FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

LEARNING OUTCOMES

After studying this chapter, you would be able to:

- Understand the Framework and its role in accounting and interpreting the transactions
- Acknowledge the various users of financial statements
- Realise the constraints of relevant and reliable information
- Comprehend the underlying assumptions and qualitative aspects of the financial statements
- Differentiate between the two forms of capital
3.2 FINANCIAL REPORTING

Purpose

Scope

Users of financial statements
- Investors
- Employees
- Lenders
- Supplier and other trade creditors
- Customers
- Government and related agencies
- Public

Objectives to prepare financial statements

Underlying assumptions
- Accrual basis
- Going concern

Qualitative aspects of financial statements
- Understandability
- Relevance
- Reliability
- Comparability

Constraints on relevant and reliable information
- Timeliness
- Cost & its benefit comparison
- Balance between qualitative characteristic

Elements of financial statements

Recognition of the elements of financial statements
- Recognition of assets
- Recognition of liabilities
- Recognition of income
- Recognition of expense

Measurement of the elements of financial statements

Financial capital maintenance vs. Physical capital maintenance
- Financial capital maintenance
- Physical capital maintenance

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1. INTRODUCTION

In general terms, a framework is a statement of generally accepted theoretical principles which form the frame of reference for a particular field of enquiry. In terms of financial reporting, these theoretical principles provide the basis for both the development of new reporting practices and the evaluation of existing ones. Since the financial reporting process is concerned with the provision of information that is useful in making business and economic decisions, a framework, in terms of financial reporting, will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated to the user.

Let’s first understand the term Financial Statement and the reason why it is being prepared by all businesses irrespective of the nature of their business process.

**Financial Statements** are kind of a statement which reflects the performance of a business (business might be for profit or for non-profit) during a period (may be for a year, month, or quarter etc.) for which such statement is being prepared. Hence, the Financial Statements consist of presentation of numbers in such a way which reflects movements within specified category (assets, liability and Income/ expenses) with explanations/ notes (by way of notes to accounts & disclosures) to understand the methodology as adopted by an entity.

Now, the next question comes how the preparation of these Financial Statements can be regularized in such a way where all such Financial Statements shall have a consistency/ uniformity across the Industry (with few exceptions e.g. specially regulated financial statements). In addition, the user of these Financial Statements shall also have an assurance of complying basic framework with a consistent approach.
2. FRAMEWORK AND ITS PURPOSE

This Framework sets out the concepts that underlie the preparation and presentation of financial statements in accordance with the Indian Accounting Standards for external users. The purpose of the Framework is to:

- assist in the development of future Ind AS and review of existing Ind AS
- assist preparers of financial statements in applying Ind AS and in dealing with topics that have yet to form the subject of an Ind AS
- assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Ind AS
- assist auditors in forming an opinion as to whether financial statements conform with Ind AS
- provide those who are interested in Ind AS with information about approach to their formulation, and
- assist in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Ind AS.

3. SCOPE OF THE “FRAMEWORK”

The framework works within a scope in which it is formulated or developed so that the user of such framework can understand its overall requirement while applying such framework on preparation of any financial statement. The framework deals with

- the objective of financial statements i.e. the purpose and the reason for which such financial statements are being prepared
- the qualitative characteristics that determine the usefulness of information in financial statements
- the definition, recognition and measurement of the elements from which financial statements are constructed e.g. assets, liabilities etc., and
- concepts of capital and capital maintenance.
The frameworks can be applied on all kinds of general purpose financial statements (including consolidated financial statements) irrespective of period for which it is being prepared (e.g. quarterly or annually).

Special purpose financial reports, for example, prospectuses and computations prepared for taxation purpose, are outside the scope of this Framework. Nevertheless, the Framework may be applied in the preparation of such special purpose reports where their requirements permit.

The Framework applies to the financial statements of all commercial, industrial and business reporting entities, whether in the public or the private sectors. The essence is to prepare financial statements by using this framework where the user relies solely on the information provided in the financial statements.

Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report.

The management of an entity has the primary responsibility for the preparation and presentation of the financial statements of the entity. The Framework does not deal with information outside the financial statements.
4. IMPORTANT FACTS-ABOUT “FRAMEWORK”

The framework provides a road map and approach which eventually will be considered as broad lines within which generally all accounting standards will be applied. However, following facts are worth to be noted:

- Since Framework is not an Indian Accounting Standard and hence does not define standards for any particular measurement or disclosure issue
- Existing standards might have some areas which contradicts (very rare in practice) with such Framework, then, requirement of the Indian Accounting Standards will prevail
- All the future Indian Accounting Standards or other pronouncement will be guided by the framework resulting in minimal conflicts
- Based on the experiences, the Framework will change to harmonise the Indian Accounting Standards across the industries.

