because depreciation is a hidden expense you do not pay for it. But the value of machinery, which is being used, is actually getting reduced.

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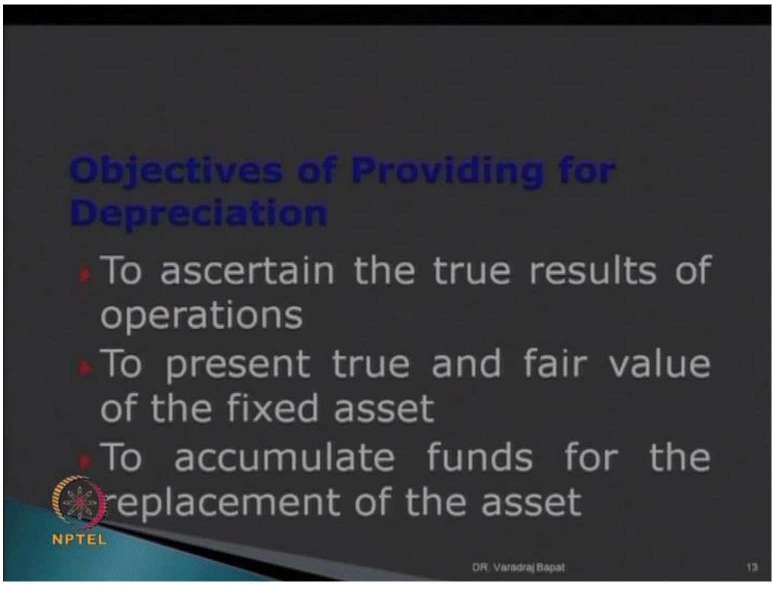

So, unless you account for that reduction the true results of operation will not be known. Second as far as the values of assets are concerned at the end of the year we need to present their true and fair value. So, the assets should be depreciated and the third objective is we also need to provide fund for replacement. So, let us assume that we have purchased machinery, it has a useful life of 5 years at the end of 5years, we will have to replace it with a new machine. So, every year we should accumulate some money. So, that we have no we have enough funds at the end of 5 years to buy new machinery. So, because of all these 3 objectives it is necessary that the depreciation is provided. Now, how do you measure or calculate the depreciation? There are 2 important aspects 1 is the estimation of the amount of depreciation is not, so easy.

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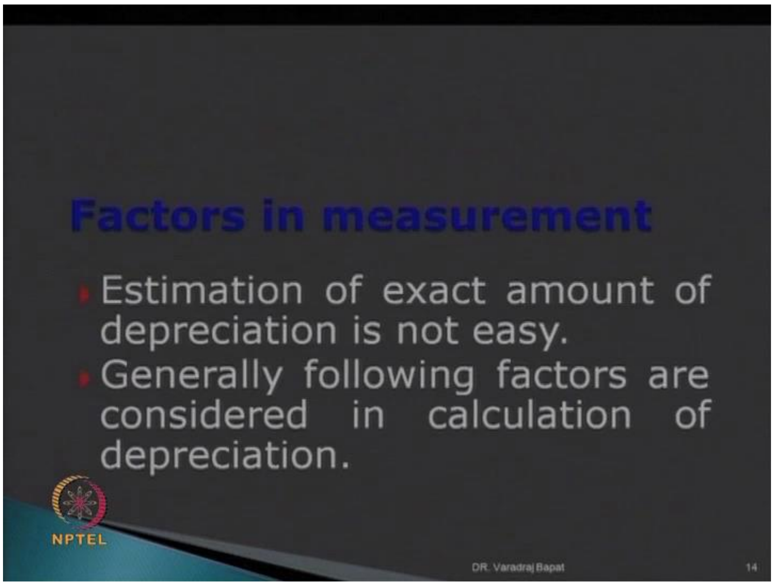

Because it is based on estimate it is not like I have paid salary 100000, so I will show it 100000. The value of asset is falling not exactly every day it may fall sometimes it may remain constant, again it may fall. But we have to have some formula some way for estimating depreciation systematically. Now, what are the aspects conceived? First is of course, the cost of asset and when we cost of consider the cost of asset. We need to include the items like expenses of installation the second is useful life of the asset. Third is estimated the estimated scrap value at the end of that useful life. Now, there are various methods of depreciation first method is straight line method.

