

Query No. 22

Subject: *Cash basis of accounting by Alternative Investment Fund (AIF).*¹

A. Facts of the Case

1. An Investment Advisory entity has proposed to launch a registered Alternative Investment Fund (AIF) under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012.

Structure of AIF:

2. The querist has stated that the AIF is defined as any fund that is
- established or incorporated in India in the form of a trust or a company or a limited liability partnership (LLP) or a body corporate;
 - is a privately pooled investment vehicle;
 - collects funds from investors (Indian or foreign investors);
 - invests in accordance with a defined investment policy for the benefit of its investors.

The querist has informed that the AIF in the extant case is formed as a ‘trust’ under Indian Trusts Act, 1882 and is not a body corporate.

3. In relation to the method of accounting that needs to be followed by AIF, the querist has analysed various legal and regulatory requirements as follows:

Regulations/Act	Requirements
SEBI AIF Regulations	Nothing has been prescribed.
Indian Income-tax Act, 1961	As per section 145 of the Act: - Income chargeable under the head ‘Profits and gains of business or profession’ or ‘Income from other sources’ shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. - The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of assesseees or in respect of any class of income.
Accounting Standards	Accounting Standard 1 - If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed. Accounting Standard 9 - It is reiterated that this Accounting Standard assumes that

¹ Opinion finalised by the Committee on 10.2.2020.

	<p>three fundamental assumptions i.e., going concern, consistency and accrual have been followed in the preparation and presentation of the financial statements.</p> <p>Accounting Standard 13</p> <ul style="list-style-type: none"> - Excludes Mutual Funds and venture capital funds and/or related asset management companies, banks ...
--	--

4. The querist has also stated that the purposes of financial statements of AIF are:
- Filing of tax returns;
 - Circulation to investors for recording their income and filing returns.

SEBI (AIF) Regulations require that “the books of accounts of the Alternative Investment Fund shall be audited annually by a qualified auditor”. However, the Regulations do not have any prescriptive guidelines in respect of accounting i.e., accounting framework (AS or Ind ASs), accrual vs. cash basis of accounting, to be followed by the entity.

5. The querist has referred to the following Authoritative Guidance:

Accounting Standards

Accounting Standard (AS) 1, Disclosure of Accounting Policies:

“10. The following have been generally accepted as fundamental accounting assumptions:-

a. Going Concern

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

b. Consistency

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

c. Accrual

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

“27. If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.”

As per the querist, it can be seen from the above that an entity is permitted to use cash basis of accounting as per AS 1. The only fact that needs to be ensured is that where cash basis of accounting has been followed by an entity that fact needs to be disclosed in the financial statements.

It is important to note that an AIF is a non corporate entity to which Companies Act, 2013 is not applicable.

Announcements of the Council Regarding Status of Various Documents Issued by the Institute of Chartered Accountants of India:

“V. Mandatory Application of Accounting Standards in respect of Certain Noncorporate Bodies

1. In May 1991 issue of ‘The Chartered Accountant’, an announcement was carried regarding the decision of the Council of the Institute of Chartered Accountants of India to defer the mandatory application of Accounting Standards 1, 7, 8, 9, 10 and 11 to accounts for periods beginning on or after 1.4.1993, in respect of the following:

- (a) Sole proprietary concerns/individuals
- (b) Partnership firms
- (c) Societies registered under the Societies Registration Act
- (d) Trusts
- (e) Hindu Undivided Families
- (f) Associations of persons.

2. The matter was re-considered by the Council at its meeting held in September, 1993 and it was decided, in partial modification of the earlier decision, that the aforesaid Accounting Standards (except Accounting Standard 11, which has already been withdrawn), shall mandatorily apply in respect of general purpose financial statements of the individual/bodies listed at (a) - (f) above for periods beginning on or after 1.4.1993, where such statements are statutorily required to be audited under any law. It may be reiterated that the Institute issues Accounting Standards for use in the presentation of general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members. The term “General Purpose Financial Statements” includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for use of shareholders/members, creditors, employees and public at large.

