Chapter 3

Review Literature

3.1 Introduction

3.2 Section1: Research Theoretical Literature

3.3 Section2: Previous Researches
3.1 Introduction

The steps in the accounting process includes collecting and recording and analyze of transactions that affects the business the accounting equation (assets = Liabilities + owners equity) must remain in balance after every transaction is recorded.

In this chapter, first research theoretical literature is explained and then previous researches are presented.

3.2 Research Theoretical Literature

3.2.1 Accounting records and systems

Recordkeeping Fundamentals

We are not concerned here with recordkeeping procedures for the purpose of training bookkeepers. Nevertheless, some knowledge of these procedures are useful for at least two reasons. First, as is the case with many subjects, accounting is something that is best learned by doing- by solving problems. Although any accounting problem, can be solved without the aid of the tools discussed in this chapter, using these tools will often speed up the problem-solving process considerably. Second, the debit-and-credit mechanism, which is the principal technique discussed here, provides an analytical framework that is similar in function to and offers the same advantages as the symbols and equations used in algebra.

In all except the smallest companies, the bookkeeping work is done on a computer. However, the computer records much detail about most transactions, and describing this detail would obscure the description of what is going on. Therefore, we focus on what is actually happening by assuming that the records are kept manually.
Permanent Accounts and Temporary Accounts:

The accounts maintained for the various items on the balance sheet are called permanent (or real) accounts. As the end of each accounting period, the balance of each permanent account is determined – each account is “balanced.” These balances are the numbers reported in the balance sheet as of the end of the period. The period-ending balance in a permanent account is carried forward into the next accounting period as that period’s beginning balance.

Recall that revenues and expenses are respectively increases and decreases in retained earnings arising from the entity’s earnings activities. Although revenue and expense transactions could be entered directly in the Retained Earnings account, this is not done in practice. Entering revenue and expense items directly to Retained Earnings would result in an intermingling of the many specific items that are required to prepare the income statement: All of these items would have to be “sorted out” – classified by income statement categories – if they were intermingled.

To avoid cluttering the Retained Earnings account, a temporary account is established for each revenue and expense item that will appear on the income statement. Thus, there are temporary accounts for sales revenues, cost of sales, selling expenses, and so on. Revenue and expense transactions are recorded in their respective temporary accounts as the period progresses. This procedure creates a “sort as you go” routine for these transactions instead of leaving them to be sorted at the end of the period. For example, all of the entries to the Sales Revenue account can be added at the end of the period to arrive at the amount of sales for the income statement. At the end of the accounting period, all of the income statement temporary account sums are combined into one net income amount, which is then entered in the Retained Earning Account. Thus, in practice, Retained Earning has fewer entries made to it than almost any other permanent account.
The Ledger:

A ledger is a group of accounts. In a manual system, it may be a bound book with the little “general ledger” printed on the cover. Inside are pages, one (or more) for each account. All the accounts of a small business could be maintained in such a book. The ledger is not necessarily a bound book, however. It may consist of a set of loose-leaf pages, or, with computers, a set of impulses on a CD or tape.

The Chart of Accounts

The accounts included in a company’s system are listed in a chart of accounts. The list often is arranged according to the items reported on the balance sheet, that is, with Cash at the beginning and Retained Earnings at the End.

For most items, there are detailed accounts, and there may be several levels of this detail. For example, beneath the cash account, there will be an account: for each bank with which the company has deposits and, for each bank, there may be an account for checking account, money market account, and other cash equivalents. The entries are made only to the accounts in the lowest level in this hierarchy, for example, the checking account at Bank A. In most systems amounts are automatically added to accounts in the highest levels of the hierarchy when an entry at the lowest level is recorded. For example, a deposit of $1,000 in the checking account of Bank A would be recorded in Checking Account, Bank A; it would also add $1,000 to the Cash Bank A account and $1,000 to the Cash account.

In developing the chart of accounts, the system designer must anticipate all the information that management might at some time want. If, for example, management wanted to know the respective level of activity of the checking account and the money market account at Bank A, and the system of accounts
could not provide this information, the system would be inadequate. A code number is assigned to each account; this simplifies the task of recording.

**The Accounting Process:**

The next section of the chapter describes the accounting process. It consists of these six steps:

1. The first and most important part of the accounting process is the analysis of transactions. This is the process of deciding which account or accounts should be debited, which should be credited and in what amounts, in order to reflect events in the accounting record. This requires both a knowledge of accounting concepts and judgment.

2. Next comes the purely mechanical step of journalizing original entries—recording the results of the transaction analysis in the journal.

3. Posting is the process of recording changes in the ledger accounts exactly as specified by the journal entries. This is also purely mechanical.

4. At the ending of the accounting period, judgment is involved in deciding on the adjusting entries. These are journalized and posted in the same way as original entries.

5. The closing entries are journalized and posted. This is a purely mechanical step.

6. Financial statements are prepared. This required judgment as to the best arrangement and terminology, but the numbers that are used result from the judgments made in steps 1 and 4.

These six steps are taken sequentially during an accounting period and are repeated in each subsequent period. The steps are therefore commonly referred to as the accounting cycle. Exhibit 3.2 depicts the accounting cycle schematically. Note that the ending balance sheet account balances from step 6 become the beginning balances for the next repetition of the cycle. Some
accountants use a worksheet in the latter steps of the accounting cycle. Worksheets are described in the appendix to this chapter.

The Accounting cycle:

a. Analyze transaction.
b. Journalize original entries.
c. Post journal entries to ledger
d. Identify, journalize, and post adjusting entries
e. Journalize and post closing entries
f. Prepare trail balance
g. Prepare financial statements

Ending balance sheet account balances from step 7 become beginning balances for reception of the cycle in the next accounting period.

Transaction Analysis

Before it is recorded, a transaction must be analyzed to determine its dual effect on the entry’s accounts. This analysis results in a decision on which account is to be debited and which is to be credited. The result of the transaction analysis must preserve the two basic identities (1) Assets = Liabilities + Owner’s equity and (2) Debits = Credits. The beginner often finds that half of the accounting entry – particularly a change in cash – is relatively obvious, but that the other half–often a change in retaining earnings – is less obvious. Our advice is to first record whichever half of the entry is more obvious, whether it is the debit or the credit portion, and then figure out the less obvious half.
Balancing Accounts:

The transactions we reordered above are called original entries. Such entries are those that obviously need to be made because a check has been written, an invoice has been received, sales have been made, and so on. After recording these original entries, a balance is taken in each account.

The Trial Balance

After determining the balance of each account, a trial balance is taken. A trial balance is simply a list of the account names and the balances in each account as of a given moment of time, with debit balances shown in one column and credit balances in another column. The preparation of a trial balance serves two principal purposes (1) it shows whether the equality of debits and credits has been maintained and (2) it provides a convenient summary transcript of the ledger records as a basis for making the adjusting and closing entries (described in the next section) that precede the preparation of the period’s financial statements.

Adjusting Entries

Most entries to be made in the accounts are original entries. However, some events that affect the accounts are not evidenced by the obvious documents associated with original entries. The effects of these events are recorded at the end of the accounting period by means of adjusting entries. The purpose of the adjusting entries is to modify account balance so that they will fairly reflect the situation as of the end of the period.

Closing Entries

The temporary revenue and expense accounts are actually subdivisions of owners’ equity (retained earnings). At the end of the period, the temporary accounts are closed to Retained Earnings in order to determine the net effect of
all the revenue and expense transactions – the net income or loss. Rather than closing each temporary account directly to Retained Earnings, however, each is first closed to an intermediate account whose purpose is to summarize the revenue and expense transactions. This account is variously called Income Summary, Profit and Loss, or Expense and Revenue Summary. This account reflects the net income or loss for a given accounting period. Income Summary is a clearing account that is then closed to Retained Earnings to complete the closing process.

The closing process consists of transferring the balance of each temporary account to the clearing account. To close a revenue account, the sum of the credits is found, and then this sum is debited to the revenue account and credited to Income Summary. This gives the revenue account a balance of zero, and transfers its former credit balance to Income Summary. The result is as thought the credit balance in the revenue account were “picked up and moved” to the credit side of Income Summary without making any entry. But in an accounting system such informality is not permitted, and the transfer of the revenue balance to Income Summary must be accomplished with an equal debit and credit.

**Preparation of financial Statement**

After the adjusting and closing entries have been made, the period’s financial statements can be prepared. The numbers for the income statement can be thought of as coming from either of two equivalent sources. (1) The balances in the temporary accounts just prior to their closing or (2) the credit (revenue) and debit (expense) entries to the Income companies, the accounts reported in the financial statements are summaries of more detailed accounts in the ledger.
The journal

In the preceding illustration of the account process, we recorded transactions directly in T accounts. In practice, transactions are initially recorded in a journal and then T account entries are made at the end of the period based on the transactions recorded in the journal.

Accounting Systems

The simple journals and ledgers described in the proceedings pages, together with the rules for using them, constitute an accounting system. But this particular system would not usually be the best system for a given organization. The optimum system is that one that best satisfies the following objectives:

1. The process the information efficiently – at low cost.
2. To obtain reports quickly.
3. To ensure a high degree of accuracy.
4. To minimize the possibility of theft or fraud.

Designing a good accounting system is a specialized job requiring a high degree of skill.

Internal Accounting Controls:

Two objectives of an accounting system stated above – accuracy and protection against theft or fraud – cannot be attained absolutely without conflicting with the other two – speed and economy. An unbeatable system would be prohibitively expensive and time consuming. A basic principle of internal accounting control, therefore, is that the system should make it as difficult as is practical for people to be dishonest or careless. Such a principle is based not on a cynical view of people in general but rather on the realistic assumption that a few people will be dishonest or careless if it is easy for them to do so.
Some of the devices used to ensure reasonable accuracy have been
touched on already; for example, the idea of verifying one set of figures against
another. The idea of divided responsibility is another important one. Whenever
feasible, one person should not be responsible for the recording all aspects of a
transaction, nor should the custodian of assets (.e.g., the storekeeper or the
casher) be permitted to do the accounting for these assets. Thus, one person’s
work is a check on another’s. Although this does not eliminate the possibility
that two people will steal through collusion, the likelihood of dishonesty is
greatly reduced.

