CHAPTER 1
CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING UNDER IND AS

ILLUSTRATIONS FROM ICAI STUDY MATERIAL

Illustration 1: Derecognition vs. Faithful Representation

As at 31 March 20X2, Natasha Ltd. carried trade receivables of ₹ 280 crores in its balance sheet. At that date, Natasha Ltd. entered into a factoring agreement with Samantha Ltd., a financial institution, according to which it transferred the trade receivables in exchange for an immediate cash payment of ₹ 250 crores. As per the factoring agreement, any shortfall between the amount collected and ₹ 250 crores will be reimbursed by Natasha Ltd. to Samantha Ltd. Once the trade receivables have been collected, any amounts above ₹ 250 crores, less interest on this amount, will be repaid to Natasha Ltd. The directors of Natasha Ltd. are of the opinion that the trade receivables should be derecognized.

You are required to explain the appropriate accounting treatment of this transaction in the financial statements for the year ending 31 March 20X2, and also evaluate this transaction in the context of the Conceptual Framework.

Solution: Accounting Treatment:

Trade Receivables fall within the ambit of financial assets under Ind AS 109, Financial Instruments. Thus, the issue in question is whether the factoring arrangement entered into with Samantha Ltd. requires Natasha Ltd. to derecognize the trade receivables from its financial statements.

As per Para 3.2.3, 3.2.4, 3.2.5 and 3.2.6 of Ind AS 109, Financial Instruments, an entity shall derecognise a financial asset when, and only when:

a) the contractual rights to the cash flows from the financial asset expire, or

b) it transfers the financial asset or substantially all the risks and rewards of ownership of the financial asset to another party.

c) In the given case, since the trade receivables are appearing in the Balance Sheet of Natasha Ltd. as at 31 March 20X2 and are expected to be collected, the contractual rights to the cash flows have not expired.

d) As far as the transfer of the risks and rewards of ownership is concerned, the factoring arrangement needs to be viewed in its substance, rather than its legal form. Natasha Ltd. has transferred the receivables to Samantha Ltd. for cash of ₹ 250 crores, and yet, it remains liable for making good any shortfall between ₹ 250 crores and the amount collected by Samantha Ltd. Thus, in substance, Natasha Ltd. is effectively liable for the entire ₹ 250 crores, although the shortfall would not be such an amount. Accordingly, Natasha Ltd. retains the credit risk despite the factoring arrangement entered.

e) It is also explicitly stated in the agreement that Samantha Ltd. would be liable to pay to Natasha Ltd. any amount collected more than ₹ 250 crores, after retaining an amount towards interest. Thus, Natasha Ltd. retains the potential rewards of full settlement.

f) A perusal of the above clearly shows that substantially all the risks and rewards continue to remain with Natasha Ltd., and hence, the trade receivables should continue to appear in the Balance Sheet of Natasha Ltd. The immediate payment (i.e. consideration as per the factoring agreement) of ₹ 250 crores by Samantha Ltd. to Natasha Ltd. should be regarded as a financial liability, and be shown as such by Natasha Ltd. in its Balance Sheet.

Illustration 2:

Explain the criteria in the Conceptual Framework for Financial Reporting for the recognition of an asset and discuss whether there are inconsistencies with the criteria in Ind AS 38, Intangible Assets.

Solution:

The Conceptual Framework defines an asset as a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. Assets should be recognized if they meet the Conceptual Framework definition of an asset and such recognition provides users of financial statements with information that is useful (i.e. it is relevant as well as results in faithful representation). However, the criteria of a cost-benefit analysis always exists i.e. the benefits of the information must be sufficient to justify the costs of providing such information. The recognition criteria outlined in the Conceptual Framework allows for flexibility in the application in amending or developing the standards.

Para 8 of Ind AS 38, Intangible Assets defines an intangible asset as an identifiable non-monetary asset without physical substance. Further, Ind AS 38 defines an asset as a resource:

a) controlled by an entity as a result of past events; and

b) from which future economic benefits are expected to flow to the entity.

