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COM 1026

# Centre for Distance and Online Education

## M.Com. First Semester

(Under CBCS)

## MASTER OF COMMERCE

## Paper: COM 1026
## FINANCIAL REPORTING AND ANALYSIS

CONTENTS:

**SLM Development Team:**

Head, Department of Commerce, GU
Co-Ordinator, M.Com Programme, GUCDOE
Prof. S.K Mahapatra, Dept of Commerce, GU
Prof. Prashanta Sharma, Dept of Commerce, GU
Mr. Rajen Chetry, Assistant Professor, GUCDOE

## Course Coordination:

| | |
|---|---|
| **Dr. Debahari Talukdar** | Director, GUCDOE |
| **Programme Coordinator** | M.Com, GUCDOE<br>Professor, Dept. of Commerce, G.U. |
| **Mr. Rajen Chetry** | Assistant Professor, GUCDOE |

## Contributors:

| | |
|---|---|
| **Jyotisman Das**<br>JRF, Dept of Commerce, GU | Block I (Unit-1) |
| **Dr. Upasana Borpujari**<br>Assistant Professor, Dept of Commerce, GU | Block I (Unit-2 & 3) |
| **Dr. Suparna Ghose**<br>Assistant Professor, Dept of Commerce, GU | Block II |
| **Neha Khaitan**<br>Assistant Professor, Rabindranath Tagore University, Hojai | Block III (Unit-1 & 2) |
| **Prof. Sujit Sikider**<br>Retired Prof, Dept of Commerce, GU | Block III (Unit-3 & 4) |
| **Dr. Surabhi Borthakur**<br>Assistant Professor, B.Boraoh College | Block IV |
| **Prof. HC Gautam**<br>Retired Professor, Dept of Commerce, GU | Block V |
| **Dr. Partha Pratim Bora**<br>Asst Professor, B.H College | Block VI (Unit 1) |
| **Mr. Jugal Kumar Boro**<br>Asst Professor, B.H College | Block VI (Unit 2) |

## Content Editing:

| | |
|---|---|
| **Prof. Bhaskarjyoti Bora** | Professor, Deptt. of Commerce<br>Gauhati University |

## Cover Page Design & Type Setting:

| | |
|---|---|
| **Bhaskar Jyoti Goswami** | GUCDOE |
| **Nishanta Das** | GUCDOE |

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# BLOCK I: Unit-1
# Financial Reporting and Analysis

**Unit Structure:**



## 1.1 Introduction

Accounting is a financial information system. As a financial information system, accounting is the process of identifying, measuring, recording and communicating information to interested parties. An accounting system that converts inputs into outputs, Inputs are business transactions and external events. The output is financial statements prepared from a record of business transactions and events. Outputs include income statement, balance sheet. Statement of cash flows etc. these statements provide information for decision making. At the end of each financial year, every business is curious to know whether it has made a profit or a loss during the accounting period.

## 1.2 Objective

After going through this unit , you shall be able to

- ✓ Explain the concept of financial reporting.
- ✓ Describe the objectives of financial reporting.
- ✓ Explain the users of financial reporting information.
- ✓ Explain Benefits of financial reporting
- ✓ Describe Qualitative characteristics of financial reporting information

## 1.3 Concept of Financial Reporting

Financial reporting is the financial results of an organization that are disclosed to its stakeholders and the public. This reporting is a key function of the trustee, which may be assisted by an investor relations officer if the organization is publicly held. Financial reporting usually involves issuing financial statements that include a profit and loss statement, a balance sheet, and a cash flow statement. . There may also be accompanying footnotes that provide more detail on certain topics as prescribed by the relevant accounting framework. In addition, a business may list any financial information it chooses to disclose about itself on its website. It may also issue annual reports to its shareholders. Finally, it may issue a prospectus regarding the organization's securities issuance to potential investors. Next, the key components of financial reports are described.

**Profit and loss statement :**An income statement is a summary of a business's sales, costs, and profits over a certain period of time. The sales figure in this report is called the "top line," while the reported profit or loss at the bottom of the report is called the "bottom line." This report is the most watched of the various reports as it shows the financial performance of the entity.

**Balance sheet :**The balance sheet presents an aggregated view of the assets, liabilities and equity of a business as of a certain date. This date is almost always the last day of the period used for the accompanying income statement. It can be used to examine the liquidity of a business and its ability to pay its debts by comparing various line items of assets and liabilities.

**Statement of cash flows :**The statement of cash flows presents a summary view of the cash flows of the enterprise, which are connected with its operation, financing and investment activities. This is a useful report for examining how cash is used in business. It can provide a better overview of the viability of the business than the income statement.

**Statement of retained earnings :**The smallest of the reports is the retained earnings statement. It shows any changes in the company's retained earnings during the reporting period. It is often excluded from the financial statements package.

### 1.4 Objectives of Financial reporting and analysis

According to the International Accounting Standards Board (IASB), the purpose of financial reporting is "to provide information about the financial position, performance and changes in the financial position of the entity that is useful to a wide range of users in making economic decisions".

The following points are a summary of the goals and objectives of financial reporting.

1. Providing information to the organization's management for use in planning, analysis, benchmarking and decision-making purposes.

2. Provide information so that investors, promoters, lenders and creditors can make rational and wise decisions about investment, credit, etc.

3. In the case of public companies, providing information to shareholders and the public about various aspects of the organization.

4. Provide information about the economic resources of the organization, the claims on those resources (debt and equity), and how these resources and claims change over time.

5. Providing information about how the organization prepares and uses different resources.

6. Providing information to various stakeholders in the performance management of the organization regarding how diligently and ethically it performs its fiduciary duties and responsibilities.
7. Facilitating audits by providing information to corporate auditors.
8. Strengthening social welfare by considering the interests of employees, trade unions and the government.

**<u>Check your progress</u>**

1. What is cash flow statement?
2. What are the various activities classified while preparing the cash flow statement?
3. What is statement of retained earning?

**1.5 Users of Financial Information**

As mentioned above, the company's financial reporting is intended to provide external user information that is useful for business and economic decisions, i.e. for reasonable choices between alternative uses of scarce resources in behavior business and economic activities. So users are potentially interested in information provided by financial reporting. Users in financial reporting can be classified based on their respective information needs.

1. Those who consider direct economic interests:

(a) Potential users including owners, creditors, employees are the most direct relating to a particular business enterprise and its ability to create favorable cash flows because their decisions concern the amount, timing, and uncertainty of expected cash flows. These users receive cash in kind interest, dividends, market price appreciation, loan repayment, payment of goods and services or salaries or wages.

(b) Customers have a direct interest in the business in terms of goods and services. They usually oversee the ability the company to use resources and ensure a continuous flow of goods and services.

© Managers and directors who are charged with the management of the business they also have a direct interest in the interests of the owners. They use financial providing information in their decisions and managerial decisions liability, including their liability to directors and owners.

2. Persons who intend to gain indirect economic benefits: Users as financial analysts and consultants and unions have indirect interests because they advise, protect or represent a large part of the bearers of direct interests. Financial analysts analyze reports and propose recommendations to their clients. Protects unions interest of the working class and negotiation with management for monetary and non-monetary benefits based on the company's financial performance.

3. Users with specialized needs: Regulatory agencies like the SEBI maintain a a hawkish eye on financial reporting to protect investors' interests and for prudent use from public money. Legislators and tax authorities often use this information in finance statement for their lawful purposes. They also have the power to search for more information for their viewing.

**1.6 Benefit of Financial Reporting**

Financial reporting has the following advantages:

1. **It helps in decision making:** True and fair financial reporting provides strong the basis for various decisions at the macro and micro level.

   **(a) Macro level decision making**

Two important economic decisions that affect the allocation of resources a that external users typically make are (a) investment in securities (b) credit decisions. Sound economic decisions require assessing the impact of current business activities and the development of the company's earning power. Both economic decisions require detailed information to determine benefits (to be received) instead of sacrifices . Information about the economic resources and liabilities of the enterprise is also needed to form a judgment about the business's ability to survive, adapt, grow and thrive in changing economic conditions.

**(b) Decision making at the micro level** :Financial reporting serves as a guide for various users including owners, potential investors, managers, consultants, suppliers, lenders, etc. to fulfill their direct or indirect targets. Regulators also amend or change laws based on information provided through the reporting mechanism

2. **Favorable impact on the company's cost of capital :**

Adequate disclosure in annual reports increases the trust and image of the company. It increases the market price of the company's share in the investment market in the long term. Higher company share prices resulting from full disclosure lead to a favorable impact on the company's cost of capital. It also increases the future marketability of the company's subsequent share issue. Choi4 claims that if Analysts are then well informed about individual companies in the long term the share price will be relatively higher. Higher security prices would mean that a the primary issue of securities could be valued higher and that the net proceeds from it would be higher. The company would thus record more income from the given issue and hence lower cost of capital.

3 **Increasing the efficiency of the stock market :** Financial reporting helps in bringing transparency to stock markets and leaves a positive impact on improving market efficiency. Such a voluntary release information by corporate houses reduces information asymmetry and stock prices accurately reflect the value of the company.

