Guidance Note on Accrual Basis of Accounting

The Institute of Chartered Accountants of India
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Foreword

Financial Statements are the reports that provide the details of the entity's financial information including assets, liabilities, equities, incomes and expenses, shareholders' contribution, cash flow, and other related information during a specific period of time. Financial statements are written records that convey the business activities and the financial performance of a company. Accrual basis of accounting is one of the fundamental accounting assumptions for the preparation and presentation of general-purpose financial statements.

The Institute of Chartered Accountants of India (ICAI) through its Research Committee has been relentlessly working to ensure that the users of financial information of world's fastest growing economy of India are always equipped with updated and reliable guidance. I am pleased to note that the Research Committee of the Institute has undertaken the task to revise 'Guidance Note on Accrual basis of accounting'. The revised Guidance Note explains the fundamental concept of Accrual Accounting and also explains the process of transition from cash basis of accounting to accrual basis.

I would like to take this opportunity to express my gratitude and thanks to CA. Anuj Goyal, Chairman, Research Committee, CA. Kemisha Soni, Vice-Chairperson, Research Committee, and all members of the Research Committee who have made invaluable contribution in the finalisation of this Guidance Note.

I am confident that this Guidance Note will be extremely useful to the members of the Institute in discharging their professional duties and others concerned.

New Delhi **CA. Atul Kumar Gupta**
January 28, 2021 **President, ICAI**

Preface

Investors and financial analysts rely on financial data to analyze the performance of a company and make predictions about its future direction of the company's stock price. One of the most important resources of reliable and audited financial data is the annual report, which contains the firm's financial statements. The financial statements are used by investors, market analysts, and creditors to evaluate a company's financial health and earnings potential. The three major financial statement reports are the balance sheet, income statement, and statement of cash flows. Financial statements are records of the financial activities and position of a business. One of the fundamental accounting assumption for preparing and presenting the financial statement is 'Accrual'. This led to the importance of Accrual basis of accounting.

Research Committee felt the need for revising '**Guidance Note on Accrual basis of Accounting**' which was issued in the year 1988. The revised guidance note highlights the need for accrual basis of accounting, provides guidance in respect of transition from cash basis to accrual basis of accounting, further states the benefits associated with accrual system of accounting. The revised guidance note covers definition of accrual, accrual basis of accounting, difference between accrual basis of accounting with cash basis of accounting, need for the accrual principle, application of accrual basis of accounting with respect to assets, liabilities with some examples, income and expenses, transition from cash to accrual accounting along with appendix.

I would like to convey my sincere thanks to CA. Atul Kumar Gupta, President, ICAI and CA. Nihar N. Jambusaria, Vice-President, ICAI for providing guidance on various activities of the Committee. I would like to convey my sincere thanks to CA. Kemisha Soni, Vice-Chairperson, Research Committee for her constant co-operation.

I wish to place on record my deep appreciation for CA. Babu Abraham Kallivayalil, Past Chairman, Research Committee, CA. Satish Kumar Gupta, Past Vice-Chairman, Research Committee, under whose guidance, task was initiated to revise the Guidance Note in a timely manner for the benefit of all.

I would also like to acknowledge the invaluable contribution made by CA. M.P. Vijay Kumar, CCM who spared his valuable time for providing significant inputs

and for representing the draft Guidance Note before the Council, CA. Santosh Maller, Resource Person for preparing the basic draft of the Guidance Note. My sincere thanks to CA. Sanjay Vasudeva, Co-opted Member, Research Committee for providing invaluable inputs and other esteemed members of Research Committee for their guidance and the branches of ICAI and Regional Councils of ICAI, members at large for their valuable suggestions.

I also appreciate the untiring efforts of Dr. Amit Kumar Agrawal, Secretary, Research Committee, CA Amit Agarwal, Senior Executive Officer and CA Sakshi Garg, Project Associate, Research Committee for finalising the Guidance Note.

I truly believe and trust that this publication would prove useful to the members of the Institute and others concerned.

New Delhi **CA. Anuj Goyal**
January 27, 2021 **Chairman, Research Committee**

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Guidance Note on Accrual Basis of Accounting

(The following is the text of the 'Guidance Note on Accrual Basis of Accounting', issued by the Council of the Institute of Chartered Accountants of India. With the issuance of this Guidance Note, the Guidance Note on Accrual Basis of Accounting issued in 1988 stands withdrawn.)

1. Introduction

1.1 Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. "Accrual" is one of the fundamental accounting assumptions. *Framework for the Preparation and Presentation of Financial Statements* under Accounting Standards (AS) considers the 'Accrual Basis' as a fundamental accounting assumption for the preparation and presentation of general-purpose financial statements. Section 128 of Companies Act, 2013 prescribes maintenance of books of account by Companies on accrual basis and according to the double entry system of accounting. For all other entities, the concept of accrual is prescribed in 'Preface to the Statements of Accounting Standards' issued by ICAI and requires Accounting Standards to be applied in respect of commercial, industrial or business activities of any enterprise. According to Accounting Standard 1, Disclosure of Accounting Policies, 'accrual' is one of the fundamental accounting assumptions, and if not followed, the fact should be disclosed. This Guidance Note does not apply to corporate enterprises which apply Accounting Standards under Companies (Accounting Standards) Rules, 2006 or Indian Accounting Standards under Companies (Indian Accounting Standards) Rules, 2015.

1.2 Paragraphs 9 and 10 of *AS-1 Disclosure of Accounting Policies* states as under:

"9. Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

10. The following have been generally accepted as fundamental

accounting assumptions:

a. Going Concern

The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

b. Consistency

It is assumed that accounting policies are consistent from one period to another.

c. Accrual

Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this standard''.

1.3 Accrual Basis of accounting is a Fundamental Accounting Assumption as per AS-1 and forms the basis for the principles in various accounting standards. Wherever the financial statements have been prepared on a basis other than 'accrual' the audit report should describe the basis of accounting followed, without necessarily making it a subject matter of a qualification.

Objective

1.4 This Guidance Note highlights the need for accrual basis of accounting, provides guidance in respect thereof and provides guidance in respect of transition from cash basis to accrual basis of accounting. In addition, this Guidance Note states the benefits associated with while following accrual system instead of cash system.

2. Accrual Basis of Accounting

2.1 Definitions

The Glossary of Terms used in Financial Statements (issued 2019) by Research Committee, ICAI also provides definitions as under:

'Accrual':

"Recognition of revenues and costs as they are earned or incurred (and not as money is received or paid). It includes recognition of transactions relating to assets and liabilities as they occur irrespective of the actual receipts or payments."

'Accrual Basis of Accounting':

"The method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts pertaining to the period in which they accrue. The 'Accrual Basis of Accounting' includes considerations relating to deferrals, allocations, depreciation and amortisation. This basis is also referred to as 'Mercantile Basis of Accounting'."