5. USERS OF FINANCIAL STATEMENTS

The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information. The users can be described broadly in the following category:

![Diagram of Users]

5.1 Investors

The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.

In reference to a listed entity, where stocks are being exchanged over a stock market, investor would require information about the performance or business activities so that any inherent risk can be evaluated. Any new or potential Investors would also analyse the activities of the business
in order to pursue for investment in the stock of such entity. All such Investor might need useful & relevant information, which will enable them to conclude their action plan.

5.2 Employees

Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.

5.3 Lenders

Lenders are one of the key stakeholders which provide fuel to the business, i.e. money, which is ultimately returned back to the lenders in the nature of return, as the business generates cash flows in future. The repayment capacity of the entity will be assessed / analyzed based on the performance of the business and accordingly restructuring, discounting in future loans, re-negotiation can be planned.

5.4 Supplier and Other Trade Creditors

Suppliers and other trade creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer.

5.5 Customers

Customers are one of the major stakeholder which eventually drives growth of any business. To deal efficiently with them, would be a key to success of any business. If the performance of the business is in good shape, then there are more chances to negotiate better deal in favor of Company and vice-versa and the same can be done by analyzing financial statements of the Company.

5.6 Government and Related Agencies

Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities of entities, determine taxation policies and as the basis for national income and similar statistics.

5.7 Public

By and large, entities affect local public in variety of ways e.g. by generating employment, by providing different kind of social events, engaging local suppliers, developing infrastructure etc. Hence, the sufficient information in terms of trends and recent development from the financial statements would be important for them to understand future of the business.
6. OBJECTIVES TO PREPARE FINANCIAL STATEMENTS

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

- Information about financial position i.e. balance sheet, statement of profit and loss, cash flows and related notes-
  - **Balance Sheet** comprises information about the economic resources controlled by the entity and its capacity in the past to modify these resources is useful in predicting the ability of the entity to generate cash and cash equivalents in the future. The balance sheet provides overall strength and capacity of a business at any point of time.
  - **Income Statement** comprises information about the performance of an entity, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future.
  - **Cash flow Statements** will be useful in order to assess its investing, financing and operating activities during the reporting period. This information is useful in providing the user with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows.
  - The information that are being captured in balance sheet, statement of profit and loss, cash flows will have certain *explanatory notes/ information*, which are being reflected in the notes to accounts. The requirement of what to disclose specifically has been defined in different Accounting Standards, however there is nothing which precludes to make any additional information that might be useful for the user of such Financial Statements.

- Provide useful information to USER of the Financial Statement only reflects a financial information-
  - The information that reflects from the Financial Statements are purely based on financial information e.g. related to the monetary aspects of such transactions
  - Users of the Financial Statements might need to evaluate such other non-financial information which might be useful for them to analyze which normally will not be available in the Financial Statements.

- To know about the management style of working and their objectives going forward.
7. UNDERLYING ASSUMPTIONS

In order to prepare any financial statements, there are some basic assumption, which shall be followed.

7.1 Accrual Basis

Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its 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.

**Illustration 1**

*Entity A sells goods to Mr. X on November, 20X1 and received payments on January 31, 20X2. The entity follows December 31, 20X1 as its annual closing of financial statements. State how this business transaction should be accounted.*

**Solution**

The goods have been sold off in the month of November, 20X1 and the payment has been received in the year 20X2 whereas the Entity A follows calendar year annual closing. Now, assuming that all recognition criteria (risk and rewards) has been met while selling off the goods in the month of November, 20X1, Entity A will recognize the sale in the Income statement with corresponding effect in accounts receivables for the year ending December 31, 20X1. This is called accrual accounting where the transaction is being recorded in the same year when it meets other recognition criteria and not when actual cash has been received/ paid.

Now, it is clear to understand that had this sale not been shown in the financial statement ending December 31, 20X1, the sale would have been understated by the same amount. Hence it has been recorded in the same period when the transaction has taken place and met recognition criteria as per applicable accounting standards.
Financial statements prepared on the accrual basis inform users not only of past transactions 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.

### 7.2 Going Concern

The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

**Example**

Balance sheet of a trader on 31st March, 20X1 is given below:

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>₹</th>
<th>Assets</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>60,000</td>
<td>Fixed Assets</td>
<td>65,000</td>
</tr>
<tr>
<td>Profit and Loss Account</td>
<td>25,000</td>
<td>Stock</td>
<td>30,000</td>
</tr>
<tr>
<td>10% Loan</td>
<td>35,000</td>
<td>Trade receivables</td>
<td>20,000</td>
</tr>
<tr>
<td>Trade payables</td>
<td>10,000</td>
<td>Deferred costs</td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bank</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,30,000</td>
<td><strong>Total</strong></td>
<td>1,30,000</td>
</tr>
</tbody>
</table>

**Additional information:**

(a) The remaining life of fixed assets is 5 years. The pattern of use of the asset is even. The net realisable value of fixed assets on 31.03.20X2 was ₹ 60,000.