4. **Reduction of stock price fluctuations :** Adequate disclosure will tend to minimize fluctuations in the shareholding of companies prices. Fluctuations in stock prices occur due to ignorance prevailing in the investment market .Fluctuations show an element of uncertainty in investment decision. If the stock market has complete information, ignorance and uncertainty will be reduced and stock prices will tend to maintain equilibrium. In addition, greater disclosure would prevent fraud and manipulation minimize the likelihood of their occurrence

● More complete information reduces uncertainty

● Less uncertainty reduces risk for investors and lenders

● Risk reduction makes investors and lenders happy with a lower rate return.

● A lower rate of return for investors and lenders means a lower cost of capital and produces higher stock prices.

5. **It affects the perception of employees :** Hiring decisions can be based on a company's perception of the economy status obtained through financial statements. Especially

prospective and contemporary employees can use financial reports to assess risk and growth potential company and therefore job security and future promotion opportunities. Work unions and individual employees can use financial statement data as a basis creating contractual requirements for wages and employee benefits. If this happens, data which incorrectly reflect the economic position and prospects of the enterprise deceive employees into making or justifying unrealistic demands.

In addition, unionized companies show a large increase in profits they are likely to face successfully negotiated demands for large wage increases. Therefore, when it comes to employee decision-making, accounting techniques that result in greater fluctuations in reported earnings appear costly to shareholders, a sharp increase in profits are likely to create a demand for a large increase in wages. Management also wants to avoid charges for manipulating net profit figures. Thus, an apparently objectively determined series that does not tend to change sharply is always desirable. Accounting based on historical costs meets these requirements.

6. **Improves public image :** The data presented in the financial statements can influence the customers and therefore have economic consequences. Customers, like employees, can use financial statement data to predict the probability and/or timing of business performance bankruptcy or inability to meet obligations. This information can be important when estimating warranty value or predicting availability after-sales support services or continued supply of goods over a longer period of time time. Financial institutions may also use financial statements to assess their financial statements current and future solvency, and thus the probability that they will be able to repay funds or fulfill promises as agreed.

7. **Manager's decision :** Accounting information disclosed in financial reports may have economic implications by its influence on the behavior of managers of corporate enterprises. The the inclusion of accounting figures in managing compensation systems or fear the market's misinterpretation of accounting reports can affect a manager's performance and funding decisions. Shareholders prefer accounting practices that mirror economic events as close as possible. However, shareholders must also be concerned that managers can manipulate reported data to increase their compensation. Therefore, shareholders also want numbers that are reliable. To summarize, information contributes significantly to better decision making, promoting understanding and creating a collaborative environment. Financial reporting creates trust and has a positive effect on company costs Capital. In the long run, financial reporting can only retain its credibility if it does what it is designed for - to provide the company with relevant and reliable information about economic events and transactions – and does not attempt to move the economy in one direction rather than the other.

## 1.7: Qualitative Characteristics of Financial Reporting Information

Qualitative characteristics of financial information can be categorized as basic (relevance and fair presentation) or enhancing (comparability, verifiability, timeliness and comprehensibility) according to how they affect the usefulness of financial information.

Basic qualitative characteristics of financial information

1. **Relevance :** Relevant financial reporting information means the ability of users (shareholders) to change their decision. Information about an economic phenomenon will help users make decisions if it contains predictive value and confirmatory value.

a) **Predictive value:** Information has predictive value if it can be useful to shareholders in predicting certain things that relate to the future. Information that is highly predictable does not necessarily have predictive value. For example, depreciation of property and equipment using the straight-line method may be highly predictable each year, but cannot help in evaluating net cash flows.

b) **Confirmatory value:** Information has confirmatory value if it confirms the validity of a previous expectation or corrects it according to previous evaluations. Results will be the same as expected in the past if the information has confirmed past expectations, while the outcome can be changed if there is a correction in past expectations.

2. **Faithful representation :** Useful financial information must not only be relevant, but also accurate. The financial reporting information contained characteristics that were complete, neutral and free of significant errors, intended to faithfully represent the economic phenomenon. One description in financial reports can correspond to several economic phenomena. For example, the buildings and equipment listed on the balance sheet may represent all the buildings and equipment owned by the entity.

a) Complete: Complete financial reporting information must contain all necessary information useful for decision-making and should not lack material facts or considerations that could cause misleading financial reporting information.

b) Neutrality: Neutrality in financial reporting information must not be biased because the information provided does not favor a particular group over another interested person. To be neutral, information must be presented in a faithful and trustworthy state without changing anything that needs to be communicated to induce someone's behavior.

c) Error-free: A set of financial reporting information is considered true if it is error-free. However, due to certain limitations and uncertainties in economic phenomena, financial reporting information does not provide an absolute value that is completely free of errors. Therefore, management uses various types of judgments and estimates based on appropriate inputs in evaluating financial reporting.

Relevance is a basic qualitative characteristic of financial information that is related to economic phenomena and must be considered first before other qualitative characteristics. Once relevance is used to distinguish which economic phenomena should be presented, faithful representation determines which characteristics best match the relevant phenomena. Therefore, relevance and fidelity must work in harmony to provide users with useful financial information.

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**Check your progress**

4. Who are the users of financial reports?
5. What are the objectives of financial reports?
6. What are the various components of financial reporting ?
7. How customers get benefited by financial reports of an organization?
8. How financial reporting improves public image?

**1.8 Significance of analysis of financial statement**

Financial analysis is the process of determining a company's financial strengths and weaknesses by establishing relationships between various elements of the balance sheet and income statement. Financial analysis can be done by the company's management or by parties outside the company, such as owners, trade creditors, creditors, investors, trade unions, analysts, and others. The nature of the analysis varies based on the analyst's goals. Methods that are often used by analysts may not serve the goals of other analysts because of differences in analyst interests. Financial analysis is useful and relevant to several users in the following ways:

(a) **Financial managers:** Financial analysis focuses on facts and relationships related to management, company efficiency, financial strengths and weaknesses, and credit worthiness of the company. Financial managers should be equipped with various analytical tools to make rational decisions for the company. Analytical tools help analyze accounting data to examine the sustainability of operating policies, the value of business investments, credit ratings, and operational efficiency. This method is equally important in financial control, they allow financial managers to continue to review the actual financial operations of the company, analyze the causes of major deviations, which can help to take corrective measures where indicated.

(b) **Top management:** The importance of financial analysis is not limited to financial managers. There is a broad scope that generally includes senior management and other functional managers. Company management will be interested in every aspect of financial analysis. It is everyone's responsibility to see that the company's resources are used more efficiently and that the company's finances are sound. Financial analysis helps managers measure the success of company operations, evaluate individual performance, and evaluate internal control systems.

(c**) Trade debt:** Trade debt assesses not only the short-term ability of a company to meet its short-term obligations, but also the long-term ability to meet all future financial obligations through the analysis of financial statements. Trade debt is concerned with the company's ability to meet its short-term requirements. Therefore, their analysis will assess the liquidity of the company.

(d) **Lenders**: Long-term debt providers are concerned with the long-term solvency and viability of the company. They analyze the profitability of the firm in a period of time, its ability to generate cash, pay interest and principal repayment, and the relationship between various sources of funds (capital structure relationship). Long-term lenders analyze historical financial statements to assess solvency and future profitability.

(e) **Investors:** Investors who put their money in the shares of the company focus on the profits of the company. As such, they analyze the company's current and future profitability. It also takes into account the company's capital structure to determine its impact on the company's profitability and risk. They also evaluate the effectiveness of management and determine whether changes are needed. However, in some large companies, the interests of shareholders are limited to buying, selling, or holding shares.

(f) **Trade Unions:** Trade unions analyze financial statements to determine whether they can now raise wages or obtain wage increases through increased productivity or price increases.

(g) **Others:** Economists, researchers, etc. they analyze financial reports to study current business and economic conditions. Government agencies need it for valuation regulations, taxation and similar purposes

**1.9 Objectives of financial statement analysis**

Analysis of the financial statements reveals important facts regarding the managerial performance and efficiency of the firm. Broadly speaking, the goal of analysis is to capture the information contained in financial statements in order to know the weaknesses and strengths of the firm and thus create a forecast of the firm's future prospects, which will enable analysts to make decisions regarding operations and further investment in the firm. To be more specific, the analysis is carried out for the following purposes (objectives)

• to assess the current profitability and operational efficiency of the firm as a whole as well as its various departments in order to assess the firm's financial health.

• find out the relative importance of different components of the company's financial position.

• identify the reasons for the change in profitability/financial position of the company.

• assess the company's ability to repay its debt and assess the company's short-term and long-term liquidity position. Through the analysis of the financial statements of various companies, the economist can assess the extent of the concentration of economic power and the pitfalls in the monitored financial policies. The analysis also provides the basis for many government measures relating to licensing, controls, price fixing, profit caps, dividend freezes, tax subsidies and other reliefs for the corporate sector.

**1.10 Tools for analysis of financial statement**

The most commonly used financial analysis techniques are the following:

1. **Comparative Statements:** These are statements that show profitability and financial position of the company in different time periods a comparative form that gives an idea of the position of two or more periods. It usually covers two important financial statements viz balance sheet and profit and loss statement processed in comparative form. Financial data will only be comparable with the same accounting principles are used in the preparation of these statements. If this is not the case, deviation in the application of accounting principles should be mentioned as footnote. Comparative figures show the trend and direction of finances position and operating results. This analysis is also known as "horizontal". analysis'.

