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<b>Principal Investigator</b>	<b>Co- Principal Investigator</b>		<b>Co- Principal Investigator and Technical Coordinator</b>
<b>Prof K V Bhanu Murthy</b> Professor Department of Commerce University of Delhi Delhi-110007	<b>Dr Jaswinder Singh</b> Principal SGTB Khalsa College University of Delhi Delhi-110007	<b>Dr. R P Singh</b> Associate Professor SGTB Khalsa College University of Delhi	<b>Dr Vimal Rarh</b> Deputy Director, Centre for e-Learning and Assistant Professor, Department of Chemistry, SGTB Khalsa College, University of Delhi  <i>Specialised in : e-Learning and Educational Technologies</i>
<b>Paper Coordinator</b>	<b>Content Writer</b>		<b>Reviewer</b>
<b>Prof. G.C. Maheshwari</b> Retd. From M.S. University Baroda	<b>Dr. Anjala Kalsie</b> Assistant Professor Faculty of Management Studies University of Delhi		<b>Prof K V Bhanu Murthy</b> Professor Department of Commerce University of Delhi

**Anchor Institute : SGTB Khalsa College, University of Delhi**

**COMMERCE**

**PAPER NO. 4: Accounting Theory and Practice**

**MODULE NO. 19: Three Basic Accounting Models**

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## 1. Learning Outcomes

After studying this module, one shall be able to:

- Know about the Constant Purchasing Power Model
- Know about Cost Accounting Model
- Understand the Capital Maintenance In Units Of Constant Purchasing Power (CMUCPP) Model
- Know about the requirements of IFRS

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## 2. Introduction

International Financial Reporting Standards (IFRS) are proposed as a communal global language for certified dealings so that enterprise accounts are reasonable and similar through international margins. They are a significance of rising world-wide shareholding and trade and are generally important for corporations that have relations in several countries.

They are increasingly swapping the many dissimilar national accounting standards. The instructions to be trailed by accountants to retain books of accounts which is similar, reasonable, dependable and relevant as per the users internal or external.

IFRS initiated as an endeavor to correspond accounting across the European Union but the value of harmonization rapidly made the idea attractive round the world. They are time to time still called by the original name of International Accounting Standards (IAS). IAS were bounded by 1973 and 2001 by the Board of the International Accounting Standards Committee (IASC). On 1 April 2001, the original International Accounting Standards Board held above from the IASC the accountability for setting International Accounting Standards

## 3. OBJECTIVE OF FINANCIAL STATEMENTS

A financial statement must imitate a true and fair opinion of the profitable affairs of the association.

IFRS authorize three basic accounting models:

- I. Current Cost Accounting, beneath Physical Capital Maintenance at all levels of inflation and deflation beneath the Historical Cost paradigm as well as the Capital Maintenance in Units of Constant Purchasing Power paradigm.
- II. Financial Capital Maintenance in Nominal Monetary Units, i.e., globally applied Historical cost accounting through low inflation and deflation only beneath the traditional Historical Cost paradigm.
- III. Financial Capital Maintenance in Units of Constant Purchasing Power, – CMUCPP – in terms of a Daily Consumer Price Index or daily rate at all levels of inflation and deflation beneath the Capital Maintenance in Units of Constant Purchasing Power paradigm.

The following are the three underlying assumptions in IFRS:

1. Going concern: an article will endure for the anticipatable future under the Historical Cost model as well as under the Capital Maintenance in Units of Constant Purchasing Power model.

2. Stable measuring unit assumption: financial capital maintenance in nominal monetary units or traditional Historical cost accounting only under the traditional Historical Cost paradigm; i.e., accountants consider changes in the purchasing power of the functional currency up to but excluding 26% per annum for three years in a row (which would be 100% cumulative inflation over three years or hyperinflation as defined in IAS 29) as immaterial or not sufficiently important for them to choose Capital Maintenance in units of constant purchasing power in terms of a Daily Consumer Price Index or daily rate [Capital Maintenance in Units of Constant Purchasing Power] at all levels of inflation and deflation as authorized in IFRS in the original Framework(1989).