Furthermore, Para 21 of Ind AS 38 states that an intangible asset shall be recognised if, and only if:

a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

b) the cost of the asset can be measured reliably.

This requirement is applicable both in case of an externally acquired intangible asset or an internally generated intangible asset. The probability of expected future economic benefits must be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset. Further, as per Para 33 of Ind AS 38, the probability recognition criterion is always considered to be satisfied for intangible assets acquired in business combinations. If the recognition criteria are not satisfied, Ind AS 38 requires the expenditure to be expensed as and when it is incurred.

It is notable that the Conceptual Framework does not prescribe a 'probability criterion'. As long as there is a potential to produce economic benefits, even with a low probability, an item can be recognized as an asset according to the Conceptual Framework. However, in terms of intangible assets, it could be argued that recognizing an intangible asset having low probability of generating economic benefits would not be useful to the users of financial statements given that the asset has no physical substance.

The recognition criteria and definition of an asset under Ind AS 38 are different as compared to those outlined in the Conceptual Framework. To put in simple words, the criteria in Ind AS 38 are more specific, but definitely do provide information that is relevant and a faithful representation. When viewed from the prism of relevance and faithful representation, the requirements of Ind AS 38 in terms of recognition appear to be consistent with the Conceptual Framework.

Illustration 3:

The directors of Hind Ltd. are particular about the usefulness of the financial statements. They have opined that although Ind AS implement a fair value model, Ind AS are failing in reflecting the usefulness of the financial statements as they do not reflect the financial value of the entity.

Discuss the views of the directors as regards the use of fair value in Ind AS and the fact that the Ind AS do not reflect the financial value of an entity, making special reference to relevant Ind AS and the Conceptual Framework.

Solution:

Usage of Fair Value in Ind AS:

Treatment under Ind AS:

The statement of the directors regarding Ind AS implementing a fair value model is not entire accurate. Although Ind AS do use fair value (and present value), it is not a complete fair value system. Ind AS are often based on the business model of the entity and on the expectations of realizing the asset- and liability-related cash flows through operations and transfers.

It is notable that what is preferred is a mixed measurement system, with some items being measured at fair value while others measured at historical cost.

About Fair Value (Ind AS 113)

Ind AS 113 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This price is an exit price.

Ind AS 113 has given consistency to the definition and application of fair value, and this consistency is applied across other Ind AS, which are generally required to measure fair value in accordance with Ind AS 113. However, it cannot be implied that Ind AS requires all assets and

liabilities to be measured at fair value. Rather, many entities measure most items at depreciated historical costs, although the exception being in the case of business combinations, where assets and liabilities are recorded at fair value on the date of acquisition. In other cases, usage of fair value is restricted.

Examples of use of fair value in Ind AS:

a) Ind AS 16 Property, Plant and Equipment permits revaluation through other comprehensive income, provided it is carried out regularly.

b) Disclosure of fair value of Investment Property in Ind AS 40, while the companies account for the same under the cost model.

c) Ind AS 38 Intangible Assets allows measurement of intangible assets at fair value with corresponding changes in equity, but only if the assets can be measured reliably by way of existence of an active market for them.

d) Ind AS 109 Financial Instruments requires some financial assets and liabilities to be measured at amortized cost and others at fair value. The measurement basis is largely determined by the business model for that financial instrument. Where the financial instruments are carried at fair value, depending on the category and circumstances, the movement in the fair value (gain or loss) is either recognized in profit or loss or in other comprehensive income.

Financial value of an entity

Although Ind AS makes use of fair values in the measurement of assets and liabilities, the financial statements prepared under Ind AS are not intended to reflect the aggregate value of the entity, as could be the notion among people. As discussed in 2.2 above, the Conceptual Framework specifically states that general purpose financial statements are not intended to show the value of a reporting entity. Furthermore, such an attempt would not be fruitful as certain internally generated intangible assets cannot be recognized under Ind AS. Instead, the objective of general purpose financial reports is to provide financial information about the reporting entity which would be useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

It is only in the case of acquisition of an entity by another entity and subsequent consolidation in group accounts that an entity's net assets are reported at fair value.