(b) The trader’s purchases and sales in 20X1-20X2 amounted to ₹ 4 lakh and ₹ 4.5 lakh respectively.

(c) The cost and net realisable value of stock on 31.03.20X2 were ₹ 32,000 and ₹ 40,000 respectively.

(d) Expenses for the year amounted to ₹ 14,900.

(e) Deferred cost is amortised equally over 4 years.

(f) Debtors on 31.03.20X2 is ₹ 25,000, of which ₹ 2,000 is doubtful. Collection of another ₹ 4,000 depends on successful re-installation of certain product supplied to the customer.
(g) Closing trade payable is ₹ 12,000, which is likely to be settled at 5% discount.
(h) Cash balance on 31.03.20X2 is ₹ 37,100.
(i) There is an early repayment penalty for the loan ₹ 2,500.

The Profit and Loss Accounts and Balance Sheets of the trader are shown below in two cases (i) assuming going concern (ii) not assuming going concern.

### Profit and Loss Account for the year ended 31st March, 20X2

<table>
<thead>
<tr>
<th></th>
<th>Case (i)</th>
<th>Case (ii)</th>
<th></th>
<th>Case (i)</th>
<th>Case (ii)</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Opening Stock</td>
<td>30,000</td>
<td>30,000</td>
<td>By Sales</td>
<td>4,50,000</td>
<td>4,50,000</td>
</tr>
<tr>
<td>To Purchases</td>
<td>4,00,000</td>
<td>4,00,000</td>
<td>By Closing Stock</td>
<td>32,000</td>
<td>40,000</td>
</tr>
<tr>
<td>To Expenses</td>
<td>14,900</td>
<td>14,900</td>
<td>By Trade payables</td>
<td>–</td>
<td>600</td>
</tr>
<tr>
<td>To Depreciation</td>
<td>13,000</td>
<td>5,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Provision for doubtful debts</td>
<td>2,000</td>
<td>6,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Deferred cost</td>
<td>2,500</td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Loan penalty</td>
<td>–</td>
<td>2,500</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Net Profit</td>
<td>19,600</td>
<td>22,200</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>4,82,000</strong></td>
<td><strong>4,90,600</strong></td>
<td></td>
<td><strong>4,82,000</strong></td>
<td><strong>4,90,600</strong></td>
</tr>
</tbody>
</table>

### Balance Sheet as at 31st March, 20X2

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Case (i)</th>
<th>Case (ii)</th>
<th>Assets</th>
<th>Case (i)</th>
<th>Case (ii)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>60,000</td>
<td>60,000</td>
<td>Fixed Assets</td>
<td>52,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Profit &amp; Loss A/c</td>
<td>44,600</td>
<td>47,200</td>
<td>Stock</td>
<td>32,000</td>
<td>40,000</td>
</tr>
<tr>
<td>10% Loan</td>
<td>35,000</td>
<td>37,500</td>
<td>Trade receivables (less provision)</td>
<td>23,000</td>
<td>19,000</td>
</tr>
<tr>
<td>Trade payables</td>
<td>12,000</td>
<td>11,400</td>
<td>Deferred costs</td>
<td>7,500</td>
<td>Nil</td>
</tr>
<tr>
<td></td>
<td><strong>1,51,600</strong></td>
<td><strong>1,56,100</strong></td>
<td>Bank</td>
<td><strong>37,100</strong></td>
<td><strong>37,100</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Usefulness of a financial statements is one of the key requirements as the information should be presented in such a way which makes sense for the user and should have consistency across the financial statements.

### 8.1 Understandability

An essential quality of the information provided in financial statements is that it is readily understandable by users who are assumed to have a reasonable knowledge of basic operations of the business. The information reflected in the financial statements should be drafted in a way which can easily provide its real meaning without getting into too much complexity. However, there may be areas which are required to be presented as important information for the users of the financial statements but being its complex nature, does not preclude the entity to present such information.

**Example**

An Oil & Gas Company maintaining well and exploration services has defined recognition of assets related to such exploration in the Financial Statements. It is expected that the user of such financial statement would know about the exploration activities and it is not expected to mention the meaning of these terms which otherwise is expected to be known by a person who uses such financial statements. However, if there is any change or any term which is specific to the entity, then the same should be properly explained e.g. any special contract and its related accounted treatment.

