

TOPIC - 1

(CHAPTER 2 OF ICAI)

FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

FRAMEWORK AND ITS PURPOSE

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

- Assist in the development of future AS and review of existing AS
- Assist preparers of financial statements in applying AS and in dealing with topics that have yet to form the subject of an AS
- Assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with AS
- Assist auditors in forming an opinion as to whether financial statements conform with AS
- Provide those who are interested in 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 AS.

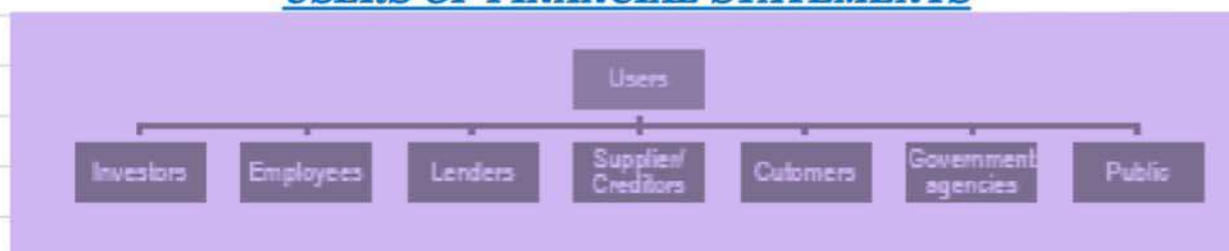
Sometimes, it may even happen that the rules in that AS will be contrary to what the Framework says.

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

When should you apply the Framework?

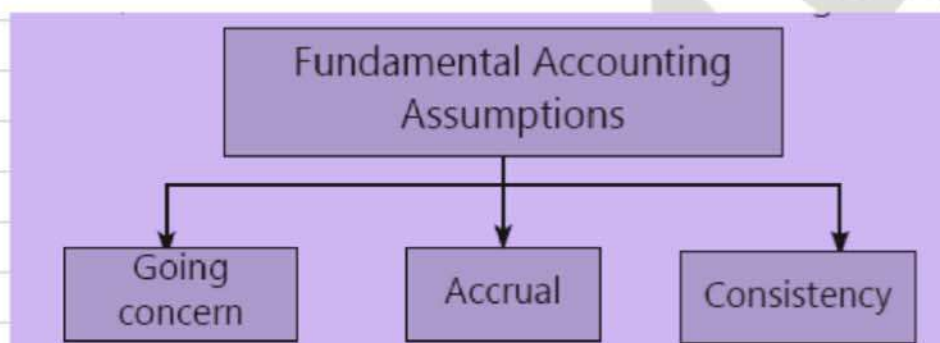
In most cases, when there are no specific rules for your transaction and you need to develop your accounting policy, then you would look to the Framework as you cannot depart from its basic principles and definitions.

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:

Particulars	Rs
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 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

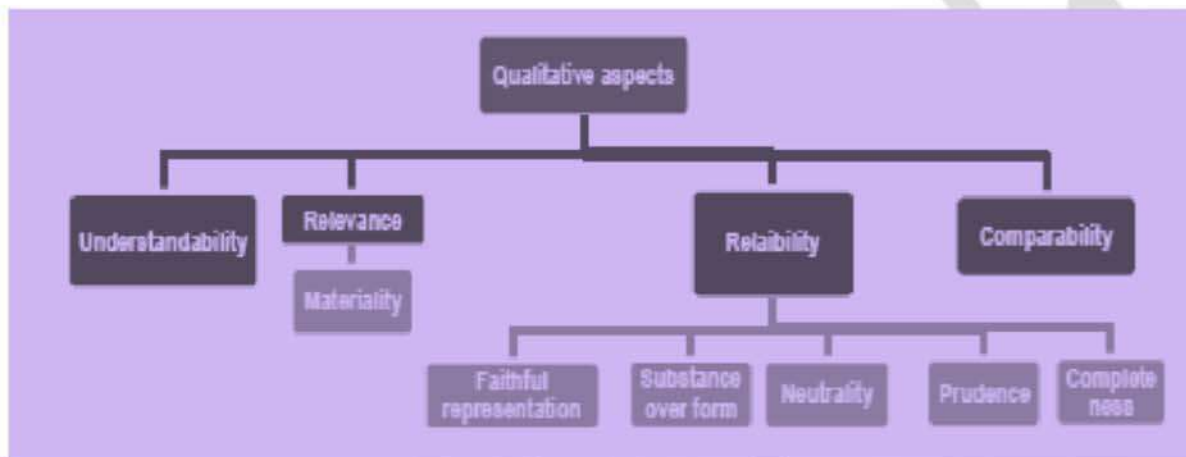
	Case (i) Rs	Case (ii) Rs
Revenue from operations – Sales (A)	4,50,000	4,50,000
Expenses		
Purchases	4,00,000	4,00,000
Changes in inventories	(2,000)	(10,000)
Employee benefit expenses	14,900	14,900
Finance cost	3,500	6,000
Depreciation and amortisation expenses	15,500	15,000
Other expenses - Provision 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
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	33,600	33,600

loan)		
	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

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 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

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

Class 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.

Class 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.

