

## **TOPIC 3.**

# **FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS**

### *Index*

S.No.	Content	Page No.
1	Basic Intro	32
2	Users of FS & Underlying Assumptions	32
3	Elements of Financial Statements	36
4	Measurement of Financial Statements	37
5	Concept of Capital Maintenance	38
6	Carve Outs/Carve Ins	41

**Quote:**

**"Keep your eyes on the stars,  
and your feet on the ground".**



## 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

### Is the Framework equivalent to the Standard?

Framework is Not a standard itself

Thus if you wish to decide on the financial reporting of certain transaction, you need to look into the appropriate INDAS.

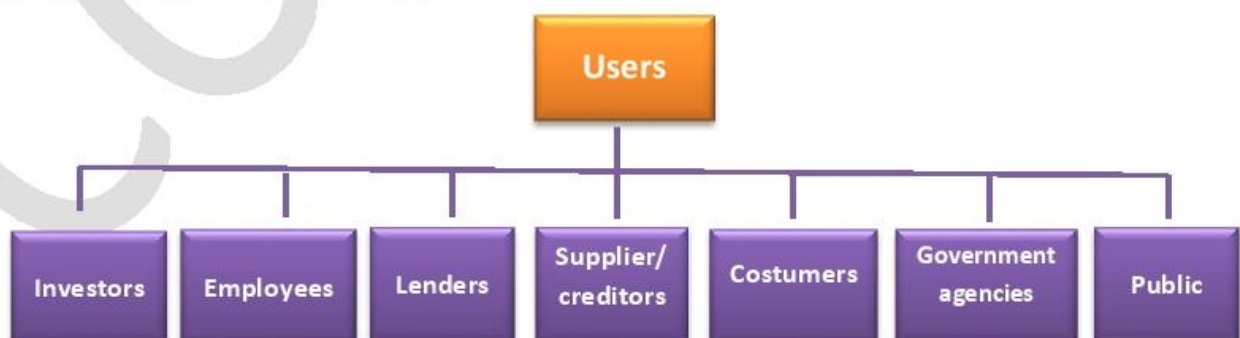
Sometimes, it may even happen that the rules in that INDAS will be contrary to what the framework says.

In this case, you need to apply the standard, not the Framework.

When should you apply the Framework?

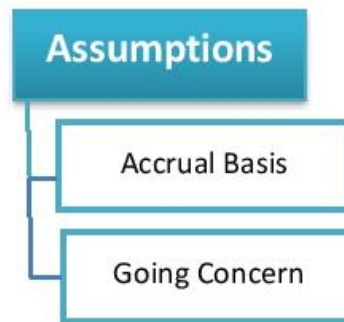
In most cases, when there are no specific rules for your transaction and you need to develop your accounting policy, then you would look to the Framework as you cannot depart from its basic principles and definitions.

## USERS OF FINANCIAL STATEMENTS



## UNDERLYING ASSUMPTIONS

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



### **Example on Going Concern**

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

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



### 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 Rs 60,000.
- (b) The trader's purchases and sales in 20X1-20X2 amounted to Rs 4 lakh and Rs 4.5 lakh respectively.
- (c) The cost and net realisable value of inventories on 31.03.20X2 were Rs 32,000 and Rs 40,000 respectively.
- (d) Employee benefit expenses for the year amounted to Rs 14,900.
- (e) Other asset is written off equally over 4 years.
- (f) Trade receivables on 31.03.20X2 is Rs 25,000, of which Rs 2,000 is doubtful. Collection of another Rs 4,000 depends on successful re-installation of certain product supplied to the customer.
- (g) Cash balance on 31.03.20X2 is Rs 37,100 before deduction of interest paid on loan.
- (h) There is an early repayment penalty for the loan Rs 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.