2. **Common Statement Size:** These are the statements that indicate the relationship of different financial statement items with a common item by expressing each item as a

percentage of that common item. The the percentage thus calculated can easily be compared with the results the corresponding percentage of the previous year or some other companies, as the numbers are put into a common base. Such statements also allow analyst to compare the operating and financial characteristics of the two companies of different sizes in the same industry. So regular size statements are useful for intercompany comparisons across years and also in an intercompany comparison for the same year or for several years flight. This analysis is also known as "vertical analysis".

3. **Trend Analysis:** It is a technique of studying operational results and financial situation over a number of years. Using data from previous years a business enterprise, trend analysis can be done to observe the percentage changes over time in the selected data. The trend percentage is percentage relationship in which each item from different years bears k the same item in the base year. Trend analysis is important because s in the long run, it can point to fundamental changes in the nature of business. By looking at the trend in a particular ratio, one can determine whether the ratio decreases, increases or remains relatively constant. From this observation a a problem is detected or a sign of good or bad management is detected.

4. **Ratio Analysis:** Describes the significant relationship that exists between different balance sheet and income statement items and loss of business. As a technique of financial analysis, it measures accounting indicators comparative importance of individual items of income a position statement. It is possible to assess profitability, solvency and efficiency of the enterprise using the technique of ratio analysis.

5. **Cash Flow Analysis:** It refers to the analysis of actual cash flow in and out of the organization. The flow of cash into a business is called such as cash flow or positive cash flow and cash flow from the firm called cash outflow or negative cash flow. Difference between cash inflow and outflow is net cash flow. The statement of cash flows is prepared to project the manner in which the cash was received and was used during the accounting year because it shows resources monetary income as well as the purposes for which payments are made. Thus, summarizes the causes of changes in the company's financial position of the company between the dates of the two balance sheets.

### 1.13 Model questions

1. State the importance of Financial Analysis?
2. What are Comparative Financial Statements?
3. What do you mean by Common Size Statements?
4. Describe the different techniques of financial analysis and explain the limitations of financial analysis.
5. Explain the usefulness of trend percentages in interpretation of financial performance of a company.
6. State whether each of the following is true or false:

   (a) The financial statements of a business enterprise include a cash flow statement.

   b) Comparative statements are a form of horizontal analysis.

   (c) Common size statements and financial ratios are two tools used in vertical analysis.

(d) Ratio analysis establishes the relationship between two financial statements.

(e) Ratio analysis is a tool for analyzing the financial statements of any business.

f) Financial analysis is used only by creditors.

(g) The income statement shows the operating performance of an company for a certain period of time.

(h) Financial analysis helps the analyst arrive at a decision.

(i) Statement of cash flows is a financial statement analysis tool.

(j) In the joint size statement, each item is expressed as a percentage of some common base.

### 1.12 References and suggested readings


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### 1.14 Answer to Check Your Progress Answers

1. A statement of cash flows is a financial statement that provides summary information regarding all of the cash flows that a company receives from its ongoing operations and external investment sources. It also includes all the cash flows that pay for business activities and investments during the period.
2. A)Operating Activities
   B)investing activies
   c) Financing activies
3. A statement of retained earnings, sometimes called a statement of changes in equity, shows the sum of the profits a company has accumulated and retained in business since it began operation
4. Management of the Company, Investors., Customers, Competitors, Government and Government Agencies, Employees, Investment Analysts, Lenders
5. Objectives of financial reports:

a) It Provide Information to the Investors and the Potential Investors
b) Track the Cash Flow in the Business organisation
c) Information About the Accounting policies being Used in the accounts
d) Enable the Analysis of the Assets, the Liabilities, and the owner's equity
e) Provide Information to the Investors and the Potential Investors
f) Track the Cash Flow in the Business

6. Various components of financial reports

a) Balance sheet
b) Income statement
c) Cash flow statement
d) Equity statement

7. Customers have a direct interest in the business in terms of goods and services. They usually oversee the ability the company to use resources and ensure a continuous flow of goods and services.
8. The data presented in the financial statements can affect customers and therefore have economic consequences. Customers, like employees, may use financial statement data to predict the likelihood and/or timing of default or default. This information can be important in estimating the value of a warranty or predicting the availability of after-sales support services or continued supply of goods over an extended period of time. Financial institutions can also use financial statements to assess the current and future solvency of their financial statements, and therefore the likelihood that they will be able to repay funds or fulfill promises as agreed.

# BLOCK I : Unit-2

# INTERNATIONAL ACCOUNTING STANDARD COMMITTEE FOUNDATION AND INTERNATIONAL FINANCIAL REPORTING INTERPRETATION COMMITTEE

**Unit Structure:**



## 2.1 Introduction

To bring an uniformity and standardization in various accounting practices all over the world.The IASC was formed in 1973 through an agreement made by professional accountancy bodies from Australia, Canada, France, Germany, Ireland, Japan, Mexico, the Netherlands, the UK and the USA. In November 1999, the IASC board itself approved the constitutional changes necessary for its own restructuring. In May 2000, the IASC was restructured in order to strengthen its working. Consequently the International Accounting Standard Committee has been converted to the International Accounting Standard Committee Foundation (IASCF). The International Accounting Standards Committee Foundation (IASCF) is the private sector independent body responsible for the development and promulgation of a single set of high quality international accounting standards. In January 2010, the IASC Foundation was again renamed as IFRS Foundation. The change of name formally took effect on 1 July 2010. The IFRS Foundation is the legal entity under which the IASB operates. The IASB( International Accounting Standard Board) is the most important organ of the IASC Foundation .TheIFRS Interpretations Committee (Interpretations Committee) is the interpretative body of the International Accounting Standards Board (IASB). The Interpretations Committee works with the IASB in supporting the consistent application of IFRS Accounting

Standards. This Interpretations Committee responds to questions about the application of the Accounting Standards and does other work at the request of the IASB. The members of the IFRIC provide the best available technical expertise and diversity of international business and market experience relating to the application of IFRS Accounting Standards

**2.2: Objectives**

After going through this unit, you will be able to:

- Understand the objectives of IASC Foundation.
- Understand theresponsibilities and functions of IASCFoundation.
- Know about International Accounting Standard Board (IASB)
- Discuss the purpose of IFRIC

**2.3 International Accounting Standards Committee Foundation (IASCF)**

The International Accounting Standard Committee Foundation is an independent body not controlled by any particular government or professional organization. Its main purpose is to oversee the IASB (International Accounting Standard Board) which is an important organ for international financial reporting, in setting the accounting principles which are used by business and other organization around the world concerned with financial reporting.

To bring uniformity and standardization in various accounting practices all over the world the IASC was formed in 1973 through an agreement made by professional accountancy bodies from Australia, Canada, France, Germany, Ireland, Japan, Mexico, the Netherlands, the UK and the USA.

In November 1999, the IASC board itself approved the constitutional changes necessary for its own restructuring. In May 2000, the IASC was restructured in order to strengthen its working. Consequently the International Accounting Standard Committee has been converted to the International Accounting Standard Committee Foundation (IASCF).

The International Accounting Standards Committee Foundation (IASCF) is theprivate sector independent body responsible for the development and promulgation of a single set of high quality international accounting standards. The governance of the foundation rests with 22 Trustees, who comprise leaders from the international business and policymaking communities around the world. The Trustees oversee the Foundation and the International Accounting Standards Board (IASB).

In December 1999, the IASC Board has appointed a Nominating Committee to select the first Trustees of International Accounting Standard Committee Foundation(IASCF).The Nominating Committee nominated 19 Trustees on 22nd of May 2000 who took office on 24th May 2000 as a result of the approval of the constituted. In execution of their duties under the constitution, the trustee formed the International Accounting Standard Committee on 6th February 2001.It has three main organs

i) Standard Advisory Council,
ii) The International Accounting Standard Board; and
iii) International Financial Reporting Interpretation Committee.

IASC Foundation is constituted of two parts: Part A and Part B. Part A deals with the organization's name and objectives, membership and appointment of trustees. Part B sets out the provisions that came into effect when the trustees formed the International Accounting Standard Committee Foundation on 6th February 2001, following a Trustees Resolution.

In January 2010, the IASC Foundation was again renamed as IFRS Foundation. The change of name formally took effect on 1 July 2010. The IFRS Foundation is the legal entity under which the IASB operates.

**2.4 Objectives of IASC Foundation**

The constitution of IASC Foundation has laid down the following objectives:

(a) To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standard that require high quality, transparent and comparable information in financial statement and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
(b) To promote the use and rigorous application of those standards; and
(c) To bring about convergence of national accounting standards and international accounting standards and international reporting standards to high quality solution.

**2.5 Responsibilities and Functions of the International Accounting Standard Committee Foundation (IASCF)**

i) The trust assumes responsibility for established and maintaining appropriate financing arrangements
ii) Establish or amend operating procedures for the trustees

iii) Determine the legal entity under which the IASCFoundation shall operate, provided that such legal entity shall be foundation or other body corporate conferring limited liability on its members and that the legal document establishing such legal entity shall incorporate provisions to achieve the same requirements as the provisions contained in IASC Foundation Constitution

iv) Review in due course the location of the IASC Foundation, both as regards its legal base and its cooperating location

v) Investigate the possibility of seeking charitable or similar status for the IASCfoundation in those countries where such status would assist fund raising;

vi) Open their meeting to the public but may at their discretion, hold certain discussions(normally only about selection , appointment and other personnel issues and funding) in private and

vii) Publish an annual report on the IASC foundation activities, including audited financial statements and priorities for the coming year.