These brief comments indicate only the nature of problem of internal accounting
control, which is a big subject. Furthermore, a book that focuses on accounting
principles, as this one does, cannot detail the complexities involved in the
operation of accounting systems. For example, cash transactions are very easy to
analyze, whereas some textbooks on auditing contain a dozen pages of questions
that should be considered in connection with the internal accounting control of
the single item cash.

Computer-Based Accounting Systems

Most organizations do their accounting work by computer. In this
section, we give a brief overview of computer-based accounting system.

What a Computer-Based System Does

As noted above, some steps in the accounting cycle involve judgment,
whereas others are primarily mechanical. These mechanical steps are usually
referred to as book-keeping. A computer based system performs some or all of
the bookkeeping steps, that is, it records and stores data, performs arithmetic
operation on data, sorts and summarizes data, and prepares reports. These
functions are described below as inputs, processing and outputs.
**Inputs**

In some computer systems, data are entered by a data-entry clerk (using a keyboard) who copies them from a paper record such as a sales order or purchase order. In other systems, the computer accepts input data from equipment located at the point of origin. Examples are factory times records; inventory counts, when the person counting uses a handheld recording device; and receiving records, when a similar device is used.

An especially striking and familiar example of direct computer data input is the scanning device used at the supermarket or department store checkout stand. The scanner reads a bar code printed on the item (or on a tag attached to the item); this code specifically identifies the item. The computer to which the scanner is connected then uses stored information on each item’s selling price to calculate an itemized list of the amount owed by the customer. A summary of sales revenue, cost of goods sold (also stored for each item in the computer), gross margin by items or categories of items, and the status of inventories is available for use by store managers at any time they desire to access the system.

The inputs to one business’s computer may be the outputs of the computer of another business. For example, a factory computer may generate purchase orders for parts to be supplied by a vendor. These outputs are transmitted electronically to the vendor, where they become sales order inputs, without a paper purchase order ever being produced. Similarly, a wholesaler’s salesperson may record orders placed by a retail store on a handheld device; the information is then transmitted to a central computer by a wireless phone.

**Processing**

Once data are in machine-readable form, the change for bookkeeping errors is reduced. The computer will not accept an entry in which debits do not equal credits. However, if a human makes an error in selecting the account, or enters the wrong number for both the debit and credit, there will be errors.
Data in machine-readable form can be used in a number of ways. For example, an airline reservation system has record of the availability of seats in each of several fare categories for every flight the airline will operate over the next several months. Any travel agent connected to the system by a terminal can request information about flight availability and price; the computer can process hundreds of such inquiries every minute. If the agent wishes to book a seat, the computer decreases availability on the flight and sends information to the travel agency’s printer, which prepares a ticket, boarding pass, itinerary, and customer invoice. Computer system also sort data in ways that may be of interest and use to management.

Outputs

Computer-based systems can prepare reports that include either tables of numbers or graphs. These can be generated at regular intervals in a prescribed format or prepared in a form specified by an individual user. In some systems, the user produces customized reports locally by using a personal computer or terminal that can retrieve data from a central computer based system.

Modules

Computer-based accounting systems are usually operated by several interconnected software programs, each of which is called a module. There may be a module for any of the following: sales orders, shipments, and the related accounts receivable (often called an order-entry module); manufacturing costs; purchase orders; inventory, and related accounts payable (a purchasing module); payroll and other personnel records, fixed asset acquisitions, location, and depreciation, income taxes; cash; and the general ledger.

Hundreds of software programs are available. Some provide a complete set of modules for a small enterprise for a few hundred dollars; for a large company, the cost may be several thousand dollars. Some programs are designed for a specific industry for example; time-intensive professional
services businesses such as law, accounting, and architectural firms. These software programs can handle quantitative nonmonetary data as well as monetary data. Manual accounting systems, by contrast, are limited primarily to monetary data.

**Problems with Computer System**

Despite their many advantages, computer based systems are not without their problems. Although a small company can purchase off-the-shelf software and have its system up and running in a few days, system development and installation in a larger, more complex organization may take many months and cost millions of dollars. Such systems usually require an outside consultant for their design and implementation. Moreover, technological advances make existing systems obsolete within a few years, and much time and money must be spend to update them. Nevertheless, the advantages of a computer-based system are so great that almost every organization needs one.

Unlike a manual system, a computer-based system does not leave a paper trail that can be readily audited. The system must therefore rely on the internal controls described above. In a few spectacular instances, the lack (or circumventions) of such controls has resulted in business frauds and resultant failure; but the number of such events is very small relative to there number of computer-based systems in use.

Finally, a computer-based system will not be fully effective until its developers learn to design reports that the system’s users need and can understand. This job of education, for both developers and users, can be substantial. If it is not done properly, the system will spew out reports that no one uses, and the potential users will not appreciate the information that they could receive if only they knew how to ask for it.
3.2.2. Finance and Corporate Strategy

Sourcing money may be done for a variety of reasons. Traditional areas of needs may be for capital asset acquirement – new machinery or the construction of a new building or depot. The development of new products can be enormously costly and here again capital may be required. Normally, such development is financed internally, whereas capital for the acquisition of machinery may come from external sources. In this day and age of tight liquidity, many organizations have to look for short term capital in the way of overdraft or loans in order to provide a cash flow cushion. Interest rates can vary from organization to organization and also according to purpose.

Sources of funds

A company might raise new funds from the following sources:

The Capital markets:

a. New share issues, for example, by companies acquiring a stock market listing for the first time.

b. Right issues

c. Loan stock

d. Retained earnings

e. Bank borrowing

f. Government sources

g. Business expansion scheme funds

h. Venture capital

i. Franchising.

Ordinary (equity) shares

Ordinary shares are issued to the owners of a company. They have a nominal or ‘face’ value, typically of $1 or 50 cents. The market value of a
A quoted company’s shares bears no relationship to their nominal value, except that when ordinary shares are issued for cash, the issue price must be equal to or be more than the nominal value of the shares.

**Deferred ordinary shares**

Are a form of ordinary shares, which are entitled to a dividend only after a certain date or if profits rise above a certain amount. Voting rights might also differ from those attached to other ordinary shares.

Ordinary shareholders put funds into their company;

a) by paying for a new issue of shares

b) Through retained profits.

Simply retaining profits, instead of paying them out in the form of dividends, offers an important, simple low-cost source of finance, although this method may not provide enough funds, for example, if the firm is seeking to grow.

A new issue of shares might be made in a variety of different circumstances:

a) The company might want to raise more cash. If it issues ordinary shares for cash, should the shares be issued pro rata to existing shareholders, so that control or ownership of the company is not affected? If, for example, a company with 200,000 ordinary shares in issue decides to issue 50,000 new shares to raise cash, should it offer the new shares to existing shareholders, or should it sell them to new shareholders instead?

i) If a company sells the new shares to existing shareholders in proportion to their existing shareholding in the company we have a rights issue. In the example above, the 50,000 shares would be issued as a one-in-four
rights issue, by offering shareholders one new shares for every four shares they currently hold.

ii) If the number of new shares being issued is small compared to the number of shares already in issue, it might be decided instead to sell them to new shareholders, since ownership of the company would only be minimally affected

b) The company might want to issue shares partly to raise cash, but more importantly to float its shares on a stick exchange.

c) The company might issue new shares to the shareholders of another company, in order to take it over.

New share issues

A company seeking to obtain additional equity funds may be:

a) An unquoted company wishing to obtain a Stock Exchange quotation

b) An unquoted company wishing to issue new shares, but without obtaining a Stock Exchange quotation

c) A company which is already listed on the Stock Exchange wishing to issue additional new shares.

The methods by which an unquoted company can obtain a quotation on the stock market are:

a) an offer for sale

b) a prospectus issue

c) a placing
d) an introduction

**Offers for sale:**

An offer for sale is a means of selling the shares of a company to the public.

a) An unquoted company may issue shares, and then sell them on the Stock Exchange, to raise cash for the company. All the shares in the company, not just the new ones, would then become marketable.

b) Shareholders in an unquoted company may sell some of their existing shares to the general public. When this occurs, the company is not raising any new funds, but just providing a wider market for its existing shares (all of which would become marketable), and giving existing shareholders the change to cash in some or all of their investment in their company.

When companies’ go public’ for the first time, a ‘large’ issue will probably take the form of an offer for sale. A smaller issue is more likely to be a placing, since the amount to be raised can be obtained more cheaply if the issuing house or other sponsoring firm approaches selected institutional investors privately.

**Rights issues**

A rights issue provides a way of raising new shares capital by means of an offer to existing shareholders, inviting them to subscribed cash for new shares in proportion to their existing holdings.

For example, a rights issue on a one-for-four basis at 280c per share would mean that a company is inviting its existing shareholders to subscribe for one new share for every four shares they hold, at a price of 280c per new share.
A company making a rights issue must set a price which is low enough to secure the acceptance of shareholders, who are being asked to provide extra funds, but not too low, so as to avoid excessive dilution of the earnings per share.

Preference shares

Preference shares have a fixed percentage divided before any dividend is paid to the ordinary shareholders. As with ordinary shares a preference dividend can only be paid if sufficient distributable profits are available, although with ‘cumulative’ preference shares the right to an unpaid dividend is carried forward to later years. The arrears of dividend on cumulative preference shares must be paid before any dividend is paid to the ordinary shareholders.