3. According to Accounting Standard 1, Disclosure of Accounting Policies, ‘accrual’ is one of the fundamental accounting assumptions. The Standard requires that if any fundamental accounting assumption is not followed in the preparation and presentation of financial statements, the fact should be disclosed. Accordingly, in respect of individual/bodies covered by para 1 above, the auditor should examine whether the financial statements have been prepared on accrual basis. In cases where the statute governing the enterprise requires the preparation and presentation of financial statements on accrual basis but the financial statements have not been so prepared, the auditor should qualify his report. On the other hand, where there is no *statutory requirement* for preparation and presentation of financial statements on accrual basis, and the financial statements have been prepared on a basis other than ‘accrual’ the auditor should describe in his audit report, the basis of accounting followed, without necessarily making it a subject matter of a qualification. In such a case the auditor should also examine whether those provisions of the accounting standards which are applicable in the context of the basis of accounting followed by the enterprise have been complied with or not and consider making suitable disclosures/ qualifications in his audit report accordingly.

4. An example of a disclosure in the audit report of an enterprise which follows cash basis of accounting is given below:

“It is the policy of the enterprise to prepare its financial statements on the cash receipts and disbursements basis. On this basis revenue and the related assets are recognised when received rather than when earned, and expenses are recognised when paid rather than when the obligation is incurred.

In our opinion, the financial statements give a true and fair view of the assets and liabilities arising from cash transactions of at and of the revenue collected and expenses paid during the year then ended on the cash receipts and disbursements basis as described in Note X.””

According to the querist, as can be seen from the above with respect to the accounting principles followed by an AIF:

- Being a trust, AIF can follow cash basis of accounting.
- Such financial statements prepared will be ‘general purpose financial statements’.
- In cases where there is no mandatory requirement to prepare the financial statements on ‘accrual’ basis of accounting then such fact would need to be mentioned in the financial statements and in the audit report without it being the subject matter of a qualification in the auditors report.

The querist has stated that as can be seen that the Institute of Chartered Accountants of India has given detailed prescriptive guidelines on the use of cash basis of accounting for certain class of enterprises. As can be noted from the above that there is no regulation that mandates the use of ‘accrual’ basis of accounting for an AIF and hence the use of ‘cash basis’ of accounting should be permissible.

“XVII. Applicability of Accounting Standards

The Council, at its 236th meeting, held on September 16-18, 2003, considered the matter relating to applicability of Accounting Standards to Small and Medium Sized Enterprises (SMEs). The Council decided the following scheme for applicability of accounting standards to SMEs. This scheme comes into effect in respect of accounting periods commencing on or after 1-4-2004.

1. For the purpose of applicability of Accounting Standards, enterprises are classified into three categories, viz., Level I, Level II and Level III. Level II and Level III enterprises are considered as SMEs. The criteria for different levels are given in Annexure I.
2. Level I enterprises are required to comply fully with all the accounting standards.
3. It has been decided that no relaxation should be given to Level II and Level III enterprises in respect of recognition and measurement principles. Relaxations are provided with regard to disclosure requirements. Accordingly, Level II and Level III enterprises are fully exempted from certain accounting standards which primarily lay down disclosure requirements. In respect of certain other accounting standards, which lay down recognition, measurement and disclosure requirements, relaxations from certain disclosure requirements are given. The exemptions/ relaxations are decided to be provided by modifying the applicability portion of the relevant accounting standards. Modifications in the relevant existing accounting standards are given in Annexure II.”

The querist has stated that it can be seen from the above, for all enterprises (i.e. Level I, Level II and Level III) there is no exemption from the recognition and measurement principles as laid down in the accounting standards. Hence, this Announcement would require that all enterprises need to follow the recognition and measurement principles of all Accounting Standards in their entirety.

Guidance Notes

The querist has stated that the concept of use of cash basis of accounting is well enshrined in the guidance notes issued by the Institute of Chartered Accountants of India. Relevant guidance notes which the querist has referred to in this regard are:

- Guidance Note on Accrual Basis of Accounting
- Guidance Note on Educational Institutes²
- Guidance Note on Accounting and Auditing of Political Parties

The querist has emphasised that as detailed above, AS 1 permits the use of cash basis of accounting. A footnote to AS 9 gives further context to applicability of other accounting standards in cases where cash basis of accounting is followed, which provides that “It is reiterated that this Accounting Standard (as is the case of other accounting standards) assumes that the three fundamental accounting assumptions i.e., going concern, consistency and accrual have been followed in the preparation and presentation of financial statements.”