**2.6 International Accounting Standard Board (IASB)**

The IASB (International Accounting Standard Board) is the most important organ of the IASC Foundation. It comprises of a fourteen-member team appointed by the trustees of the IASC Foundation. The IASB is completely responsible for all technical matters including the preparation and issuing of International Accounting Standard. International Financial Reporting Standard, and exposure draft. The publication of an exposure draft, International Accounting Standard, International Financial Reporting Standard, or final interpretation of the interpretation financial reporting. Interpretation committee shall require the approval by eight of the fourteen members of the IASB.

**2.7 International Financial Reporting Interpretation Committee (IFRIC)**

The international financial reporting interpretation committee, is comprised of fourteen voting members, appointed by the trustees for renewable terms of three years. The trustees select members of the interpretation committee so that it comprises a group of people representing within that group, the best available combination of technical expertise and diversity of international business and market experience in the practical application of IFRSs and analysis of financial statements prepared in accordance with IFRSs.

The trustees shall appoint the chairperson of the interpretation committee. The chair has the right to speak to the technical issues being considered but to vote. The trustees as they deem necessary, shall appoint as non-voting observers representatives of regulatory organization, who shall have the right to attend have the right t attend and speak at meetings

### 2.8 Purpose of the Committee

The interpretations committee shall meet as and when required for the following purposes

a) Interpret the application of IFRSs and provide timely guidance on financial reporting issues not specifically addressed in IFRSs, in the context of the IASB,S framework, and undertake other tasks at the request of the IASB,
b) In carrying out its work under (a) above, have regard to the IASB’s objective of working actively with national standard-setters to bringabout convergence of national accounting standards and IFRSs to high quality solutions;
c) Publish after clearance by the IASB draft interpretation for public comment and consider comments made within a reasonable period before finalizing an interpretation; and
d) Report to the IASB and obtain the approval of nine of its members for final interpretation if there are fewer than sixteen members, or by ten of its members if there are sixteen members.

**Check Your Progress**

1. Explain the functions of InternationalAccounting Standard Committee Foundation (IASCF).
2. Identify the objectives of International Financial Reporting Interpretation Committee (IFRIC).

### 2.9 Summing up

- The International Accounting Standards Committee Foundation (IASCF) is the private sector independent body responsible for the development and promulgation of a single set of high quality international accounting standards.
- To bring an uniformity and standardization in various accounting practices all over the world the IASC was formed in 1973 through an agreement made by professional accountancy bodies from Australia, Canada, France, Germany, Ireland, Japan, Mexico, the Netherlands, the UK and the USA.

- International Financial Reporting Interpretation Committee (IFRIC)Interprets the application of IFRSs and provide timely guidance on financial reporting issues not specifically addressed in IFRSs, in the context of the IASB's framework, and undertake other tasks at the request of the IASB

## 2.10 Key Terms

- **IASCF:** International Accounting Standard Committee Foundation is an important organisation associated with setting International accounting standard.
- **IFRIC:** Interational Financial Reporting Interpretation Committee is a fourteen member committee which interpret the application of IFRSs and provide timely guidance on financial reporting issues not specifically addressed in IFRSs, in the context of the IASB,S framework, and undertake other tasks at the request of the IASB,
- **IASB:** International Accounting Standard Board is the most important organisation associated with the development of International Financial Reporting Standards in association with IASCF.

## 2.11 References and suggested readings

1. Banerjee, Abhijit. Indian Accounting Stanadard. Taxman Publication New Delhi.
2. Ghosh. T.P. 2007. Accounting Standards And Corporate Accounting Practices. 8thEdition.Volume 1. Taxman Allied Services(P.) Ltd.New Delhi
3. Ghosh. T.P. 2010.Understanding IFRSs. Taxman Allied Services(P.) Ltd.New Delhi
4. Wild, John.J. 2006.Financial Statement Analysis 9E. Tata McGraw- Hill Education
5. Lal, Jawahar.2003. Accounting Theory- An Introduction. Himalaya Publishing House. Mumbai.
6. www.iasplus.com/en/resources/ifrsf/history/resources
7. https://www.ifrs.org/groups/ifrs-interpretations-committee

## 2.12 Model questions

***Long Answer Question***:

1. Elaborate the process of issuing IFRSs.
2. Explain the functions and responsibilities of IASCF.

3. What is meant by IFRIC? Also explain the objectives of IFRIC

***Short- Answer Question***:

1. State the function of IASCF.
2. Elucidate the responsibilities of IASCF
3. What is meant by IFRIC?

**2.13 Answer to Check Your Progress**

**Q1. Explain the functions of International Accounting Standard Committee Foundation (IASCF).**

Answer: The following are the functions of International Accounting Standard Committee Foundation (IASCF):

i) The trust assumes responsibility for established and maintaining appropriate financing arrangements
ii) Establish or amend operating procedures for the trustees
iii) Determine the legal entity under which the IASCFoundation shall operate, provided that such legal entity shall be foundation or other body corporate conferring limited liability on its members and that the legal document establishing such legal entity shall incorporate provisions to achieve the same requirements as the provisions contained in IASC Foundation Constitution
iv) Review in due course the location of the IASC Foundation, both as regards its legal base and its cooperating location
v) Investigate the possibility of seeking charitable or similar status for the IASCfoundation in those countries where such status would assist fund raising;
vi) Open their meeting to the public but may at their discretion, hold certain discussions(normally only about selection , appointment and other personnel issues and funding) in private and
vii) Publish an annual report on the IASC foundation activities, including audited financial statements and priorities for the coming year.

**Q2. Identify the objectives of International Financial Reporting Interpretation Committee (IFRIC).**

Answer: The objectives of theInternational Financial ReportingInterpretations Committee are given below:

a) To interpret the application of IFRSs and provide timely guidance on financial reporting issues not specifically addressed in IFRSs, in the context of the IASB,S framework, and undertake other tasks at the request of the IASB,
b) To carry out its work under (a) above, have regard to the IASB's objective of working actively with national standard-setters to bringabout convergence of national accounting standards and IFRSs to high quality solutions;
c) To publish after clearance by the IASB draft interpretation for public comment and consider comments made within a reasonable period before finalizing an interpretation; and
d) To report to the IASB and obtain the approval of nine of its members for final interpretation if there are fewer than sixteen members, or by ten of its members if there are sixteen members.

## BLOCK I : Unit 3

## INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

**Unit Structure:**



### 3.1: Introduction:

International Financial Reporting Standard is a single set of accounting standard, developed and maintained by the International Accounting Standard Board to bring uniformity in the financial statements prepared across the globe. Accounting Standard presents prepares of financial statements with a set of rules to abide by when preparing an entity's accounts ensuring this standardization across the markets

**3.2: Objectives**: After going through this unit, you will be able to:

- Understand the concept IFRS.
- Determine the scope and objectives of IFRS
- Discuss the process of issuing IFRS

### 3.3: Scope and Objectives of IFRS.

International Financial Reporting Standard is a single set of accounting standard, developed and maintained by the International Accounting Standard Board to bring uniformity in the financial statements prepared across the globe. Accounting Standard presents prepares of financial statements with a set of rules to abide by when preparing an entity's accounts ensuring this standardization across the markets.

The basic intention or scope of financial reporting standard is todevelop a single set of accounting standards, which are capable of being applied on a globally consistent basis by developed, emerging and developing economies thus providing investors and other users of financial statements with the ability to compare the financial performance of companies with their international peers.

The IFRS Standards are now mandated for use in more than 100countries around the globe.All the participating countries and the international organizations have been consistently working with the Board to achieve the objective of global convergence.

**Check Your Progress**

1. What does IFRS stand for?
2. Explain the meaning and scope of International Financial Reporting Standard (IFRS)..
3. Mention the steps involved in issuing International Financial Reporting Standards.

**3.4: Process of issuing International Financial Reporting Standards.**

The international financial reporting standards are a set of international accounting standard stating how particular types of transactions and other events should be reported in financial statements the point f IFRS is to maintain stability and transparency throughout the financial world.

The IASB and the IFRS international committee are responsible for the maintenance of IFRS standard. The types of issues that the interpretation committee is called on to deal with include the identification of divergent practices that have emerged for particulars transaction, cases of doubt about the appropriate transactions, cases of doubt about the appropriate treatment for a particular circumstances or concerns expressed by investors about poorly specified disclosure requirements.

Thus IFRS are developed by the IASB in consultation with IFRIC and along with interested individuals and organizations from around the world.The due process comprises six stages, with the Trustees of the IFRS Foundation having the opportunity to ensure compliance at various points throughout:

1. Setting the agenda
2. Planning the project
3. Developing and publishing the Discussion Paper, including public consultation
4. Developing and publishing the Exposure Draft, including public consultation
5. Developing and publishing the Standard

6. Procedures after a Standard is issued

The above steps are explained hereunder:

**1. Setting the agenda:**

An agenda on important issues is set with due consideration with IASB. The IASB calculates the merits of adding a potential item to its agenda, also known as the work plan, mainly by reference to the needs of the investors. The IASB considers;

- The relevance to users of the information and the reliability that could be provided
- Whether existing guidance is available
- The possibility of increasing convergence
- The quality of the standard to be developed and
- Resource constraints

To help the IASB in considering its future agenda, its staff are asked to identify, review and raise issues that might warrant the IASB's attention.

