CHAPTER

A INTRODUCTION

SYNOPSIS

In the present era of globalization, and liberalization the world has become an economic village. The globalization of the business world, the attendant structures and regulations, which support it, as well as the development of e-commerce make it imperative to have single globally accepted financial reporting system. A number of multinational companies are establishing their business in various countries with emerging economies and *vice versa*. The use of different accounting framework in different countries, which requires inconsistent treatment and presentation of same underlying economic transactions, creates confusion for users of financial statements. This confusion leads to inefficiency in capital markets across the world. Therefore increasing complexities of business transactions and globalization of capital markets call for a single set of high quality accounting standards.

International Financial Reporting Standards (IFRSs) are considered as **"Principle–based"** set of standard. In fact, they establish broad rules rather than dictating specific treatments. Every major nation is moving towards adopting them to some extent.

India made a commitment towards the convergence of Indian accounting standards with IFRS at the G20 summit in 2009. In line with this, the Ministry of Corporate Affairs, Government of India (MCA) previously issued a roadmap for implementation of Indian Accounting Standards (Ind ASs) converged with International Financial Reporting Standards (IFRSs) beginning in April 2011. However, this plan was suspended due to unresolved tax and other issues. In the presentation of the Union Budget 2014–15, the Honourable Minister for Finance, Corporate Affairs and Information and Broadcasting proposed the adoption of Ind AS. In accordance with the Budget statement, the MCA has notified Companies (Indian Accounting Standards) Rules, 2015 vide its G.S.R. dated 16th February, 2015. Accordingly, it has notified 39 Ind AS and has laid down an Ind AS transition road map for companies other than banking companies, insurance companies and non-banking finance companies. These rules were amended every year through many notifications.

Ind AS for banks

On 5th April, 2018, the Reserve Bank of India (RBI) through its press release deferred the implementation of Indian Accounting Standards (Ind AS) by one year for scheduled commercial banks, i.e., 2019-20 would be the first year of Ind AS with 2018-19 as the comparative year.

The implementation of Ind AS by banks requires certain legislative changes in the format of financial statements to comply with disclosures required by Ind AS. The change in format requires an amendment to the Third Schedule of the Banking Regulation Act, 1949 to make it compatible with accounts under Ind AS.

1. SALIENT FEATURES (CA Final-May 2024)

- Early adoption permitted from 1st April, 2015, with one year comparatives;
- Once adopted, cannot be revoked;
- Companies not covered by the roadmap to continue to apply existing standards.

PHASE 1 applicable from 1st April, 2016 onwards to (it means first balance sheet dated 31st March, 2017)

(a) Companies whose **equity or debt** securities **are listed** or are in the process of being listed on any stock exchange in India or outside India **and** having **net worth** >= ₹ 500 crore; **(Listed)**

(b) Companies other than point (a) and having net worth of ₹ 500 crore or more; (**Unlisted**)

(c) Holding, subsidiaries, joint ventures or associates of these companies.

PHASE 2 applicable from 1st April, 2017 onwards to (it means first balance sheet dated 31st March, 2018)

(a) Companies whose **equity or debt** securities **are listed** or are in the process of being listed on any stock exchange in India or outside India; **and** were not covered in the earlier phase of Ind AS application; **(Listed)**

(b) **Unlisted** companies whose net worth is >= ₹ 250 crores but < ₹ 500 crores **and** were not covered in the earlier phase of Ind AS application; **(Unlisted)**

(c) Holding, subsidiaries, joint ventures or associates of (a) & (b) companies.

Not applicable to those companies whose securities are **listed or are in the process of being listed on SME exchange** as referred to in Chapter XB or on the Institutional Trading Platform without initial public offering in accordance with the provisions of Chapter XC of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Applicability to NBFC

The following NBFCs shall comply with the Ind AS for accounting periods beginning on or after the 1st April, 2019, with comparatives for the periods ending on 31st March, 2019, or thereafter—

(a) NBFCs whose equity or debt securities are listed or in the process of listing on any stock exchanges in India or outside India and having net worth less than ₹500 crore;

(b) NBFCs, that are unlisted companies, having net worth of ₹250 crore or more but less than ₹500 crore; and

(c) Holding, subsidiary, joint venture or associate companies of companies covered under item (A) or item (B) of sub-clause (b), other than those already covered in clauses (i), (ii) and (iii) of sub-rule (1) or item (B) of sub-clause (a) of clause (iv);

2. CALCULATION OF NET WORTH OF COMPANIES

(a) Based on the **stand-alone financial statements** of the company as on 31st March, 2014 or the first audited financial statements for accounting period which ends after that date;

(b) For companies which are not in existence on 31st March, 2014 or an existing company falling under any of thresholds for the first time after 31st March, 2014, the net worth shall be calculated on the basis of the first-audited financial statements ending **after that date** in respect of which it meets the thresholds.

Situation 1: *Say* if the net worth of a company is 200 crore as on 31st March, 2014 and it crossed 500 crore on 31st March, 2015 (It is taking place before Phase I) - It will fall in Phase I and prepare Ind AS financials from 01st April, 2016 onwards.

Situation 2: *Say* if the net worth of a company is 600 crore as on 31st March, 2014 and it went down to 200 crore in the subsequent years - Even though the net worth reduced subsequently, as it complied with as 31st March, 2014, it will fall in Phase I and prepare Ind AS financials from 01st April, 2016 onwards.