Hence, the accounting standards mandated by the Institute envisage the scenario that other accounting standards may not have applicability where a fundamental accounting assumption is not followed.

A similar reference can also be drawn where another fundamental accounting assumption is not followed (viz. going concern). Where financial statements are prepared on other than going concern basis, there are departures from the accounting standards laid out by the ICAI.

6. The querist also reproduced paragraph 3.3 of the ‘Preface to the Statements of Accounting Standards’, issued by the Institute of Chartered Accountants of India (ICAI), as follows:

“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 organised in corporate, co-operative 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. Accounting Standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature.”

The querist re-iterates the views expressed above that, AS 1 permits the use of cash basis of accounting. A footnote to AS 9 gives further context to applicability of other accounting

² It is noted that there is no such Guidance Note namely, Guidance Note on Educational Institutes; however, there is a Guidance Note on Accounting by Schools.

standards in cases where cash basis of accounting is followed – “It is reiterated that this Accounting Standard (as is the case of other accounting standards) assumes that the three fundamental accounting assumptions i.e., going concern, consistency and accrual have been followed in the preparation and presentation of financial statements.”

And hence, as per the querist, the use of cash basis of accounting cannot be construed as not following accounting standards. An entity following cash basis of accounting, follows accounting – by definition – on receipts and payments basis. Since, the entity does not follow accrual basis of accounting, rather follows cash basis of accounting, it cannot be said that an entity is not following the accounting principles as detailed by the Institute of Chartered Accountants of India.

Further, the option to not follow a fundamental accounting assumption is enshrined in AS 1 and an entity that follows cash basis of accounting necessarily cannot follow all the other accounting standards in its entirety. The fact is also acknowledged by the Institute by way of footnote to AS 9.

Hence, the querist is of the view that in respect of AIFs, it is permissible to follow cash basis of accounting and prepare general purpose financial statements with adequate disclosures in the financial statements.

B. Query

7. On the basis of above, opinion of the Expert Advisory Committee has been sought as to whether an alternative investment fund (AIF) can prepare and present general purpose financial statements by opting ‘cash basis of accounting’.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to whether the Alternative Investment Fund (AIF) can prepare and present general purpose financial statements by opting cash basis of accounting. The Committee has, therefore, considered only this issue and not examined any other issue that may arise from the Facts of the Case, such as, disclosures under AS 1, AS 9 and other standards, manner of reporting by auditor in the auditor’s report, etc. Further, the opinion issued is purely from accounting perspective and not from the perspective of legal interpretation of Indian Trusts Act, 1882, Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012, Income-tax Act, 1961 etc. At the outset, the Committee wishes to point out that since the querist has referred to the Accounting Standards, issued by the Institute of Chartered Accountants of India (ICAI) in the facts supplied, the Committee has expressed its views considering the same.

9. In order to address the basic issue raised, the Committee considers it appropriate to first evaluate the legal and regulatory requirements applicable to the entity. Secondly, the Committee also considers it necessary to evaluate the purpose and objective of financial statements. As far as legal and regulatory requirements are concerned, the Committee notes from the Facts of the Case that the AIF in the extant case has been formed as Trust and the Trust has been formed under the Indian Trusts Act, 1882. The Committee notes that section 19 of the Indian Trusts Act, 1882 states as follows:

“19. Accounts and information.-A trustee is bound (a) to keep clear and accurate accounts of the trust-property, and (b), at all reasonable times, at the request of the beneficiary, to furnish him with full and accurate information as to the amount and state of the trust-property.”

From the above, the Committee notes that the Act does not provide anything in this respect of accounting standards or basis of accounting to be followed.

The Committee also notes that the AIF in the extant case is also regulated by Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (hereinafter referred to as AIF Regulations), of which clause 20(5) under Chapter IV, 'General Obligations and Responsibilities and Transparency' provides as follows:

“(5) The books of accounts of the Alternative Investment Fund shall be audited annually by a qualified auditor.”