### 8.2 Relevance

The information that is being reflected in the financial statements must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic
decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

**Example**

1. A default by a customer who owes INR 1,000 to a Company having net assets of worth INR 10 million is not relevant to the decision making needs of users of the financial statements. However, if the amount of default is, say, INR 2 million, the information becomes relevant to the users as it may affect their view regarding the financial performance and position of the company.

2. A fire has been broken out at the end of the period but before issue of financial statements, could be relevant for the user to know about the estimated impact on future performance of the business even though the assessment of such loss was not possible to calculate, at the time of approving of such financials.

Relevance have some assessment pillars within which it can further be correlated.

**8.2.1 Materiality**

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

**Illustration 2**

*Entity A is having inventory amounting INR 100,000 in total with the details as below:*

<table>
<thead>
<tr>
<th></th>
<th>INR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spare parts</td>
<td>30,000</td>
</tr>
<tr>
<td>Finished goods</td>
<td>25,000</td>
</tr>
<tr>
<td>Work in progress</td>
<td>40,000</td>
</tr>
<tr>
<td>Tools</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>1,00,000</strong></td>
</tr>
</tbody>
</table>

*Materiality limit has been assessed INR 30,000 based on the management estimation pertaining to annual profit basis. What should be the presentation requirement under the “Materiality” criteria?*

**Solution**

Entity A has estimated its materiality limit of INR 30,000 which suggests that everything which is more than this amount will be required to present separately, subject to its nature (nature means the components of inventory in this example). Hence, Entity needs to show Inventory as below by way of notes to account –
## 3.14 Financial Reporting

<table>
<thead>
<tr>
<th>Description</th>
<th>INR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work in progress</td>
<td>40,000</td>
</tr>
<tr>
<td>Spare parts</td>
<td>30,000</td>
</tr>
<tr>
<td>Finished goods &amp; Tools</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,00,000</strong></td>
</tr>
</tbody>
</table>

Since, Work in progress and Spare parts are more than materiality limits, hence, they have been shown separately based on its defined separate nature whereas finished goods & Tools have amount lower than materiality limits and same has been clubbed together.

### 8.3 Reliability

The information which is relevant for the user of the financial statement but not reliable would eventually mislead the financial statements presentation and may influence the decision taken by the user of such financial statements. Information should be relevant and reliable as it is expected to have an error free and unbiased impact on the presentation of the financial statements.

**Illustration 3**

*A legal case has been filed against the Company A however, expected outcome at the yearend cannot be evaluated. What would be relevant information and what would be reliable in it?*

**Solution**

It may be inappropriate for the entity to recognise the full amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

### 8.3.1 Faithful Representation

It means that, unless the recognition criteria of any element of financial statement i.e. assets, liabilities, income or expenses etc. is fulfilled/met, there should not be any recognition of such elements in order to be faithful to the users who actually rely on information reflecting from the financial statements.

**Examples**

1. If there is a revenue which is to be recognized as per the relevant accounting standard but if the amount can’t be ascertained then if an entity still does so, it will be unfaithful representation of the information.

2. There could be a recoverability of debtors in which management provides a written communication to ensure about expectation of recovery in full, however, the chances are
remote then this would be treated as unfaithful representation of debtor’s amount in the financial statements.

8.3.2 Substance over Form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form.

**Illustration 4**

*An asset has been sold from Company A to Mr. X and immediately after this transaction, Mr. X has leased out the same to Company A. What would be the correct form to record the transaction using concept of “substance over form”?*

**Solution**

*The asset has been actually transferred to pass on legal title of the asset to Mr. X and convert that into a lease asset. Hence, in substance, the economic benefits still is being enjoyed by Company A. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).*

8.3.3 Neutrality

The information contained in the financial statements should be free from any bias i.e. neutral and there should not be any kind of influence which makes the information undesirable or undisclosed. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

8.3.4 Prudence

Often certain estimates are being required to be made by the preparer of the financial statements which may or may not be 100% correct. However, one should use its prudence which is without any biasness and best possible action to reach to the conclusion in such cases. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

**Example**

*Receivables recoveries are being assessed based on some estimation by the management and to arrive to such estimation for provision for bad debts, there must be a prudent action which is required to identify the recoverability of the debtors. The prudence could be used by meeting*
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personally with the debtors, reviewing correspondences with the debtors, visiting the business premises to ensure the health of debtor’s business before it is concluded for making any provision.

8.3.5 Completeness

The financial statements should be prepared to ensure that it covers all the transactions that has been done during the period and control must be establish to ensure its completeness of transactions without having any left out entries/ transactions which purposely/ by error are recorded in next period or not recorded at all. It may be due to wrong classification of nature of the transactions as well.