New issues may also arise from a change in the IASB's Conceptual Framework. In addition, the IASB raises and discusses potential agenda items in the light of comments from other standard-setters and other interested parties, the IFRS Advisory Council and the IFRS Interpretations Committee, and staff research and other recommendations.

The IASB receives requests from constituents to interpret, review or amend existing publications. The staff considers all such requests, summarize major or common issues raised, and present them to the IASB from time to time as candidates for when the IASB is next considering its agenda.

***IASB meetings:***The IASB's discussions of potential projects and its decisions to adopt new projects take place in public IASB meetings.Before reaching such decisions the IASB consults the IFRS Advisory Council and accounting standard-setting bodies on proposed agenda items and setting priorities. In making decisions regarding its agenda priorities, the IASB also considers factors related to its convergence initiatives with accounting standard-setters.The IASB's approval to add agenda items, as well as its decisions on their priority, is by a simple majority vote at an IASB meeting.

2. **Planning the project:**

Once an item to its active agenda, the IASB decides whether to conduct the project alone r jointly with another standard- setter.
Similar due process is followed under both approaches. After considering the nature of the issues and the level of interest among constituents, the IASB may establish a **Consultative group** at this stage.

A team is selected for the project by the two most senior members of the technical staff:

- The **Director of Technical Activities;** and
- The **Director of Research**.

The project manager draws up a project plan under the supervision of those Directors. The team may also include members of staff from other accounting standard-setters, as deemed appropriate by the IASB.

3. **Development and publication of a Discussion Paper:**

**Although a Discussion Paper is not mandatory, the IASB normally publishes it as its first publication on any major new topic to explain the issue and solicit early comment from constituents.**If the IASB decides to omit this step, it will state why.Typically, a Discussion Paper includes:

- **a comprehensive overview of the issue;**
- **possible approaches in addressing the issue;**
- **the preliminary views of its authors or the IASB;** and
- **an** <u>invitation to comment</u>.

This approach may differ if another accounting standard-setter develops the research paper.
Discussion Papers may result either from:

- a <u>research project</u> being conducted by another accounting standard-setter; or
- as the first stage of an active agenda project carried out by the IASB.

In the first case, the Discussion Paper is drafted by another standard-setter and published by the IASB. Issues related to the Discussion Paper are discussed in IASB meetings, and publication of such a paper requires a simple majority vote by the IASB.
If the Discussion Paper includes the preliminary views of other authors, the IASB reviews the draft Discussion Paper to ensure that its analysis is an appropriate basis on which to invite public comments.

For Discussion Papers on agenda items that are under the IASB's direction, or include its preliminary views, the IASB develops the paper or its views on the basis of analysis drawn from staff research and recommendations, as well as suggestions made by the IFRS Advisory Council, **Consultative groups** and standard-setters and presentations from invited parties. All discussions of technical issues related to the draft paper take place in public sessions.

**4. Development and publication of an Exposure Draft:**

**Publication of an Exposure Draft is a mandatory step in due process.** Irrespective of whether the IASB has published a Discussion Paper, an Exposure Draft is the IASB's main vehicle for consulting the public.

Unlike a Discussion Paper, an Exposure Draft sets out a specific proposal in the form of a proposed Standard (or amendment to an existing Standard).

The development of an Exposure Draft begins with the IASB considering:

- issues on the basis of staff research and recommendations;
- comments received on any Discussion Paper; and
- suggestions made by the IFRS Advisory Council, Consultative groups and accounting standard-setters, and arising from public education sessions.

After resolving issues at its meetings, the IASB instructs the staff to draft the Exposure Draft. When the draft has been completed, and the IASB has **balloted** on it, the IASB publishes it for **public comment.**

**5. Development and publication of an IFRS Standard:**

**The development of an IFRS Standard is carried out during IASB meetings, when the IASB considers the comments received on the Exposure Draft**. After resolving issues arising from the Exposure Draft, the IASB considers whether it should expose its revised proposals for public comment, for example by publishing a second Exposure Draft.

In considering the need for re-exposure, the IASB:

- identifies substantial issues that emerged during the comment period on the Exposure Draft that it had not previously considered;
- assesses the evidence that it has considered;

- evaluates whether it has sufficiently understood the issues and actively sought the views of constituents; and
- considers whether the various viewpoints were aired in the Exposure Draft and adequately discussed and reviewed in the basis for conclusions.

*Drafting the Standard:*The IASB's decision on whether to publish its revised proposals for another round of comments is made in an IASB meeting. If the IASB decides that re-exposure is necessary, the due process to be followed is the same as for the first Exposure Draft. When the IASB is satisfied that it has reached a conclusion on the issues arising from the Exposure Draft, it instructs the staff to draft the Standard.

*Pre-ballot draft:*A pre-ballot draft is usually subject to external review, normally by the IFRS IC. Shortly before the IASB ballots the Standard, a near-final draft is posted on e-IFRS**.**

Finally, after the due process is completed, all outstanding issues are resolved, and the IASB members have balloted in favors of publication, the Standard is issued.

**6. Procedures after a Standard is issued:**

After a Standard is issued, the staff and the IASB members hold regular meetings with interested parties, including other standard-setting bodies, to help understand unanticipated issues related to the practical implementation and potential impact of its proposals.

The IFRS Foundation also fosters educational activities to ensure consistency in the application of IFRS Standards.

After a suitable time, the IASB may consider initiating studies in the light of:

- its review of the Standard's application;
- changes in the financial reporting environment and regulatory requirements; and
- comments by the IFRS Advisory Council, the IFRS Interpretations Committee, standard-setters and constituents about the quality of the Standard.

These discussions may result in items being added to the IASB's work plan.

The IFRS set by the IASB after due consultation with various international organizations and other interested bodies are reviewed from time to time after considering various changes that takes place in the business environment.This standards are set with the basic objectives of bringing transparency , uniformity and comparability of financial information around the globe. Hence these international accounting standards are followed and considered while setting accounting standards at national level to bring in an aspect of congruence in financial statements prepared worldwide.

## 3.5: Summing up:

- International Financial Reporting Standard is a single set of accounting standard, developed and maintained by the International Accounting Standard Board to bring an uniformity in the financial statements prepared across the globe. Accounting Standard presents prepares of financial statements with a set of rules to abide by when preparing an entity's accounts. Ensuring this standardization across the markets.
- The due process of issuing financial reporting standards comprises of six stages, with the Trustees of the IFRS Foundation having the opportunity to ensure compliance at various points throughout which includes
  1. setting of the agenda
  2. planning the project
  3. Development and publication of a Discussion Paper
  4. Development and publication of an Exposure Draft
  5. Development and publication of an IFRS Standard
  6. Procedures after a Standard is issued

## 3.6: References and suggested readings:


1. Banerjee, Abhijit. Indian Accounting Standard. Taxman Publication New Delhi.
2. Ghosh. T.P. 2007. Accounting Standards And Corporate Accounting Practices. 8th Edition.Volume 1. Taxman Allied Services(P.) Ltd.New Delhi
3. Ghosh. T.P. 2010.Understanding IFRSs. Taxman Allied Services(P.) Ltd.New Delhi
4. Wild, John.J. 2006.Financial Statement Analysis 9E. Tata McGraw- Hill Education
5. www.iasplus.com/en/resources/ifrsf/history/resources


## 3.7:Model questions:

1. What are IFRS?
2. What are the scopes and objectives of IFRS?
3. Discuss the Process of issuing International Financial Reporting Standards
4. Explain the role of IFRS in bringing uniformity in the financial reporting system around the globe?

## 4.8:Answer to Check Your Progress:

***1 Answer*: IFRS stands for** International Financial Reporting Standard.

***2 Answer***: International Financial Reporting Standard is a single set of accounting standard, developed and maintained by the International Accounting Standard Board to bring an uniformity in the financial statements prepared across the globe. Accounting Standard presents prepares of financial statements with a set of rules to abide by when preparing an entity's accounts ensuring this standardization across the markets.

The basic intention or scope of financial reporting standard is todevelop a single set of accounting standards, which are capable of being applied on a globally consistent basis by developed, emerging and developing economies thus providing investors and other users of financial statements with the ability to compare the financial performance of companies with their international peers.

*3 Answer*: The due process of issuing financial reporting standards comprises of six stages, with the Trustees of the IFRS Foundation having the opportunity to ensure compliance at various points throughout which includes

7. setting of the agenda
8. planning the project
9. Development and publication of a Discussion Paper
10. Development and publication of an Exposure Draft
11. Development and publication of an IFRS Standard
12. Procedures after a Standard is issued

# BLOCK II : Unit-1

## Meaning and Significance of Conceptual Framework for Preparation and Presentation of Financial Statements

**Unit Structure:**



**1.0 Introduction:**

Conceptual framework is a constitution which provides guidance for the preparation and presentation of financial statements. It works as the basis for the preparation and presentation of financial statements for external users. In the words of Financial Accounting Standard Board (FASB), USA, Conceptual Framework is a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function and limits of financial accounting and financial statements. The objectives identify the goals and the purposes of accounting. The fundamentals are the underlying concepts of accounting that guide the selection of transactions, events and circumstances to be accounted for, their recognition and measurement, and the means of summarising and communicating them to interested parties. Concepts of that type are fundamental in the sense that other concepts flow from them and repeated reference to them will be necessary in establishing, interpreting and applying accounting and reporting standards. The conceptual framework is intended to act as a constitution for the standard setting process. Conceptual framework projects are not intended to develop solutions to specific issues in financial reporting. They develop criteria to guide the Board's subsequent decisions on specific technical issues.