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Paid up share capital	XXX
All reserves created out of profits	XXX
Security Premium account	XXX
Less: Accumulated Losses	XXX
Less: Deferred expenditure	XXX

Less: Miscellaneous expenditure not written off	XXX
Net worth	XXX

BUT Net worth **does NOT** include reserves created out of revaluation of assets, write back of depreciation and amalgamation.

Note: **Consider** Capital reserve which was created on receipt of government grant in the nature of promoter's contribution as per AS-12 & ESOP reserve which arises as part of Employee stock option plan;

Explanation: *For the purposes of sub-clause (b), the companies meeting the specified thresholds given in sub-rule (1) (Phase I) for the first time at the end of an accounting year* ***shall apply Ind AS from the immediate next accounting year*** *in the manner specified in sub-rule (1) (Phase I).*

***Illustration*—(*i*)** The companies meeting threshold for the first time as on 31st March, 2017 shall apply Ind AS for the financial year 2017-18 onwards.

(*ii*) The companies meeting threshold for the first time as on 31st March, 2018 shall apply Ind AS for the financial year 2018-19 onwards and so on.

- Standards **once required to be complied** with in accordance with these rules, **shall apply to both stand-alone** and **consolidated** financial statements (CFS).
- Companies to which Ind AS are applicable as specified in these rules shall prepare their first set of financial statements in accordance with the Ind AS effective at the end of its first Ind AS reporting period.
- *Explanation*—For the removal of doubts, it is hereby clarified that the companies preparing financial statements applying the Ind AS for the accounting period beginning on 1st April, 2016 shall apply the Ind AS effective for the financial year ending on 31st March, 2017.
- Overseas subsidiary, associate, joint venture and other similar entities of an Indian company may prepare its standalone financial statements in accordance with the requirements of the specific jurisdiction provided that such Indian company shall prepare its CFS in accordance with the Ind AS.
- Indian company which is a subsidiary, associate, joint venture and other similar entities of a foreign company shall prepare its financial statements in accordance with the Ind AS either voluntarily or mandatorily.
- Any company opting to apply the Ind AS voluntarily for its financial statements shall prepare its financial statements as per the Ind AS consistently.
- **Once the Ind ASs are applied voluntarily, it shall be irrevocable** and such companies shall not be required to prepare another set of financial statements in accordance with Accounting Standards specified in Annexure to Companies (Accounting Standards) Rules, 2006.
- **Once a company starts** following the Ind AS **either voluntarily or mandatorily**, it **shall be required to follow** the Ind AS for all the subsequent financial statements **even if any of the criteria specified in this rule does not subsequently apply to it**.
- For companies which are not in existence on 31st March, 2014 or an existing company falling under any of Ind AS applicability thresholds for the first time after 31st March, 2014, the net worth will be calculated on the basis of the first-audited financial statements ending after that date in respect of which it meets the Ind AS applicability net worth. These companies will apply Ind AS from the immediate next accounting year onward. *For example*, if the companies meet the net worth limit as on 31st March, 2017, then the Ind AS will be applicable from financial year 2017-18 onward. Companies meeting the net worth limit as on 31st March, 2018 then the Ind AS will be applicable from financial year 2018-19 onwards.

Concept capsule 1

Company X, on standalone basis, had a net worth of above ₹ 250 crore but below ₹ 500 crore on 31st March, 2014 as well as on 31st March, 2015 and is exceeded ₹ 500 crore in financial year 2015-16.

Whether the Company X be required to comply with Ind AS from financial year 2017-18, i.e., under Phase II, given that the net worth as on 31st March, 2014 was below ₹ 500 Crore and the Company X was a company existing as on 31st March, 2014 and was already falling under the threshold as on 31st March, 2014 itself irrespective of the fact that the net-worth as on 31st March, 2016 might be above ₹ 500 crore.

Suggested answer

(Read the explanation given after calculation of net worth carefully before answering)

In view of the requirement at (b) above, any company that meets the thresholds as specified in the Rules in a particular financial year, Ind. AS will become applicable to such company in **immediately next financial year**.

Therefore, in the given case, company X which had net worth of above ₹ 250 crore but below ₹ 500 crore in financial year 2013-14 as well as in financial year 2014-15 and is exceeded ₹ 500 crore in financial year 2015-16, has to prepare Ind AS financial statements from April 1, 2016 onwards i.e. for FY 2016-17.

It means – Companies, which do not meet Ind AS applicability criteria on the first cut-off date, will need to **reassess** Ind AS applicability criteria at **each balance sheet date**. They will be covered under Ind AS applicability as soon as applicability criterion is met.

Concept capsule 2

Can an entity apply Ind AS partly and AS partly in preparation of financial statements?

Suggested answer

The roadmap is clear that companies need to apply either Ind AS **or** AS in the entirety. Companies are not allowed to adopt standards by mix and match or slicing and dicing.