Example

Some direct costs booked into general overheads, has overstated the Gross Margin, which otherwise should have been booked as direct costs. There should be some check and balances to ensure that all elements reflected in the financial statements are complete in all aspects.

8.4 Comparability

Users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities.

Example

There are certain expenses that have been grouped under cost of sales in the previous year, whereas, in the current year, the amount has been shown under other general expenses without regrouping the previous year numbers which eventually distort the comparison of amounts of cost of sales & general expenses on yearly basis.

Users wish to compare the financial position, performance and cash flows of an entity over time, it is important that the financial statements show corresponding information for the preceding periods. Information which is necessary to provide details relating to any change in accounting policy should be clearly mentioned with impact of such change for the current and previous period.
9. CONSTRAINTS ON RELEVANT AND RELIABLE INFORMATION

9.1 Timeliness

It is one of the common objectives to provide useful and reliable financial reports to the user but it should never be at the cost of time. If there are certain situations where the relevant inputs are taking too much of time to retrieve, then it will not serve a meaningful purpose by justifying a time that has been spent on the same. However, time constraint should not preclude the management to get rid with reliable inputs as required to be presented to ensure faithful representation.

9.2 Cost and its Benefit Comparison

At the same time, if information requires too much efforts in terms of utilization of resources and efforts comparing to its benefit to the user of such financial statements, then the same should be analyze carefully by the management for consideration.

Undue efforts and cost will fade its utility and will not make any sense to user of such financial statements.

Example

There is an additional verification (as part of normal policy to be applied to all debtors) which has been requested by the management for some small debtor which are totally immaterial. The
verification was intended by visiting customer business place which are far from the Company Head office and would take at least 2 working days to complete the process with a significant amount of expense on travel. The management should perform such procedure by using some other alternative procedure to avoid cost which will not make any sense to substantiate an immaterial customer balance.

9.3 Balance between Qualitative Characteristic

There should be a balance between the qualitative information provided in financial statements and its objective. Over information will not serve any purpose and hence, a balance between the qualitative information and its objective should be made.

10. ELEMENTS OF FINANCIAL STATEMENTS

Broadly, a statement of financial position or balance sheet comprises three elements viz. Asset, Liability and Equity which can be described as below –

**ASSETS** – “An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity”

The Standard emphasis on future economic benefits to flow to the entity is not only related to its legal form but it should also be assessed in line of substance over form and accordingly, an asset should be recognized.

**Example : Control over Asset (substance over form)**

Due to some legal constraints in the country, Entity A holds some assets on behalf of Company B which are being used/directed by the Company B itself, without any interfere by the Company A. All production benefits will exclusively be used by Company B.

Merely holding an asset as its legal owner will not satisfy recognition criteria for an asset, hence, Asset will be recognized in the books of Company B as all the future economic benefit which is expected to flow to Company B only.

**Example: Economic Benefits Flow to the Entity**

A Pharma Company incurs some expenditure which is expensed off in order to develop its new drug. The future economic benefits will not have expected to flow to the Pharma Company because research phase itself does not establish any rationale to provide any kind of benefit which will flow to the Company at this stage (as per the relevant accounting standards).

Hence all expenditures will not be eligible to recognize as asset unless its benefits are expected to flow to the entity in future.
Example: Results from Past Transactions

An entity expected to purchase some asset in future which will increase profitability for the Company will not satisfy the definition of the Asset. Since the transaction/expenses incurred should result from past event and not something which belongs to any future course of action, an asset will not be recognized based on any future course of action.

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

Some of the notable words as per the definition are – Liability is a present obligation arises from past events which essentially means there should not be any future expected obligation on which a liability would be created. In other words, there should be some form of legal binding agreement (although it is not essential to have explicit legal agreement) against which future outflow is expected from the entity. For example, purchase contracts where an entity has received the goods and therefore, is legally bound to make a payment in future point of time as per the agreed terms.

Example: Present Obligation based on Past Events

An Entity has got an information about the requirement to implement new taxation system based on proposed change in legislation in the country. The amount that is expected to outflow from the entity is not based on past events and hence this cannot be treated as present obligation.

Example: Additional Custom Duty Rate Changes

An import has been done in the past on which there is change in additional duty, as announced by the government of that country, which is to be paid in future. Since, the goods have been imported in the past period and new additional custom duty obligation arises because of this past event, hence this will result in a present obligation based on past events and therefore, a liability will be created.

Settlement of such liability could be in cash, transfer of other assets, conversion of obligation into equity etc.