The International Accounting Standards Board (IASB) issued its 'Framework for the Preparation and Presentation of Financial Statements' in 1989. This is referred to as its conceptual framework. The IASB's conceptual framework is described in the document, "Framework for Preparation and Presentation of Financial Statements." Both the IASB and the FASB have a conceptual framework. The IASB and the FASB are now working on a joint project to develop an improved common conceptual framework that provides a sound foundation for developing future accounting standards. In India, the Institute of Chartered

Accountants of India (ICAI) has issued its conceptual framework for the preparation and presentation of financial statements.

A conceptual framework is, therefore, a statement of theoretical principles for financial accounting and reporting. The framework seeks to identify the purpose, qualitative characteristics and broad content of general purpose financial reporting. It describes the objective of, and the concepts for, general purpose financial reporting. The Conceptual Framework is, thus, the foundation as the criteria or the basic ideas of this framework assist in financial accounting and reporting.

**1.1: Objectives**: After going through this unit, you will be able to

- Understand the concept of conceptual framework.
- Explain the meaning and purpose of conceptual framework.
- Explain the objectives of the financial statement
- Determine the users of the financial statement

## 1.2: Conceptual framework for preparation and presentation of financial statements.

***1.2.1: Meaning of Conceptual Framework*:** Conceptual framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. It is not an accounting standard. The conceptual framework does not override any specific accounting standard. It is stated that if there is a conflict between the framework and an accounting standard, the requirements of the Accounting standard prevail over those of the framework. Conceptual framework is a constitution which provides guidance for the preparation and presentation of financial statements. It works as the basis for the preparation and presentation of financial statements for external users

***1.2.2: Significance of Conceptual framework:*** The following functions reflects the significance of this framework :

(a) assist preparers of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;

(b) assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;

(c) assist the Accounting Standards Board 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;

(d) assist auditors in forming an opinion as to whether financial statements conform with Accounting Standards;

(e) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and

(f) provide those who are interested in the work of the Accounting Standards Board with information about its approach to the formulation of Accounting Standards.

**Check your Progress.**

1) ICAI stands for……………….
2) The International Accounting Standards Board (IASB) issued its 'Framework for the Preparation and Presentation of Financial Statements' in…………..
3) FASB stands for……………….

## 1.3: Objectives and Users of financial statements:

### 1.3.1: *Objectives of financial statements:*

Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, a statement of profit and loss (also known as ‘income statement’), a cash flow statement and notes and other statements and explanatory material that are an integral part of the financial statements. Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events, and do not necessarily provide non-financial information. The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.

### 1.3.2: *Users of financial statements:*

The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their information needs. The users and their varied needs are summarised as follows:

(a) ***Investors.*** The providers of risk capital are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. They are also interested in information which enables them to assess the ability of the enterprise to pay dividends.

(b) ***Employees***. Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.

(c) ***Lenders***. Lenders are interested in information which enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

(d) ***Suppliers*** and other trade creditors. Suppliers and other creditors are interested in information which enables them to determine whether amounts owing to them will be paid when due.

(e) ***Customers***. Customers have an interest in information about the continuance of an enterprise, especially when they have a long term involvement with, or are dependent on, the enterprise.

(f) ***Governments and their agencies***. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises and determine taxation policies, and to serve as the basis for determination of national income and similar statistics.

(g) ***Public***. Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As providers of risk capital to the enterprise, investors need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

**Check your Progress**

**4)What are the objectives of Financial Statement?**

**5)Who are the users of Financial Statement?**

### 1.4: Elements of financial statement:

Three elements relating to the statement of financial position (balance sheet) are asset, liability and equity and two elements related to statement of comprehensive income are income and expense. Therefore, the elements of financial statements are asset, liability, equity, income and expense.

**Asset** : 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.

**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.

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

**Income**: Income is the increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decrease 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.

### 1.4: Summing Up:

1) Conceptual framework is a constitution which provides guidance for the preparation and presentation of financial statements. A conceptual framework is a statement of theoretical principles for financial accounting and reporting. The framework seeks to identify the purpose, qualitative characteristics and broad content of general purpose financial reporting

2) The International Accounting Standards Board (IASB) issued its 'Framework for the Preparation and Presentation of Financial Statements' in 1989

3) In India, the Institute of Chartered Accountants of India (ICAI) has issued its conceptual framework for the preparation and presentation of financial statements.

4) The following are the purposes of this framework :

(a) assist preparers of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;
(b) assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;
(c) assist the Accounting Standards Board in promoting harmonization 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;
(d) assist auditors in forming an opinion as to whether financial statements conform with Accounting Standards;
(e) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and
(f) provide those who are interested in the work of the Accounting Standards Board with information about its approach to the formulation of Accounting Standards.

5) The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.

6) There are various users of accounting information such as investors, employees, lenders, customers, Governments and their agencies and Public. Enterprises

## 1.6: Answer to Check your Progress:

1) ICAI stands for Institute of Chartered Accountants of India
2) The International Accounting Standards Board (IASB) issued its 'Framework for the Preparation and Presentation of Financial Statements' in 1989
3) FASB stands for International Accounting Standards Board
4) The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.
5) There are various users of accounting information such as investors, employees, lenders, customers, Governments and their agencies and Public.

## 1.7: Model Questions:

1) Discuss the conceptual framework of financial statement issued by the ICAI?

2) Discuss the purpose of conceptual framework.

3) Discuss the objectives of Financial Statement.

4) Who are the users of the Financial Statement? Elaborate.

## 1.8: References and suggested readings


- Lal, Jawahar. 2003. Accounting Theory- An Introduction. Himalaya Publishing House. Mumbai.

- Mukherjee Amitabha. 2011 Illustrated Guide to Indian accounting Standards (IND Ass) and IFRSs. Taxmann Publications(P.) Ltd. New Delhi.
- Porwal, LS . 2007. Accounting Theory- An Introduction. Tata Mcgraw- Hill Publishing Company Limited. New Delhi
- Sharma, D.G. 2015.Advanced Accounting Including Applicable Accounting Standards 3rd edition. Taxmann Publications. New Delhi.
- www.icai.org.
- www.ifrs.org

# BLOCK II : Unit-2

# Conceptual Framework issued by ICAI

**Unit Structure:**



## 2.1: Introduction:

Conceptual framework means a constitution which guides the preparation and presentation of financial statements. It acts as a guide to the establishment, interpretation and application of accounting and reporting standards.The Framework is concerned with general purpose financial statements (hereafter referred to as 'financial statements'). Such financial statements are prepared and presented at least annually and are directed towards the common information needs of a wide range of users. The users have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view.

Conceptual framework does not help in solving specific issues or problems in financial recording and reporting. It sets out the concepts that underlie the preparation and presentation of financial statements for external users. The framework is not an accounting standard and hence does not define standards for any particular measurement or disclosure issue. Framework does not override any specific accounting standard.

### 2.2: Objectives:

**After going through this unit you will be able to:**

- Understand the meaning and purpose of conceptual framework of financial statements issued by the ICAI
- Focus on the objectives and users of financial statements
- Identify the qualitative characteristics that determine the usefulness of information in financial statements
- Define the elements of financial statements
- Recognize the elements from which financial statements are constructed
- Understand the measurement of assets and liabilities reported in financial statements
- Highlight the concepts of capital and capital maintenance

### 2.3: Meaning and purpose

Conceptual framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. It is not an accounting standard. The conceptual framework does not override any specific accounting standard. It is stated that if there is a conflict between the framework and an accounting standard, the requirements of the Accounting standard prevail over those of the framework.

The following are **the purposes of this framework** :

(a) assist preparers of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;

(b) assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;

(c) assist the Accounting Standards Board 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;

(d) assist auditors in forming an opinion as to whether financial statements conform with Accounting Standards;

(e) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and

(f) provide those who are interested in the work of the Accounting Standards Board with information about its approach to the formulation of Accounting Standards.

## 2.4: Objectives and Users of financial statements

### 2.*4.1Objectives of financial statements*

Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, a statement of profit and loss (also known as 'income statement'), a cash flow statement and notes and other statements and explanatory material thatare an integral part of the financial statements. Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events, and do not necessarily provide non-financial information. The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.

### 2.4.2: *Users of financial statements*

The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their information needs. The users and their varied needs are summarised as follows:

(**a) Investors**. The providers of risk capital are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. They are also interested in information which enables them to assess the ability of the enterprise to pay dividends.

**(b) Employees**. Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enablesthem to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.

(**c) Lenders**. Lenders are interested in information which enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

(**d) Suppliers** and other trade creditors. Suppliers and other creditors are interested in information which enables them to determine whether amounts owing to them will be paid when due.