From the company’s point of view, preference shares are advantageous in that:

- Dividends do not have to be paid in a year in which profits are poor, while this is not the case with interest payments on long term debt (loans or dentures).
- Since they do not carry voting rights, preference shares avoid diluting the control of existing shareholders while an issue of equity shares would not.
- Unless they are redeemable, issuing preference shares will lower the company’s gearing. Redeemable preference shares are normally treated as debt when gearing is calculated.
- The issue of preference shares does not restrict the company’s borrowing power, at least in the sense that preference share capital is not secured against assets in the business.
- The non-payment of dividend does not give the preference shareholders the right to appoint a receiver, a right which is normally given to debenture holders. However, dividend payments on preference shares re not tax deductible in the way that interest payment on debt are. Furthermore, for preference shares to be
attractive to investors, the level of payment needs to be higher than for interest on debt to compensate for the additional risk.

- For the investor, preference shares are less attractive than loan stock because:
- they cannot be secured on the company’s assets
- the dividend yield traditionally offered on preference dividends has been much too low to provide an attractive investment compared with the interest yields on loan stock in view of the additional risk involved.

**Loan stock**

Loan stock is long-term debt capital raised by a company for which interest is paid, usually half yearly and at a fixed rate. Holders of loan stock are therefore long-term creditors of the company.

Loan stock has a nominal value, which is the debt owed by the company, and interest is paid at a stated “coupon yield” on this amount. For example, if a company issues 10% loan stocky the coupon yield will be 10% of the normal value of the stock, so that $100 of stock will receive $10 interest each year. The rate quoted is the gross rate, before tax.

Debentures are a form of loan stock, legally defined as the written acknowledgement of a debt incurred by a company, normally containing provisions about the payment of interest and the eventual repayment of capital.

**Debentures with a floating rate of interest**

These are debentures for which the coupon rate of interest can be changed by the issuer, in accordance with changes in market rates of interest. They may be attractive to both lenders and borrowers when interest rates are volatile.
Security

Loan stock and debentures will often be secured. Security may take the form of either a fixed charge or a floating charge.

a) Fixed charge: security would be related to a specific asset or group of assets, typically land and buildings. The company would be unable to dispose of the asset without providing a substitute asset for security, or without the lender’s consent.

b) Floating charge; With a floating charge on certain assets of the company (for example, stocks and debtors), the lender’s security in the event of a default payment is whatever assets of the appropriate class the company then owns (provided that another lender does not have a prior charge on the assets). The company would be able, however, to dispose of its assets as it chose until a default took place. In the event of a default, the lender would probably appoint a receiver to run the company rather than lay claim to a particular assets.

The redemption of loan stock

Loan stock and debentures are usually redeemable. They are issued for a term of ten years or more, and perhaps 25 to 30 years. At the end of this period, they will “mature” and become redeemable (at par or possibly at a value above par).

Most redeemable stocks have an earliest and latest redemption date. For example, 18% Debenture Stock 2007/09 is redeemable, at any time between the earliest specified date (in 2007) and the latest date (in 2009). The issuing company can choose the date. The decision by a company when to redeem a debt will depend on:

a) How much cash is available to the company to repay the debt
b) The nominal rate of interest on the debt. If the debentures pay 18% nominal interest and the current rate of interest is lower, say 10%, the company may try or raise a new loan at 10% to redeem the debt which costs 18%. On the other hand, if current interest rates are 20%, the company is unlikely to redeem the debt until the latest date possible, because the debentures would be a cheap source of funds.

There is no guarantee that a company will be able to raise a new loan to pay off a maturing debt, and one item to look for in a company’s balance sheet is the redemption date of current loans, to establish how much new finance is likely to be needed by the company and when.

Mortgages are a specific type of secured loan. Companies place the title deeds of freehold or long leasehold property as security with an insurance company or mortgage broker and receive cash on loan, usually repayable over a specified period. Most organizations owning property which is unencumbered by any change should be able to obtain a mortgage up to two thirds of the value of the property.

As far as companies are concerned, debt capital is a potentially attractive source of finance because interest charges reduce the profits chargeable to corporation tax.

Retained earnings

For any company, the amount of earnings retained within the business has a direct impact on the amount of dividends. Profit reinvested as retained earnings is profit that could have been paid as a dividend. The major reasons for using retained earnings to finance new investments, rather than to pay higher dividends and then raise new equity for the new investments, are as follows:
a) The management of many companies believes that retained earnings are funds which do not cost anything, although this is not true. However, it is true that the use of retained earnings as a source of funds does not lead to a payment of cash.

b) The dividend policy of the company is in practice determined by the directors. From their standpoint, retained earnings are an attractive source of finance because investment projects can be undertaken without involving either the shareholders or any outsiders.

c) The use of retained earnings as opposed to new shares or debentures avoids issue costs.

d) The use of retained earnings avoids the possibility of a change in control resulting from an issue of new shares.

Another factor that may be of importance is the financial and taxation position of the company’s shareholders. If, for example, because of taxation considerations, they would rather make a capital profit (which will only be taxed when shares are sold) than receive current income, then finance through retained earnings would be preferred to other methods.

A company must restrict its self-financing through retained profits because shareholders should be paid a reasonable dividend, in line with realistic expectations, even if the directors would rather keep the funds for re-investing. At the same time, a company that is looking for extra funds will not be expected by investors (such as banks) to pay generous dividends, nor over-generous salaries to owner-directors.
Bank lending

Borrowings from banks are an important source of finance to companies. Bank lending is still mainly short term, although medium-term lending is quite common these days.

Short term lending may be in the form of:

a) an overdraft, which a company should keep within a limit set by the bank. Interest is charged (at a variable rate) on the amount by which the company is overdrawn from day to day.

b) a short-term loan, for up to three years.

Medium-term loans are loans for a period of from three to ten years. The rate of interest charged on medium-term bank lending to large companies will be a set margin, with the size of the margin depending on the credit standing and riskiness of the borrower. A loan may have a fixed rate of interest or a variable interest rate, so that the rate of interest charged will be adjusted every three, six, nine or twelve months in line with recent movements in the Base Lending Rate.

Lending to smaller companies will be at a margin above the bank’s base rate and at either a variable or fixed rate of interest. Lending on overdraft is always at a variable rate. A loan at a variable rate of interest is sometimes referred to as a floating rate loan. Longer-term bank loans will sometimes be available, usually for the purchase of property, where the loan takes the form of a mortgage. When a banker is asked by a business customer for a loan or overdraft facility, he will consider several factors known commonly by the mnemonic PARTS.

- Purpose
- Amount
- **Repayment**
- **Term**
- **Security**

| P | The purpose of the loan. A loan request will be refused if the purpose of the loan is not acceptable to the bank. |
| A | The amount of the loan. The customer must state exactly how much he wants to borrow. The banker must verify, as far as he is able to do so, that the amount required to make the proposed investment has been estimated correctly. |
| R | How will the loan be repaid? Will the customer be able to obtain sufficient income to make the necessary repayments? |
| T | What would be the duration of the loan? Traditionally, banks have offered short-term loans and overdrafts, although medium-term loans are now quite common. |
| S | Does the loan require security? If so, is the proposed security adequate? |

**Leasing**

A lease is an agreement between two parties, the “lessor” and the “lessee”. The lessor owns a capital asset, but allows the lessee to use it. The lessee makes payments under the terms of the lease to the lessor, for a specified period of time.

Leasing is, therefore, a form of rental. Leased assets have usually been plant and machinery, cars and commercial vehicles, but might also be computers and office equipment. There are two basic forms of lease; “Operating leases” and “finance leases”.

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Operating leases

Operating leases are rental agreements between the lessor and the lessee whereby;

a) the lessor supplies the equipment to the lessee

b) the lessor is responsible for servicing and maintaining the leased equipment

c) the period of the lease is fairly short, less than the economic life of the asset, so that at the end of the lease agreement, the lessor can either

i) lease the equipment to someone else, and obtain a good rent for it, or

ii) sell the equipment secondhand.

Finance lease

Finance lease are lease agreements between the user of the leased assets (the lessee) and a provider of finance (the lesser) for most, or all, of the asset’s expected useful life.

Suppose that a company decides to obtain a company car and finance the acquisition by means of a finance lease. A car dealer will supply the car. A finance house will agree to act as lessor in a finance leasing arrangement, and so will purchase the car from the dealer and lease it to be company. The company will take possession of the car from the car dealer, and make regular payments (monthly, quarterly, six monthly or annually) to the finance house under the terms of the lease.

Other important characteristics of a finance lease:

a) the lease is responsible for the upkeep, servicing and maintenance of the asset. The lesser is not involve din this at all.
b) The lease has a primary period, which covers all or most of the economic life of the asset. At the end of the lease, the lessor would not be able to lease the asset to someone else, as the asset would be worn out. The lessor must, therefore, ensure that the lease payments during the primary period pay for the full cost of the asset as well as providing the lessor with a suitable return on his investment.

c) It is usual at the end of the primary lease period to allow the lessee to continue to lease the asset for an indefinite secondary period, in return for a very low nominal rent. Alternatively, the lessee might be allowed to sell the asset on the lessor’s behalf (since the lessor is the owner) and to keep most of the sale proceeds, paying only a small percentage (perhaps 10%) to the lessor.

**Why might leasing be popular?**

The attractions of leases to the supplier of the equipment, the lessee and the lessor are as follows:

- The supplier of the equipment is paid in full at the beginning. The equipment is sold to the lessor, and apart from obligations under guarantees or warranties, the supplier has no further financial concern about the asset.

- The lessor invests finance by purchasing assets form suppliers and makes a return out of the lease payments from the lessee. Provided that a lessor can find lessees willing to pay the amounts he wants to make his return, the lessor can make good profits. He will get capital allowances on his purchase of the equipments.

- Leasing might be attractive to the lessee:
- if the lessee does not have enough cash to pay for the asset, and would have difficulty obtaining a bank loan to buy it, and so has to rent it in one way or another if he is to have the use of it at all; or
• if finance leasing is cheaper than a bank loan. The cost of payments under a loan might exceed the cost of a lease.