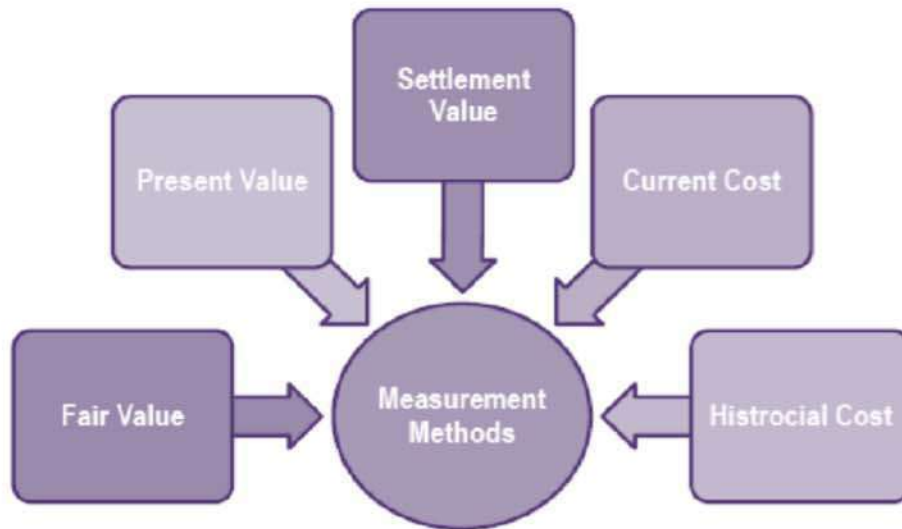
Settlement of such liability could be in cash, transfer of other assets, conversion of obligation into equity etc. There are liabilities, where timing & amount are not certain, but meets the recognition criteria, then the amounts are being estimated using some techniques and shown as provisions.

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.

Class 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).

Mr. X purchased a machine on 1st January, 20X1 at ₹ 7,00,000. As per historical cost basis, he has to record it at ₹ 7,00,000 i.e. the acquisition price. As on 1.1.20X6, Mr. X found that it would cost ₹ 25,00,000 to purchase that machine. Mr. X also took loan from a bank as on 20X1 ₹ 5,00,000 @ 18% p.a. repayable at the end of 15th year together with interest.

As per historical cost, the liability is recorded at ₹ 5,00,000 at the amount or proceeds received in exchange for obligation and asset is recorded at ₹ 7,00,000.

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

Class 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).

A machine was acquired for \$ 10,000 on deferred payment basis. The rate of exchange on the date of acquisition was ₹ 49/\$. The payments are to be made in 5 equal annual instalments together with 10% interest per year. The current market value of similar machine in India is ₹ 5 lakhs.

Current cost of the machine = Current market price = ₹ 5,00,000.

By historical cost convention, the machine would have been recorded at ₹ 4,90,000.

To settle the deferred payment on current date one must buy dollars at ₹ 49/\$. The liability is therefore recognised at ₹ 4,90,000 ($\$ 10,000 \times ₹ 49$). Note that the amount of liability recognised is not the present value of future payments. This is because, in current cost convention, liabilities are recognised at undiscounted amount.

- **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.

Class 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.

Class 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.

Class Example

Equity investment listed at stock market where it has substantial exchange every day could be used as the fair value of the Investment.

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 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 .

Class 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.

Class 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) x 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.

Class 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)

CLASS WORK QUESTION

Question 1

(ICAI MODULE)

Carrying amount of a machine is 40,000 (Historical cost less depreciation).

The machine is expected to generate ₹ 10,000 net cash inflow. The net realisable value (or net selling price) of the machine on current date is 35,000. The enterprise's required earning rate is 10% per year.

Question 2 (ICAI MODULE)

Mohan started a business on 1st April 20X1 with ₹ 12,00,000 represented by 60,000 units of ₹ 20 each. During the financial year ending on 31st March, 20X2, he sold the entire stock for ₹ 30 each. In order to maintain the capital intact, calculate the maximum amount, which can be withdrawn by Mohan in the year 20X1-X2 if Financial Capital is maintained at historical cost.

Question 3 (ICAI MODULE)

Balance Sheet of Anurag Trading Co. on 31st March, 20X1 is given below:

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	50,000	Fixed Assets	69,000
Profit and Loss A/c	22,000	Stock in Trade	36,000
10% Loan	43,000	Trade Receivables	10,000
Trade Payables	18,000	Deferred Expenditure	15,000
	-	Bank	3,000
	1,33,000		1,33,000

Additional Information:

- (i) Remaining life of fixed assets is 5 years with even use. The net realisable value of fixed assets as on 31st March, 20X2 was 64,000.
- (ii) Firm's sales & purchases for the year 20X1-X2 amounted to 5 lacs & 4.50 lacs respectively.
- (iii) The cost and net realisable value of the stock were 34,000 and ₹ 38,000 respectively.
- (iv) General Expenses for the year 20X1-X2 were 16,500.
- (v) Deferred Expenditure is normally amortised equally over 4 years starting from F.Y. 20X0-X1 i.e. 5,000 per year.
- (vi) Out of debtors worth 10000, collection of 4000 depends on successful re design of certain product already supplied to the customer.
- (vii) Closing trade payable is 10000 which likely to be settled at 95%.
- (viii) There is pre-payment penalty of 2000 for bank loan outstanding.

Prepare profit & loss account for the year ended 31.3.20X2 by assuming it is not a Going concern.



Student Notes:-

COVID-19

COVID-19