Accountants implementing the stable measuring unit assumption (traditional Historical Cost Accounting) during annual inflation of 25% for 3 years in a row would erode 100% of the real value of all constant real value non-monetary items not maintained constant under the Historical Cost paradigm.

3. Units of constant purchasing power: Capital Maintenance in Units of Constant Purchasing Power at all levels of inflation and deflation - including during hyperinflation as required in IAS 29 - in terms of a Daily Consumer Price Index or daily rate only under the Capital Maintenance in Units of Constant Purchasing Power paradigm; i.e. the total rejection of the stable measuring unit assumption at all levels of inflation and deflation.

Capital Maintenance in Units of Constant Purchasing Power in terms of a Daily Consumer Price Index or daily rate of all constant real value non-monetary items in all entities that at least break even in real value at all levels of inflation and deflation - ceteris paribus - remedies for an indefinite period of time the erosion caused by Historical Cost Accounting of the real values of constant real value non-monetary items never maintained constant as a result of the implementation of the stable measuring unit assumption at all levels of inflation and deflation under HCA.

It is not inflation doing the corroding. Inflation and deflation have no consequence on the real value of non-monetary articles. It is the enactment of the stable determining unit assumption, i.e., traditional HCA, which erodes the real value of continual real value non-monetary items never sustained continuous in a double entry simple accounting model. Constant real value non-monetary items are non-monetary articles with continual real standards over time whose values within an entity are not usually determined in a marketplace on a day-to-day base.

All continual real value non-monetary articles are constantly and universally measured in units of continual purchasing power at all levels of inflation (including during hyperinflation) and deflation beneath CMUCPP in terms of a Daily CPI or daily rate under the Capital Maintenance in Units of Constant Purchasing Power paradigm. The constant purchasing power gain or loss is planned while current period continual items are not measured in units of constant purchasing power.

#### 4. Monetary items constitute the money supply.

Historic and current period monetary items are required to be inflation-adjusted on a daily basis in terms of a daily index or rate under the Capital Maintenance in Units of Constant Purchasing Power paradigm. The net monetary loss or gain as well-defined in IAS 29 is essential to be considered and accounted when they are not inflation-adjusted on a day-to-day source through the present financial period.

Inflation-adjusting the total money supply (excluding bank notes and coins of the fiat functional currency created by means of fractional reserve banking within an economy) in terms of a daily index or rate under complete co-ordination would result in zero cost of inflation (not zero inflation) in only the entire money supply (as qualified) in an economy.

Variable real value non-monetary items are non-monetary items with variable real values over time. Examples include quoted and unquoted shares, property, plant, equipment, inventory, intellectual property, goodwill, foreign exchange, finished goods, raw material, etc.

Current period variable real value non-monetary items are required to be measured on a daily basis in terms of IFRS excluding the stable measuring unit assumption under the Capital Maintenance in Units of Constant Purchasing Power paradigm. When they are not valued on a daily basis, then they as well as historic variable real value non-monetary items are required to be updated daily in terms of a daily rate as indicated above.

Current period impairment losses in variable real value non-monetary items are required to be treated in terms of IFRS. They are constant real value non-monetary items once they are accounted. All accounted losses and profits are constant real value non-monetary items.

Under the Capital Maintenance in Units of Constant Purchasing Power paradigm day-to-day dimension is required of all items in terms of

(a) A Daily Consumer Price Index or monetized daily indexed unit of account, through low inflation, high inflation and deflation and (b) in terms of somewhat steady foreign currency equivalent amount (generally the US Dollar daily equivalent rate) daily index throughout hyperinflation.

## 5. Hyperinflation

Hyperinflation is defined in IAS 29 as collective inflation equal to or imminent 100 per cent over three years, i.e. 26% annual inflation for 3 existences in a row.

Qualitative features of financial proclamations

Qualitative features of financial proclamations comprise:

- Relevance (Materiality)
- Faithful representation
- Enhancing qualitative characteristics include:
- Understandability

Elements of financial statements (IAS 1 article 10) the financial position of an enterprise is primarily provided in the Statement of Financial Position. The elements include:

Asset

Liability

Equity

Constant Purchasing Power Model equity is the constant real value of shareholders' equity.

