

ACCOUNTANCY TRAVELOGUE : GALLERY OF AS-9

By Shri Kameswara Rao Challa, FCA, DISA

We have travelled extensively the "Land of Opportunities" i.e. AS-9 Revenue Recognition. Logically our next stop is "Land of Spending" i.e. Accounting for Expenses. Nature's philosophy is that inlet and outlet are equally important for an object. As per accountancy philosophy top line (i.e. sale price) and bottom line (i.e. profit) of business are determined based on the expenditure incurred. Hence there should be proper control of expenditure to earn profit and expenditure should not be a constraint to maintain the quality. Yes, you are right; there should be proper and adequate accounting of expenditure by a company or other entity. In this land we use the terms 'expense', 'expenses', 'expenditure' and 'cost' interchangeable.

Surprisingly no Accounting Standard was framed by the Institute of Chartered Accountants of India or under the Companies (Accounting Standards) Rules 2006. Thus we have to heavily lean on Part-II to Schedule-VI of the Companies Act, 1956 (ACT). 'Guidance Note on Terms Used in Financial Statements' (GN-Terms) and 'Guidance Note on Accrual Basis of Accounting' (GN-Accrual) are of some help in this regard. An auditor can depend on 'Guidance Note on Audit of Expenses' for the purpose of verification of expenses in discharging his attest functions.

What is Expense:

GN-Terms define '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". Thus costs relating to any of the following shall be treated as expense.

- a) Costs relating to operations of an accounting period - costs are recognised based on accounting period;
- b) Costs relating to the revenue earned during the period - costs related to revenues earned during the accounting period.

However costs relating to a period beyond the accounting period are not recognised as expenses, rather they are recognised as 'pre-paid expense'. Similarly expenses incurred, but not paid will be provided for as 'Outstanding expense'.

Components of Expense:

Important components of Expense and their definitions as per GN-Terms are:

- a) Accrued Expense - '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 service (including the use of money) which at the date of accounting have been only partly performed, and not yet billable.'
- b) Cost - 'The amount of expenditure incurred on or attributable to a specified article, product or activity.'
- c) Cost of Goods Sold - 'The cost of goods sold during an accounting period. In manufacturing operations, it includes (i) cost of materials; (ii) labour and factory overheads; selling and administrative expenses are normally excluded.'
- d) Cost of Sales - 'Cost of goods sold plus selling and administrative expenses.'
- e) Deferred Expenditure - 'Expenditure for which payment has been made or a liability incurred but which is carried forward on the presumption that it will be of benefit over a subsequent period or periods. This is also referred to as deferred revenue expenditure.'

Bases of Accounting:

We are aware of three bases/ methods/ systems of accounts in use, viz.

- (i) Accrual - This is the preferred basis of accounting. This method is compulsory under section 209 of the Act;
- (ii) Cash - Not generally preferred basis. This is generally followed by Not-For-Profit-Organisations and Government;
- (iii) Hybrid - This basis is not preferred, since it lacks consistency.

The preferred basis of accounting is: Accrual, Cash and Hybrid in that order. We take a journey of the 'bases of accounting' on a later date. For the present let's travel through this **Land of Spending**.

Disclosure Requirements under Accrual Basis:

Disclosure requirements in respect of Accrual Basis of Accounting are located under 'Rules for Expense Recognition' in GN-Accrual. Two principle approaches of accounting under accrual basis are: (a) Costs are matched against revenues, and (b) Costs are matched against relevant time period.

(a) Costs are matched against revenues:

Under GN-Accrual, "costs are identified 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 expense and are charged to income for the period".

This method of accounting is helpful in the following classes of business or activity:

- i) Revenue from Construction Contracts (As-7);
- ii) Mining and oil exploration;
- iii) Software Development.

Under this concept 'Expenses' incurred are correlated against the 'Revenue'. This principle can be applied where revenue earned can be identified with the costs incurred. This helps in measuring profit from each particular activity against the costs incurred to realise revenue. Under this method, the organisation should have a detailed system of identifying costs or expenses. It shall account for all the direct and indirect costs separately in respect of each activity. In an organisation it is quite possible, some expenses are not exclusively identified to each activity, some expenditure may be pertaining to more than one activity (e.g. salary of Supervisor) or all activities of the organisation (e.g. Salary of Managing Director). In all such cases, common expenditure is allocated or apportioned to various activities based on time or energy allocated to each activity, past experience or turnover. Detailed costing techniques are applied under this system of accounting. As per GN-Accrual, 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. Similarly costs which are not charged against income of the period are carried forward i.e. treated as prepaid expenditure.

(b) Costs are matched against relevant time period:

As per GN-Accrual, "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, traveling. Similarly, the costs the benefits of which do not clearly extend beyond the accounting period are also charged as expenses."

In most of the businesses or for most of the organisations, the costs and revenues are continuous in nature and cannot be directly related to revenues. Thus in manufacturing, trading or servicing sectors, earning income and incurring expenditure is a continuous process and it is not practicable to correlate revenues and expenses. For this reason generally 'Matching Costs Against Relevant Time Period' approach under Accrual Basis of Accounting is followed.

This approach primarily recognises the fact that expenses are incurred over a period of time. Two important rules of GN-Accrual for accounting under this approach are:

- a) Expenses relating to a future period are accounted for as '**Prepaid Expenses**' even though they are paid for in the current accounting period.
- b) Expenses of the current year, for which payment has not yet been made are charged in the current accounting period as '**Outstanding Expenses**'.

Auditor's Responsibility:

Auditor's responsibilities in respect of verification of expenses are as under.

- i The company is following accrual basis of accounting as per section 209 of the Act.
- i In respect of other entities ensure that the basis of accounting followed is consistent year-after-year.
- i Where the basis of accounting is changed, he shall report the affect of change on the profit.
- i Where Accrual Basis of Accounting is followed, ensure that the entity is following Guidance Note on Accrual Basis of Accounting.
- i In respect of a company ensure that disclosure is in accordance with Part-II to Schedule-VI of the Act.
- i The auditor has to follow Guidance Note on Audit of Expenses in discharge of his duties.