There are liabilities, where timing and amount are not certain, but meets the recognition criteria, then the amounts are being estimated using some techniques and shown as provisions.

EQUITY - Equity is the residual interest in the assets of the entity after deducting all its liabilities.

In simplest form, an equity is a difference between total assets and total liability which shows initial cash/capital that was brought into and additional performance in terms of profit or loss of the Company since inception.
Equity, however, is divided in many sub-parts e.g. security premium, reserves fund, retained earning etc. The segregation will eventually describe the capacity of an entity to pay dividends in the future. The existence of some funds within the equity sometimes are required by the law and it provides an insight to the user of financial statements.

Equity will be an amount which is finally distributed among its shareholder in case the business closed down. It reflects the value of the assets and corresponding liabilities that are being shown in the financial statements. However, it should not be confused with the selling price which would eventually be reflected once business is being disposed of. Some accounting standards, however, requires to measure such assets, which are to be disposed of in near future, at its fair value.

**INCOME** - Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity.

Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains are often reported net of related expenses.

**EXPENSES** - Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, wages and depreciation.

Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity

Expense is something which reduces economic benefits during the reporting period.

11. RECOGNITION OF THE ELEMENTS OF FINANCIAL STATEMENTS

Once we understood the definition of the elements of a financial statements, let us now understand the recognition criteria of such elements. In other words, it provides a direction when such elements would be eligible for recognition. Hence, all items which meet the definition of the elements will not automatically be eligible for recognition.
Let’s understand the general criteria to recognize the elements –

An Item which satisfies the definition of an element should be recognised only if
- it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- the item has a cost or value that can be measured with reliability.

A. Understanding – Probability of future economic benefits

Uncertainty will be inherent in an environment of any entity and it’s a matter of judgment to assess whether it is probable that economic benefit will inflow/ outflow from/to the Company.

Probable has not been defined by the framework, however, certain accounting standards defines probable as “more likely than not” which means there are more chances of happening the inflow/ outflow rather it does not. Hence remote probability will not suffice in order to recognize an element in financial statement.

There are certain assets which are contingent in nature and can never be recognized in the financial statements because benefit inflow to the company is remote and might never be realized.

Example

An Insurance claim which is likely to be finalized will not be recognized as an asset unless there is a probability of success which ideally should be more likely than not. Same rule will apply to the Contingent liability and hence cannot recognize as a liability.

B. Understanding – Reliability to measure cost or value

There could be a situation where an item meets the definition and other recognition criteria as an asset but there is no clarity or reasonable estimate, which can be made in order to arrive its recognition amount to be recognized.

Example

There are some contracts which are currently under work- in progress where it is not reasonably possible to arrive at estimated cost incurred and hence, it would be not be viable to recognize income/ assets, as the case may be. Measurement of the cost or value should be done reliably otherwise it will not provide a true view to the users of the financial statements.

11.1 Recognition of Assets

An item will be recognized as an asset in the Balance sheet when it is probable that the future economic benefit will flow to the entity and the asset has a cost or value that can be measured reliably.
3.22 FINANCIAL REPORTING

Example
A legal case has been filed against the entity and there was an order which was yet to be received at the end of closing of the financial statements. There was no reliable estimation that could be made to arrive to an amount which is expected to inflow to the Company at the end of year and hence there is no recognition of asset during that period of financial statements. However, in subsequent periods, once the amount of such claim can be estimated reliably then the recognition of asset can be established.

It is clear that the non-recognition of an asset does not mean that the expectation of economic benefit from the expenditure was misguided rather it is just a deferment of period till the cost/value of the asset can be reliably estimated.

11.2 Recognition of Liabilities

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

Example
A Company has sold some goods to Mr. X in the current year and found that there were some defects in the goods supplied. Mr. X has asked for damage/repair reimbursement from the Company. At the year end, the Company made an assessment using its past experiences in similar kind of condition and made a provision in the books at the year end. Since the Company A has agreed to compensate Mr. X as a matter of custom of the business relationship, it is certain that the economic benefit will outflow from the company because of past event of selling off the goods. Further, the Company was able to estimate the amount of provision which was based on its past experience and hence, a liability has been recognized.

11.3 Recognition of Income

Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.

Example
A construction company has done some construction activities during the current year and at the end of the year, it was found that the proportionate work that has been done, is not identifiable and there is no history of similar kind of work that had ever been performed by the entity. Hence, if the value of the revenue cannot be estimated reliably, then, no revenue will be recognized in
the period. However, it will be recognized when the estimation can be reliably measured in one or more subsequent periods.