The financial presentation of an enterprise is mainly providing in the Statement of Comprehensive Income (income statement or profit and loss account). The components of an income proclamation or the components that extent the financial presentation are as follows:

Revenues: rises in economic advantage during an accounting period in the form of inflows or enhancements of assets, or decrease of liabilities that result in increases in equity. However, it does not include the contributions made by the equity participants, i.e., proprietor, partners and shareholders.

Expenses: decreases in financial benefits during an accounting period in the form of expenditures, or depletions of assets or incurrences of liabilities that result in declines in equity.

Revenues and expenses are measured in nominal monetary units under the Historical Cost Accounting Model and in units of constant purchasing power (inflation-adjusted) under the Units of Constant Purchasing Power model.



## 6. Statement of Changes in Equity

An article is accepted in the financial statements when: it is probable future economic benefit will flow to or after an entity. The resource can be reliably measured – otherwise the stable measuring unit assumption is applied under the Historical Cost Accounting model: i.e. it is assumed that the monetary unit of account (the functional currency) is perfectly stable (zero inflation or deflation); it is simply assumed that there is no inflation or deflation perpetual, and articles are specified at their original insignificant

Under the Capital Maintenance in Units of Constant Purchasing Power (CMUCPP) model, all constant real value non-monetary items are restrained in units of continual purchasing power in terms of a daily index at all levels of inflation and deflation; i.e. all items in the Statement of Comprehensive Income, all items in shareholders' equity, Accounts Receivables, Accounts Payables, all non-monetary payables, all non-monetary receivables, provisions, etc.

Measurement is the procedure of defining the monetary amounts at which the basics of the financial statements are to be acknowledged and approved in the balance sheet and income statement. This includes the collection of the specific base of measurement.

A number of dissimilar quantity bases are working to different units and in varying arrangements in financial statements. They include the following:

(a) Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) Realisable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.

Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be carried at market value and pension liabilities are carried at their present value.

Furthermore, some entities use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

## 7. Concepts of capital

A financial concept of capital is accepted by most objects in organizing their financial statements. Under a financial perception of capital, such as financed money or financed purchasing power, capital is identical with the net assets or equity of the unit. Under a physical perception of capital, such as operating competence, capital is viewed as the productive capacity of the article based on, for instance, units of output per day.

The collection of the appropriate perception of capital by an entity should be created on the wants of the workers of its financial statements. Thus, a financial perception of capital should be accepted if the users of financial statements are mainly troubled with the looking after of nominal invested capital or the purchasing power of invested capital. If, though, the foremost anxiety of users is with the operating competence of the article, a physical perception of capital should be used. The perception specifies the goal to be achieved in defining profit, however there may be some dimension, problems in making the concept operational.

Perceptions of capital maintenance and the purpose of profit capital maintenance:

(a) Financial capital look after. Under this perception a profit is received only if the financial (or money) quantity of the net assets at the end of the period go beyond the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and assistances from, holders through the period. Financial capital maintenance can be restrained in either insignificant monetary units or elements of constant purchasing power.

(b) Physical capital preservation. Under this perception a profit is received only if the physical productive capacity of the entity at the end of the period exceeds the physical productive capacity at the beginning of the period, after discounting any allocations to, and offerings from, owners during the period.

Concepts of capital throughout the low inflation and deflation:

(1) Physical capital preservation: possible through low inflation and deflation. Current Cost Accounting perfect arranged by IFRS

(2) Financial capital preservation in insignificant monetary units (Historical cost accounting): approved by IFRS but not arranged—voluntary throughout low inflation and deflation. Historical cost accounting. Financial capital preservation in insignificant monetary entities per se during inflation and deflation is a myth: it is incredible to uphold the real value of financial capital perpetual with dimension in nominal financial units per se during inflation and deflation.