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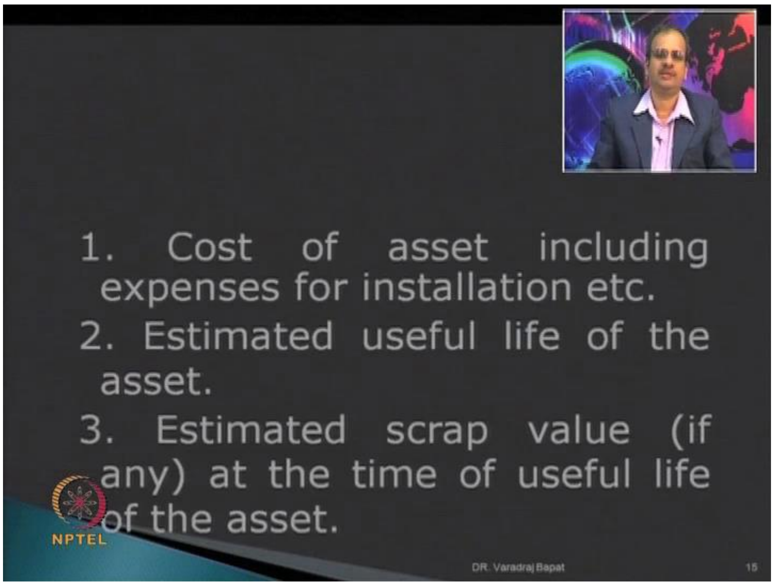

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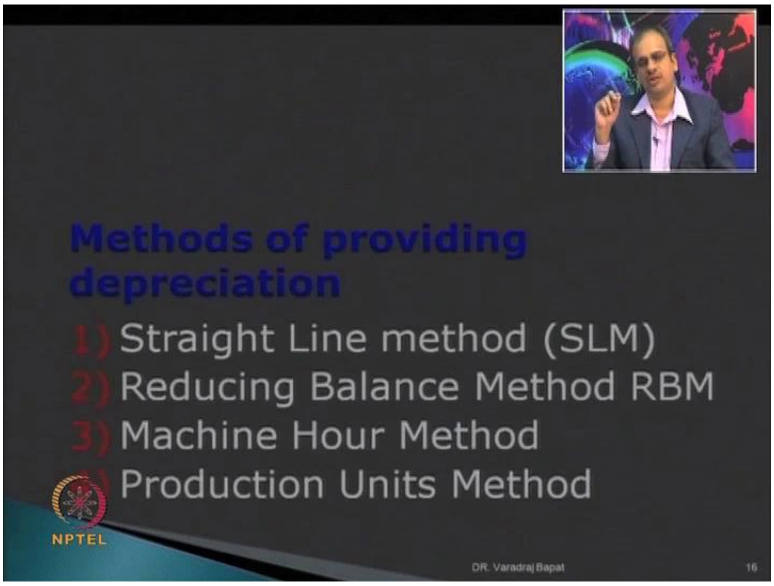

The second method is reducing balance method reducing balance method is 1 of the most popular methods, which is generally accepted by most of the laws. The third is machine hour method and fourth is production units method. Now, let us discuss this methods little more in detail and when we solve the problem you will also understand how the depreciation is measured or estimated based on this 3 factors. Now, the first method as the name suggest, it is known as straight line method. Because the same amount of depreciation is charge every year. So, suppose the value of asset is 1000000, it has a life of 5 years, we will simply divided by 1000000 by 5 and charge 200000 as depreciation every year. At the end of its working life that at end of 5 years the value will fall from 1000000 to 0.