Operating lease have further advantages:

• The leased equipment does not need to be shown in the lessee’s published balance sheet, and so the lessee’s balance sheet shows no increase in its gearing ratio.
• The equipment is leased for a shorter period than its expected useful life. In the case of high-technology equipment, if the equipment becomes out-of-date before the end of its expected life, the lessee does not have to keep on using it, and it is the lessor who must bear the risk of having to sell obsolete equipment secondhand.

The lessee will be able to deduct the lease payments in computing his taxable profits.

**Hire purchase**

Hire purchase is a form of installment credit. Hire purchase is similar to leasing, with the exception that ownership of the goods passes to the hire purchase customer on payment of the final credit installment, whereas a lessee never becomes the owner of the goods.

Hire purchase agreements usually involve a finance house.

a. The supplier sells the goods to the finance house.
b. The supplier delivers the goods to the customer who will eventually purchase them.
c. The hire purchase arrangement exists between the finance house and the customer.

The finance house will always insist that the hirer should pay a deposit towards the purchase price. The size of the deposit will depend on the finance company’s
policy and its assessment of the hirer. This is in contrast to a finance lease, where the lessee might not be required to make any large initial payment.

An industrial or commercial business can use hire purchase as a source of finance. With industrial hire purchase, a business customer obtains hire purchase finance from a finance house in order to purchase the fixed asset. Goods bought by businesses on hire purchase include company vehicles, plant and machinery, office equipment and farming machinery.

**Government assistance**

The government provides finance to companies in cash grants and other forms of direct assistance, as part of its policy of helping to develop the national economy, especially in high technology industries in areas of high unemployment. For example, the Indigenous Business Development Corporation of Zimbabwe (IBDC) was set up by the government to assist small indigenous business in the country.

**Venture capital**

Venture capital is money put into an enterprise which may all be lost if the enterprise fails. A businessman starting up a new business will invest venture capital of his own, but he will probably need extra funding from a source other than his own pocket. However, the term ‘venture capital’ is more specifically associated with putting money, usually in return for an equity stake, into a new business, a management buy-out or a major expansion scheme.

The institution that puts in the money recognizes the gamble inherent in the funding. There is a serious risk of losing the entire investment, and it might take a long time before any profits and returns materialize. But there is also the prospect of very high profits and a substantial return on the investment. A venture capitalist will require a high expected rate of return on investments, to compensate for the high risk.
A venture capital organization will not want to retain its investment in a business indefinitely, and when it considers putting money into a business venture, it will also consider its “exit”, that is, how it will be able to pull out of the businesses eventually (after five to seven years, say) and realize its profits. Examples of venture capital organizations are: Merchant Bank of Central Africa Ltd. And Anglo American Corporation Services Ltd.

When a company director’s look for help from a venture capital institution, they must recognize that:

- The institution will want an equity stake in the company
- It will need convincing that the company can be successful
- It may want to have a representative appointed to the company board, to look after its interests.

The directors of the company must then contact venture capital organizations, to try and find one or more which would be willing to offer finance. A venture capital organization will only give funds to a company that it believes can succeed, and before it will make any definite offer, it will want from the company management:

a) a business plan
b) details of how much finance is needed and how it will be used
c) the most recent trading figures of the company, a balance sheet, a cash flow forecast and a profit forecast
d) details of the management team, with evidence of a wide range of management skills
e) details of major shareholders
f) details of the company’s current arrangements and any other sources of finance
g) any sales literature or publicity material that the company has issued.
A high percentage of requests for venture capital are rejected on an initial screening, and only a small percentage of all requests survive both this screening and further investigation and result in actual investments.

**Franchising**

Franchising is a method of expanding business on less capital than would otherwise be needed. For suitable business, it is an alternative to raising extra capital for growth. Franchisors include Budget Rent-a-Car, Wimpy, Nando’s Chicken and Chicken Inn.

Under a franchising arrangement, a franchisee pays a franchisor for the right to operate a local business, under the franchisor’s trade name. The franchisor must bear certain costs (possibly for architect’s work, establishment costs, legal costs, marketing costs and the cost of other support services) and will charge the franchisee an initial franchise fee to cover set-up costs, relying on the subsequent regular payments by the franchisee for an operating profit. These regular payments will usually be a percentage of the franchisee’s turnover.

Although the franchisor will probably pay a large part of the initial investment cost of a franchisee’s outlet, the franchisee will be expected to contribute a share of the investment himself. The franchisor may well help the franchisee to obtain loan capital to provide his-share of the investment cost.

The advantages of franchises to the franchisor are as follows:

- The capital outlay needed to expand the business is reduced substantially.
- The image of the business is improved because the franchisees will be motivated to achieve good results and will have the authority to take whatever action they think fit to improve the results.
The advantage of a franchise to a franchisee is that he obtains ownership of a business for an agreed number of years (including stock and premises, although premises might be leased from the franchisor) together with the backing of a large organization’s marketing effort and experience. The franchisee is able to avoid some of the mistakes of many small businesses, because the franchisor has already learned from its own past mistakes and developed a scheme that works.²

The Role of Finance in the Strategic-Planning and Decision Making Process

Financial Goals and Metrics Help Firms Implement Strategy and Track Success

The fundamental success of a strategy depends on three critical factors: a firm’s alignment with the external environment, a realistic internal view of its core competencies and sustainable competitive advantages, and careful implementation and monitoring.³

Any person, corporation, or nation should know who or where they are, where they want to be, and how to get there.⁴ The strategic-planning process utilizes analytical models that provide a realistic picture of the individual, corporation, or national at its “consciously incompetent” level, creating the necessary motivation for the development of a strategic plan.⁵ The process requires five distinct steps outlined below and the selected strategy must be sufficiently robust to enable the firm to perform activities differently from its rivals or to perform similar activities in a more efficient number.⁶

A good strategic plan includes metrics that translate the vision and mission into specific end points.⁷ this is critical because strategic planning is ultimately about resource allocation and would not be relevant if resources were unlimited.
The Strategic-Planning and Decision-Making Process

1. Vision Statement

The creation of a broad statement about the company’s values, purpose, and future direction is the first step in the strategic-planning process. The vision statement must express the company’s core ideologies – what it stands for and why it exists – and its vision for the future, that is, what is aspires to be, achieve, or create.

2. Mission Statement

An effective mission statement conveys eight key components about the firm: target customers and markets; main products and services; geographic domain; core technologies; commitment to survival, growth, and profitability; philosophy; self-concept; and desired public image. The finance component is represented by the company’s commitment to survival, growth, and profitability. The company’s long-term financial goals represent its commitment to a strategy that is innovative, updated, unique, value-driven, and superior to those of competitors.

3. Analysis

This third step is an analysis of the firm’s business trends, external opportunities, internal resources, and core competencies. For external analysis, firms often utilize Porter’s five forces model of industry competition, which identifies the company’s level of rivalry with existing competitors, the treat of substitute products, the potential for new entrants, the bargaining power of suppliers, and the bargaining power of customer.

For internal analysis, companies can apply the industry evolution model, which identifies takeoff (technology, product quality, and product
performance features), rapid growth (driving costs down and pursuing product innovation), early maturity and slowing growth (cost reduction, value services, and aggressive tactics to maintain or gain market share), market saturation (elimination of marginal products and continuous improvement of value-chain activities), and stagnation or decline (redirection to fastest-growing market segments and efforts to be a low-cost industry leader).  

Another method, value-chain analysis clarifies a firm’s value-creation process based on its primary and secondary activities. This becomes a more insightful analytical tool when used in conjunction with activity-based and benchmarking tools that help the firm determine its major costs, resource strengths, and competencies, as well as identify areas where productivity can be improved and where re-engineering may produce a greater economic impact.

SWOT (strengths, weakness, opportunities, and threats) is a classic model of internal and external analysis providing management information to set priorities and fully utilize the firm’s competencies and capabilities to exploit external opportunities determine the critical weakness that need to be corrected, and counter existing threats

4. **Strategy Formulation**

To formulate a long-term strategy, Porter’s generic strategies model is useful as it helps the firm aim for one of the following competitive advantages: a) low-cost leadership (product is a commodity, buyers are price-sensitive, and there are few opportunities for differentiation); b) differentiation (buyers’ needs and preferences are diverse and there are opportunities for product differentiation); c) best-cost provider (buyers expect superior value at a lower price); d) focused
low-cost (market niches with specific tastes and needs); or e) focused differentiation (market niches with unique preferences and needs).

5. **Strategy Implementation and Management**

In the last ten years, the balanced scorecard (BSC)\(^{17}\) has become one of the most effective management instruments for implementing and monitoring strategy execution as it helps to align strategy with expected performance and it stresses the importance of establishing financial goals for employees, functional areas, and business units. The BSC ensures that the strategy is translated into objectives, operational actions, and financial goals and focuses on four key dimensions; financial factors, employee learning and growth, customer satisfaction, and internal business process.

**The Role of Finance**

Financial metrics have long been the standard for assessing a firm’s performance. The BSE supports the role of finance in establishing and monitoring specific and measurable financial strategic goals on a coordinated, integrated basis, thus enabling the firm to operate efficiently and effectively. Financial goals and metrics are established based on benchmarking the “best-in-industry” and include:

1. **Free Cash Flow**

This is a measure of the firm’s financial soundness and shows how efficiently it financial resources are being utilized to generate additional cash for future investments.\(^{18}\) It represents the net cash available after deducting the investments and working capital increases from the firm’s operating cash flow. Companies should utilize this metric when they anticipate substantial capital expenditures in the near future or follow-through for implemented projects.
2. Economic Value-Added

This is the bottom-line contribution on a risk-adjusted basis and helps management to make effective, timely decisions to expand businesses that increase the firm’s economic value and to implement corrective actions in those that are destroying its value. It is determine by deducting the operating capital cost from the net income. Companies set economic value-added goals to effectively assess their businesses’ value contributions and improve the resource allocation process.