(**e) Customers**. Customers have an interest in information about the continuance of an enterprise, especially when they have a longterm involvement with, or are dependent on, the enterprise.

(f)**Governments** and their agencies. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises and determine taxation policies, and to serve as the basis for determination of national income and similar statistics.

(g) **Public**. Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including thenumber of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As providers of risk capital to the enterprise, investors need more comprehensive information than other users. The provision of financial statements thatmeet their needs will also meet most of the needs of other users that financial statements can satisfy.

## 2.5 The qualitative characteristics that determine the usefulness of information in financial statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

### Understandability

An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business, economic activities and accounting and study the information with reasonable diligence.

### Relevance

To be useful, information must be relevant to the decision-making needsof users. Information has the quality of relevance when it influences theeconomic decisions of users by helping them evaluate past, present or futureevents or confirming, or correcting, their past evaluations. The relevance of information is affected by its materiality.

### Reliability

To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be relied upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

### Comparability

Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows.

Apart from these four principal qualitative characteristics, there are certain other characteristics which make the financial information useful to the users. These are as follows:

### Materiality

The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error,
judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

### Faithful Representation

To be reliable, information must represent faithfully the transactionsand other events it either purports to represent or could reasonably be expectedto represent. Thus, for example, a balance sheet should represent faithfullythe transactions and other events that result in assets, liabilities and equity ofthe enterprise at the reporting date which meet the recognition criteria.

**Substance over Form**
If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.
**Neutrality**
To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.
**Prudence**
Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances. The uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements.
**Completeness**
To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.
**Timeliness**
If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability.
**Balance between Benefit and Cost**
The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared. For these reasons, it is difficult to apply a cost-benefit test in any particular case.

### True and Fair View
Financial statements are frequently described as showing a true and fair view of the financial position, performance and cash flows of an enterprise. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of such information.

## 2.6: The definition of the elements of financial Statements

Financial statement forms a part of the process of financial reporting. A complete set of financial statements include a balance sheet, a statement of profit and loss and a statement of cash flows. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financialposition in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of profit and loss are income and expenses. The cash flow statement usually reflects elements of statement of profit and loss and changes in balance sheetelements.Three elements relating to the statement of financial position (balance sheet) are asset, liability and equity and two elements related to statement of comprehensive income are income and expense. Therefore, the elements of financial statements are asset, liability, equity, income and expense.

**Asset** : 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.

**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.

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

**Income:** Income is the increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decrease 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.

**2.7: Recognition of the Elements from which financial statements are constructed:**

Recognition is the process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisfies the criteria for recognition. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the totals of balance sheet or statement of profit and loss. Items that satisfy the recognition criteria should be recognised in the balance sheet or statement of profit and loss. An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and

(b) the item has a cost or value that can be measured with reliability.

### Recognition of Assets

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably. An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period.

### Recognition of Liabilities

A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements.

### Recognition of Income

Income is recognised in the statement of profit and loss when increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

### Recognition of Expenses

Expenses are recognised in the statement of profit and loss when decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees' salaries or the depreciation of plant and machinery). Many expenses are recognised in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. This process is commonly referred to as the matching of costs with revenues.

**2.8: Measurement of assets and liabilities reported in financial statements**

Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognised and carried in the balance sheet and statement of profit and loss. This involves the selection of the particular basis of measurement. A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

*(a)*Historical cost: Historical cost is the money figure at which an asset or liability is initially recorded and is the basis for all subsequent accounting, for those assets and liabilities. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) Current cost:Current cost of an asset is the amount of cash or other consideration that would be required today to obtain the same asset or its equivalent. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) Realisable: (settlement) value:Realisable value is the amount of cash or its equivalent that would be received currently if an asset were sold in the normal course of business. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.

(d) Present value :Present value is the cash flows associated with the expected sale or conversion of an asset at some future date discounted at an appropriate rate of interest. Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

## 2.9: Concepts of Capital and Capital Maintenance

Maintenance of capital by an entity is very essential in order to survive. Capital maintenance is a principle of accounting which states that a profit is the residual revenue of a reporting period after the initial value of the capital of the business has been restored. Broadly, there are two concepts of capital maintenance- financial capital maintenance and physical capital maintenance. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day. The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

The concepts of capital give rise to the following concepts of capital maintenance:

(a) *Financial capital maintenance*. Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

(b) *Physical capital maintenance*. Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise 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.

The concept of capital maintenance is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return *on* capital and its return *of* capital; only inflows of assets in excess of amounts needed to maintain capitalcan be regarded as profit and therefore as a return on capital. Hence, profitis the residual amount that remains after expenses (including capitalmaintenance adjustments, where appropriate) have been deducted fromincome. If expenses exceed income, the residual amount is a net loss.

The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the enterprise is seeking to maintain. 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 enterprise. In general terms, an enterprise 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.

Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. 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. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

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 enterprise are viewed as changes in the measurement of the physical productive capacity of the enterprise; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements under the chosen model.

### 2.10: Summing up

Conceptual framework acts as a guide to the establishment, interpretation and application of accounting and reporting standards. Financial statements form a part of the process of financial reporting both to the internal and external users. Qualitative characteristics like relevance, understandability, reliability, materiality and the like are the attributes that make the information provided in financial statements useful to users.Items that satisfy the recognition criteria should be recognised in the balance sheet or statement of profit and loss. The elements of financial statements are to be recognised and carried in the balance sheet and statement of profit and loss by assigning monetary values. Maintenance of capital by an entity is very essential in order to survive. Capital maintenance is a principle of accounting which states that a profit is the residual revenue of a reporting period after the initial value of the capital of the business has been restored. The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statementsThe Conceptual framework will be applicable to the accounting models used in the preparation and presentation of financial statements

### 2.11: References and suggested readings


- Dam B.B.2009, Gautam H.C, Kakati P.C., Chakraborty D, Barman J.K. Theory and Practice of financial accounting. Capital Publishing Company. Guwahati.
- Lal, Jawahar.2003. Accounting Theory- An Introduction. Himalaya Publishing House. Mumbai.
- Mukherjee Amitabha.2011 Illustrated Guide to Indian accounting Standards (IND Ass) and IFRSs. Taxmann Publications(P.) Ltd.New Delhi.
- Porwal, LS .2007. Accounting Theory- An Introduction. Tata Mcgraw- Hill Publishing Company Limited.New Delhi
- Sharma, D.G. 2015.Advanced Accounting Including Applicable Accounting Standards 3rd edition. Taxmann Publications. New Delhi.
- www.icai.org.
- www.ifrs.org


### 2.12: Model questions

1. Mention the objectives and users of financial statements

2. What are the qualitative characteristics that determine the usefulness of information in financial statements ?

3. Define the elements of financial statements

4. Mention the criteria for recognition of the elements from which financial statements are constructed.

5 . What are the different basis of measurement of assets and liabilities reported in financial statements?

6. Write a note on the concept of capital and capital maintenance.

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# BLOCK II : Unit 3

## Conceptual Framework of Financial Statements Issued by the International Accounting Standards Board (Iasb)-I

**Unit Structure:**



**3.1: Introduction:** The International Accounting Standards Board (IASB) issued its 'Framework for the Preparation and Presentation of Financial Statements' in 1989. This is referred to as its conceptual framework**.**The framework sets out the concepts that shape the preparation and presentation of financial statements for external users. The framework does not have the status of an accounting standard. The purpose of the framework is to assist the IASB in developing and revising IFRS that are based on consistent concepts,to help preparers develop consistent accounting policies when no IFRS Standard applies to a particular transaction or event, or when a Standard allows a choice of accounting policy;and to assist all parties to understand and interpret IFRS.

**3.2: Objectives**: After going through this unit you shall be able

- Understand the meaning and purpose of Conceptual framework issued by IASB
- Identify the objectives and the users of framework issued by IASB
- Understand the concept of reporting entity.

**3.3:<u>Conceptual framework of financial statements issued by the International Accounting Standards Board (IASB</u>):**The IASB's conceptual framework is described in the document, "Framework for Preparation and Presentation of Financial Statements." Both the IASB and the FASB have a conceptual framework. The IASB and the FASB are now working on a joint project to develop an improved common conceptual framework that provides a sound foundation for developing future accounting standards. Such a framework is essential to fulfilling the Boards' goal of developing standards that are principles-based, internally consistent, and internationally converged, and that lead to financial reporting that provides the information investors need to make sound and effective decisions. The new framework will be built on the existing IASB and FASB frameworks, and consider developments subsequent to the issuance of these frameworks.It is a practical tool that:

a. assists the Board to develop IFRS Standards that are based on consistent concepts;
b. assists preparers to develop consistent accounting policies when no IFRS Standard applies to a particular transaction or event, or when a Standard allows a choice of accounting policy; and
c. assists others to understand and interpret the Standards.

**3.4: <u>Objectives and users of financial statements:</u>**

The objective of the Conceptual Framework is to improve financial reporting by providing a more complete, clear and updated set of concepts. To achieve this, the Board is building on the existing Conceptual Framework—updating it, improving it and filling in the gaps instead of fundamentally reconsidering all aspects of the Conceptual Framework.