Thus, the AIF Regulations require the books of account of AIF to be audited. The Committee also notes that the said AIF Regulations are silent on the basis of accounting or Accounting Standards to be followed by AIF.

The Committee also notes the prescriptions of Securities and Exchange Board of India (SEBI) in relation to similar asset or fund management schemes, for example, SEBI (Mutual Funds) Regulations, 1996 requires mutual funds to follow various accounting standards issued by the ICAI, such as, Accounting Standard (AS) 9, Accounting Standard (AS) 10, Accounting Standard (AS) 29, etc.; prescribe to measure certain assets at their fair value; and also prescribe to provide for bad and doubtful debts, depreciation, etc. Similarly, SEBI Regulations for Real Estate Investment Trusts (REITs) prescribe that the financial information for the purpose of offer document as well as for continuous disclosure of financial information to stock exchanges, shall be prepared in accordance with Indian Accounting Standards as defined in Companies (Indian Accounting Standards) Rules, 2015. This indicates that SEBI policies are directed towards use of high quality accounting standards aligned with the global best practices.

As far as the purpose and objectives of financial statements are concerned, the Committee notes paragraphs 12 and 22 of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI, as follows:

“12. The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.”

“22. In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.”

From the above, the Committee notes the objective of financial statements will be met only when these are prepared using accrual basis of accounting.

10. The Committee further notes that the Announcement issued by the ICAI on 'Mandatory Application of Accounting Standards in respect of Certain Non-corporate Bodies', which was published in the ICAI's Journal, 'The Chartered Accountant' in January 1994, inter alia, provides as follows:

“1. In May 1991 issue of 'The Chartered Accountant', an announcement was carried regarding the decision of the Council of the Institute of Chartered Accountants of India

to defer the mandatory application of Accounting Standards 1, 7, 8, 9, 10 and 11 to accounts for periods beginning on or after 1.4.1993, in respect of the following:

- (a) Sole proprietary concerns/individuals
- (b) Partnership firms
- (c) Societies registered under the Societies Registration Act
- (d) Trusts
- (e) Hindu Undivided Families
- (f) Associations of persons.

2. The matter was re-considered by the Council at its meeting held in September, 1993 and it was decided, in partial modification of the earlier decision, that the aforesaid *Accounting Standards (except Accounting Standard 11, which has already been withdrawn)*, shall mandatorily apply in respect of general purpose financial statements of the individual/bodies listed at (a) – (f) above for periods beginning on or after 1.4.1993, where such statements are statutorily required to be audited under any law. It may be reiterated that the Institute issues Accounting Standards for use in the presentation of general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members. The term “General Purpose Financial Statements” includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for use of shareholders/members, creditors, employees and public at large. (Emphasis supplied by the Committee.)

3. According to Accounting Standard 1, Disclosure of Accounting Policies, ‘accrual’ is one of the fundamental accounting assumptions. The Standard requires that if any fundamental accounting assumption is not followed in the preparation and presentation of financial statements, the fact should be disclosed. Accordingly, in respect of individual/bodies covered by para 1 above, the auditor should examine whether the financial statements have been prepared on accrual basis. In cases where the statute governing the enterprise requires the preparation and presentation of financial statements on accrual basis but the financial statements have not been so prepared, the auditor should qualify his report. On the other hand, where there is no *statutory requirement* for preparation and presentation of financial statements on accrual basis, and the financial statements have been prepared on a basis other than ‘accrual’ the auditor should describe in his audit report, the basis of accounting followed, without necessarily making it a subject matter of a qualification. In such a case the auditor should also examine whether those provisions of the accounting standards which are applicable in the context of the basis of accounting followed by the enterprise have been complied with or not and consider making suitable disclosures/ qualifications in his audit report accordingly.”