3. Asset management

This calls for the efficient management of current assets (cash, receivables, inventory) and current liabilities (payables, accruals) turnovers and the enhanced management of its working capital and cash conversion cycle. Companies must utilize this practice when their operating performance falls behind industry benchmarks or benchmarked companies.

4. Financial Decisions and Capital Structure

Here, financing is limited to the optimal capital structure (debt ratio or leverage), which is the level that minimizes the firm’s cost of capital. This optimal capital structure determines the firm’s reserve borrowing capacity (short-and long-term) and the risk of potential financial distress. Companies establish this structure when their cost of capital rises above that of direct competitors and there is a lack of new investments.

5. Profitability Ratios

This is a measure of the operational efficiency of a firm. Profitability ratios also indicate inefficient areas that require corrective actions by management; they measure
profit relationships with sales, total assets, and net worth. Companies must set profitability ratio goals when they need to operate more effectively and pursue improvements in their value-chain activities.

6. Growth Indices

Growth indices evaluate sales and market share growth and determine the acceptable trade-off of growth with respect to reduction in cash flows, profit margins, and returns on investment. Growth usually drains cash and reserve borrowing funds, and sometimes, aggressive asset management is required to ensure sufficient cash and limited borrowing. Companies must set growth index goals when growth rates have lagged behind the industry norms or when they have high operating leverage.

7. Risk Assessment and Management

A firm must address its key uncertainties by identifying, measuring, and controlling its existing risks in corporate governance and regulatory compliance, the likelihood of their occurrence, and their economic impact. Then, a process must be implemented to mitigate the causes and effects of those risks. Companies must make these assessments when they anticipate greater uncertainty in their business or when there is a need to enhance their risk culture.

8. Tax Optimization

Many a functional areas and business units need to manage the level of tax liability undertaken in conducting business and to understand that mitigating risk also reduces expected taxes. Moreover, new initiatives, acquisitions, and product development projects must be weighed against their tax implications and net after-tax contribution to the firm’s value. In general, performance must, whenever possible, be measured on an after-tax basis. Global companies must adopt this measure when operating in different tax environments, where they are able to take advantage of inconsistencies in tax regulations.
3.2.3 Going Concern

Introduction

This memorandum provides background to proposed International Standard of Auditing (ISA) 570 (Redrafted), “Going Concern.” The proposed ISA has been redrafted in accordance with conventions agreed by the International Auditing and Assurance Standards Board (IAASB) to be applied to all ISAs. The IAASB approved the proposed redrafted ISA for exposure in February 2007.

Background

As part of its project to improve the clarity of its International Standards, the IAASB has undertaken to redraft all of its ISAs in accordance with its new clarity drafting conventions. This approach responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect. The IAASB has agreed, in response to the general call for the Clarity project to be completed within a reasonable time, that while a significant number of the ISAs are under substantive revision as well as redrafting to reflect the new conventions, others will be subject to a limited redrafting to reflect only the conventions and matters of clarity generally. ISA 570 is in the latter category.

The conventions used by the IAASB in redrafting ISA 570 for exposure, and the authority and obligation attaching to those conventions are established in the amended “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services” (Preface), approved by the IAASB in September 2006.
Scope of this ISA

This International Standard on Auditing (ISA) deals with the auditor’s responsibility in the audit of financial statements with respect to management’s use of the going concern assumption in the preparation and presentation of the financial statements.

The Going Concern Assumption

Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. Financial statements and, in particular, all general purpose financial statements, are therefore prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. There may be some circumstances where special purpose financial statements are prepared in accordance with a financial reporting framework for which the going concern basis is not relevant (e.g., some financial statements prepared on a tax basis in particular jurisdictions.)

Responsibilities of the Auditor and of Management

Some financial reporting frameworks contain an explicit requirement. (The detailed requirements regarding management’s) responsibility to assess the entity’s ability to continue as a going concern and related financial statement disclosures may be set out in the financial reporting framework, law or regulation). For management to make a specific assessment of the entity’s ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. For example, International Accounting standard (IAS) 1, ‘Presentation of Financial Statements” requires management to make an assessment of an entity’s ability to continue as a going concern. (International Accounting Standard (IAS) 1 as at 31 December 2005, “Presentation of Financial Statements” paragraphs 23 and 24 states : “When preparing financial statements, management shall make an assessment of an
entity’s ability to continue as a going concern. Financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of financial uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, those uncertainties shall be disclosed. When financial statements are not prepared on a going concern basis that fact shall be disclosed, together within the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern.

In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate may be reached without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.”

In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity’s ability to continue as a going concern. Nevertheless, since the going concern assumption is a fundamental principle in the preparation of the financial statements as describe din paragraph 2, management has a responsibility to access the entity’s ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

Management’s assessment of the entity’s ability to continue as a going concern involves making a judgment, at a particular point in time, about the future outcome of events or conditions which are inherently uncertain. The following factors are relevant to that judgment:
• The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future a judgment is being made about the outcome of an event or condition. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.

• The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors all affect the judgment regarding the outcome of events or conditions.

• Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may be inconsistent with a judgment which was reasonable at the time it was made.

The auditor’s responsibility is to evaluate the appropriateness of management’s use of the going concern assumption in the preparation of the financial statements and conclude whether there is a material uncertainty. (The phrase “material uncertainty” is used in IAS 1 in discussing the uncertainties related to events or conditions which may cast significant doubt on the entity’s ability to continue as a going concern that should be disclosed in the financial statements. In other financial reporting frameworks, and elsewhere in the financial statements. In other financial reporting frameworks, and elsewhere in the ISAs, the phrase “significant uncertainty” is used in similar circumstances.) about the entity’s ability to continue as a going concern that need to be disclosed in the financial statements. The auditor evaluates the appropriateness of management’s use of the going concern assumption even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity’s ability to continue as a going concern.

The auditor cannot predict future events or conditions that may cause an entity to cease to continue as a going concern. Accordingly, the absence of any reference to going concern uncertainty in an auditor’s report cannot be viewed as a guarantee as to the entity’s ability to continue as a going concern.
Effective Date

This ISA is effective for audits of financial statements for periods beginning on or after (This date will be not be earlier than December 15, 2008).

Objectives

The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence about whether management’s use of the going concern assumption in the preparation of presentation of the financial statements is appropriate in the circumstances; and

(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern and, if such a material uncertainty exists, to consider the implications for the auditor’s report.

Requirements

Performing Risk Assessment Procedures (Ref. : Para A4-A7)

When performing risk assessment procedures to obtain an understanding of the entity, the auditor shall:

(a) Inquire of management as to whether events or conditions exist that, individually or collectively, as cast significant doubt about the going concern assumption; and either

(b) Consider management’s assessment of the entity’s ability to continue as a going concern, if such an assessment has been performed, to determine whether management has identified events or
conditions that may cast significant doubt on the entity’s ability
to continue as a going concern and management’s plans to
address them; or

(c) Discuss with management the basis for its intended use of the going
concern assumption, if management has not yet performed such as
assessment.

The auditor shall remain alert throughout the audit for audit evidence of events or
conditions that may cast significant doubt on the entity’s ability to continue as a going
concern.

**Evaluating Management’s Assessment** (Ref. para A8-A15)

The auditor shall evaluate management assessment of the entity’s ability to continue
as a going concern.

The auditor’s evaluation shall cover the same period s that used by management to
make its assessment under the applicable financial reporting framework. If
management’s assessment of the entity’s ability to continue as a going concern covers
less than twelve months forms the balance sheet date, the auditor shall request
management to extend its assessment period to twelve months from the balance sheet
date.

In evaluating management’s assessment, the auditor shall consider whether
management has taken into account all relevant information of which the auditor is
aware as a result of the audit.
Period Beyond Management’s Assessment (Ref: Para A16)

The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of assessment used by management that may cast significant doubt on the entity’s ability to continue as a going concern.

Further Audit Procedures when Events or Conditions are Identified (Ref.; para A17-A20)

When events or conditions have been identified which may cast significant doubt on the entity’s ability to continue as a going concern, the auditor shall:

(a) Obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of other mitigating factors. When analysis of a cash flow forecast is a significant factor in considering the future outcome of events or conditions the auditor shall:
   (i) Evaluate the reliability of the entity’s information system for generating such information; and
   (ii) Determine whether there is adequate support for the assumptions underlying the forecast.

(b) Evaluate management’s plans for future actions based on its going concern assessment and whether the outcome of these plans will improve the situation, and obtain sufficient appropriate audit evidence that management’s plans are feasible in the circumstances.

(c) Determine whether any additional facts or information have become available since the date on which management made it assessment.

(d) Request specific written representations form management regarding its plans for future action.
Audit Conclusions and Reporting

Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor’s judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact is such that, in the auditor’s judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for the fair presentation of the financial statements in accordance with a fair presentation financial reporting framework, or in the case of a compliance framework, for the financials statements not to be misleading.

Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists
(Ref. Para A21-25)

When the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall conclude whether the financial statements;

(a) Adequately describe the principal events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern and management’s plans to deal with these events or conditions; and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion but shall include an Emphasis of Matter paragraphs in the auditor’s report to:
(a) Highlight the existence of a material uncertainly relating to the event or condition that may cast significant doubt on the entity’s ability to continue as a going concern; and to

(b) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 18 (See ISA 706(Revised), “Emphasis of Mater Paragraphs and Other Matter(s) paragraphs in the Independent Auditor’s Report.”

If adequate disclosure is not made in the financial statements the auditor shall express a qualified or adverse opinion, as appropriate (See ISA 705 (Revised), “Modifications to the Opinion in the Independent Auditor’s Report”). The auditor shall include specific reference in the auditor’s report to the fact that there is a material uncertainty that may cast significant doubt about the entity’s ability to continue as a going concern.

**Going Concern Assumption Inappropriate** (Ref. Para. A26)

If, in the auditor’s judgment, the entity will not be able to continue as a going concern, the auditor shall express an adverse opinion if the financial statements have been prepared on a going concern basis, regardless of whether or not appropriate disclosure has been made. 23
3.2.4. Indian Accounting Standards

Preface to the Statements of Accounting Standards (Revised 2004)

The following is the text of the preface to the statements of accounting standards (revised 2004), issued by the council of the institute of chartered accounts of India.