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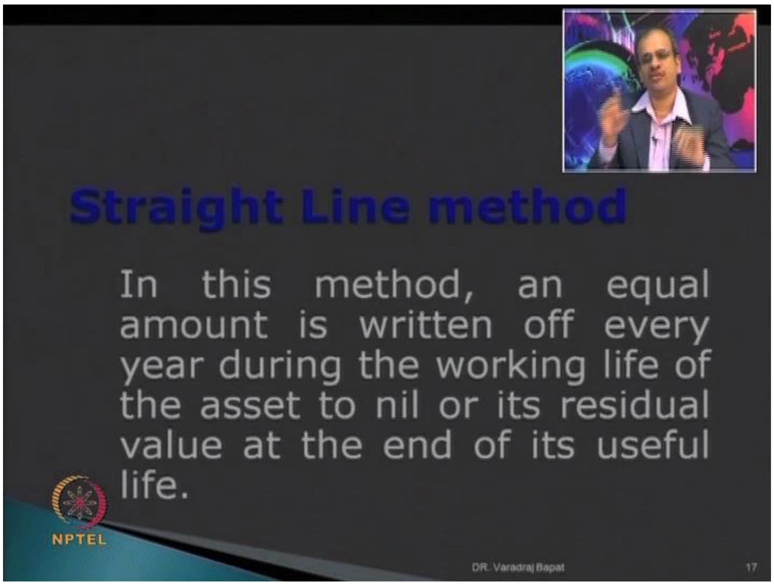

So, it is called as straight line method of course, at the end of life useful life its value may not be 0. If it has some scrap value, we will consider that, but whatever is depreciable amount, we will write it off or we will show it equally over its useful life that is A Straight line method. So, you can see the formula that the cost of asset minus scrap value divided by useful life. Now, the under lying assumption is that over the period of useful life we have more or less equal utility from the asset. So, we are going to charge depreciation equally over its useful life. You can see a simple example, if the cost of machinery is 18000 installation charges are 2000, useful life is 5 years, what will be the depreciation under straight line method.

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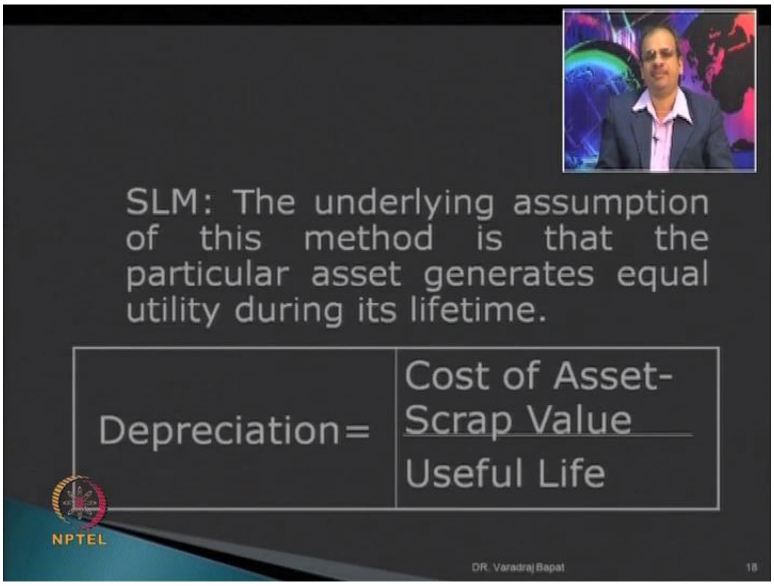