2.2 What exactly is an "accrual"?

If entities received cash payments for all revenues at the same time when they were earned and made cash payments for all expenses at the time when they were incurred, there wouldn't be a need for accruals. However, most entities have some revenues in the period that were earned but for which consideration was not received. This needs to be accounted for as revenue. Similarly, if the entities incurred expenses but did not pay for them at the time of incurrence of expenses, then these expenses also need to be accounted for in the relevant accounting period.

2.3 Under the Accrual basis of accounting, the enterprise records the financial effects of the transactions, events, and circumstances in the period in which they occur rather than in the period(s) in which cash is received or paid by the enterprise. It recognises that the buying, producing, selling and other economic events that affect enterprise's performance often do not coincide with the cash receipts and payments of the period. The goal of accrual basis of accounting is to relate the accomplishments (measured in the form of revenue or income) and the efforts (measured in terms of cost/expense) so that reported net income measures an enterprise's performance during a period instead of merely listing its cash receipts and payments. Accrual basis of accounting recognises assets, liabilities or components of incomes and expenses for amounts received or paid in cash in past, and amounts expected to be received or paid in cash in the future. It may be noted that even under accrual basis of accounting, recognition criteria must be met for recognition of an element of financial statements.

Accrual Basis of Accounting vs. Cash Basis of Accounting

2.4 The major difference between accrual accounting and cash-based accounting, is in timing of recognition of assets, liabilities, income, expenses, gains and losses. Cash receipts in a particular period may to some extent reflect the effects of activities of the enterprise in the earlier periods, while many of the cash outlays may relate to activities and efforts expected in future periods. Thus, an account showing cash receipts and cash outlays of an enterprise for a short period cannot solely indicate how much of the cash received is return of investment and how much is return on investment and, therefore, cannot provide the correct information in terms of profitability and financial position, although cash receipts and cash outlays is also useful in assessing the financial operations on an enterprise.

Appendix I illustrates how the choice of accounting method determines the timing of when revenue and expenses are recognised.

2.5 An entity following the accrual basis of accounting will record a sale as soon as it meets the recognition requirements of applicable Accounting Standards e.g. under AS 9, revenue is recognised when an entity has transferred to the buyer the property in the goods for a price with all significant risks and rewards of ownership having been transferred, while an entity following cash basis would instead wait to receive the consideration for recording the sale. Similarly, an entity following accrual basis of accounting will record an expense as incurred, while an entity following cash basis would instead wait to pay its vendor before recording the expense.

2.6 Accrual accounting measures the performance and position of an entity recording the economic events regardless of completion of corresponding payment or receipt of consideration. The economic events are recognised by recording the assets, liabilities, income and expenses at the time when the transactions occur rather than when consideration is paid or received.

2.7 The business transactions may occur over a longer period of several months or years i.e., several accounting periods. Accrual accounting reflects that income earned and expenses incurred in one accounting period can be carried over in the books of account as receivable and payable respectively to the succeeding accounting periods till the receipt or payment of consideration in cash is completed.

Therefore, the accrual basis of accounting provides a more accurate picture of an entity's (a) performance in terms of income and expense, during an accounting period (b) assets and liabilities at the end of an accounting period. This method is more appropriate in assessing the health of the organisation in financial terms.

Table 1- Table 3 of Appendix I illustrates why accrual accounting provides a more complete picture of a company's financial performance as compared with cash basis of accounting.

2.8 Accrual basis of accounting provide more appropriate recognition of revenues and expenses over time, and so is considered by users of financial statements to be the most acceptable accounting system for ascertaining the results of operations and financial position of a business. The accrual basis requires the use of allowances for sales returns, bad debts and inventory obsolescence etc. and at the end of each reporting period, entities pass adjusting journal entries to record any accruals.

Accrual basis of accounting recognises income, expenses, gains and losses along with corresponding increase or decrease in assets and liabilities in the period during which the event occurs irrespective of the cash movement. This results into accurate reporting of net income, assets, liabilities and retained earnings which improves analysis of the entity's financial performance and financial position over different periods.

2.9 The Need for the Accrual Principle:

The complexity of business transactions

The accrual method of accounting came into use as a response to the practice of deferred collection and payment. Entities that sell goods on credit may continue to collect the consideration over a long period of time from goods that were sold earlier. Recording such transactions when the sale proceeds are actually received would reflect an inaccurate picture of the entity's financial position, whereas the users of financial statements require timely and accurate reporting of an entity's financial position. With the accrual accounting method, entities can present the most accurate picture of the financial position of the entity.

Measuring the performance of a business in a particular period

When an entity wants to examine its actual performance during a specific period of time, such as a quarter or half year or fiscal year, the financial statements prepared on accrual method of accounting provides a complete picture. The financial information recorded under accrual accounting enables the business to make meaningful comparisons across different periods by way of key financial metrics or ratios e.g. gross profit margin, operating profit margin, and net profit margin and various capital ratios, etc.

Paragraph 14 of the Conceptual Framework under Accounting Standards (AS) "Framework for the Preparation and Presentation of Financial Statements (Framework 2000)" states the following as one of the objectives of financial statements.

"14. Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management."

Given the investment and stewardship objectives of general purpose financial reports, there are presumed to be informational advantages that make accrual accounting a 'better' basis for assessing past and future performance than cash-based information.

Accrual method of accounting is central to the process of accounting. Measurement requirements are necessary for accrual accounting. In order to give greater practical clarity and foundation to the overarching objective of financial reporting, it is therefore necessary to reconcile it with the underlying mechanics of accrual-based double entry.

Over the life of an enterprise the cash flows and accruals will be identical. Similarly, the earnings and cash realisation are equivalent over the life of the enterprise. Yet the distinctive informational content of accounting is periodic, and it is these limited time frames with which the users of financial statements are concerned. Accounting data provide information relevant to the forecasting of future cash flows.

Accrual method allocates the transaction price to one or more financial reporting periods. For example, revenue is recognised when it is earned by the enterprise rather than when it is realised. Depreciation on Property, Plant and Equipment is accrued over the period of putting the asset to use rather than when the payment to the vendor is made.

Limitations of the Accrual Principle

2.10 While accrual accounting is known to help increase operational efficiency in practice, the significant limitation of the accrual principle of accounting is that accounts prepared on the basis of accrual accounting may indicate that a business generated profits during a specific accounting period while the resultant cash flows are yet to be received. The business under such situation may appear as profitable even when it lacks sufficient cash flow to finance its operations.

3. Preparation of Financial Statements on Accrual Basis of Accounting

3.1 Conceptual Framework under Accounting Standards (AS) "Framework for the Preparation and Presentation of Financial Statements (Framework 2000)"

Paragraph 22 of the above referred Conceptual Framework describes the accrual basis as follows:

"22. 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 a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the

periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions."

3.2 As per Paragraphs 27 & 28 of Ind AS1 "Presentation of Financial Statements", an entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting. When the accrual basis of accounting is used, an entity recognises items as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the Framework.

3.3 Further, section 128 of the Companies Act, 2013 requires every company to prepare books of accounts following accrual system of accounting.