With the issuance of this revised Preface, the Preface to the Statements of Accounting Standards, issued in January, 1979, stands superseded.

1. Formation of the Accounting Standards Board

1.1 The Institute of Chartered Accounts of India (ICAI), recognizing the need to harmonies the diverse accounting policies and practices in use in India, constituted the Accounting standards Board (ASB) on 21st April, 1977.

1.2 The composition of the ASB is fairly broad-based and ensures participation of all interest-groups in the standard-setting process. Apart from the elected members of the Council of the ICAI nominated on the ASB.

2. Objectives and Functions of the Accounting Standards Board

a. The following are the objectives of the Accounting Standards Board:

(i) To conceive of and suggest areas in which Accounting Standards need to be developed.

(ii) To formulate Accounting Standards with a view to assisting the Council of the ICAI in evolving and establishing Accounting Standards in India.
(iii) To examine how far the relevant International Accounting Standard/international Financial Reporting Standard (see paragraph 2.3 below) can be adapted while formulating the Accounting Standard and to adapt the same.

(iv) To review, at regular intervals, the Accounting Standards from the point of view of acceptance or changed conditions, and, if necessary, revise the same.

(v) To provide, form time to time, interpretations and guidance on Accounting Standards.

(vi) To carry out such other functions relating to accounting Standards.

3. General Purpose Financial Statements

3.1 For discharging its functions, the ASB will keep in view the purposes and limitations of financial statements and the attest function of the auditors. The ASB will enumerate and describe the basic concept to which accounting principles should be oriented and state the accounting principles to which the practices and procedures should conform.

3.2 The ASB will clarify the terms commonly used in financial statements and suggest improvements in the terminology wherever necessary. The ASB will examine the various current alternative practices in vogue and endeavor to eliminate or reduce alternatives within the bounds of rationality.

3.3 Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which are subject to the attest function of the members of the ICAI. Accounting standards apply in respect of any enterprise (whether organized incorporate,
cooperative (With the issuance of this revised Preface, General Clarification (GC) – 12/2002, Applicability of Accounting Standards to Co-operative Societies, issued by the Accounting Standards Board in October, 2002 stands superseded.) or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes.

3.4 The term ‘General Purpose Financial Statements’ includes balance sheet, statement of profit and loss, a cash flow statement (wherever applicable) and statements and explanatory notes which form part thereof, issued for the use of various stakeholders, Governments and their agencies and the public. References to financial statements in this Preface and in the standards issued form time to time will be construed to refer to General Purpose Financial Statements.

3.5 Responsibility for the preparation of financial statements and for adequate disclosure is that of the management of the enterprise. The auditor’s responsibility is to form his opinion and report on such financial statements.

4. **Scope of Accounting Standards**

4.1 Efforts will be made to issue Accounting Standards which are in conformity with the provisions of the applicable laws, customs, usages and business environment in India. However, if a particular Accounting Standard is found to be not in conformity with law, the provisions of the said law will prevail and the financial statements should be prepared in conformity with such law.

4.2 The Accounting Standards by their very nature cannot and do not override the local regulations which govern the preparation and presentation of financial statements in the country. However, the ICAI will determine the extent of disclosure to be made in financial statements
and the auditor’s report thereon. Such disclosures may be by way of appropriate notes explaining the treatment of particular items. Such explanatory notes will be only in the nature of clarification and therefore need not be treaded as adverse comments on the related financial statements.

4.3 The Accounting Standards are intended to apply only to items which are material. Any limitations with regard to the applicability of a specific Accounting Standard will be made clear by the ICAI from time to time. The date from which a particular Standard will come into effect, as well as the class of enterprises to which it will apply, will also be specified by the ICAI. However, no standard will have retroactive application, unless otherwise stated.

4.4 The Institute will use its best Endeavour’s to persuade the Government, appropriate authorities, industrial and business community to adopt the Accounting Standards in order to achieve uniformity in preparation and presentation of financial statements.

4.5 In formulation of Accounting Standards, the emphasis would be on laying down accounting principles and not detailed rules for application and implementation thereof.

4.6 The Standards formulated by the ASB include paragraphs in bold italic type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. An individual standard should be read in the context of the objective stated in that standard and this Preface.

4.7 The ASB may consider any issue requiring interpretation on any accounting Standard. Interpretations will be issued under the authority of the Council. The authority of Interpretation is the same as that of Accounting Standard to which it relates.
3.2.4.1 Accounting Standard (AS) 1

(Issued 1979)

Disclosure of Accounting Policies

(This Accounting Standard includes paragraphs 24-27 set in bold italic type and paragraphs 1-23 set in plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preference to the Statement of Accounting Standards.)

The following is the text of the Accounting Standard (AS) issued by the Accounting Standards Board, the Institute of Chartered Accountants of India on ‘Disclosure of accounting Policies’. The Standard deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements.

In the initial years, this accounting standard will be recommendatory in chapter. During this period, this standard is recommended for use by companies listed on a recognized stock exchange and other large commercial, industrial and business enterprise in the public and private Sectors.

(1 Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

2. It may be noted that this Accounting Standard is now mandatory. Reference may be made to the section titled ‘Announcements of the Council regarding status of various documents issued by the Institute of Chartered Accountants of India’ appearing at the beginning of this
Compendium for a detailed discussion on the implications of the mandatory status of an accounting standard).

3.2.4.2 Accounting Standards (AS)2

(Revised 1999)

Objective

A primary issue in accenting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognized. This Statement deals with the determination of such value, including the ascertainment of cost of inventories and any write-down thereof to net realizable value.

Measurement of Inventories

Inventories should be valued at the lower of cost and net realizable value.

Cost of Inventories

The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Cost of Purchase

The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise form the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the cost of purchase.
Cost of Conversion

The costs of conversion of inventories include cost directly related to the units of production, such as direct labor. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory.

3.2.4.3 Accounting Standard (As) 3

(Revised 1997)

Objective

Information about the cash flows of an enterprise is usual in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

The Statement deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating investing and financing activates.

Benefit of Cash Flow Information

A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flow in order to adapt to changing circumstances and opportunities. Cash flow information is
useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to access and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

3.2.4.4 Accounting Standards (AS)4

(Revised 1995)

Contingencies and Events Occurring After the Balance Sheet Date

1. This Statement deals with the treatment in financial statements of

   (a)  Contingencies, and

   (b)  Events occurring after the balance sheet date.

2. The following subjects, which may result in contingencies, are excluded from the scope of this Statement in view of special consideration applicable to them:

   (a)  Liabilities of life assurance and general insurance enterprises arising from policies issued;

   (b)  Obligations under retirement benefit plans; and

   (c)  Commitments arising from long-term lease contacts.
3.2.4.5 Accounting Standard (AS)5

(Revised 1997)

Net profit or loss for the period, prior Period Items and Changes in Accounting Policies

Objective

The objective of this Statement is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepared and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Statement requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

3.2.4.6 Accounting Standard (AS)6

(Revised 1994)

Depreciation Accounting

This Statement deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply:-

(i) Forests, plantations and similar regenerative natural resources;

(ii) Wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;

(iii) Expenditure on research and development;
(iv) Goodwill;

(v) Live stock.

This statement also does not apply to land unless it has a limited useful life for the enterprise.

Different accounting policies for depreciation are adopted by different enterprises. Disclosure of accounting policies for depreciation followed by an enterprise is necessary to appreciate the view presented in the financial statements of the enterprise.

3.2.4.7 Accounting Standard (AS) 7

(Revised 2002)

Construction Contracts

Objective

The objective of this Statement is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contacts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Statement uses the recognition criteria established in the Framework for the preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognized as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria.
3.2.4.8  Accounting Standard(As)9

(Issued 1985)

Introduction

This Statement deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Statement is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

- the sale of goods
- the rendering of services, and
- the use by other of enterprise resources yielding interest, royalties and dividends.

This Statement does not deal with the following aspects of revenue recognition to which special considerations apply:

(i) Revenue arising form construction contracts,

(ii) Revenue arising form hire-purchase lease agreements;

(iii) Revenue arising form government grants and other similar subsidies;

(iv) Revenue of insurance companies arising form insurance contracts.
Financial statements disclose certain information relating to fixed assets. In many enterprises these assets are grouped into various categories, such as land, buildings, plant and machinery, vehicles, furniture and fittings, goodwill, patents, trade marks and designs. This statement deals with accounting for such fixed assets except as describe din paragraphs 2 to 5 below.

This statement does not deal with the specialized aspects of accounting for fixed assets that arise under a comprehensive system reflecting the effects of changing prices but applied to financial statements prepared on historical cost basis.

this statement does not deal with accounting for the following items to which special considerations apply:

(i) forest, plantations and similar regenerative natural resources;

(ii) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources;

(iii) expenditure on real estate development; and

(iv) live stocks.

Expenditure on individual items of fixed assets used to develop or maintain the activities covered in (i) to (iv) above, but separable from those activities, are to be accounted for in accordance with this Statement.
This statement does not cover the allocation of the depreciable amount of fixed assets to future periods since this subject is dealt with in Accounting Standard 6 on ‘Depreciation Accounting’.

This statement does not deal with the treatment of government grants and subsidies, and assets under leasing rights. It makes only a brief reference to the capitalization of borrowing costs, and to assets acquired in an amalgamation or merger. These subjects require more extensive consideration than can be given within this Statement.

3.2.4.10 Accounting Standard (AS) 11

(Revised 2003)

The Effects of Changes in Foreign Exchange Rates

An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise’s reporting currency and the financial statements of foreign operations must be translated into the enterprise’s reporting currency.

The principal issues in accenting for foreign currency transactions and foreign operations are to decide which exchange rate to use and how to recognize in the financial statement the financial effect of changes in exchange rates.