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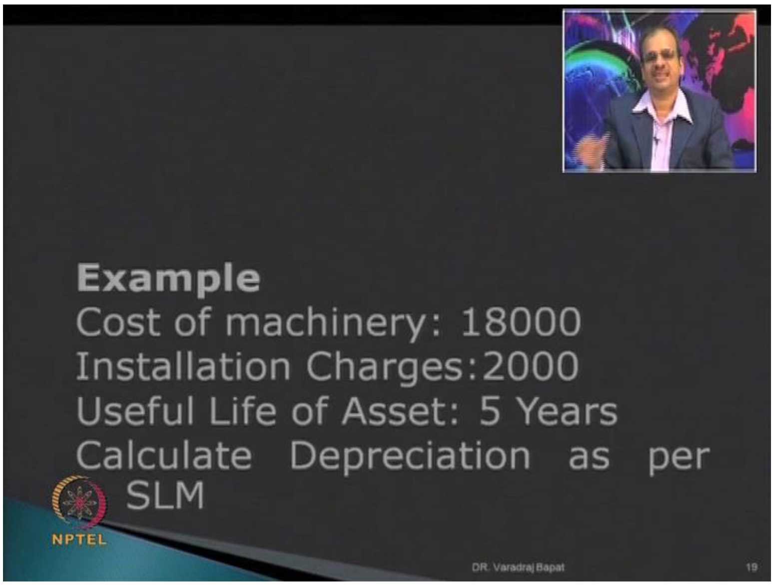

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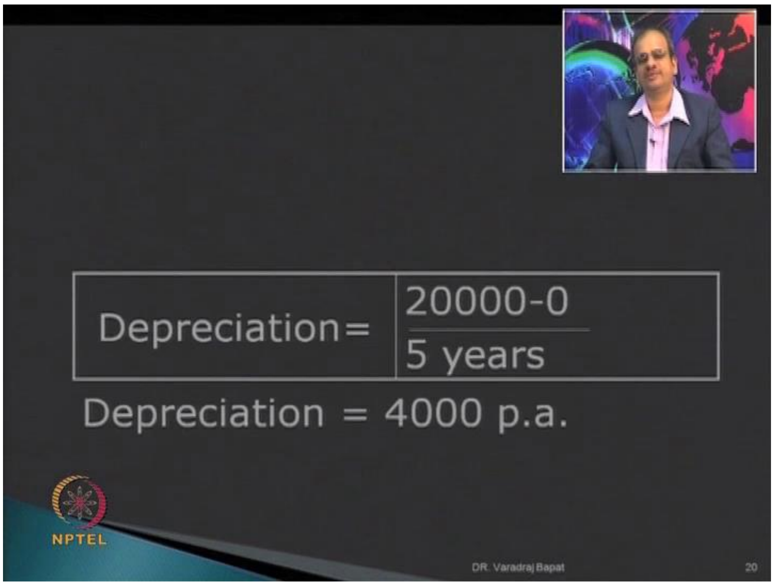

So, how much is depre, it is 18 plus 12 we have 20000 distributed over the period of 5 years. So, 20 upon 5, so you can see the calculation 20000 minus 0 because scrap value will be 0, 20000 minus 0 up on 5, so depreciation comes to 4000 per annum. Next is reducing balance method now, this method is slightly different from S L M, because here the value of depre asset as is falling the amount of depreciation also falls. So, we arrive at a particular depreciation rate and each year is value is written down value, which is equal to acquisition cost minus depreciation. And the depreciation for that year is charge as W D V into depreciation rate.