### Solution:

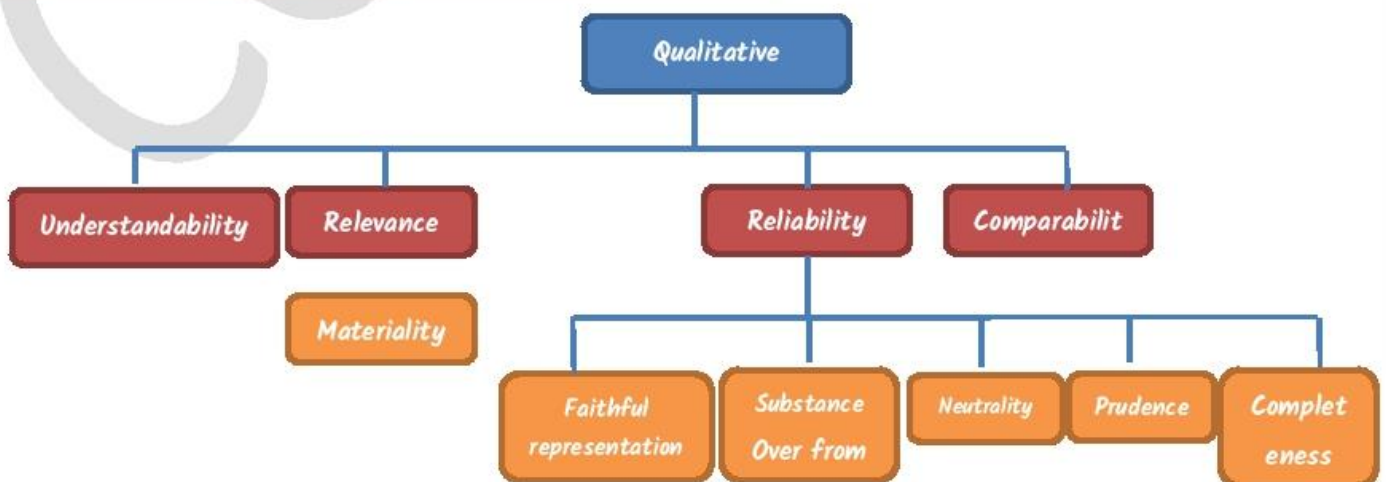
#### Profit and Loss Account for the year ended 31st March, 20X2

	Case (i) Rs	Case (ii) Rs
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

Liabilities	Case (i) Rs	Case (ii) Rs
<b>Assets</b>		
<u>Non-current assets</u>		
Property, Plant and Equipment	52,000	60,000
<u>Current Asset</u>		
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
	<b>1,48,100</b>	<b>1,52,600</b>
<b>Equity and Liabilities</b>		
<u>Equity</u>		
Share Capital	60,000	60,000
Other Equity - Profit & Loss A/c	41,100	43,100
<u>Non-current liabilities</u>		
10% Loan	35,000	37,500
<u>Current liabilities</u>		
Trade payables	12,000	12,000
	<b>1,48,100</b>	<b>1,52,600</b>

### QUALITATIVE ASPECTS OF FINANCIAL STATEMENTS





## **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.”

### **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 interference 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 be 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

**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

### **Example: Present Obligation based on Past Events**

An Entity has got 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.

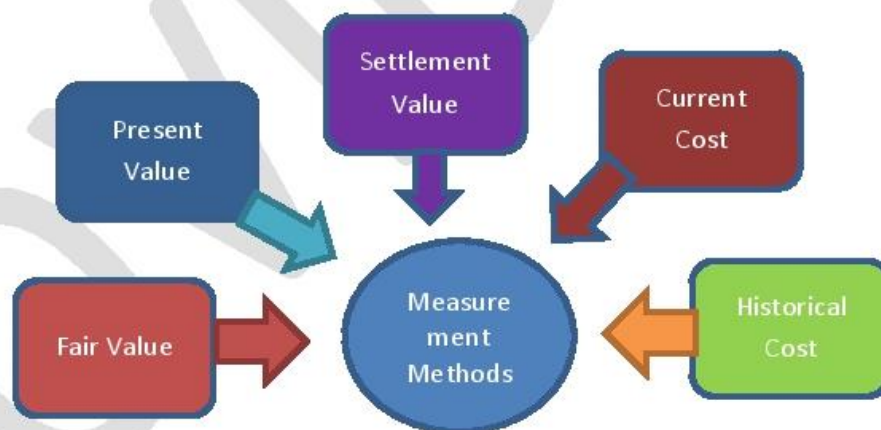
Settlement of such liability could be in cash, transfer of other assets, conversion of obligation into equity etc. There are liabilities, where timing and amount are not certain, but meets the recognition criteria, then the amounts are being estimated using some techniques and shown as provisions.