It means, the company following AS per rules notified in 2006 will apply *AS-13 – Accounting for investment i.e.*, Cost based measurement of investment and it does not allow fair value accounting. These companies cannot use Ind AS-109 – *Financial instruments* where investments are accounted at fair value. *However, a company may be able to use Ind AS-109 – Principles for derivative and hedge accounting, to the extent these are not contrary to notified AS.*

Concept capsule 3

Company A is a listed company and has three Subsidiaries Company X, Company Y and Company Z. As on 31st March, 2014, the net worth of Company A is ₹ 600 Crores, net worth of Company X is ₹ 100 Crores, Company Y is ₹ 400 Crores and Company Z is ₹ 210 Crores. All the three subsidiaries are non-listed public companies. Whether the subsidiaries also need to prepare financial statements in accordance with Ind AS?

Suggested answer

As per the rules – If a company meets the Ind AS applicability threshold limits (net worth), all its holding, subsidiaries, joint ventures or associates of the company also should prepare financial statements as per Ind AS.

Consider the above rule – all the subsidiaries also prepare Ind AS financial statements.

Concept capsule 4

Continuation to the above concept capsule 3

During the financial year 2014-15, Company A has sold off its entire investment in **Company X** on 31st December, 2014. Therefore, Company X is no longer a subsidiary of Company A for the purposes of preparation of financial statements as on 31st March, 2015. Should Company X prepare its financial statements as per the Companies (Accounting Standards) Rules, 2006 or the Companies (Indian Accounting Standards) Rules, 2015?

Suggested answer

Company A has sold off its entire investment in Company X on 31st December, 2014; Company X is no longer a subsidiary of Company A as at the beginning of 1st April, 2016. Therefore, in this case, Company X would continue to prepare financial statements for the accounting periods commencing from 1st April, 2016, as per the Companies (Accounting Standards) Rules, 2006 (NOT Ind AS).

Concept capsule 5

Continuation to the above concept capsule 3

During the financial year 2015-16, Company A has sold off its investment in **Company Y** on 31st December, 2015. Therefore, Company Y is no longer a subsidiary of Company A for the purposes of preparation of financial statements **as on 31st March, 2016**. Should Company Y prepare its financial statements as per the Companies (Accounting Standards) Rules, 2006 or the Companies (Indian Accounting Standards) Rules, 2015?

Suggested answer

Company A has sold its investment in subsidiary Company Y on 31st December, 2015, in consequence of which Company Y is no longer subsidiary of Company A as at the beginning of 1st April, 2016. Therefore, the Companies (Indian Accounting Standards) Rules, 2015 will not be applicable to Company Y. Therefore, Company Y would continue to prepare financial statements for accounting periods **commencing from April 1, 2016** under the Companies (Accounting Standards) Rules, 2006.

It falls on Phase 2 as its net worth crosses ₹ 250 crore, it needs to apply Ind AS rules from 1st April, 2017.

Concept capsule 6

Continuation to the above concept capsule 3

During the financial year 2016-17, Company A has sold off its investment in Company Z **on 31st December, 2016**, therefore company Z is no longer a subsidiary of Company A for the purposes of preparation of financial statements **as on 31st March, 2017**. Should Company Z prepare its financial statements as per the Companies (Accounting Standards) Rules, 2006 or the Companies (Indian Accounting Standards) Rules, 2015?

Suggested answer

In the given case, Company A has sold its investment in subsidiary Company Z on 31st December, 2016; therefore, Company Z was a subsidiary of Company A as **at the beginning of 1st April**, 2016. Company Z being subsidiary of Company A as at the beginning of 1st April, 2016, would have to prepare financial statements for the accounting periods commencing from 1st April, 2016 as per the Companies (**Indian Accounting Standards**) Rules, 2015.

I hope you understood from the above concept capsules,

if there is holding and subsidiary relationship existed on the beginning of financial year in which holding started following Ind AS, the subsidiary should continue with compliance of Ind AS even if the relationship ceases at the later point of time *(i.e., based on the point "**Once a company starts** following the Ind AS **either voluntarily or mandatorily**, it **shall be required to follow** the Ind AS for all the subsequent financial statements **even if any of the criteria specified in this rule does not subsequently apply to it**")*

Concept capsule 7

As per the roadmap, subsidiary companies of the companies covered under Ind AS roadmap also need to apply Ind AS from the same date. Does this requirement cover only direct subsidiaries or it will also cover indirect/step down subsidiaries?

Suggested answer

The definition of the term "Subsidiary", both under the Companies Act, 2013 and accounting standards, is clear that it covers direct as well as indirect/step down subsidiaries also. Hence roadmap covers all the subsidiaries.

Concept capsule 8 (Applicability of Ind AS to an Indian subsidiary of a foreign company)

Company X Ltd. and Company Y Ltd. registered in India having net worth of ₹ 600 crores and ₹ 100 crores respectively are subsidiaries of a Foreign company viz., ABC Inc., which has net worth of more than ₹ 500 crores in financial year 2015-16. Whether Company X Ltd. and Y Ltd. are required to comply with Ind AS from financial year 2016-17 on the basis of net worth of the parent Foreign Company or on the basis of their own net worth?

Suggested answer

As per the above discussed rules, Company X having net worth of ₹ 600 crores in the year 2015-16, would be required to prepare its financial statements for the accounting periods commencing from 1st April, 2016, as per the Companies (Indian ASs) Rules, 2015.

Company Y Ltd. having net worth of ₹ 100 crores in the year 2015-16, would be required to prepare its financial statements as per the Companies (ASs) Rules, 2006.

