

Framework for Preparation and Presentation of Financial Statements

The Accounting Standards Board (ASB) of the ICAI issued framework in July, 2000 which provides the fundamental basis for development of new standards as also for review of existing standards.

Purpose of the Framework

The framework sets out the concepts underlying the preparation and presentation of general purpose financial statements prepared by enterprises for external users. The main purpose of framework is to assist:

- ❖ Enterprises in preparation of their financial statements in compliance with the accounting standards and in dealing with the topics not yet covered by any accounting standard.
- ❖ Accounting Standard Board (ASB) in its task of development and review of accounting standards.
- ❖ ASB in promoting harmonisation of regulations, accounting standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by accounting standards.
- ❖ Auditors in forming an opinion as to whether financial statements conform to the AS.
- ❖ Users in interpretation of financial statements.

Components of Financial Statements

Balance sheet	Portrays value of economics resources controlled by an enterprise.
Statement of P&L	Presents the results of operations of an enterprise.
Cash flow statement	Shows the way an enterprise generates cash and uses it.
Notes and schedules	Presents supplementary information explaining different items

Users of Financial Statements

Investors	Analysis of performance, profitability, financial position of Co.
Employees	Knowledge of stability, continuity, growth
Suppliers, creditors	Determination of credit worthiness
Customers	Analysis of stability, profitability.
Govt.	Evaluation of entity's performance and contribution to social objectives.

Fundamental Accounting Assumptions

Accrual	Transactions are recognized as and when they occur, without considering receipt /payment of cash.
Going concern	Enterprise will continue in operation in foreseeable future & will not liquidate.
Consistency	Using same accounting policies for similar transactions in all A/cing periods.

Qualitative Characteristics of Financial Statements

Understandability	Information presented in financial statements should be understandable by the users with reasonable knowledge of business and economic activities.
Relevance	Financial statements should contain relevant information. Information, which is likely to influence the economic decisions by the users, is called relevant.
Reliability	Information must be reliable; i.e, it must be free from material error and bias.
Comparability	Financial statements should permit both inter-firm and intra-firm comparison.

True and Fair view	Financial statements should show a true and fair view of the performance, financial position and cash flows of an enterprise.
---------------------------	---

Elements of Financial Statements

Asset	Resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise
Liability*	Present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of a resource embodying economic benefits.
Equity	Residual interest in the assets of an enterprise after deducting all its liabilities.
Income/gain	Increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decreases in liabilities that result in increase in equity other than those relating to contributions from equity participants
Expense/loss	Decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity other than those relating to distributions to equity participants.

* Example:

A Ltd. has entered into a binding agreement with P Ltd. to buy a custom-made machine Rs. 40,000. At the end of 2019-20, before delivery of the machine, A Ltd. had to change its method of production. The new method will not require the machine ordered and it will be scrapped after delivery. The expected scrap value is nil. A liability is recognised when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured.

In the given case, A Ltd. should recognise a liability of Rs. 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:

P&L A/c Dr. 40,000
To P Ltd. 40,000

(Loss due to change in production method)

Measurement Basis of Elements in Financial Statements

Historical cost	Acquisition price
Current Cost	Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
Realisable (Settlement) Value	For assets, amount currently realisable on sale of the asset in an orderly disposal. For liabilities, this is the undiscounted amount expected to be paid on settlement of liability in the normal course of business.
Present Value	Assets are carried at present value of future net cash flows generated by the concerned assets in the normal course of business. Liabilities are carried at present value of future net cash flows that are expected to be required to settle the liability in the normal course of business.

Capital Maintenance

Financial capital maintenance	At historical cost	Opening and closing assets are stated at historical costs.
	At current purchasing power	Restatement at closing prices using average price indices.
Physical capital maintenance	Restatement at closing prices using specific price indices.	

Example 1 (Financial Capital Maintenance at historical cost)

A trader commenced business on 01/01/2019 with Rs. 12,000 represented by 6,000 units of a certain product at Rs. 2 per unit. During the year 2019 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 2020 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 2 (Financial Capital Maintenance at current purchasing power)

In the previous example (Example 1), 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.

Example 3 (Physical Capital Maintenance)

In the previous example (Example 1) suppose that the price of the product at the end of year is Rs. 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) x 125 = 6,000 x 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.

Question 1

Shankar started a business on 1st April 2019 with Rs. 12,00,000 represented by 60,000 units of Rs. 20 each. During the financial year ending on 31st March, 2020, he sold the entire stock for Rs. 30 each. In order to maintain the capital intact, calculate the maximum amount, which can be withdrawn by Shankar in the year 2019-20 if Financial Capital is maintained at historical cost.

Solution

Particulars	Rs.
Closing equity (Rs. 30 x 60,000 units)	18,00,000 represented by cash
Opening equity	60,000 units x Rs. 20 = 12,00,000
Permissible drawings to keep Capital intact	6,00,000 (18,00,000 – 12,00,000)

Question 2

Balance sheet of a trader on 31st March, 2019 is given below

Liabilities	Amount	Assets	Amount
Capital	60,000	Fixed Assets	65,000
Profit and Loss Account	25,000	Stock	30,000
10% Loan	35,000	Trade receivables	20,000
Trade payables	10,000	Deferred costs	10,000
		Bank	5,000
	1,30,000		1,30,000

Additional information:

- 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 31.03.20 was Rs. 60,000.
- The trader's purchases and sales in 2019-20 amounted to Rs. 4 lakh and Rs. 4.5 lakh respectively.
- The cost and net realisable value of stock on 31.03.20 were Rs. 32,000 and Rs. 40,000 respectively.
- Expenses for the year amounted to Rs. 14,900.
- Deferred cost is amortised equally over 4 years.
- Debtors on 31.03.20 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.
- Closing trade payable is Rs. 12,000, which is likely to be settled at 5% discount.
- Cash balance on 31.03.20 is Rs. 37,100.
- There is an early repayment penalty for the loan Rs. 2,500.

Prepare the Profit and Loss Accounts and Balance Sheets of the trader in two cases

- assuming going concern
- not assuming going concern

Solution**Profit and Loss Account for the year ended 31st March, 2020**

	Case (i)	Case (ii)		Case (i)	Case (ii)
To Opening Stock	30,000	30,000	By Sales	4,50,000	4,50,000
To Purchases	4,00,000	4,00,000	By Closing Stock	32,000	40,000
To Expenses	14,900	14,900	By Trade payables	-	600
To Depreciation	13,000	5,000			
To Provision for doubtful debts	2,000	6,000			
To Deferred cost	2,500	10,000			
To Loan penalty	-	2,500			
To Net Profit (b.f.)	19,600	22,200			
	4,82,000	4,90,600		4,82,000	4,90,600

Balance Sheet as at 31st March, 2020

Liabilities	Case (i)	Case (ii)	Assets	Case (i)	Case (ii)
Capital	60,000	60,000	Fixed Assets	52,000	60,000
Profit and Loss Account	44,600	47,200	Stock	32,000	40,000
10% Loan	35,000	37,500	Trade receivables	23,000	19,000
Trade payables	12,000	11,400	Deferred costs	7,500	-
			Bank	37,100	37,100
	1,51,600	1,56,100		1,51,600	1,56,100

*Assumed that Rs. 14,900 includes interest on 10% loan amount for the year.