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

**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.

**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.

### MEASUREMENT OF THE ELEMENTS OF FINANCIAL STATEMENTS



- **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.

## CAPITAL MAINTAINANCE:

### FINANCIAL CAPITAL MAINTAINANCE VS. PHYSICAL CAPITAL MAINTAINANCE

- 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 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 .





### Example A – Historical Cost Capital Maintenance

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

Opening Equity = Rs 12,000 represented by 6,000 units at Rs 2 per unit.

Closing Equity = Rs 12,000 (Rs 18,000 – Rs 6,000) represented entirely by cash.

Retained Profit = Rs 12,000 – Rs 12,000 = Nil

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

### Example B – Financial Capital Maintenance

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 = Rs 12,000 represented by 6,000 units at Rs 2 per unit.

Opening equity at closing price =  $(Rs\ 12,000 / 100) \times 120 = Rs\ 14,400$  (6,000 x Rs 2.40)

Closing Equity at closing price

= Rs 12,000 (Rs 18,000 – Rs 6,000) represented entirely by cash.

Retained Profit = Rs 12,000 – Rs 14,400 = (-) Rs 2,400

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund Rs 12,000 is not sufficient to buy 6,000 units again at increased price Rs 2.40 per unit. In fact, he should have restricted his drawings to Rs 3,600 (Rs 6,000 – Rs 2,400). Had the trader withdrawn Rs 3,600 instead of Rs 6,000, he would have left with Rs 14,400, the fund required to buy 6,000 units at Rs 2.40 per unit.

### Example C – Physical Capital Maintenance

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

Current cost of opening stock =  $(Rs\ 12,000 / 100) \times 125 = 6,000 \times Rs\ 2.50 = Rs\ 15,000$

Current cost of closing cash = Rs 12,000 (Rs 18,000 – Rs 6,000)

Opening equity at closing current costs = Rs 15,000

Closing equity at closing current costs = Rs 12,000

Retained Profit = Rs 12,000 – Rs 15,000 = (Rs 3,000)

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund Rs 12,000 is not sufficient to buy 6,000 units again at increased price Rs 2.50 per unit. The drawings should have been restricted to Rs 3,000 (Rs 6,000 – Rs 3,000).



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

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

**Financial Capital Maintenance at historical costs**

	Rs	Rs
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**

	Rs	Rs
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**

	Rs	Rs
Closing capital (At current cost)		12,000
Less: Capital to be maintained		
Opening capital (At current cost)	15,000	
Introduction (At current cost)	Nil	(15,000)
Retained profit		(3,000)



## WHAT ARE CARVE OUTS/INS IN IND AS?

The Government of India in consultation with the ICAI decided to converge and not to adopt IFRS issued by the IASB.

The decision of convergence rather than adoption was taken after the detailed analysis of IFRS requirements and extensive discussion with various stakeholders.

Accordingly, while formulating IFRS-converged Indian Accounting Standards (Ind AS), efforts have been made to keep these Standards as far as possible in line with the corresponding IAS/IFRS and departures have been made where considered absolutely essential. These changes have been made considering various factors, such as.

- Various terminology related changes have been made to make it consistent with the terminology used in law, e.g., 'statement of profit and loss' in place of 'statement of comprehensive income' and 'balance sheet' in place of 'statement of financial position'.
- Removal of options in accounting principles and practices in Ind AS vis-a-vis IFRS, have been made to maintain consistency and comparability of the financial statements to be prepared by following Ind AS. However, these changes will **not result into carve outs**.
- Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS. These differences are due to differences in application of accounting principles and practices and economic conditions prevailing in India. These differences which are in deviation to the accounting principles and practices stated in IFRS, are commonly known as '**Carve-outs**'.

**Note:** In Ind AS 103 "Business Combination", an additional guidance on "Accounting of Business Combinations of Entities under Common Control" is given which is over and above what is given in IFRS. This is termed as '**Carve-in**'.



Student Notes:-





Student Notes:-

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Student Notes:-

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