Since, the Foreign company ABC Inc., is not a company incorporated under the Companies Act, 2013 or the earlier Companies Act, 1956, it is not required to prepare its financial statements as per the Companies (Indian Accounting Standards) Rules, 2015. As the foreign company is not required to prepare financial statements based on Ind AS, the net worth of foreign company ABC would not be the basis for deciding whether Indian Subsidiary Company X Ltd. and Company Y Ltd. are required to prepare financial statements based on Ind AS.

Concept capsule 9

Company X Ltd. is being covered under Phase I of Ind AS and needs to apply Ind AS from financial year 2016-17. Company Y which is an associate company of Company X Ltd. is a charitable organisation and registered under section 8 of the Companies Act, 2013.

Whether Company Y is required to comply with Ind AS from financial year 2016-17?

Suggested answer

As per the rules discussed above, it may be noted that holding, subsidiary, joint venture, associate companies of companies falling under any of the thresholds specified in Rule 4(1)(ii) are required to comply with Ind AS from financial year 2016-17.

Further, it may be noted that the companies covered under Section 8 are required to comply with the provisions of the Companies Act, 2013, unless and until any exemption is provided.

Section 8 companies are not exempted from the requirements of section 133 and section 129 of the Companies Act, 2013.

In view of the above, in the given case, **Company Y will be required to apply Ind AS** from financial year 2016-17.

Concept capsule 10

If a company follows Ind AS voluntarily, does its holding, subsidiary, joint venture and associates also need to comply with Ind AS from the same date?

Suggested answer

If a parent company **voluntarily or mandatorily** adopts Ind AS then its holding, subsidiary, joint venture or associate company whether through direct or indirect association **shall comply with** Ind AS from the financial year in which the parent company starts complying with Ind AS.

Ind AS financial statements format is discussed in Division II to Schedule III of the Companies Act, 2013. The following is an **extract** of it. For detailed information one should refer the ICAI material.

Concept capsule 11

Can “Ind AS **override** the Law”?

Suggested answer

No. Ind AS cannot override the law **except Schedule III division II & Definitions of the Companies Act**.

Notified Ind ASs are intended to be in conformity with the provisions of applicable laws. However, if due to subsequent amendment in the law, if a particular Ind AS is not in conformity with such provisions of the law, law will prevail and financial statements will be prepared in conformity with such law.

Concept capsule 12

In view of the increasing inflow of foreign capital and the resultant complexities in financial instruments and transactions, critically examine the necessity for the introduction of Indian Accounting Standards (Ind AS) in place of the erstwhile Accounting Standards (AS).

Suggested answer

The increasing inflow of foreign capital and the resulting complexities in financial transactions necessitated the introduction of Indian Accounting Standards (Ind AS) to replace the earlier Accounting Standards (AS) due to the following reasons:

1. **Complex Financial Instruments:** AS lacks explicit guidance on accounting for complex capital-raising instruments such as optionally or compulsorily convertible shares and debentures, leading to inconsistent treatment across entities.
2. **Derivative Instruments and Embedded Features:** The proliferation of derivative instruments embedded in foreign currency bonds, equity instruments and commodity derivatives require comprehensive accounting principles which are inadequately addressed under AS.
3. **Group Restructuring and Business Combinations:** Activities such as mergers, acquisitions, demergers and slump sales are increasingly common but lack a uniform accounting framework, creating discrepancies in recognition and measurement.
4. **Emerging Business Models and Revenue Arrangements:** The rise of innovative digital economy business models introduce complex revenue recognition issues that are not explicitly covered in AS, leading to divergent practices.
5. **Stock-based Compensation:** Diverse and innovative remuneration models, especially for senior management and executives, demand detailed standards which AS do not comprehensively provide.
6. **Complex Tax Provisions:** The determination of current and deferred tax was complicated by changing tax laws and business structures, requiring enhanced guidance beyond the limited scope of AS.
7. **Shareholder Returns and Investments in Kind:** Varied modes of providing returns to shareholders and investments during group reorganizations lacked clear accounting principles under AS.
8. **Need for Enhanced Disclosures:** The limited disclosure requirements under AS in areas such as revenue, related party transactions, segment reporting and business combinations were insufficient for providing investors with a complete understanding of business risks and performance.
9. **Alignment with Global Standards:** To attract foreign investment and ensure comparability with international financial reporting, adoption of Ind AS aligned with IFRS became essential.

Ind AS was introduced to address the above complexities and to provide a comprehensive, consistent and transparent accounting framework that improves the quality of financial reporting and enables investors to make informed decisions.

Concept capsule 13

Discuss the key relevant provisions of the Companies Act, 2013 with reference to Ind AS and the matters to be included in the Report of the Board of Directors and the Report of the Statutory Auditors of the company in respect of the compliance of Indian Accounting Standards as notified by the Central Government under Section 133 of the Companies Act, 2013.

Suggested answer

Following are the some of the key relevant provisions of the Companies Act 2013, which gives reference to Ind AS:

1. Section 2(2) states that accounting standards means the standards of accounting or any addendum thereto for companies or class of companies referred to in Section 133.
2. Section 133 states the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority. Under the power given to the Central Government under section 133, it notified the Companies (Indian Accounting Standards) Rules, 2015.

3. Section 129 suggests the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III.
4. Section 134(5)(a), a statement that the applicable accounting standards had been followed with proper explanation relating to material departures shall be given in the Director Responsibility Statement to be issued under section 134(3)(c) in the Director's report to be published in Annual General Meeting.
5. Section 143, auditor has to opine whether the financial statements comply with the accounting standards.