Illustration 4:

Everest Ltd. is a listed company having investments in various subsidiaries. In its annual financial statements for the year ending 31 March 20X2 as well as 31 March 20X3, Everest Ltd. classified Kanchenjunga Ltd. a subsidiary as 'held-for-sale' and presented it as a discontinued operation. On 1 November 20X1, the shareholders had authorized the management to sell all of its holding in Kanchenjunga Ltd. within the year. In the year to 31 March 20X2, the management made a public announcement of its intention to sell the investment but did not actively try to sell the subsidiary as it was still operational within the Everest group.

Certain organizational changes were made by Everest Ltd. during the year to 31 March 20X3, thereby resulting in additional activities being transferred to Kanchenjunga Ltd. Additionally, during the year ending 31 March 20X3, there had been draft agreements and some correspondence with investment bankers, which showed in principle only that Kanchenjunga was still for sale.

Discuss whether the classification of Kanchenjunga Ltd. as held for sale and its presentation as a discontinued operation is appropriate, by referring to the principles of the relevant Ind AS and evaluating the treatment in the context of the Conceptual Framework for Financial Reporting.

Solution:

Kanchenjunga Ltd. is a disposal group in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations. Disposal group can be defined as a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

Para 6 of Ind AS 105 provides that a disposal group shall be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. Ind AS 105 is particularly strict as far as the application of held for sale criteria is concerned, and often the decision to sell an asset or a disposal group is made well before the criteria are met.

Thus, as per Ind AS 105, for the asset (or disposal group) to be classified as held for sale, it must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable.

For the sale to be highly probable:

- The appropriate level of management must be committed to a plan to sell the asset (or disposal group).
- An active programme to locate a buyer and complete the plan must have been initiated.
- The asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.
- The sale should be expected to qualify for recognition as a completed sale within one year from the date of classification.
- It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

In the given case, the draft agreements and correspondence with investment bankers are not specific enough to fit in the points above to prove that the criteria for held for sale was met at that date. Additional information would be needed to confirm that the subsidiary was available for immediate sale, and that it was being actively marketed at an appropriate price so as to satisfy the criteria in the year to 31 March 20X2.

Further, the organizational changes made by Everest Ltd. in the year 20X2-20X3 are a good indicator that Kanchenjunga Ltd. was not available for immediate sale in its present condition at the point of classification. The fact that additional activities have been given to Kanchenjunga Ltd. indicate that the change wasn't insignificant. The shareholders had authorized for a year from 1 November 20X1. There is no evidence that this authorization extended beyond 1 November 20X2.

Conclusion:

Based on the information provided in the given case, it appears that Kanchenjunga Ltd. should not be classified by Everest Ltd. as a subsidiary held for sale. Instead, the results of the subsidiary should be reported as a continuing operation in the financial statements for the year ending 31 March 20X2 and 31 March 20X3.

Evaluation of treatment in context of the Conceptual Framework

The Conceptual Framework states that the users need information to allow them to assess the amount, timing and uncertainty of the prospects for future net cash inflows. Highlighting the results of discontinued operations separately equips users with the information that is relevant to this assessment as the discontinued operation will not contribute to cash flows in the future.

If a company has made a firm decision to sell the subsidiary, it could be argued that the subsidiary should be classified as discontinued operation, even if the criteria to classify it as 'held for sale' as per Ind AS 105 have not been met, because this information would be more useful to users. However, Ind AS 105 criteria was developed with high degree of strictness on classification. Accordingly, this decision could be argued to be in conflict with the Conceptual Framework.

Illustration 5:

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. Suppose

- 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 or
- the average price indices at the beginning and at the end of year are 100 and 120 respectively.

Find out:

a. Financial capital maintenance at Historical Cost

b. Financial capital maintenance at Current Purchasing Power

c. Physical Capital Maintenance

Solution:

Financial capital maintenance at Historical Cost

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.

Financial capital maintenance at Current Purchasing Power

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.