3.4 As per the Master Circular of Reserve Bank of India on "Disclosure in Financial Statements"[1], Banks are also required to comply with AS-1. Therefore, banks also have to follow accrual basis in preparation of financial statements. Further, accrual being a fundamental accounting assumption, the auditor would need to consider modification or reference in the report, wherever cash basis of accounting is followed, unless permitted by any law or statute.

3.5 The Insurance Regulatory and Development Authority (Preparation of Financial Statements and of Insurance Companies) Regulations, 2000[2] states that "Every Balance Sheet, Revenue Account [Policyholders' Account], Receipts and Payments Account [Cash Flow statement] and Profit and Loss Account [Shareholders' Account] of an insurer shall be in conformity with the Accounting Standards (AS) issued by the ICAI, to the extent applicable to insurers carrying on life insurance business, except AS 3 and AS 17"

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[1] Circular No.- DBOD.BP. BC No.14 /21.04.018/2012-13 dated 2nd July 2012.

[2] Notification No.- F. No. IRDA/ Reg/ 8/ 2000 under The Insurance Regulatory and Development Authority (Preparation of Financial Statements and of Insurance Companies) Regulations, 2000.

It further states the recognition of income, expenses and other items of financial statements on accrual basis, unless otherwise permitted by any law or statute.

4. Application of Accrual Basis of Accounting

In the following paragraphs, the application of accrual basis of accounting with reference to key elements of financial statements is explained.

4.1 Assets and Liabilities

It is important to understand the definition and recognition criteria of assets and liabilities under the conceptual framework.

Framework for the Preparation and Presentation of Financial Statements under Accounting Standards

An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

A *liability* is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

4.2 The essential features of accrual basis of accounting:

(i) Asset and Liabilities are recognised when those meet the definition and recognition criteria of Conceptual Framework and relevant accounting standards, if any.

(ii) Changes in carrying amount of assets and liabilities are recognised as income and expenses, except where changes relate to transactions with owners of the entity.

It may be noted from the above definitions and recognition criteria that receipt and payment of cash is not the criteria for recognition of assets and liabilities, rather the existence of resource or obligation which results in inflow or outflow of economic benefits.

The application of above principles can be further demonstrated with four examples as follows.

Example 1: Property, Plant and Equipment (PPE)

Paragraph 7 of AS 10, Property, Plant and Equipment (Revised 2016)

The cost of an item of property, plant and equipment should be recognised as an asset if, and only if:

(a) ***it is probable that future economic benefits associated with the item will flow to the enterprise; and***

(b) ***the cost of the item can be measured reliably.***

Similar principles are stated in Ind AS 16 Property, Plant and Equipment.

Based on the recognition criteria, an entity has to recognise an item of PPE if it meets the above criteria regardless of when the cash payment is made for the above assets. e.g. if an entity has purchased a plant and machinery or building say for ₹ 100,000 but the payment will be made after a month. In this scenario, under accrual basis of accounting the entity has to recognise the PPE of ₹ 100,000 when it is acquired and recognise a liability for the amounts to be paid.

Example 2: Employee Benefits

Paragraph 10 of AS 15 Employee Benefits (Revised 2005)

When an employee has rendered service to an enterprise during an accounting period, the enterprise should recognise the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service:

(a) ***as a liability (accrued expense), after deducting any amount already paid. If the amount already paid exceeds the undiscounted amount of the benefits, an enterprise should recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and***

(b) ***as an expense, unless another Accounting Standard requires or permits the inclusion of the benefits in the cost of an asset.***

Similar principles are stated in Para 11 of Ind AS 19 Employee Benefits.

Based on the recognition criteria, an entity has to recognise an item of a liability for salaries, wages, bonus, leave encashment and other short-term benefits as and when the employee renders the service regardless of when the actual payments are made.

Example 3: Provisions, Contingent Liabilities and Contingent Assets

Paragraph 14 of AS 29, Provisions, Contingent Liabilities and Contingent Assets lays down the following recognition criteria for a provision

A provision should be recognised when:

(a) ***an enterprise has a present obligation as a result of a past event;***

(b) ***it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and***

(c) ***a reliable estimate can be made of the amount of the obligation.***

If these conditions are not met, no provision should be recognised.

Similar principles are stated under Para 14 of Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets.

Based on the recognition criteria, an entity has to recognise an item of an obligation as a liability if it meets the above criteria regardless of when the cash expenditure is incurred for the above. E.g. if an entity has sold goods with a warranty for 3 years, then the entity has to recognise a provision for warranty expenses on estimated basis when the goods are sold and not when the actual warranty claims are settled.

Example 4: Gratuity

Accounting standard, AS 15, requires an actuarial valuation to be done for certain types of employee benefits schemes, including gratuity benefit. Actuarial valuations are required by AS 15 and Ind AS 19, to recognise liability when an employee has provided service in exchange for employee benefits to be paid in future and to recognise an expense when the enterprise consumes the economic benefit arising from service provided by an employee in an exchange for employee benefits.

Accounting Standard (AS) 15, "Employee Benefits" requires provision for defined employee benefit plans such as Gratuity benefits on accrual basis except where the relaxations have been granted under the standard to certain entities fulfilling the exemption criteria mentioned therein. This means that the accounting treatment for the employee benefits must be recognised in the balance sheet of the enterprise and there must be a provision for gratuity every year in the financial statements of employers.

4.3 Income and Expenses

Similar to assets and liabilities, the Framework for Preparation & Presentation of Financial Statements under AS lays down recognition criteria for income and expenses. Accrual is co-terminus with recognition criteria prescribed under Accounting Standards. It is highlighted below.

Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.

Expenses are recognised in the statement of profit and loss when decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees' salaries or the depreciation of plant and machinery).

Many expenses are recognised in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under the Framework for the Preparation and Presentation of Financial Statements under AS does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as property, plant & equipment, patents and trademarks; in such cases the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

An expense is recognised immediately in the statement of profit and loss when expenditure produces no future economic benefits or when, and to the extent that future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.

An expense is also recognised in the statement of profit and loss in those cases when a liability is incurred without the recognition of an asset, as when a liability under a product warranty arises.

It may be noted from the above definitions and recognition criteria that receipt and payment of cash is not the criteria for recognition of income and expenses, rather the increase and decrease in assets and liabilities and the criteria of reliability measurement. The application of above principles can be further demonstrated with following examples.

Revenue Recognition Principle

4.4 The Accounting Standard on "Revenue Recognition" (AS-9) also assumes that the three fundamental accounting assumption of accruals is followed in the preparation and presentation of financial statements. It deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. This standard lays down principles for recognition of revenue arising in the course of the ordinary activities of the enterprise from

(i) Sale of goods,

(ii) Rendering of services, and

(iii) Use of resources of the enterprise by others yielding interest, royalties and dividends.

4.5 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of service or the use of resources of the enterprise by others it would not be unreasonable to expect ultimate collection.

4.6 The accrual basis of accounting necessitates adjustments for income received in advance as well as for outstanding income at the end of the period of accounting since the receipts during the period may not coincide with what is properly recognisable as income for the period.