11.4 Recognition of Expense

Expenses are recognized in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

Following are some applications approach relating to the expenses:

- Matching costs with revenue generated

  **Example**
  
  A Manufacturing Company captures all cost which would have been incurred against the inventory that has been produced during the period. This concept is called Matching concept. However, the expenses will only be recognized in this case when it meets recognition criteria as per the definition.

- Economic benefit to arise in one or more accounting periods

  **Example**
  
  A maintenance contract has been signed for repairing the tools which are being used under the production process. The contract has been made for 3 years. There are no limits/reference in the contract which defines the number of tools that can be repaired. However, the maintenance contract amount is to be paid on yearly basis even when there are no repairs of tool. In this situation, there is no other basis to allocate these expenses over the period but to allocate on straight line basis over the period, hence the maintenance expense will be equally spread over the 3 year period irrespective of its actual use in repairing the tools.

- Immediate recognition of expense

  **Example**
  
  A company has incurred an amount of INR 1,00,000 on a land surfacing and at the later part of the year, it was found that the title of land was not transferred in the name of the Company due to some legal restrictions. Hence, the deal to purchase a land will be cancelled. Now, the amount that has been incurred relating to surfacing the land will have no future economic value and hence there is no allocation of expenses for any future benefits. Hence this cost of INR 1,00,000 will be expensed out immediately in full.
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- Recognition of a liability with an expenses

**Example**

A Company has sold some product with warranty for next 2 years. The Company has history of making such repairs and based on the estimate, has made a provision for next 2 years. The said recognition of liability will have corresponding expenses over the period of such provision.

### 12. MEASUREMENT OF THE ELEMENTS OF FINANCIAL STATEMENTS

As the name suggest, the measurement refers to the amount/ numeric which needs to be recognised. There could be several measurement methods as defined/ required by respective accounting standards. Brief descriptions of the same can be referred below:


cell| Measurement Methods |
---|---------------------|
FAIR VALUE | Present Value |
FAIR VALUE | Fair Value |
FAIR VALUE | Settlement Value |
FAIR VALUE | Current Cost |
FAIR VALUE | HISTORICAL COST |

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- **Historical Cost** – means the transaction value that has been given or received at the time of recognising such element in the financial statements together with all attributable costs incurred or expected to be incurred.

  **Example**
  Property, Plant and Equipment is capitalized considering all direct expenses that have been incurred in order to bring the asset into its present condition (subject to other costs).

- **Current Cost** – means the value of an element which has been recognised at its recent paid/received price.

  **Example**
  A liability which is to be paid in short period will be recognised at current cost rather than discounted value (which is used when the liability is to be paid in more than one year).

- **Settlement Value** - means the value of an element which are required to be recognised at the value which is to be received/paid by selling or for immediate settlement.

  **Example**
  An Asset held for sale or liability which is to be settled in recent future.

- **Present Value** - Present value means present discounted value of the future net cash inflows/outflows that the item is expected to generate/settle in the normal course of business. The calculated value will represent its current value.

  **Example**
  A liability to be paid after 20 years will be discounted by using incremental borrowing rate of the entity to calculate the present value of the liability.

- **Fair Value** – means an amount at which asset/liability could be exchanged/settled, between knowledgeable, willing parties in an arm’s length transaction.

  **Example**
  Equity investment listed at stock market where it has substantial exchange every day could be used as the fair value of the Investment.
13. FINANCIAL CAPITAL MAINTENANCE VS. PHYSICAL CAPITAL MAINTENANCE

A. Financial Capital maintenance

Under this concept, a profit is earned only if the financial amount of the net assets at the end of the period exceeds the financial amount of net assets at the beginning of the period, after excluding any distribution to, and contribution from, owners during the period.

B. Physical Capital maintenance

Under this concept, a profit is earned only if the physical productive or operating capability of the entity at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

13.1 Major differences between Physical Capital & Financial Capital

- The physical capital maintenance concept requires the adoption of the current cost basis as measurement whereas financial capital maintenance concept does not require the use of a particular basis of measurement.

- 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.

- Financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit.

- Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement 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.

This Framework is applicable to wide variety of financial statements based on the selection of measurement as per relevant accounting standards. The overall objective is to provide the framework so that presentation requirements and principals remains consistent. However, the framework supplements the requirements of various accounting standards and does not intend to override any of such specific guidance available in any accounting standards.
Example A

A trader commenced business on 01/01/20X1 with INR 12,000 represented by 6,000 units of a certain product at INR 2 per unit. During the year 20X2 he sold these units at INR 3 per unit and had withdrawn INR 6,000. Thus:

- Opening Equity = INR 12,000 represented by 6,000 units at INR 2 per unit.
- Closing Equity = INR 12,000 (INR 18,000 – INR 6,000) represented entirely by cash.
- Retained Profit = INR 12,000 – INR 12,000 = Nil

The trader can start year 20X3 by purchasing 6,000 units at INR 2 per unit once again for selling them at INR 3 per unit. The whole process can repeat endlessly if there is no change in purchase price of the product.