CHAPTER

B CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING UNDER IND AS (CONCEPTUAL FRAMEWORK)

SYNOPSIS

Before starting this topic, we have few questions for you. Try to answer these then you will understand how important this topic is.

What is an asset or liability? Please define?

When can you recognise an asset or liability in the books of account?

What is equity and what is the difference between a liability and equity?

Don't think that these are small questions. Try sincerely and test your concepts. Without knowing these basics, you cannot understand Ind AS. Hence, read every word of the book carefully. We say again and again read till you really understand the concepts very clearly.

1. CONCEPTUAL FRAMEWORK DEALS WITH

- The objectives of financial statements;
- The **qualitative characteristics** of financial statements;
- **Definition, recognition and measurement of items in financial statements;** and
- Concepts of capital and capital maintenance.

2. GENERAL POINTS

Financial Statements should be **prepared and presented at least annually** and give common information required by users of financial statements which have consistency and uniformity across the industry.

Conceptual framework is applicable **only to general purpose financial statements (include consolidated financial statements)** and NOT for Special purpose financial reports, e.g. prospectus and computations prepared for taxation purposes. This Conceptual framework may be used if the special purpose report requirement permits.

Complete set of financial statements include the following statements:

1. Balance Sheet;
2. Statement of Profit and Loss;
3. Cash flow statement;
4. Statement of changes in equity;
5. Notes on Accounts & other explanatory material that are an integral part of financial statements.

It **DOESN'T** include the following: (Conceptual framework does not deal with information outside financial statements:

- ✪ Board of Director's report;
- ✪ Statements by chairman;
- ✪ Management analysis, etc.

What are Notes to accounts?

Notes to accounts include significant accounting policies and a detailed explanation & information of the items presented in the financial statements (BS, P&L and CFS). As it is not possible to give every information on the face of the financial statements, the management gives it by way of notes.

3. OBJECTIVE OF FS

Objective is to provide financial information of an entity which is useful to a wide range of users in making economic decisions ***like*** whether to hold or sell their investment in the entity, whether to reappoint or replace the management based on performance or whether to lend the money or collect the loan if the performance is not good.

4. ASSUMPTIONS IN PREPARATION OF FS

The following are assumptions which are taken by the USERS of financial statements when they use it:

1. Going concern
2. Consistency
3. Accrual Basis

We have a detailed discussion about these words in Ind AS-1 – *"Presentation of financial statements"*. If the financial statements are NOT prepared using above fundamental assumptions, Company should disclose the fact and the basis of preparation of financial statements.

5. QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

If financial information is to be useful, it must be **relevant and faithfully represent** what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

It should have the following qualitative characteristics:

(a) ***Relevance***: Given information in financials should be relevant to the decision making needs of the users. Financial information is capable to influence the decisions **if it has predictive value**, **confirmatory value** or both. The information should be useful to the users in making their own predictions. It is confirmatory value -if it provides feedback about (confirms or changes) previous evaluations;

(b) ***Materiality***: Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users (i.e., either to hold or sell the shares, etc). It is an entity specific and depends on nature, relative size or both.

(c) ***Faithful presentation***: To be useful, financial information must not only represent relevant, but it must also faithfully represent that it intends to represent. To be a perfectly faithful representation, as it should have three characteristics. It would be complete, neutral (without bias) and free from error *(free from error does not mean perfectly accurate in all respects)*. Of course, perfection is rarely possible, but not impossible. The Board's objective is to maximise those qualities to the extent possible.

6. ENHANCING QUALITATIVE CHARACTERISTICS (CA Final-Nov. 2024)

(a) ***Comparability***: This enables users to identify and understand similarities in, and differences among, items. A comparison requires at least two items. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal. If the presentation is consistent in it will be useful to compare the current year position or performance with the previous year or other entities in the industry.

(b) ***Verifiability***: Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.

(c) ***Timeliness***: It is one of the common objective 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 of with reliable inputs as required to be presented to ensure faithful representation.

(d) ***Understandability***: Classifying, characterising and presenting information clearly and concisely make it understandable.

The Elements of Financial statements:

This is very important discussion of the whole Ind ASs and the terms discussed in this topic are linked with all Accounting Standards. This requires your attention.

In this topic we understand what is asset, liability, equity, income and expenditure and when can you recognise these in the books of account.

Asset

An *asset* is **a present economic resource controlled by the entity as a result of past events.**

What is a RIGHT?

Conceptually, the economic resource is the set of rights, not the physical object. However, describing the set of rights as the physical object will often provide a faithful representation of those rights in the most concise and understandable way.

Rights may take many forms like

(a) Our right creates an obligation to another partly like debtors, loans and advances, investment in debentures, etc.,;

(b) Rights do not create an obligation to other party like owning PPE, Intangible assets, Inventory, investment in equity shares of another entity, etc.

Many rights are established by contract, legislation or similar means. For example, an entity might obtain rights from owning or leasing a physical object, from owning a debt instrument or an equity instrument, or from owning a registered patent.

Legal ownership of a physical object may give rise to several rights, including:

(a) the right to use the object;

(b) the right to sell rights over the object;

(c) the right to pledge rights over the object; and

(d) other rights.