From the above, the Committee notes that the above Announcement, inter alia, requires that the Accounting Standards specified in the Announcement, shall mandatorily apply in respect of *general purpose financial statements* of the Trusts for periods beginning on or after 1.4.1993, where such statements are statutorily required to be audited under any law. Thus, since the books of account of AIF in the extant case are required to be audited as per the AIF Regulations, Accounting Standards based on accrual basis of accounting are mandatorily applicable on the AIF. Further, the Committee notes that the above Announcement was issued

in 1993 and since then, there has been a paradigm shift in the accounting standards framework, which now contains various Accounting Standards apart from those given in the above Announcement, which are necessarily based on accrual basis of accounting. The Committee is of the view that cash basis of accounting is considered to be an inappropriate basis for general purpose financial statements of entities carrying on commercial activities. Besides, the Announcements issued subsequent to the above Announcement and the Preface to the Statements of Accounting Standards, issued by the ICAI also acknowledge/support this fact and require all enterprises which are engaged in commercial, industrial or business activities to follow Accounting Standards issued by the ICAI. In this regard, the Committee also notes the requirements of the ICAI's Announcement on Applicability of Accounting Standards, (which was published in November 2003 issue of the ICAI's Journal), as also reproduced by the querist, which is applicable to all enterprises including trusts and which while categorising the enterprises into Level I, II and III requires to follow the Accounting standards issued by the ICAI, which are necessarily based on accrual basis of accounting.

The Committee further notes that the 'Preface to the Statements of Accounting Standards' (revised 2004), issued by the Institute of Chartered Accountants of India (ICAI) provides as follows:

“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 organised in corporate, co-operative 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. Accounting Standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature.

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 from time to time will be construed to refer to General Purpose Financial Statements.”

Further, with regard to the applicability of Accounting Standards issued by the ICAI to the Trust, the Committee also notes that paragraph 40 of Technical Guide on Accounting for Not-for-Profit Organisations (NPOs), issued by the Research Committee of the ICAI, states as follows:

“40. As far as non-company NPOs (including trusts, societies registered under the Societies Registration Act, 1860) carrying on even a very small proportion of commercial, industrial or business activities are concerned, Accounting Standards, formulated by the Institute of Chartered Accountants of India, are mandatory for the members of the Institute in the performance of their attest functions as per the relevant announcements made by the Institute of Chartered Accountants of India from time to time.”

From the above, the Committee notes that even NPOs which are formed as trusts, if carrying on commercial, industrial or business activities are required to follow Accounting Standards issued by the ICAI. Similarly, Guidance Note on Accounting by Schools, issued by the ICAI also prescribes to follow accrual basis of accounting.

It is amply clear from the Facts of the Case that the Trust in the extant case is formed to carry out commercial and business activities. Thus, on a harmonious reading of the above requirements, the Committee is of the view that the AIF in the extant case should follow the accounting standards issued by the ICAI, which are based on accrual basis of accounting, for its general purpose financial statements.

Incidentally, in the above context, the Committee also wishes to point out that since as per AIF Regulations, Alternative Investment Fund may be established or incorporated in the form of a trust or a company or a limited liability partnership or a body corporate and since an AIF incorporated or established as a company or body corporate is required to follow Accounting Standards or Indian Accounting Standards as per their respective governing laws, which are based on accrual system of accounting, it is not desirable/rational that an AIF which is not a company or body corporate would follow a system of accounting other than accrual basis of accounting.

11. The Committee also does not agree with the view of the querist that the use of cash basis of accounting cannot be construed as following accounting standards due to the requirements of AS 1 and AS 9, as reproduced by the querist. The Committee is of the view that AS 1 and AS 9 paragraphs reproduced by the querist are inherently in the context of accrual basis and require to follow accrual basis of accounting, without which the financial statements shall not provide true and fair view. Cash basis of accounting is not enshrined in the ICAI's authoritative literature on accounting because it neither permits nor give any elaborative framework on cash basis of accounting. It only defines the same to differentiate from well recognised and extensively applied accrual basis of accounting. The Committee also wishes to point out that the Exposure Draft of Guidance Note on Accounting of Political Parties has also disregarded the cash basis of accounting.

D. Opinion

12. On the basis of above, the Committee is of the opinion that the AIF in the extant case should follow the accounting standards issued by the ICAI, which are based on accrual basis of accounting, as discussed in paragraph 10 above.