Originally issued in 1989 and revised in 1994. The standard has been revised again in 2003.

Attention is specifically drawn to paragraph 4.3 of the preface, according to which Accounting Standards are intended to apply only to items which are material.

Reference may be made to the section titled ‘Announcements of the Council regarding status of various documents issued by the Institute of Chartered Accountants
of India’ appearing at the beginning of this Compendium for a detailed discussion on the implications of the mandatory status of an accounting standard.

3.2.4.11 **Accounting Standard (As)12**

**(Issued 1999)**

**Accounting for Government Grants**

This Statement deals with accounting for government grants. Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, etc.

This statement does not deal with: The special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices.

3.2.4.12 **Accounting Standard (AS) 13**

**(Issued 1993)**

**Accounting of Investments**

This Statement deals with accounting for investments in the financial statements of enterprises and related disclosure requirements.

This statement does not deal with:

(a) the bases for recognition of interest, dividends and rentals earned on investments which are covered by Accounting Standard 9 on Revenue Recognition;
(b) operating or finance leases;
(c) investments of retirement benefit plans and life insurance enterprises; and
(d) Mutual funds and venture capital funds and/or the related asset management companies, banks and public financial
institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956.

3.2.4.13 Accounting Standard (AS) 14

(Issued 1994)

Accounting for Amalgamations

This statement deals with accounting for amalgamations and the treatment of any resultant goodwill or serves. This statement is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.

This statement does not deal with cases of acquisitions which arise when there is a purchase by one company (referred to as the acquiring company) of the whole or part of the shares, or the whole or part of the assets, of another company (referred to as the acquired company) in consideration for payment in cash or by issue of shares or other securities in the acquiring company or partly in one form and partly in the other. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

- A limited revision to this Standard has been made in 2004, pursuant to which paragraphs 23 and 42 of this Standard have been revised (see footnotes 4 and 8)

- Attention is superficially drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

- Reference may be made to the section titled ‘Announcements of the Council regarding status of various documents issued by the Institute of Chartered Accountants of India’ appearing at the beginning of this
Compendium for a detailed discussion on the implications of the mandatory status of an accounting standard.

3.2.4.14 **Accounting Standard (As) 15**

*(Revised 2005)*

**Employee Benefits**

The objective of this Statement is to prescribe the accounting and disclosure for employee benefits. The Statement requires an enterprise to recognize:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) an expenses when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

3.2.4.15 **Accounting Standard (AS) 16**

*(Issued 2000)*

**Borrowing Costs**

The objective of this Statement is to prescribe the accounting treatment for borrowing costs.

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. The amount of borrowing costs eligible for capitalization should be determined in accordance with this statement. Other borrowing costs should be recognized as an expense in the period in which they are incurred.

Borrowing costs are capitalized as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the enterprise and the
costs can be measured reliably. Other borrowing costs are recognized as an expense in the period in which they are incurred.

3.2.4.16 Accounting Standard (AS)17

(Issued 2000)

Segment Reporting

The objective of this Statement is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements:

(a) better understand the performance of the enterprise;
(b) better assess the risks and returns of the enterprises; and
(c) make more informed judgments about the enterprise as a whole.

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. Information about different types of products and services of an enterprise and its operations in different geographical areas – often called segment information – is relevant to assessing the risks and returns of a diversified or multi-locational enterprise but may not be determinable from the aggregated data. Therefore, reporting of segment information is widely regarded as necessary for meeting the needs of users of financial statements.
3.2.4.17 Accounting Standard (As) 18

(Issued 2000)

Related Party Disclosures

Accounting Standard (AS) 18, ‘Related Party Disclosures’, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2001. This Standard is mandatory in nature in respect of accounting periods commencing on or after 1-4-2004’. For the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors’ resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statement exceeds Rs.50 corer, Turnover does not include ‘other income’.

(vii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.
The enterprises which do not fall in any of the above categories are not required to apply this Standard.

**Objective**

The objective of this Statement is to establish requirements for disclosure of:

(a) related party relationships; and
(b) transactions between a reporting enterprise and its related parties.

**3.2.4.18  Accounting Standard (AS 19)**

*(Issued 2001)*

**Leases**

Accounting Standard (As) 19, ‘Leases,’ issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of all assets leased during accounting periods commencing on or after 1.4.2001 and is mandatory in nature from the date. Accordingly, the ‘Guidance Note on Accounting for Leases’ issued by the Institute in 1995, is not applicable in respect of such assets. Earlier application of this Standard, is however, encouraged.

**Objective**

The objective of this Statement is to prescribe, for lessees and lassoers, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.
3.2.4.19 Accounting Standard (AS)20

(Issued 2001)

Earnings Per Share

Accounting Standard (As) 20, ‘Earnings Per Share’, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1.4.2001 and is mandatory in nature from the date, in respect of enterprises whose equity shares or pot entail equity shares are listed on a recognized stock exchange in India.

Objective

The objective of this Statement is to prescribe principles for the determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise. The focus of this Statement is on the denominator of the earnings per share calculation. Even though earnings per share data has limitations because of different accounting policies used for determining ‘earnings’, a consistently determined denominator enhances the quality of financial reporting.

3.2.4.20 Accounting Standard (AS)21

(Issued 2001)

Consolidated Financial Statements

Accounting Standard (As)21, ‘Consolidated Financial Statements’, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1.4.2001. An enterprise that presents consolidated financial statements should prepare and present these statements in accordance with this Standard. The following is the text of the Accounting Standard.
Objective

The objective of this Statement is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. These statements are intended to present financial information about a parent and its subsidiary (ies) as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources.

3.2.4.21 Accounting Standard (AS) 22

(Issued 2001)

Accounting for Taxes on Income

Accounting Standard (AS) 22, ‘Accounting for taxes on Income’, issued by the Council of the Institute of Chartered Accounts of India, comes into effect in respect of accounting periods commencing on or after 1.4.2001. It is mandatory in nature for:

(a) All the accounting periods commencing on or after 1.4.2001, in respect of the following:

(i) Enterprises whose equity or debt securities are listed on a recognized stock exchange in India and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognized stock exchange in India as evidenced by the board of directors’ resolution in this regard.

(ii) All the enterprises of a group, if the parent presents consolidated financial statements and the Accounting Standard is mandatory in nature in respect of any of the enterprises of that group in terms of (i) above.
(b) All the accounting periods commencing on or after 1.4.2002, in respect of companies not covered by (a) above.

(c) All the accounting periods commencing on or after 1.4.2006, in respect of all other enterprises.

The Guidance Note on Accounting for Taxes on Income, issued by the Institute of Chartered Accountants of India in 19991, stands withdrawn from 1.4.2001. the following is the text of the Accounting Standard.

Objective

The objective of this Statement is to prescribe accounting treatment for taxes on income. Tax on income is one of the significant items in the statement of profit and loss of an enterprise. In accordance with the matching concept, taxes on income are accrued in the same period as the revenue and expenses to which they relate. Matching of such taxes against revenue for a period poses special problems arising form the fact that in a number of cases, taxable income may be significantly different form the accounting income. This divergence between taxable income and accounting income arises due to two main reasons. Firstly, there are differences between items of revenue and expenses as appearing in the statement of profit and loss and the items which are considered as revenue, expenses or deductions for tax purposes. Secondly, there are differences between the amount in respect of a particular item of revenue or expense as recognized in the statement of profit and loss and the corresponding amount which is recognized for the computation of taxable income.
Accounting for Investments in Associates in Consolidated Financial Statements

Accounting Standard (As) 23, Accounting for Investments in Associates in Consolidated Financial Statements, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1.4.2002. An enterprise that presents consolidated financial statement should account for investments in associates in the consolidated financial statement in accordance with this Standard. The following gives the text of the Accounting Standard.

Objective

The objective of this Statement is to set out principles and procedures for recognizing, in the consolidated financial statements, the effects of the investments in associates on the financial position and operating results of a group.

Discounting Operations

Accounting Standard (As) 24, ‘Discounting Operations’, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1.4.2004. This Standard is mandatory in nature in respect of accounting periods commencing on or after 1.4.2004 for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.
(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors’ resolution in this regard.

(iii) Banks including co-operative banks

(iv) Financial Institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include ‘other income’.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

3.2.4.24 Accounting Standard (AS)25

(Issued 2002)

Interim Financial Reporting

Accounting Standard (As) 25, ‘Interim Financial Reporting’, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1.4.2002. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard. The following is the text of the Accounting Standard.
Objective

The objective of this Statement is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in a complete or condensed financial statement for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an enterprise’s capacity to generate earnings and cash flows, its financial condition and liquidity.

3.2.4.25 Accounting Standard (As) 26

(Issued 2002)

Intangible Assets

Accounting Standards (AS) 26, ‘Intangible Assets’, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1.4.2003 and is mandatory in nature form that date for the following:

(i) Enterprises who equity or debt securities are listed on a recognized stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognized stock exchange in India as evidenced by the board of directors’ resolution in this regard.

(ii) All other commercial, industrial and business reports enterprises, who turnover for the accounting period exceeds Rs.50 crores.

In respect of all other enterprises, the Accounting Stand comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1.4.2004 and is mandatory in nature form that date.
Objective

The objective of this Statement is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another accounting Standard. This Statement requires an enterprise to recognize an intangible asset if, and only if, certain criteria are met. The Statement also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

3.2.4.26 Accounting Standard (AS) 27
(Issued 2002)

Financial Reporting of Interests in Joint Ventures

Accounting Standard (AS) 27, ‘Financial Reporting of Interests in Joint Ventures’, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1.4.2002. In respect of separate financial statements of an enterprise, this Standard is mandatory in nature from that date. In respect of consolidated financial statements of an enterprise, this Standard is mandatory in nature where the enterprise prepares and presents the consolidated financial statements in respect of accounting periods commencing on or after 1.4.2002. Earlier application of the Accounting Standard is encouraged. The following is the text of the Accounting Standard.