4.7 Accounting Standard (AS)-12 - Accounting for Government Grants states that it is fundamental to the 'income approach' that Government grants be recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs. Income recognition of Government grants on a receipts basis is not in accordance with the accrual accounting assumption.

Expense Recognition Principle

a) The Glossary of Terms used in Financial Statements (Issued 2019) by Research Committee, ICAI, explains the term 'Expense' as "a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period".

b) In the accrual basis of accounting, costs are matched either against revenues or against the relevant time period to determine periodic income. Further, costs which are not charged against income of the period are carried forward. If any particular item of cost has lost its utility or its power to generate future revenue the same is written off as an expense or a loss.

c) Under accrual basis of accounting, expenses are recognised by the following approaches:

(i) *Identification with revenue transactions*

Costs directly associated with the revenue recognised during the relevant period (in respect of which whether money has been paid or not) are considered as expenses and are charged to income for the period.

Examples of application of above concepts are as follows.

- Contracts costs recognition under percentage of completion method of AS 7 Construction Contracts or amortisation of incremental costs of obtaining a contract as per Ind AS 115 Revenue from Contracts with Customers.
- Accounting for transaction costs of financial asset (classified under Amortised Cost) as part of Effective Interest Method of Ind AS 109 Financial Instruments.

(ii) *Identification with a period of time*

In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time. Such costs are regarded as 'period costs' and are expensed in the relevant period, e.g., salaries, telephone, travelling, depreciation on office building etc. Similarly, the costs the benefits of which do not clearly extend beyond the accounting period are also charged as expenses.

Examples of application of above concepts are as follows.

- Depreciation of Property, Plant and Equipment over its useful life as per AS 10 Property, Plant and Equipment and Ind AS 16 Property, Plant and Equipment.
- Recognition of employee benefits costs as per AS 15 Employee Benefits and Ind AS 19 Employee Benefits.
- Recognition of Share-based payments expense under Ind AS 102 Share-based payments and Guidance Note on Share Based Payments.

d) Expenses relating to a future period are accounted for as prepaid expenses even though they are paid for in the current accounting period. Similarly, expenses of the current year, for which payment has not yet been made (outstanding expenses) are charged to the profit and loss account for the current accounting period.

e) The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:

(i) It is probable that at the date of the financial statements events subsequent thereto will confirm that (after taking into account any related probable recovery) an asset has been impaired or a liability has been incurred as at that date, and

(ii) a reasonable estimate of the amount of the resulting loss can be made.

f) The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in point(e) is not met, unless the possibility of a loss is remote.

g) Recognition of deferred tax assets and liabilities under AS 22-Accounting for Taxes on Income arising on accounting of timing differences between accounting income and tax income is another example of application of accrual concept of accounting. The objective of recognising deferred tax assets and liabilities is to link the overall tax expense with the profits as per books of account, rather than profit computed in terms of provisions of various tax laws.

5. Change in the Basis of Accounting

5.1 When an enterprise which was earlier following cash basis of accounting for all or any of its transactions, changes over to the accrual basis of accounting, the effect of the change should be ascertained with reference to the transactions of the previous accounting periods also, to the extent such transactions have an impact on the current financial position of the enterprise. The fact of such change should be disclosed in the financial statements. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made to reflect the effect of such change. Where the effect of the change is not ascertainable, wholly or in part, the fact should be indicated. If the change has no material effect on the financial statements for the current period but is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

5.2 Conversion of books of accounts from cash basis to accrual, requires a series of adjustments with journal entries in the financial accounting system so that the financial statements (Balance Sheet, Profit & Loss A/c, etc.) present organisation's assets, liabilities, revenues and expenses in the proper period. These adjustments are known as ***"adjusting journal entries"*** and they fall into two categories:

1. Accruals:

Accruals involve recording a transaction in the current period's financial statements in which the underlying economic event (i.e. the trigger for the transaction) has occurred, although cash related to the transaction has not yet changed hands in the current period.

2. Deferrals:

Deferrals are the result of cash flows occurring before they are allowed to be recognised under accrual accounting. Posting deferrals in the accounting system involves transactions where the cash impact has taken place during the current period although the economic event has not yet taken place. Such transactions should not be recorded in the current period's statement of Profit & loss A/c forming part of financial statements as these shall be recognised in a later accounting period.

The Glossary of Terms used in Financial Statements (Issued 2019) by Research Committee, ICAI defines Deferral as

"Postponement of recognition of a revenue or expense after its related receipt or payment (or incurrence of a liability) to a subsequent period to which it applies. Common examples of deferrals include prepaid rent and taxes, unearned subscriptions received in advance by newspapers and magazine selling companies, etc."

5.3 The accrual transactions would include the followings primarily:

1. Accrued Expenses

An accrued expense refers to an expense that is recognised in the books before it has been paid; the expense is recorded in the accounting period in which it is incurred, as it represents an entity's obligation to make future cash payments. These are shown on an entity's balance sheet as current liabilities; accrued expenses are also known as accrued liabilities or outstanding expenses. Virtually all expenses should be accounted for irrespective of the payments made, such as direct materials received, office supplies received, expenses incurred, salary and wages earned by employees etc. even if these have not yet been paid. An accrued expense can also be an estimate and may differ from the supplier's invoice which is yet to be received.

The Glossary of Terms used in Financial Statements (Issued 2019) by Research Committee, ICAI defines Accrued Expense as "an expense which has been incurred in an accounting period but for which no enforceable claim has become due in that period against the enterprise. It may arise from the purchase of services (including the use of money) which at the date of accounting have been only partly performed and are not yet billable".

2. Prepaid Expenses

Prepaid expenses are future expenses that have been paid in advance. In other words, prepaid expenses are expenses that have been paid but are not used in the relevant financial year by the entity or have not yet expired.

Such cash payments may relate to assets that have not been consumed in the accounting period in which cash is paid, e.g. insurance policies, memberships, rent deposits etc. The expenditure made during the accounting period need to be checked to see if there are any prepaid expenses, and then the unused portion of these items need to be transferred to an asset account. Generally, the amounts of prepaid expenses that will be used up within one year are reported on an entity's balance sheet as a current asset. As the amount expires, the current asset is reduced, and the amount of the reduction is reported as an expense on the income statement.

The Glossary of Terms used in Financial Statements (Issued 2019) by Research Committee, ICAI defines Pre-paid Expense as “Payment for expense in an accounting period, the benefit for which will accrue in the subsequent accounting period(s).”

3. Accounts Receivable

When an entity provides goods or services and invoices the customers, it recognises account receivable. The invoice amount remains a receivable until the customer pays the entity. The accounts receivables are not accounted for in cash-basis of accounting. While switching to accrual, all unpaid customer invoices are to be accounted for in the books.

The Glossary of Terms used in Financial Statements (Issued 2019) by Research Committee, ICAI defines Sundry Debtors or Accounts Receivable as “Person from whom amounts are due for goods sold or services rendered or in respect of contractual obligations. Also termed as debtor, trade debtor, account receivable.”