All the rights of the entity are not assets. Only those, which have the potential to produce economic benefits beyond the economic benefits available to all other parties and it must be under the control of the entity.

For example - rights available **to all parties** without significant cost is not considered as asset like rights of access to public goods, such as public rights of way over land, or know-how that is in the public domain—are typically not assets for the entities that hold them.

An entity cannot have a right to obtain economic benefits from **itself**. Hence:

(a) debt instruments or equity instruments issued by the entity and repurchased and held by it—for example, **treasury shares**—are not economic resources of that entity; and

(b) if a reporting entity comprises more than one legal entity, debt instruments or equity instruments issued by one of those legal entities and held by another of those legal entities are not economic resources of the reporting entity.

Potential to produce economic benefits

- An economic resource is a right that has the potential to produce economic benefits. A right can meet the definition of an economic resource, and hence can be an asset, even if the probability that it will produce economic benefits is low. Nevertheless, that low probability might affect decisions about what information to provide about the asset and how to provide that information, including decisions about whether the asset is recognised and how it is measured.
- An economic resource could produce economic benefits for an entity by way of receipt of contractual cash flows or other resource, exchange of resources in favourable terms, producing the goods / services, leasing, selling the resource, etc. and this economic resource should be present on the balance sheet date.
- There is a close association between incurring expenditure and acquiring assets, but the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that the entity has sought future economic benefits, but does not provide conclusive proof that the entity has obtained an asset. Similarly, the absence of related expenditure does not preclude an item from meeting the definition of an asset. Assets can include, for example, rights that a government has granted to the entity free of charge or that another party has donated to the entity.

Control

- An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it. Control includes the present ability to prevent other parties from directing the use of the economic resource and from obtaining the economic benefits that may flow from it. It follows that, if one party controls an economic resource, no other party controls that resource.
- Control usually arises from an ability to enforce legal rights. At the same time, it arises from other means as well like Right of use of know-how that is not in the public domain if the entity has access to the know-how and the present ability to keep the know-how secret, even if that know-how is not protected by a registered patent.
- Sometimes one party (a principal) engages another party (an agent) to act on behalf of, and for the benefit of, the principal. For example, a principal may engage an agent to arrange sales of goods controlled by the principal. If an agent has custody of an economic resource controlled by the principal, that economic resource is not an asset of the agent. Furthermore, if the agent has an obligation to transfer to a third party an economic resource controlled by the principal, that obligation is not a liability of the agent, because the economic resource that would be transferred is the principal's economic resource, not the agent's.

Liability

A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

For a liability to exist, three criteria must all be satisfied:

(a) the entity has an **obligation**;

(b) the obligation is to transfer an economic resource; and

(c) the obligation is a present obligation that exists as a result of past events

Obligation

- Present means exist on the balance sheet date;
- An obligation is a duty or responsibility that an entity has no practical ability to avoid;
- It is not necessary to know the identity of the party (or parties) to whom the obligation is owed;
- One party has an obligation and recognising a liability that does not necessarily mean that other party has to recognise an asset. The other party needs to deal with it other specific Ind AS;
- Obligations are
  - o Contractual;
  - o Legal;
  - o Customary practices, published polices, public statements made (these are called as "constructive obligations");
- The factors used to assess whether an entity has the practical ability to avoid transferring an economic resource may depend on the nature of the entity's duty or responsibility. For example, in some cases, an entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself. However, neither an intention to make a transfer, nor a high likelihood of a transfer, is sufficient reason for concluding that the entity has no practical ability to avoid a transfer;
- In some cases, it is uncertain whether an obligation exists. For example, if another party is seeking compensation for an entity's alleged act of wrongdoing, it might be uncertain whether the act occurred, whether the entity committed it or how the law applies. Until that existence uncertainty is resolved— for example, by a court ruling— it is uncertain whether the entity has an obligation to the party seeking compensation and, consequently, whether a liability exists.

Transfer of economic resource

- The second criterion for a liability is that the obligation is to transfer an economic resource;
- To satisfy this criterion, the obligation must have the potential to require the entity to transfer an economic resource to another party (or parties). For that potential to exist, it does not need to be certain, or even likely, that the entity will be required to transfer an economic resource—the transfer may, for example, be required only if a specified uncertain future event occurs. It is only necessary that the obligation already exists and that, in at least one circumstance, it would require the entity to transfer an economic resource.
- An obligation can meet the definition of a liability even if the probability of a transfer of an economic resource is low.

Present obligation as a result of past events

- The third criterion for a liability is that the obligation is a present obligation that exists as a result of past events;
- A present obligation exists as a result of past events only if:
  - (a) the entity has already obtained economic benefits or taken an action; and
  - (b) as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer;
- The enactment of legislation is not in itself sufficient to give an entity a present obligation. Similarly, customary practices, published policies also create present obligation only when the entity has taken an action;
- A present obligation can exist even if a transfer of economic resources cannot be enforced until some point in the future.

Equity

Equity is the **residual** interest in the net assets after deducting the liabilities, i.e., who is ready to accept the remaining funds after clearing the liabilities. This is generally called as **owner's fund**.