Physical Capital Maintenance

Current cost of opening stock = (INR 12,000 / 100) x 125 = 6,000 x INR 2.50 = INR 15,000

Closing cash after adjustment of stock at current costs = INR 9,000 [(INR 6,000 x 2.5) – INR 6,000]

Opening equity at closing current costs = INR 15,000

Closing equity at closing current costs = INR 9,000

Retained Profit = INR 9,000 – INR 15,000 = (-) INR 6,000

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund INR 9,000 is not sufficient to buy 6,000 units again at increased price INR 2.50 per unit. There should not be any drawings in the year.

Had the trader withdrawn nothing during the year 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

	INR	INR
Closing capital (At historical cost)	12,000	
Less: Capital to be maintained		
Opening capital (At historical cost)	12,000	
Introduction (At historical cost)	Nil	(12,000)
Retained profit		Nil

Financial Capital Maintenance at current purchasing power

	INR	INR
Closing capital (At closing price)	12,000	
Less: Capital to be maintained		
Opening capital (At closing price)	14,400	
Introduction (At closing price)	Nil	(14,400)
Retained profit		(2,400)

Physical Capital Maintenance

	INR	INR
Closing capital (At current cost)		9,000
Less: Capital to be maintained		
Opening capital (At current cost)	15,000	
Introduction (At current cost)	Nil	(15,000)
Retained profit		(6,000)

QUESTIONS FROM ICAI STUDY MATERIAL

Q1: The directors of Jayant Ltd. have received the following email from its majority shareholder:

To: Directors of Jayant Ltd. Re: Measurement

I recently read an article published in the financial press about the 'mixed measurement approach' that is used by lots of companies. I hope Jayant Ltd. does not follow such an approach because 'mixed' seems to imply 'inconsistent'. I believe that consistency is of paramount importance, and hence feel it would be better to measure everything in a uniform manner. It would be appreciated if you could provide further information at the next annual general meeting on measurement bases, covering what approach is taken by Jayant Ltd. and why, and the potential effect such an approach has on the investors trying to analyse the financial statements.

Prepare notes for the directors of Jayant Ltd. to discuss the issue raised in the shareholders' email with reference to the Conceptual Framework wherever appropriate.

Ans: 'Mixed measurement' approach implies that a company selects different measurement bases (e.g. historical cost or fair value) for its various assets and liabilities, rather than using one single measurement basis for all items. The measurement basis so selected should reflect the type of entity and the sector in which it operates and the business model that the entity adopts.

There are criticisms of the mixed measurement approach, particularly under the IFRS regime, because investors think that if different measurement bases are used for assets and liabilities, the resulting figures could lack relevance or exhibit little meaning.

It is however important to note that figures of items in the financial statements cannot be derived by following a one-size-fits-all approach. Such an approach may not provide relevant information to users. A particular measurement basis may be easier to understand, more verifiable and less costly to implement. Therefore, to state that 'mixed measurement' approach is 'inconsistent' is a poor argument. In reality, a mixed approach may actually provide more relevant information to the stakeholders.

The Conceptual Framework confirms the allowance of the usage of a mixed measurement approach in developing standards. The measurement methods included in the standards are those which the standard-setters believe provide the most relevant information and which most faithfully represent the underlying transaction or event. Based on the reactions to the convergence to Ind AS, it feels that most investors feel this approach is consistent with their analysis of financial statements. Thus, the arguments against a mixed measurement are far outweighed by the greater relevance achieved by such measurement bases.

Jayant Ltd. prepares its financial statements under Ind AS, and therefore applies the measurement bases permitted in Ind AS. Ind AS adopt a mixed measurement basis, which includes current value (fair value, value in use, fulfilment value and current cost) and historical cost.

Where an Ind AS allows a choice of measurement basis, the directors of Jayant Ltd. must exercise judgment as to which basis will provide the most useful information for its primary users. Furthermore, when selecting a measurement basis, measurement uncertainty should also be considered. The Conceptual Framework states that for some estimates, a high level of measurement uncertainty may outweigh other factors to such an extent that the resulting information may be of little relevance.