4. Grants Receivable

Grants and contributions that were formally committed to the entity as of the balance sheet date but not yet been received by the entity would need to be worked out and accounted for as Grants Receivable.

5. **Customer Prepayments or Advances Received**

Advances received from the customers against their orders or contracts would have been recorded as sales under the cash basis of accounting even though the goods or the services had not been delivered. Whereas under the accrual basis of accounting, revenues received in advance of being earned are reported as a liability. These advances should instead be recorded as short-term liabilities until such time as the entity has delivered the related goods or provided the related services and raised sale invoices there against.

5.4 Issues to be addressed- Transition from Cash to Accrual Accounting

The following issues may be addressed at the time of transition to accrual accounting:

- **Decide the type of transactions to be transitioned from cash basis to accrual basis**

An entity may choose to undertake a phased approach to transition. In order to decide what transition plan to undertake, entities will need to decide which transaction types to transition and when and how this might occur.

Appendix II details some of the considerations and scenarios which may influence a transition plan.

- **Opening balance sheet**

The systematic identification and measurement of assets and liabilities as at the date from which accrual accounting is to commence is an essential step in the move to accrual basis accounting. The concept of materiality may be used to make judgments about assets and liabilities that should receive the most attention during this exercise. Similarly, as discussed below, the phasing of the implementation process may also assist in prioritising this task appropriately.

Opening balance sheet is to be prepared at the beginning of the financial period in which the enterprise transitions to accrual basis accounting. This means that in the first financial period in which an enterprise transitions to accrual basis accounting, the comparative information for previous period shall continue to be presented on cash basis, thereby causing, lack of comparability within the same set of financial statement. Although, ideally, comparability within the financial statements is essential feature of financial statements, restatement of previous financial statements would be cumbersome and the efforts for restating comparable information may outweigh the benefits associated. Lack of comparability can be overcome by providing adequate disclosures in the financial statements in the financial period in which the enterprise transitions to accrual basis accounting.

In the financial period in which an enterprise transitions to accrual basis accounting, it shall explain how the transition from cash basis accounting to accrual basis accounting affected its reported Balance sheet and financial performance. This can be done by providing a reconciliation of equity reported in accordance with the previous cash basis accounting to its equity in accordance with accrual basis accounting for both of the following dates:

— Opening balance sheet (as explained above), and

— The end of the latest period presented in the enterprise's most recent annual financial statements prepared on cash basis accounting

Similarly, a reconciliation between the net profit/ loss reported in latest period presented in the enterprise's most recent annual financial statements prepared on cash basis accounting and the net profit that would have been there had the enterprise followed accrual basis accounting shall be provided.

Preparation of the first financial statements under accrual basis accounting: The decision on the format of financial statements on migration to accrual basis accounting and generation of first set of financial statements is of key importance in transition. The format has to facilitate transparent, accurate and complete depiction of financial position.

Appendix III & IV provide guidance to assess what liabilities and assets should be included in the Opening Balance Sheet.

Checks and balances have to be in place to ensure appropriate measurement and recording of accounting data.

Issues like preparation of Assets register and measurement of assets, depreciation, inventory recognition and valuation have to be addressed.

The role of the accountant as well as the auditor is significant in ensuring a smooth transition to accrual basis of accounting. Auditors may be helpful in framing the accounting policies on assets and liabilities, recognition of revenues and expenses, reporting period, measurement basis and other criteria.

Appendix I

Cash vs. Accrual Basis of Accounting

To illustrate how the choice of accounting method determines the timing of when revenue and expenses are recognised, two different scenarios are presented.

In each scenario, a subscriber purchases a two-year subscription for online new content. In the first scenario, the subscriber pays in the first year. In the second scenario, the subscriber pays in the second year. Under both scenarios, information communicated and conclusions drawn about the financial condition of the company differ depending on whether the cash or accrual basis of accounting is used.

First, a narrative discussion that only focuses on the income statement is provided for each scenario. A more detailed explanation is then provided that incorporates an income statement, and a balance sheet.

Table 1 shows the opening balances at the beginning of the year. The set of financial statements in **Table 2-Table 3**, report transactions if the payment was received in the first year for a two-year subscription.

Table 2-Table 3 provide a better illustration of why accrual accounting provides a more complete picture of a company's financial performance as compared with cash basis of accounting, when the payment is received before the service is provided.

In the examples below, a fictitious small company provides online subscription-only news service. The company is called XYZ and has a single subscriber during the two-year business cycle.

A subscription requires a two-year commitment and costs ₹ 2,400 (total), which must be paid in full at either the beginning of the first or second year. The ₹ 2,400 cost of the subscription for the client is revenue for XYZ. Assume that XYZ incurs service expenses (costs) of ₹ 600 each year, or ₹ 1,200 total. On April 1, 2020, XYZ had ₹ 600 cash on hand, same as the owners' interest (or ownership equity).

Scenario: Payment Received in the First Year

Cash Basis

XYZ receives a one-time payment of ₹ 2,400 in April 2020 for two-year subscription. At the end of 2020-21, XYZ has recognised ₹ 2,400 in revenue and ₹ 600 in expenses for an income (profit) of ₹ 1,800.

In 2021-22, no revenue is recognised by XYZ because the subscriber's full payment was recognised as revenue in 2020-21. XYZ incurs ₹ 600 in expenses to provide the service in 2021-22, resulting in a loss for the year.

Accrual Basis

XYZ receives a payment of ₹ 2,400 in April 2020. Because XYZ is following the matching principle of accrual accounting, it only recognises revenue for which it has incurred expenses and services have been rendered.

XYZ recognises ₹ 1,200 in revenue and ₹ 600 in expenses for an income of ₹ 600 in 2020-21.

Similar to 2020-21, under accrual basis of accounting XYZ only recognises revenue for which it has incurred expenses in 2021-22. Thus in 2021-22, XYZ recognizes ₹ 1,200 in revenue and ₹ 600 in expenses for an income of ₹ 600.

A more comprehensive treatment of which basis of accounting a company uses and how it affects the company's income statement and balance sheet appear in **Table 2**- **Table 3**. The figures also provide a detailed explanation by line item.

Payment Received in the First Year—Income Statement and Balance Sheet

Perspective for Tables 1-3

As previously discussed, the following examples (**Table 2-Table 3**) illustrate how revenue, expenses, and earnings can be exaggerated and give a misleading impression of a company's performance under cash basis of accounting.

Table 1 shows the beginning balance for XYZ. No transactions are recorded other than beginning cash balance and owners' equity. Transaction descriptions by line item for cash and accrual basis are provided below the financial statements.