Observe the definition carefully, it says equity is residual interest where **the entity has no obligation** to pay and it is the amount left with the entity. We can alternatively say, equity is which is not a liability;

INCOME

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

- Gains include realised gains and unrealised gains. Gains are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. *(Refer Ind-AS 1 for detailed discussion)*
- Various kinds of assets may be received or enhanced by income; *examples* include cash, receivables and goods and services received in exchange for goods and services supplied.
- Income may also result *from the settlement of liabilities*, i.e., when the entity settled the liability by giving less value assets.

Expense

Expenses are decrease in economic benefits during the accounting period in the form of outflow or depletion of assets or incurrence of liabilities that result in decrease in equity, other than those relating to distributions to equity participants.

- Losses include realised and unrealised losses. Losses are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. *(Refer Ind-AS 1);*
- This is nothing but **matching concept** i.e. ***If income is recorded in a particular year i.e., 2018, expenditure related to such income should be recorded in the same year i.e., 2018***.
- The expenditure does not always generate income to the entity. When there are no future economic benefits from an asset/expenditure, it will be accounted as expenditure in P&L.

Recognition process (CA Final-May 2024)

- Recognition means recording in the books of account;
- Only items that meet the definition of an asset, a liability or equity are recognised in the balance sheet. Similarly, only items that meet the definition of income or expenses are recognised in the statement of profit and loss. However, not all items that meet the definition of one of those elements are recognised.
- Do not recognise the asset, liability, equity, income and expense when it satisfies the definition partly;
- If the **probability of an inflow or outflow of economic benefits is low,** the most relevant information about the asset or liability may be information about the magnitude of the possible inflows or outflows, their possible timing and the factors affecting the probability of their occurrence. The typical location for such information is in the notes.
- Even if the probability of an inflow or outflow of economic benefits is low, recognition of the asset or liability may provide relevant information beyond the information described in paragraph 5.16. Whether that is the case may depend on a variety of factors.

For example:

(a) if an asset is acquired or a liability is incurred in an exchange transaction on market terms, its cost generally reflects the probability of an inflow or outflow of economic benefits. Thus, that cost may be relevant information, and is generally readily available. Furthermore, not recognising the asset or liability would result in the recognition of expenses or income at the time of the exchange, which might not be a faithful representation of the transaction.

(b) if an asset or liability arises from an event that is not an exchange transaction, recognition of the asset or liability typically results in recognition of income or expenses. If there is only a low probability that the asset or liability will result in an inflow or outflow of economic benefits, users of financial statements might not regard the recognition of the asset and income, or the liability and expenses, as providing relevant information.

Measurement uncertainty

- For an asset or liability to be recognised, it must be measured. In many cases, such measures must be estimated and are therefore subject to measurement uncertainty.

- The use of reasonable estimates is an essential part of the preparation of financial information and does not undermine the usefulness of the information if the estimates are clearly and accurately described and explained;
- Even a high level of measurement uncertainty does not necessarily prevent such an estimate from providing useful information;
- In some cases, the level of uncertainty involved in estimating a measure of an asset or liability may be so high that it may be questionable whether the estimate would provide a sufficiently faithful representation of that asset or liability and of any resulting income, expenses or changes in equity.
- The level of measurement uncertainty may be so high if, for example, the only way of estimating that measure of the asset or liability is by using cash-flow-based measurement techniques and, in addition, one or more of the following circumstances exists:
  - the range of possible outcomes is exceptionally wide and the probability of each outcome is exceptionally difficult to estimate;
  - the measure is exceptionally sensitive to small changes in estimates of the probability of different outcomes—for example, if the probability of future cash inflows or outflows occurring is exceptionally low, but the magnitude of those cash inflows or outflows will be exceptionally high if they occur;
  - measuring the asset or liability requires exceptionally difficult or exceptionally subjective allocations of cash flows that do not relate solely to the asset or liability being measured.
- In these cases, financial statements should be accompanied by a description of the estimate and an explanation of the uncertainties that affect it;
- In limited circumstances, exceptionally high level of uncertainty is involved and such estimations will be not useful / relevant to the users even if proper description is given. In such cases, do not recognise it;

Concept capsule 1

ABC Ltd. purchased a building on Jan 15th, 2010 from Mr. X and they entered into an agreement on the same date and ABC occupied the building on the same date. Subsequently on April 15th, 2010, the agreement is registered. ABC Ltd's balance sheet date is March 31st, 2010.

When should ABC Ltd. recognise the building? Is it on Jan 15th or April 15th? When should Mr. X recognise the sale transaction?

Suggested answer

Asset can be recognised when they get the control on the future economic benefits. ABC Ltd. got the control (entered into agreement & occupied the premises) on Jan 15th and they can restrict the access of the future economic benefits from that date. So, ABC Ltd. should recognise on Jan 15th and on the same date Mr. X should account for sale of building. Registration of the agreement is a formality to ensure safety, hence it is not considered (substance over form).

Concept capsule 2

ABC Ltd. ordered goods i.e., given a purchase order for some goods. Do they need to record any entry in the books of accounts? Do they have a present obligation or not?

Suggested answer

ABC Ltd. will have a present obligation only when they receive the goods and not when they order for it. Ordering is a FUTURE COMMITMENT and NOT a present obligation. Hence there is no need to record any entry in the books.

An obligation normally arises only when the asset is delivered, or the entity enters into an irrevocable agreement to acquire the asset.

Even if it is an irrecoverable agreement, ABC Ltd. need not to record any Journal entry. The reason being, it will be considered as executory contract, i.e., both the parties to the agreement did equal work or both did not do any work and one becomes liable only when it receives the goods.