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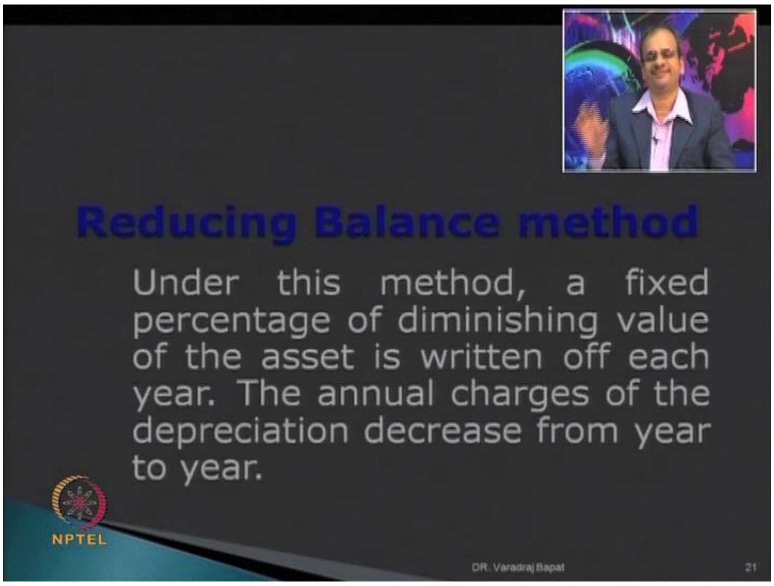

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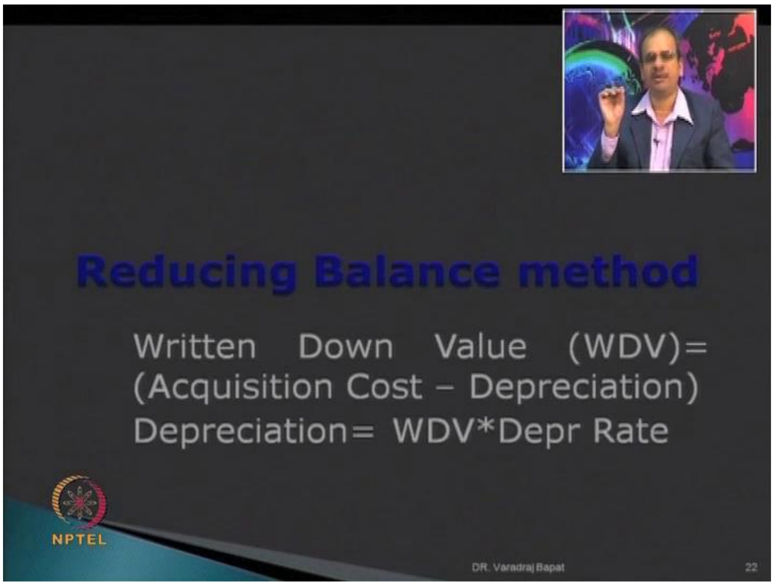

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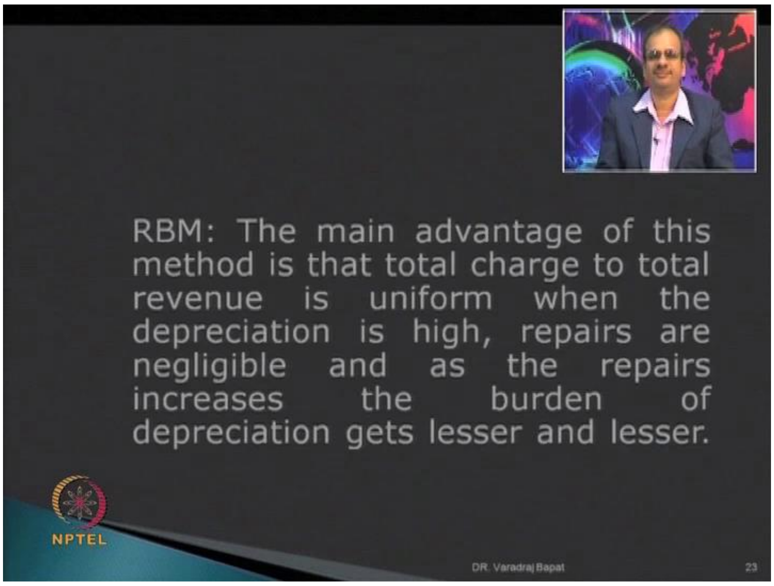

Now, the main advantage of R B M method is the value of depreciation goes on falling. So, in as the asset becomes older the repairs rise the depreciation falls, the total cost of asset use is going to be more or less constant. So, here you can see in the first year the depreciation is charge on acquisition value. So, acquisition value minus into rate from second year on words it is written down value into rate. So, let us see a small example the cost of machinery is 500000, scrap value is 5000, useful life is 10 years company has decided depreciation rate at 15 percent. So, how much will be depreciation each year calculate it for the first 2 years.