Table 1. XYZ's Beginning Financial Statements, April 1, 2020

Cash Basis		**Accrual Basis**	
Income Statement		**Income Statement**	
Revenue	—	Revenue	-
Expenses	—	Expenses	-
	______		______
Income	—	Income	-
	______		______
Balance Sheet		**Balance Sheet**	
ASSETS		**ASSETS**	
Cash	600	Cash	600
Receivables not recognised	-	Receivables not recognised	-
LIABILITIES		**LIABILITIES**	
Payables not recognised	-	Payables not recognised	-
EQUITY	______	**EQUITY**	______
Owner's equity	600	Owner's equity	600

Guidance Notes on Accrual Basis of Accounting

Cash Basis	**Accrual Basis**
1. Revenue: None recorded because it is the beginning balance.	1. Revenue: None recorded because it is the beginning balance.
2. Expenses: None recorded because it is the beginning balance.	2. Expenses: None recorded because it is the beginning balance.
3. Income: There is no beginning balance income to record without revenue or expenses.	3. Income: There is no beginning balance income to record without revenue or expenses.
4. Cash: ₹ 600 cash on hand at the beginning of the year.	4. Cash: ₹ 600 cash on hand at the beginning of the year.
5. Receivables: No receivables at inception. Cash basis would not normally recognise receivables.	5. Receivables: No receivables at inception
6. Payables: No payables at inception. Cash basis would not normally recognise payables.	6. Payables: No payables at inception.
7. Owners' Equity: ₹ 600 in owners' equity at the beginning of the year.	7. Owners' Equity: ₹ 600 in owners' equity at the beginning of the year.

Table 2 shows year-end financial statement for XYZ for the first year. XYZ provided the first years' service and incurred related expenses. It received the full payment for the two-year subscription from the client in April 2020. Transaction descriptions by line item for cash and accrual basis are provided below the financial statements.

Table 2. XYZ's Year-End Financial Statements, March 31, 2021

Cash Basis		**Accrual Basis**	
Income Statement		**Income Statement**	
1. Revenue	2,400	1. Revenue	1,200
2. Expenses	(600)	2. Expenses	(600)
Income	1,800	Income	600
Balance Sheet		**Balance Sheet**	
ASSETS		**ASSETS**	
Cash	2,400	Cash	2,400
Receivables not recognised	—	Receivables not recognised	-
LIABILITIES		**LIABILITIES**	
Payables not recognised	—	Unearned Income	(1,200)
EQUITY		**EQUITY**	
Owner's equity	2,400	Owner's equity	1,200

Cash Basis	**Accrual Basis**
1. Revenue: ₹ 2400 payment is recognised as revenue in 2020 because the payment was received in April 2020.	1. Revenue: ₹ 1,200 in revenue is recognised even though ₹ 2,400 was received as payment. Under accrual basis of accounting, only the first year's revenue is recognised.
2. Expenses: ₹ 600 is recognised as expense in the first year even though the revenue for both years has been recognised.	2. Expenses: ₹ 600 is recognised as expense in the current year.
3. Income: ₹ 1,800 in income is recognised under cash basis. The amount is higher than under accrual basis because the full amount of the revenue for the two years was recognised in the first year, but only the first year's expense	3. Income: ₹ 600 in income is recognized under accrual basis.

was recognised, resulting in higher income than under accrual basis. 4. Cash: ₹ 2400 cash on hand at the end of the first year. XYZ began the year with ₹ 600 cash on hand and received a one-time payment of ₹ 2,400 in April 2020, resulting in ₹ 3,000 cash on hand in April of 2020. During 2020 cash was spent to pay for business operating expenses ₹ 600 resulting in ₹ 2,400 cash on hand at the end of the year. (600+2,400-600 = 2,400). 5. Receivables: Cash basis of accounting generally does not recognise receivables. 6. Deferred Revenue: Cash basis does not record the liability, deferred revenue. Should the client cancel the subscription for the last twelve months, a refund of ₹ 1,200 would need to be made to the client. 7. Owners' Equity: ₹ 2,400 in owners' equity at year-end, as the full payment of cash was recognised as revenue in 2020-21.	4. Cash: ₹ 2400 cash on hand at the end of the first year. (Calculation same as cash basis) 5. Receivables: No receivables are recorded as the full payment for the two years of service was received in April 2020. 6. Deferred Revenue: ₹ 1,200 is recorded as deferred revenue, which will not be recognized as revenue until the service is provided in 2021-22. Deferred revenue is a liability that will be reduced by ₹ 100 for each month of service provided, reduced by ₹ 1,200 by end of the second year, 2021-22. 7. Owners' Equity: ₹ 1,200 in owners' equity at year-end, which is less than under cash basis because ₹ 1,200 as deferred revenue is recorded under accrual basis and not under cash basis

Table 3 shows year-end financial statement for XYZ for the second year, 2021-22. At this point, XYZ has provided the second years' service and incurred related expenses. Under cash basis of accounting, the company has no revenue and records a loss. The company's cash on hand and owners' equity also decreased as compared with the first year (see **Table 2**). The deteriorating financial condition of the company under the cash basis could give the impression of a company in financial trouble, possibly going out of business. On an accrual basis, however, the picture looks quite different. Transaction descriptions by line item for cash and accrual basis are provided below the financial statements.

Table 3. XYZ's Year-End Financial Statements, March 31, 2022

Cash Basis		**Accrual Basis**	
Income Statement		**Income Statement**	
Revenue	—	Revenue	1,200
Expenses	(600)	Expenses	(600)
Income	600	Income	600
Balance Sheet		**Balance Sheet**	
ASSETS		**ASSETS**	
Cash	1,800	Cash	1,800
Receivables not recognised	—	Receivables not recognised	—
LIABILITIES			
Payables not recognised	—	**LIABILITIES**	
		Unearned Income	—
EQUITY		**EQUITY**	
Owner's equity	1,800	Owner's equity	1,800

Guidance Notes on Accrual Basis of Accounting

Cash Basis	Accrual Basis
1. Revenue: No revenue is recognised under cash basis in 2021-22 because the full amount of the payment, ₹ 2,400, was recognised as revenue in 2020-21.	1. Revenue: ₹ 1,200 is recognised as revenue in 2021-22 (same as 2020-21).
2. Expenses: ₹ 600 is recognised as expense in current year.	2. Expenses: ₹ 600 is recognised as expense in the current year.
3. Income: ₹ 600 is recognised as loss in 2021-22 because the full amount of the payment, ₹ 2,400, was recognised as revenue in 2020-21.	3. Income: ₹ 600 is recognised as income in the current year.
4. ₹ 1,800 of cash is available to the company at the end of two years.	4. ₹ 1,800 of cash is available to the company at the end of two years.
5. Receivables/Payables: Cash basis of accounting generally does not recognise receivables or payables.	5. Receivables: There are no receivables because the full payment was received in 2020-21 & no liabilities at the end of two years.
	6. Deferred revenue of ₹ 1,200 that was recorded at the end of 2020-21 has been recognised as revenue in 2021-22.
6. Owners' Equity: ₹ 1,800 in owners' equity, a decrease of ₹ 600 as compared with the end of 2020-21 due to the loss of ₹ 600 recorded in 2021-22.	7. Owners' Equity: ₹ 1,800 in owners' equity, an increase of ₹ 1,200 since the beginning of 2020-21.