(3) Financial capital keep in units of continual purchasing power (Capital Maintenance in Units of Constant Purchasing Power): accepted by IFRS but not certain—voluntary through low inflation and deflation. Capital Maintenance in Units of Constant Purchasing Power is decided over hyperinflation in IAS 29: i.e. the restatement of Historical Cost or Existing Cost period-end financial proclamations in terms of the period-end once-a-month distributed Consumer Price Index. Only financial capital maintenance in units of continual purchasing power (Capital Maintenance in Units of Constant Purchasing Power) in terms of a day-to-day index per se can mechanically retain the real value of financial capital continual at all stages of inflation and deflation in all objects that at least

break even in actual value—*ceteris paribus*—for an unlimited period of time. This would occur whether these articles own evaluable fixed assets or not and short of the requisite of more money or extra reserved profits to merely retain the present constant real value of existing shareholders' equity constant.

Financial capital maintenance in units of constant purchasing power requires the calculation and accounting of net monetary losses and gains from holding monetary items during low inflation and deflation. The calculation and accounting of net monetary losses and gains during low inflation and deflation have thus been authorized in IFRS since 1989.

The concept of capital maintenance is concerned with how an entity defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an entity's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital.

Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income the residual amount is a loss.

The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the entity is seeking to maintain.

The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period.

Any amount over and above that required to maintain the capital at the beginning of the period is profit. Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period.

Thus, rises in the prices of assets said over the period, usually stated to as allotment gains, are, abstractly, profits. They may not be recognized as such, though, till the assets are liable of in an interchange transaction. When the conception of financial capital upkeep is defined in terms of continuous purchasing power components, profit signifies the rise in participated purchasing power over the period. Thus, only that portion of the rise in the prices of assets that go beyond the rise in the overall level of prices is viewed as profit. The rest of the growth is treated as a capital preservation alteration and, hence, as part of equity.

Under the perception of physical capital maintenance when capital is distinct in terms of the physical productive capacity, profit signifies the increase in that capital over the period. All price alterations disturbing the assets and liabilities of the entity are viewed as changes in the dimension of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time, it is not the intention of the Board of IASC to prescribe a particular model other than in exceptional circumstances, such as for those entities reporting in the currency of a hyperinflationary economy. This intention will, however, be reviewed in the light of world developments.

## 8. Requirements of IFRS

IFRS financial statements consist of (IAS1.8)

- a Statement of Financial Position
- a Statement of Comprehensive Income separate statements comprising an Income

Statement and distinctly a Statement of Complete Income, which settles Profit or Loss on the Income statement to total complete income

- a Statement of Changes in Equity (SOCE)
- a Cash Flow Statement or Statement of Cash Flows
- notes, containing a summary of the important accounting policies

Reasonable statistics is essential for the previous reporting period (IAS 1.36). An entity making IFRS accounts for the first interval need to apply IFRS in full for the current and qualified period while there are transitional exemptions (IFRS1.7).

On 6 September 2007, the IASB issued a revised IAS 1 Presentation of Financial Statements.

The primary modifications from the previous type are to include that an entity must:

- Present all non-owner alterations in equity (that is, 'comprehensive income') either one in one Statement of comprehensive income or in two statements (a distinct income proclamation and a proclamation of comprehensive income). Components of complete income may not be obtainable in the Statement of changes in equity.
- Present a statement of financial position (balance sheet) as at the establishment of the first proportional period in a whole set of financial proclamations when the article applies the new standard.
- Present a proclamation of cash flow.
- Make essential disclosure by the way of a note.

The revised IAS 1 is effective for annual periods beginning on or after 1 January 2009.

## 9. Summary

- Current Cost Accounting, under Physical Capital Maintenance at all levels of inflation and deflation under the Historical Cost paradigm as well as the Capital Maintenance in Units of Constant Purchasing Power paradigm
- Financial capital maintenance in nominal monetary units, i.e., globally implemented Historical cost accounting during low inflation and deflation only under the traditional Historical Cost paradigm
- Financial capital maintenance in units of constant purchasing power, i.e., Constant Item Purchasing Power Accounting – CIPPA – in terms of a Daily Consumer Price Index or daily rate at all levels of inflation and deflation under the Capital Maintenance in Units of Constant Purchasing Power paradigm and Constant Purchasing Power Accounting – CPPA – during hyperinflation under the Historical Cost paradigm.
- IAS 29
- Requirements to record the Financial Statements by IFRS