Example

In the previous example A, suppose that the average price indices at the beginning and at the end of year are 100 and 120 respectively.

- Opening Equity = INR 12,000 represented by 6,000 units at INR 2 per unit.
- Opening equity at closing price = (INR 12,000 / 100) x 120 = INR 14,400 (6,000 x INR 2.40)
- Closing Equity at closing price = INR 12,000 (INR 18,000 – INR 6,000) represented entirely by cash.
- Retained Profit = INR 12,000 – INR 14,400 = (–) INR 2,400

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund INR 12,000 is not sufficient to buy 6,000 units again at increased price INR 2.40 per unit. In fact, he should have restricted his drawings to INR 3,600 (INR 6,000 – INR 2,400).

Had the trader withdrawn INR 3,600 instead of INR 6,000, he would have left with INR 14,400, the fund required to buy 6,000 units at INR 2.40 per unit.

Example (Physical Capital Maintenance)

In the previous example A, suppose that the price of the product at the end of year is INR 2.50 per unit. In other words, the specific price index applicable to the product is 125.

- Current cost of opening stock = (INR 12,000 / 100) x 125 = 6,000 x INR 2.50 = INR 15,000
- Current cost of closing cash = INR 12,000 (INR 18,000 – INR 6,000)
- Opening equity at closing current costs = INR 15,000
- Closing equity at closing current costs = INR 12,000
- Retained Profit = INR 12,000 – INR 15,000 = (INR 3,000)
The negative retained profit indicates that the trader has failed to maintain his capital. The available fund INR 12,000 is not sufficient to buy 6,000 units again at increased price INR 2.50 per unit. The drawings should have been restricted to INR 3,000 (INR 6,000 – INR 3,000).

Had the trader withdrawn INR 3,000 instead of INR 6,000, he would have left with INR 15,000, the fund required to buy 6,000 units at INR 2.50 per unit.

Capital maintenance can be computed under all three bases as shown below:

### Financial Capital Maintenance at historical costs

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<thead>
<tr>
<th></th>
<th>INR</th>
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<tr>
<td>Closing capital (At historical cost)</td>
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<td>12,000</td>
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<td>Less: Capital to be maintained</td>
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<td></td>
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<tr>
<td>Opening capital (At historical cost)</td>
<td></td>
<td>12,000</td>
</tr>
<tr>
<td>Introduction (At historical cost)</td>
<td>Nil</td>
<td>(12,000)</td>
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<tr>
<td>Retained profit</td>
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<td>Nil</td>
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### Financial Capital Maintenance at current purchasing power

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<td>Closing capital (At closing price)</td>
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<td>12,000</td>
</tr>
<tr>
<td>Less: Capital to be maintained</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening capital (At closing price)</td>
<td></td>
<td>14,400</td>
</tr>
<tr>
<td>Introduction (At closing price)</td>
<td>Nil</td>
<td>(14,400)</td>
</tr>
<tr>
<td>Retained profit</td>
<td></td>
<td>(2,400)</td>
</tr>
</tbody>
</table>

### Physical Capital Maintenance

<table>
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<td>Less: Capital to be maintained</td>
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<tr>
<td>Opening capital (At current cost)</td>
<td></td>
<td>15,000</td>
</tr>
<tr>
<td>Introduction (At current cost)</td>
<td>Nil</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Retained profit</td>
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<td>(3,000)</td>
</tr>
</tbody>
</table>

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**TEST YOUR KNOWLEDGE**

**Practical Question**

A Ltd. has entered into a binding agreement with P Ltd. to buy a custom-made machine INR 40,000. At the end of 20X1-20X2, before delivery of the machine, A Ltd. had to change its method of production. The new method will not require the machine ordered and shall be scrapped after delivery. The expected scrap value is nil. State at which amount the liability shall be recognised.

**Answer to the Practical Question**

A liability is recognised when outflow of economic resources will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In the given case, A Ltd. should recognise a liability of INR 40,000 to P Ltd.

When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognised as an expense rather than as an asset. In the present case, flow of future economic benefit from the machine to the enterprise is improbable. The entire amount of purchase price of the machine should be recognised as an expense. The accounting entry is suggested below:

```
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<tr>
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<th>INR</th>
</tr>
</thead>
<tbody>
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<td>Profit and Loss Account (Loss due to change in production method)</td>
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</tr>
<tr>
<td>To P Ltd.</td>
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