Appendix II

Transition from Cash to Accrual

The following chart illustrates what types of transactions are to be transitioned and how this will be dealt in the financial statements:

	Cash Accounting		Accrual Accounting	
Type of Liability	**Rationale**	**Transaction**	**Rationale**	**Transaction**
1. Creditors				
(a) On purchase	No creditor is recognised in the Financial Statements.	NA	A creditor is recognised when the significant risks and rewards of the underlying good/ service are obtained rather than when the creditor is paid. The expense will have impact on the Statement of Profit & Loss.	Dr. Expense Cr. Creditor
(b) Payment	When paid, the payment will be recorded on the Statement of Cash Receipts and Payments	Dr. Payment Cr. Cash	When paid, there is no impact on the Statement of P&L, instead there is a decrease in liability and a decrease in cash – both the Balance Sheet items.	Dr. Creditor Cr. Cash
2. Loans (Long Term/ Short Term)				
(c) Initial receipt	The loan is recorded when the cash is received	Dr. Cash Cr. Loan Received	The loan is recorded when the cash is received. The loan is	Dr. Cash Cr. Loans Payable

	The cash received is included in the Statement of Cash Receipts and Payments		established as a liability in the Balance Sheet.	
(d) Subsequent repayments	When paid, the repayments will be recorded in the Statement of Cash Receipts & Payments	Dr. Loan Payments Cr. Cash	The repayments reduce the loans payable liability leaving a balance outstanding in the Balance Sheet.	Dr. Loans Payable Cr. Cash
3. Interest on Loan				
(e) On accrual	No interest is recognised in the Financial Statements.	NA	Accrued interest on loan is shown as an expense in Statement of P&L and shown as liability in Balance Sheet.	Dr. Interest Expense Cr. Accrued Interest on Loan
(f) On payment	When paid, the payment will be recorded on the Statement of Cash Receipts and Payments	Dr Interest Cr. Cash	When paid, there is no impact on the Statement of P&L, instead there is a decrease in liability and a decrease in cash – both the Balance Sheet items.	Dr. Accrued Interest on Loan Cr Cash
4. **Advance Receipts**				
(g) On receipt	Receipt is recorded when cash received	Dr. Cash Cr Receipt	Revenue is recorded when earned regardless of	Dr. Cash Cr Advance Receipts Liability

	regardless of whether it has been earned		when received	
(h) When earned	No treatment done	NA	Revenue is recorded and impacts on the Statement of P/L	Dr Advance Receipts Liability Cr Revenue
5. **Accrued Expenses**				
(i) Initial establishment	The concept is generally not applied in cash accounting	NA	This arises when an expense has been incurred but has not been paid	Dr Expense Cr Accrued Expenses
6. **Provisions**				
(j) Provision	Liabilities are not recognised in cash accounting	NA	Expenses are "provided for" when the enterprise has a present obligation as a result of the past event, the outflow of economic resources is probable, and the reliable estimate/ measurement of the obligation can be done. E.g. land restoration	Dr Expense Cr Provision
(k) Utilisation	To pay for expenses incurred	Dr. Payment Cr. Cash	When the liability is to be settled, the provision is utilised	Dr. Provision Cr. Cash

Appendix III

Assessment of what liabilities should be included in Opening Balance Sheet

Once the transition approach as demonstrated in Appendix II has been decided, the entity can utilise this information to assess what amounts, if any, need to be included as part of the opening Balance sheet. Entities will need to base their assessment on the "Transition" date.

For the purposes of this exercise:

Year	Definition
Year 2	The second year preceding the Transition year
Year 1	The year immediately prior to the Transition year. The Year 0 opening Balance Sheet will reflect accrual balances at the end of Year 1.
Year 0	The Transition year. The opening Balance Sheet will reflect accrual balances at the beginning of the Transition year
Year 1	The year after the Transition year
Year 2	The second year after the Transition year

The general principles for inclusion on the opening balance sheet are:

Principle #1: If a prior period payment (made Year 1 or before) which in accrual terms relates in some part up to and including Year 0, then ignore since it is fully realised.

Principle #2: If a prior period payment (made Year 1 or before) which in accrual terms relates in some part to Year 1, Year 2 or future years, then account for the remaining amount outstanding at end of Year 1 on the opening Balance Sheet.

Refer to **Table 1** for a pictorial representation of assessing balances which should be in the Opening Balance Sheet.

To assist in undertaking the calculation to quantify each liability which needs to form part of the opening Balance Sheet, refer to **Table 2**. This also gives the relevant journal entries required to effect the transactions.

Analysis of Liability for Opening Balance

Type of Liability	Type of Occurrence	Treatment
Trade Creditors of short duration	If any creditors were paid in Year 1 and relate partly to Year 0	Ignore (Principle #1)
Creditors of medium duration < 1 year[1]	If any creditors were paid in Year 1 and relate to a significant part of Year 0	Ignore (Principle #1)
Creditors of long duration > 1 year[1]	If any creditors were paid in Year 2 and relate to all of Year 1 and part of Year 0	Ignore (Principle #1)
	If any creditors were paid in Year 1 and relate to Year 0 and Year 1 and any future years	Pick up the balance outstanding at the end of Year 1 in the opening Balance Sheet (Principle #2)
	If any creditors were paid in Year 2 and relate to Year 0, Year 1, Year 2 and beyond	Pick up the balance outstanding at the end of Year 1 in the opening Balance Sheet (Principle #2)
Short Term Loans	Where the loan will be cleared within 12 months, and the repayments will not fall beyond the end of Year 0	Ignore (Principle #1)
Long Term Loans	Where the loan will not be cleared before the end of Year 0	Pick up the balance outstanding at the end of Year 1 in the opening Balance Sheet. (Principle #2)

[1] For simplicity, short term period of assets and liabilities has been restricted to 1 year. However, in Schedule III to The Companies Act, 2013; the meaning can be wider.

Guidance Notes on Accrual Basis of Accounting

Advance Receipts	Where the revenue received in advance relates to periods beyond the end of Year 0	Pick up the balance outstanding at the end of Year 1 in the opening Balance Sheet. (Principle #2)
	Revenue received in advance relates to a period before the end of Year 0	Ignore (Principle #1)
Accrued Expense	By their nature, accrued expenses are, in most cases, short term and therefore it is unlikely that these should extend beyond Year 0	Ignore (Principle #1)
Provisions	These can be provisions for settlement of a legal case, rehabilitation of land, etc. AS 29 and Ind AS 37 prescribe treatment for Provisions. It is likely that the liability for these will extend beyond Year 0	Pick up each in the opening Balance Sheet with the amount which would be required to settle the liability at the end of Year 1. (Principle #2)

Table 1: Assess transactions which should be in Opening Balance Sheet

Trade creditors of short duration } Creditors of medium duration < 1 year }	No impact on Year 1 or future years	→ Ignore
Creditors of long duration > 1 year	Will transactions impact Year 1 & beyond	Yes → Opening Entry* No → Ignore
Short term loans	No impact on Year 1 or future years	→ Ignore
Long term loans	Will transactions impact Year 1 & beyond	Yes → Opening Entry No → Ignore
Advance Receipts	Will transactions impact Year 1 & beyond	Yes → Opening Entry No → Ignore
Accrued Expenses	No impact on Year 1 or future years	→ Ignore
Provisions	Will obligation extend beyond Year 1	Yes → Opening Entry No → Ignore

***Note:** any long term creditors or long term loans which exist at year -1 will necessarily need to be included because they will affect Year 1 and beyond.