Concept capsule 3

A Ltd. has entered into a binding agreement with P Ltd. to buy a custom-made machine costing ₹ 40,000. At the end of 2020-21, 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. Show the treatment of machine in the books of A Ltd.

Suggested answer

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 ₹ 40,000 to P Ltd.

When flow of economic benefit to the entity 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 entity is improbable. The entire amount of purchase price of the machine should be recognised as an expense except to the extent of scrap value realisable.

Concept capsule 4 ***(CA Final – May 2022)***

Discuss the following in the context of 'Conceptual Framework for Financial Reporting under Indian Accounting Standards':

(i) The cost constraint on useful financial information

(ii) Executory contracts.

Suggested answer

(i) **The cost constraint on useful financial information;**

Role of Cost: Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that these costs are justified by the benefits of reporting that information.

Basis of Assessment of Cost: Both the providers and users of financial information incur costs in reporting and analysing financial information. In applying the cost constraint, ICAI assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. When applying the cost constraint in formulating a proposed Ind AS, the ICAI seeks information from providers of financial information, users, auditors, academics and others about the expected nature and quantity of the benefits and costs of that Ind AS. In most situations, assessments are based on a combination of quantitative and qualitative information.

Cost Perspective: Due to the inherent subjectivity, assessments of different individuals about the costs and benefits of reporting particular items of financial information will vary. Therefore, ICAI seeks to consider costs and benefits in relation to financial reporting generally, and not just in relation to individual reporting entities.

(ii) **Executory Contracts:**

Definition: An executory contract is a contract, or a portion of a contract, that is equally unperformed — neither party has fulfilled any of its obligations, or both parties have partially fulfilled their obligations to an equal extent.

Outcome of Executory Contract: An executory contract establishes a combined right and obligation to exchange economic resources. The rights and obligations are inter-dependent and cannot be separated. Hence, the combined rights and obligations constitute a single asset or liability.

The entity has an asset if the terms of the exchange are currently favourable; it has a liability if the terms of the exchange are currently unfavourable.

Derecognition process (CA Final-May 2024)

Derecognition is the removal of items from the books of account either fully or partly;

Derecognition normally occurs when that item no longer meets the definition of an asset or of a liability:

(a) for an **asset**, derecognition normally occurs when the entity **loses control of all or part** of the recognised asset; and

(b) for a **liability**, derecognition normally occurs when the **entity no longer has a present obligation** for all or part of the recognised liability.

Accounting requirements for derecognition aim to faithfully represent both:

(a) any assets and liabilities retained after the transaction or other event that led to the derecognition (including any asset or liability acquired, incurred or created as part of the transaction or other event); and

(b) the change in the entity's assets and liabilities as a result of that transaction or other event.

In some cases, an entity might appear to transfer an asset or liability, but that asset or liability might nevertheless remain an asset or liability of the entity. For example:

(a) if an entity has apparently transferred an asset but retains exposure to significant positive or negative variations in the amount of economic benefits that may be produced by the asset, this sometimes indicates that the entity might continue to control that asset; or

(b) if an entity has transferred an asset to another party that holds the asset as an agent for the entity, the transferor still controls the asset.

Concept capsule 5 (Need to have knowledge of Ind AS-109) ***(ICAI Material)***

As on 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.

Suggested answer

Trade Receivables fall within the scope of 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.

An entity should de-recognise 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.

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.

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.

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**.

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.

Concept capsule 6 ***(ICAI Material)***

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

Suggested answer

Usage of Fair Value in Ind AS:

Treatment under Ind AS:

The statement of the directors w.r.t. fair value model is not entirely 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 like Ind AS-16 – PPE , Ind AS-38- Intangible assets and, etc.

Examples of use of fair value in Ind AS:

(a) Ind AS-16 PPE permits revaluation through OCI, 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. **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**.

Concept capsule 7 ***(ICAI Material)***

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.

Suggested answer

'Mixed measurement' approach implies that a company selects different measurement basis (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 basis 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 basis.

Jayant Ltd. prepares its financial statements under Ind AS, and therefore applies the measurement basis 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.

Capital Maintenance Adjustments

This topic discussion available in my Youtube channel – Ravi Kanth Miriyala

The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are **not included in the P&L** under certain concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves.

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.

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 Conceptual 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 Conceptual framework so that presentation requirements and principals remain consistent. However, the Conceptual 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 1

A trader commenced business on 01/01/2018 with ₹ 12,000 represented by 6,000 units of a certain product at ₹ 2 per unit. During the year 2018 he sold these units at ₹ 3 per unit and had withdrawn ₹ 6,000. Thus:

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

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

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

The trader can start year 2019 by purchasing 6,000 units at ₹ 2 per unit once again for selling them at ₹ 3 per unit. The whole process can repeat endlessly if there is no change in purchase price of the product.

Example 2

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

Opening equity at closing price = (₹ 12,000/100) × 120 = ₹ 14,400 (6,000 × ₹ 2.40)

Closing Equity at closing price

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

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

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

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

Example 3 (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 = (₹ 12,000 /100) × 125 = 6,000 × ₹ 2.50 = ₹ 15,000

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

Opening equity at closing current costs = ₹ 15,000

Closing equity at closing current costs = ₹ 12,000

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

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

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