Objective

The objective of this Statement is to set out principles and procedures for accounting interests in joint ventures and reporting of joint venture assets, liabilities, income and expenses in the financial statements of ventures and investors.
3.2.4.27 Accounting Standard (AS) 28

(Issued 2002)

Impairment of Assets


Objective

The objective of this Statement is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Statement requires the enterprise to recognize an impairment loss. This Statement also specifies when an enterprise should reverse an impairment loss and it prescribes certain disclosures for impaired assets.

3.2.4.28 Accounting Standard (AS) 29

(Issued 2003)

Provisions, Contingent Liabilities and Contingent Assets


Objective

The objective of this Statement is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable
users to understand their nature, timing and amount. The objective of this Statement is also to lay down appropriate accounting for contingent assets.

3.2.5 Reading Financing and its implication methods

During the last three decades age, lots of researches have been conducted in order to investigate financing and its implication methods. Some of these researches to be mentioned are as follows:

Modareas Zadeh, M (1993) conducted a study entitled “struggle for attraction of wandering liquidity” discussed the history and foundation of stock exchange throughout the world in general and Iran in particular. She mentions stock exchange as a finance source for different enterprises and comes to this conclusion that governments should develop internal, local development companies.  

Soltaninezhad, H, (2006) in a research entitled comparative study of share borrowing sale under Islamic commitment tried to investigate share borrowing sale as one of the financing method for enterprises. In this study, he discusses topics like trading through share borrowing sale mechanism, capital debt market mechanism.

Share borrowing exchanges, limitation of share borrowing sale, pricing and soon.


He believes that implementation of such methods and techniques of financial management in financing the enterprises seem vital and devising.

Accurate financial approaches and its application may enforce the company to achieve its goals. He also suggests the best financing methods containing using, international share borrowing sale as a financing source.
In electricity industry, The research also reviews the shortage of financing resources in Iran and the researcher believes that the problem has been started form manufacturer enterprises specially recently privatized ones which were in a bad financial position during state administration period and now for the expansion of their activities they need to refill the vacancies and they also need finance for new investments.  

Toghyani, A. (2003) conducted a research entitled “Review and designing of a multicourse, mathematical model for most efficient planning for financing in Iran Khodro enterprise”. In designing such a model, he initially suggests the current financing methods in the company, then the mathematical issues on designing a model and finally he proposes the most efficient model. The application of the results of this research is useful for Iran Khodro which is one of the statistical populations of this research.

It can also be generalized to the same situation in Auto production industry.  

Firoozabadi, D. (2004) studies financing methods in companies accepted in stock exchange market and the impact of these methods on stock value of the companies.

As, the present study tries to study financing in Auto Production companies and some parts are the same as Dehqhan’s research, the results can be applied by other related scholars and researchers.  

Ebrahimi, M. (1999) discusses the devising of comparative approaches of external financing in Electricity Industry. He also mentions some results of this research approaches like the application of financial engineering instruments in Cash flow risk reduction, borrowing from foreign banks and other financing centers and contracts like Boof, Boo, and Bot.
Finally, the researcher introduces Bot approach as strong long term approach for the replacement of previous short term financing approaches.

Raizat, F. (1996) conducted a research on Financing and Investment of cash accounts patterns in Islamic Investment Banks. He reviews a history of such investment in the world and introduces different types of these cash accounts. He also reviews financing methods and investment patterns in these cash accounts.30

Fathi, M. (1993) did a research on financing methods in companies accepted in Stock exchange Market in Tehran and recognition of these methods and their impact on companies’ stock value.

This research was a step forward in the development of market and providing the most efficient investment situation and activating the finance science in applied field. This is a descriptive coefficient study in which hypothesis testing and ANOVA are used in two separate independent methods. One part the recognition of relationship between liability and stock value of a company using its trading linear regression and also the comparison of stock price changing percentage with the liability ratio. Statistically the researchers uses T,F,Z tests to test the hypothesis.31

Abtahi, Sh (1995) did a research on the investigation and proposition of modern financing methods for the accepted companies in Tehran stock exchange market. Research results show that financing through liabilities is much cheaper and the application of this approach is suggested by users and applicants.32

Rahmani (1374) carried out a study on, the review of financing methods containing long term approaches and expansion of normal shares and their influence on the stock price in the accepted companies in Tehran stock exchange market. He introduced different external financing method and finally he investigated the impact of selection of these sources and their methods on the stock value in the mentioned companies.
Ahangaran in another research surveyed the prediction of future of different financing methods in higher education department and how to find new financing sources. To achieve such a goal, he first explained the present situation of financing sources and its related fallacies and limitations and then he introduces efficient approaches to solve this problem.

He concludes that educational planners in Iran must involve in internal educational system and try to internally change and amend the present educational system. They should also implement the sources as well as management styles and get all the system parts as available involved in their planning and through investigation of role and influence ratio on educational development and try to use the present limited sources of higher education more efficiently.33

Panahi (1999) studies the economical impact of securities and their application expansion methods in financing of investment projects. The main objective is to analyze the importance of such instruments as securities in monetary policies and reliability of instruments like security in controlling the liquidity amount of the society and also in direct financing in a society.

In this research, a past progress method regarding longitudinal studies with chronological studies and library techniques and documentary techniques and technical analyses and Theoretical studies have been used.

It also investigates the position of securities in economical development, controlling liquidity and financing projects by using a comparative case of civil budgeting with securities and without them in securities share of civil budget.34

Ministry of culture and higher education (1998) in a research project discuss “Designing the Dynamic financing system of the universities. The project operator is research and planning institute affiliated to education ministry. In this project 7 other projects are assigned regarding designing a modern financing system.
This projects has further sub-classified into define activities and also each activity has been broken down into sub-activities with each activity investigates the present position of the system and the other surveys the state universities financing situation of the countries.

And the third sub activity focuses on the designing the optimum situation of Iran universities.

The operation of these three sub activities makes the project practical and plan is put into practice through operation of projects.\(^{35}\)

Other studies have also been carried out regarding the continuity of activity.

A close look at the studies done shows that the information obtained form cash flow statements altogether with basic financial statements can help users in evaluation of cash flows in future.\(^ {36}\)

Also it should be mentioned that there is not a significant relationship between accrual ratio and cash proportion. And disclosure of one of them essentially does not reveal the other.\(^ {37}\)

Furthermore the current operation index of an institute is not a reliable factor for the valuation of going concern. Because continuation of an activity is basically a long term and auditors, investors can not be used in evaluation of going concern as they are subject to quick and continual charges.\(^ {38}\)

Bal and Brown(1968) came to this conclusion that earning in comparison with liquidity of operation is more in correlation with the stock efficiency.\(^ {39}\)

Carslow, C. and J. Mills (1991) used to cash flow information predicting bankruptcy. The research related that the information of cash flow operation cannot provide us with more predicting power compared to accrual ratio. While
it proved that not considering the cash flow ratios in Oltman’s research of bankruptcy has not been successful.

In this research two ratios of earning of cash flow earning divided by current liabilities and also the ratio of cash flow compared with the total liabilities.\(^\text{40}\)

Based on theoretical studies in (2001), among all financial ratios resulted form cash flow statements, only capital expenditure ratio can be used as a criteria for the evaluation of going concern of companies. Meanwhile, the traditional liquidity ratio has long been used as criteria in evaluation. So the ratios of these two groups and their information were used.

Before the circulation of No.59 America Auditing standard, auditing researchers had suggested models for the prediction of economical enterprises going concern. These models can be used as instrument in auditing decision making for the recognition of those entities which are qualified to be granted the going concern.

Mutchler(1984):

However, in previous studies different methods have been applied yet the results are the same. For example going concern can be successfully predicted by using the financial variables. Mutchler could accurately classify almost 83 percent of the sample companies using these variables.

Most of the previous studies had considered the financial ratio as a criteria related to going concern, while Mutchler, through a direct interview with auditors, realized that they do not essentially use ratio analysis in their decision making activities regarding commenting on going concern. And they emphasize other factors which are apparently representing the potential in continuation. For instance, if different acts of agreement on loans have not been observed or there
would be any incapability in planned payment, then the whole going concern would be under question.

In such cases, Auditors believe that there would be a high cost or not expressing the opinion about the going concern. If the company faces any bankruptcy later, Auditors would be badly blamed and questioned.\(^{41}\)

Chen and Church (1992) conducted a research entitled non-payment debt and assigning going concern act. In this study, they wanted to see Auditors using of the nonpayment debt situation in decision making for expressing their opinion regarding going concern.

The results showed that non-payment debt and revision of payment planning can be considered as an potential index which puts the going concern under question.\(^{42}\)

Raghunandan & Rama (1995) in a research “Auditing report for the companies facing financial crisis before and after Auditing Standard No.59 America” studied the same matter. The results showed that after enforcement of application of 59 standards, Auditors tend to show more interest in applying the activity continuation for the companies facing crisis or about the bankruptcy.\(^{43}\)

Otlman and MacGuff carried a research on evaluation of a company as a running entity tried to classify some of the criteria which helps Auditors in recognition of the situation of a company as a running entity. Some of the criteria is as follows:

A1) Financing Problems: Difficulty in implementation of commitments

1. Deficiency in liquidity:
2. Problem in equity
3. Non-payment debt
4. Cash shortage

B1) Operational Problems:

1. Frequent operational language
2. Doubt in acquiring expected income.
3. Operation continuation being in danger
4. Weak operation controlling

As the final decision of Auditor would be based on the danger of operation stop of an entity, the judgment passed seems to be suitable based on the provided models. Keyda presented a list of problem index in going concern which had been recognized in previous studies. He analyzed the responses given by Auditors to see which events are considered as activity continuation problem by Auditors. He prepared this list;

1. Giving the company to state authorities by the court
2. Revision of debt payment time table
3. Inability in interest payment
4. In profitability in three subsequent years.
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