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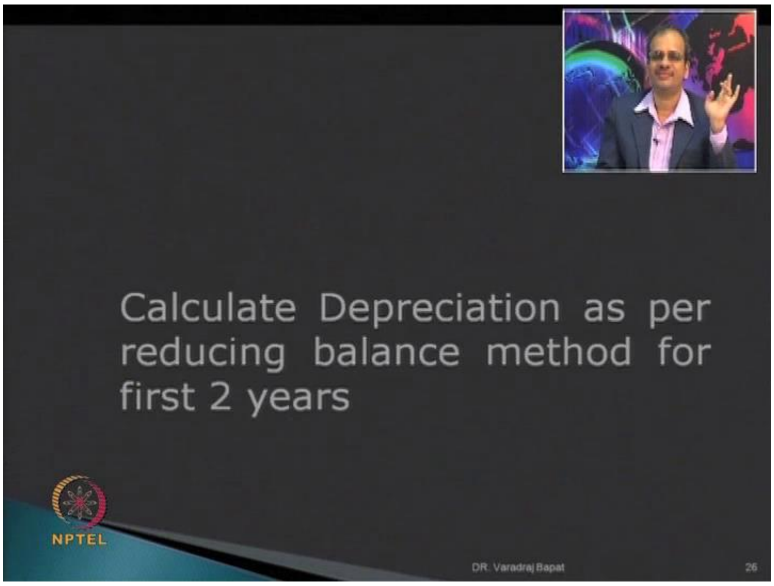

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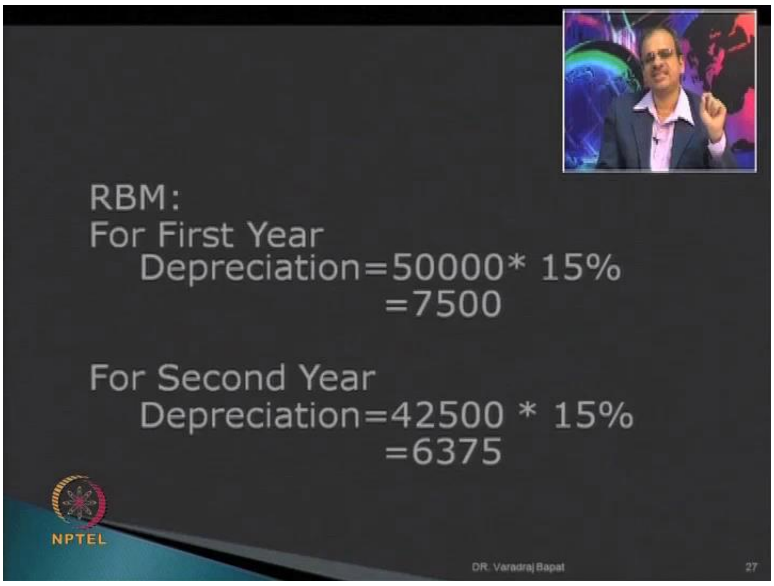

So, in this case we will not worry about the scrap value or the life the cost of the asset is 500000 so on 500000 depreciation will be charge at 15 percent. So, depreciation for year 1 becomes 7500 in years 2 the depreciation will not remain at 7500, it is not a straight line method. Here what we will do is at the end of year 150000 minus 7500. So, the value of asset or W D V is now, 42500 the depreciation will be charge on 42500. So, second year depreciation is 42500 into 15 percent. So, it is 6375 I hope you have understood. So, these 2 are the important methods of depreciation straight line and reducing balance in the next session, we will see some more methods of depreciation.