Table 2: Impact on Opening Balance Sheet

Types of Transactions	Calculation	Opening Balance Sheet Impact Accounting Entries	Comments
Trade creditors of short duration – approx. 1 – 3 months	N/A	Nil	No requirement as no impact on Year 1 and beyond
Creditors of medium duration < 1 year	N/A	Nil	No requirement as no impact on Year 1 and beyond
Creditors of long duration > 1year	Calculate current outstanding balance of creditor and pass journal entry	Dr. Accumulated funds Cr. Creditor	Only required if the loan impacts on Year 1 and beyond
Short Term Loans	N/A	Nil	No requirement as no impact on Year 1 and beyond
Long Term Loans	Calculate current outstanding balance of loan and pass journal entry	Dr. Accumulated funds Cr. Loan Payable	Only required if the transaction impacts on Year 1 and beyond
Advance Receipts	If revenues received > 1	Dr. Accumulated	Only required if the transaction

	year in advance, calculate the value of the remaining benefit	funds Cr. Advance Receipts	impacts on Year 1 and beyond
Accrued Expenses	N/A	Nil	No requirement as no impact on Year 1 and beyond
Provisions		Dr. Accumulated funds Cr. Provisions	Assess whether circumstances are such that require a provision.

Appendix IV

Assessment of what assets should be included in Opening Balance Sheet

Once the transition approach as demonstrated in Appendix II has been decided, the entity can utilise this information to assess what amounts, if any, need to be included as part of the opening Balance sheet. Entities will need to base their assessment on the "Transition" date.

For the purposes of this exercise:

Year	Definition
Year 2	The second year preceding the Transition year
Year 1	The year immediately prior to the Transition year. The Year 0 opening Balance Sheet will reflect accrual balances at the end of Year 1.
Year 0	The Transition year. The opening Balance Sheet will reflect accrual balances at the beginning of the Transition year
Year 1	The year after the Transition year
Year 2	The second year after the Transition year

The general principles for inclusion in the opening balance sheet are:

Principle #1: If a prior period payment (made Year 1 or before) which in accrual terms relates in some part up to and including Year 0, then ignore since it is fully realised.

Principle #2: If a prior period payment (made Year 1 or before) which in accrual terms relates in some part to Year 1, Year 2 or future years, then pick up the remaining amount outstanding at end of Year 1 on the opening Balance Sheet.

Refer to **Table 1** for a pictorial representation of assessing balances which should be in the Opening Balance Sheet

To assist in undertaking the calculation to quantify each liability which needs to form part of the opening Balance Sheet, refer to **Table 2**. This also gives the relevant journal entries required to effect the transactions.

Analysis of Asset for Opening Balance

Type of Asset	Type of Occurrence	Treatment
Trade Receivables of short duration	If any trade receivable were received in Year 1 and relate partly to Year 0	Ignore (Principle #1)
Trade Receivables of medium duration < 1 year[1]	If any trade receivable were received in Year 1 and relate to a significant part of Year 0	Ignore (Principle #1)
Trade Receivables of long duration > 1 year[1]	If any trade receivables were received in Year 2 and relate to all of Year 1 and part of Year 0	Ignore (Principle #1)
	If any trade receivables were received in Year 1 and relate to Year 0 and Year 1 and any future years	Pick up the balance outstanding at the end of Year 1 in the opening Balance Sheet (Principle #2)
	If any trade receivables were received in Year 2 and relate to Year 0, Year 1, Year 2 and beyond	Pick up the balance outstanding at the end of Year 1 in the opening Balance Sheet (Principle #2)
Short Term Loans & Advances (Receivable)	Where the loan will be realised within 12 months, and the realisation will not fall beyond the end of Year 0	Ignore (Principle #1)
Long Term Loans & Advances (Receivable)	Where the loan will not be realised before the end of Year 0	Pick up the balance outstanding at the end of Year 1 in the opening Balance Sheet. (Principle #2)

[1] For simplicity, short term period of assets and liabilities has been restricted to 1 year. However, in Schedule III to The Companies Act, 2013; the meaning can be wider.

Guidance Notes on Accrual Basis of Accounting

Prepaid expenses	Where the prepaid expenses relate to periods beyond the end of Year 0	Pick up the balance outstanding at the end of Year 1 in the opening Balance Sheet. (Principle #2)
	Prepaid expenses relate to a period before the end of Year 0	Ignore (Principle #1)
Accrued Interest receivables	By their nature, accrued interest is, in most cases, short term and therefore it is unlikely that these should extend beyond Year 0	Ignore (Principle #1)

Table 1: Assess transactions which should be in Opening Balance Sheet

Trade receivables of short duration }		
Trade receivables of medium duration < 1 year }	No impact on Year 1 or future years	→ Ignore
Creditors of long duration > 1 year	Will transactions impact Year 1& beyond	Yes → Opening Entry* No → Ignore
Short term loan receivable	No impact on Year 1 or future years	→ Ignore
Long term loan receivable	Will transactions impact Year 1 & beyond	Yes → Opening Entry No → Ignore
Prepaid expense	Will transactions impact Year 1 & beyond	Yes → Opening Entry No → Ignore
Accrued Interest income	No impact on Year 1 or future years	→ Ignore

***Note:** any long term trade receivables or long term loans and advances which exist at year 1 will necessarily need to be included because they will affect Year 1 and beyond.

Table 2: Impact on Opening Balance Sheet

Types of Transactions	Calculation	Opening Balance Sheet Impact Accounting Entries	Comments
Trade receivable of short duration approx. 1 – 3 months	N/A	Nil	No requirement as no impact on Year 1 and beyond
Trade receivable of medium duration < 1 year	N/A	Nil	No requirement as no impact on Year 1 and beyond
Trade receivable of long duration > 1year	Calculate current outstanding balance of trade receivable and pass journal entry	Dr. Trade receivable Cr. Accumulated funds	Only required if the trade receivable impacts on Year 1 and beyond
Short Term Loans & Advances Receivable	N/A	Nil	No requirement as no impact on Year 1 and beyond
Long Term Loans & Advances receivable	Calculate current outstanding balance of loan and pass journal entry	Dr. Loan & Advance Receivable Cr. Accumulated funds	Only required if the transaction impacts on Year 1 and beyond
Prepaid expense	If expenses are paid > 1 year in advance,	Dr. Prepaid Expense Cr.	Only required if the transaction impacts on Year 1

	calculate the value of the remaining benefit	Accumulated funds	and beyond
Accrued Interest	N/A	Nil	No requirement as no impact on Year 1 and beyond