QUESTIONS FROM OTHER SOURCE

Q 2 Balance sheet of a trader on 31st March, 20X1 is given below:

Particulars	₹
Assets	
Non-current assets	
Property, Plant and Equipment	65,000
Current assets	
Inventories	30,000
Financial assets	
Trade receivables	20,000
Other asset	10,000
Cash and cash equivalents	5,000
	1,30,000
Equity and Liabilities	
Equity	
Share capital	60,000
Other Equity - Profit and Loss Account	25,000
Non-current liabilities	
10% Loan	35,000
Current liabilities	
Financial liabilities	
Trade payables	10,000
	1,30,000

Additional information

a) The remaining life of Property, Plant and Equipment is 5 years. The pattern of use of the asset is even. The net realisable value of Property, Plant and Equipment 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 inventories on 31.03.20X2 were ₹ 32,000 and ₹ 40,000 respectively.

(d) Employee benefit expenses for the year amounted to ₹ 14,900.

(e) Other asset is written off equally over 4 years.

(f) Trade receivables 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) Cash balance on 31.03.20X2 is ₹ 37,100 before deduction of interest paid on loan.

(h) 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.

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

	Case (i)	Case (ii)
	₹	₹
Revenue from operations – Sales (A)	4,50,000	4,50,000
Expenses		
Purchases	4,00,000	4,00,000
Changes in inventories	(2,000)	(10,000)
Employee benefit expenses	14,900	14,900
Finance cost	3,500	6,000
Depreciation and amortisation expenses	15,500	15,000
Other expenses - Provision for doubtful debts	2,000	6,000
Total Expenses (B)	4,33,900	4,31,900
Profit for the period (A-B)	16,100	18,100

Balance Sheet as at 31st March, 20X2

	Case (i) ₹	Case (ii) ₹
Assets		
Non-current assets		
Property, Plant and Equipment	52,000	60,000
Current Asset		
Inventories	32,000	40,000
Financial assets		
Trade receivables (less provision)	23,000	19,000
Other asset	7,500	Nil

Cash and cash equivalents (after interest paid on loan)	33,600	33,600
	1,48,100	1,52,600
Equity and Liabilities		
Equity		
Share Capital	60,000	60,000
Other Equity - Profit & Loss A/c	41,100	43,100
Non-current liabilities		
10% Loan	35,000	37,500
Current liabilities		
Trade payables	12,000	12,000
	1,48,100	1,52,600

QUESTIONS FROM RTP/MTP/EXAMS

Q3. Mr. Unique commenced business on 1/04/17 with ₹ 20,000 represented by 5,000 units of the product @ ₹ 4 per unit. During the year 2017-18, he sold 5,000 units @ ₹ 5 per unit. During 2017-18, he withdraw ₹ 4.000.

- 31/03/18: Price of the product @ ₹ 4.60 per unit
- Average price indices: 1/4/17: 100 & 31/3/18: 120

Find out:

a. Financial capital maintenance at Historical Cost

b. Financial capital maintenance at Current Purchasing Power

c. Physical Capital Maintenance **[Exam May 2019]**

Ans: **Financial Capital Maintenance at historical costs**

	₹	₹
Closing capital (₹ 25,000 – ₹ 4,000)		21,000
Less: Capital to be maintained		
Opening capital (At historical cost)	-	
Introduction (At historical cost)	20,000	(20,000)
Retained profit		1,000

Financial Capital Maintenance at current purchasing power

	₹	₹
Closing capital (₹ 25,000 – ₹ 4,000)		21,000
Less: Capital to be maintained		
Opening capital (At closing price) (5,000 x ₹ 4.80)	24,000	
Introduction (At closing price)	Nil	(24,000)
Retained profit		(3,000)

Physical Capital Maintenance

	₹	₹
Closing capital (At current cost) [₹ (5,000 x 4.6) – ₹ 4,000]		19,000
Less: Capital to be maintained		
Opening capital (At current cost) (5,000 x ₹ 4.60)	23,000	
Introduction (At current cost)	Nil	(23,000)
Retained profit		(4,000)