***3.4.1: Objectives of financial statements*:**

A financial statement is a formal record of the financial activities and position of a business. Its purpose is to convey an understanding of some financial aspects of a business firm .The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. This would guide in deciding statements, their contents and disclosures. A set of general purpose statements focus on financial position, performance and cash flows of an entity which could be used by any user group to assess investment decision, employment stability or growth, debt servicing, business continuity and ability to make societal contribution. General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

***3.4.2: Users of financial statements*:**

The different user groups of financial statements include the following:

1. Investors: Information need of the group primarily relates to decision making of buy, hold or sale entity's share. Also dividend paying ability of the entity is a matter of interest.

2. Employees: Employees need to know about the stability and continued profit ability of the employer which would ensure payment of remuneration, employee opportunities and retirement benefits.
3. Lenders: Lenders are interested in debt servicing capability.
4. Suppliers and other trade creditors: This group is interested in information about the entity's ability in the short run to pay their dues. Of course, they are interested in the long run viability of the entity, if it is their major customer.
5. Customers: Customers seek information about the continuation of the entity in particular if the entity is their major supplier.
6. Government and their agencies: They have manifold interests like taxation, contribution of the entity in employment generation and economic activities of the nation and also the infrastructural facilities to be provided to sub serve the need of the entity commensurate with is contribution to the society.
7. Public : Mostly interested in employment generation and societal contribution.

**<u>3.5: Reporting entity:</u>**

A reporting entity is an entity that chooses, or is required, to present general purpose financial statements. When one entity (the parent) has control over another entity (the subsidiary), the boundary of the reporting entity can be determined by either direct control only (leading to unconsolidated financial statements) or by direct and indirect control (leading to consolidated financial statements). It does not have to be a legal entity and can comprise only a portion of an entity or two or more entities. Consolidated financial statements are generally more likely to provide useful information to users than unconsolidated financial statements. In consolidated financial statements, an entity reports on both its own (directly controlled) assets and liabilities; and its indirect assets and liabilities (those of its subsidiaries: the entities that it controls). In unconsolidated financial statements, an entity reports only on its own (directly controlled) assets and liabilities. The IASB is of the view that, in general, consolidated financial statements are more likely to provide useful information to users of financial statements than unconsolidated financial statements. Unconsolidated financial statements may also provide useful information. The IASB asserts that if an entity chooses, or is required, to prepare unconsolidated financial statements, it would need to disclose how users may obtain the consolidated financial statements. A reporting entity does not have to be a legal entity. If a reporting entity is not a legal entity, the boundary of the reporting entity needs to be set in such a way that the financial statements: (a) provide the relevant financial information needed by those existing and potential investors, lenders and other creditors who rely on the financial statements; and (b) faithfully represent the economic activities of the entity.

**3.6: Summing up**

The framework sets out the concepts that shape the preparation and presentation of financial statements for external users.The objective of the Conceptual Framework is to improve financial reporting by providing a more complete, clear and updated set of concepts through a set of complete financial statements.The general purpose financial statements are required to be presented by a reporting entity.A reporting entity does not have to be a legal entity and can comprise only a portion of an entity or two or more entities.

## 3.7: References and suggested readings:


- Lal, Jawahar.2003. Accounting Theory- An Introduction. Himalaya Publishing House. Mumbai.
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- www.icai.org.
- www.ifrs.org


## 3.8: Model questions

1. Mention the objectives of financial statements

2. Mention the different user groups of financial statements

3. What is meant by reporting entity?

# BLOCK III : Unit-1

# REGULATORY FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

## 1.1 Introduction

The regulatory framework for the preparation and presentation of the financial statements has been issued by Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI). The framework is being governed in the context of Companies (Accounting Standard) Rules, 2021 (which has replaced Companies (Accounting Standard ) Rules, 2006 as amended from time to time) notified by the Central Government through the Ministry of Corporate Affairs (MCA) and Accounting Standards issued by ICAI. ICAI has issued Indian Accounting Standard 1 commonly referred as Ind AS1: Presentation of Financial Statements for the said purpose.

**The scope of the regulatory framework is about –**

(i) the objectives of the financial statements.

(ii) the qualitative characteristics that determine the usefulness of information provided in financial statements;
(iii) definition, recognition and measurement of the elements from which financial statements are constructed; and
(iv) concepts of capital and capital maintenance.

**Purpose of the framework**

The Framework sets down the concepts that underlie the preparation and presentation of financial statements for external users. As per the *Framework for the Preparation and Presentation of Financial Statements,* July 2000;issued by ICAI, the purpose of the Framework is--

- assist preparers of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;

- assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;

- assist the Accounting Standards Board 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;

- assist auditors in forming an opinion as to whether financial statements are in conformity with Accounting Standards;

- ➢ assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and
- ➢ provide those who are interested in the work of the Accounting Standards Board with information about its approach to the formulation of Accounting Standards.

The Framework is not an Accounting Standard and therefore doesn't define standards for any particular measurement or disclosure issue. There is nothing in the Framework which overrides any specific Accounting Standard. If in any case, there is a conflict between the Framework and the Accounting Standards, the requirements of the Accounting Standards prevail over those of the Framework. However, the Accounting Standard Board (ASB) of ICAI will take into consideration the Framework in the development of future Accounting Standards and in its review of existing Standards. The Framework will also be revised from time to time on the basis of experience and working of the Accounting Standards Board with it.

**1.2 Objectives:** After going through this unit, you will be able to:

**-** understand the meaning, scope and purpose of the regulatory framework.

- understand the nature, objective and components of the financial statements.

- explain the contents and its preparation of the regulatory framework.

### 1.3 Meaning and Nature of the Financial Statements

The financial statements which are prepared for Companies are called as '*General purpose financial statements'* because it cater the common information needs of a wide range of users of accounting information and the regulatory framework deals with the General purpose financial statements. This framework doesn't deals with the special purpose reports such as tax and cost reports, audit reports or prospectus etc. The special purpose reports are meant to fulfill the information needs of limited or specific group of users. **The purpose of the financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a large number of users in taking economic decisions.** The different elements of financial statements which provide information about an entity is as follows:

- Assets
- Liabilities
- Equity
- Income and expenses (also including gains and losses)
- Contributions by and distributions to owners in their capacity as owners.
- Cash-flows

Financial statements form a significant part of the process of financial reporting. The framework is applicable to financial reporting of all kinds of business enterprises, whether industrial, commercial, other business activities and working in private sector or in public sector. **The financial statements comprises of the following-**

- Balance sheet ( Statement showing financial position of an enterprise)
- Statement of Profit & Loss(also known as income statement).
- Cash flow Statement
- Statement of changes in Equity
- Notes to accounts

**Underlying assumptions of Financial Statements**

- **Accrual basis**

Financial Statements are prepared on accrual basis of accounting. Under this system, transactions and other events are recognized on the basis of the accounting period to which they relate to, irrespective of the fact cash is paid/received or not. This means credit sales and credit purchases will be recognized in the books of accounts in the year in which the transaction has occurred. Similarly because of the accrual concept, we also take into account accrued income and outstanding liabilities in the calculation of profit or loss incurred in a particular year.

- **Going Concern**

According to going-concern, the life of the business is indefinite and there is no intention to dissolve or close the business in the near future. The financial statements are prepared on the assumption of going-concern that it will continue its operation and business activities for the foreseeable future. If this assumption is defied in the preparation of financial statements of an enterprise, it must be given proper disclosure and reasons thereof in the financial statements.

- **Consistency**

The financial statements are prepared in assumption of the principle of consistency in its accounting policies and methods so that it fulfills the objective of comparability of financial statements of an enterprise over a period of time. The change in accounting policy is desirable if-

(a) it is required by law or Accounting Standard

(b) ifit is apparent that change would be more appropriate having regard to the criteria for the selection and application of accounting policies.

The change if any and its effects must be given proper disclosure in the financial statements.

**Qualitative characteristics of financial Statements**

Qualitative characteristics are the attributes of financial statements that makes the information provided useful to the users of the financial statements. The main attributes are understandability, relevance, reliability and comparability.

- **Understandability:** The financial statements must be prepared in such a manner that it is understandable to the users of accounting information. For this purpose, it is assumed that users have reasonable knowledge of business and economic activities and it will help them in its interpretation. On the other hand, complex matters which are relevant for economic decision-making by the users should not be excluded on the ground that it would be too difficult for the users to understand it.
- **Relevance:** In order to make the financial statements more useful, it must be relevant in the sense that it affects the economic decision making of the users. Relevance is affected by*Materiality* dimension. Any material information must not be omitted or erroneous (material misstatement) in the preparation and presentation of the financial statements which affects the decision-making of the users of the accounting information.
- **Reliability:** The information contained in financial statements must be reliable to be useful for the users. Information is said to be reliable if it is free from material error and bias. The other dimensions which affects the reliability of financial statements are as follows:

  ~ *Faithful representation:*In order to be reliable, information must represent faithfully the transactions and other events which it purports to report or is reasonably be expected to represent. Thus, for example Balance sheet of an enterprise must faithfully represent its assets, liabilities and equity of business (financial position) at the reporting date which meet the recognition criteria.

  ~ *Substance over form:* The transactions and other events which are accounted and represented should be on the basis of its substance rather than mere legal form of the transaction.

  ~*Neutrality:* In order to be reliable, the information contained in financial statements should be neutral, that is free from bias. The financial statements are meant to be useful for a wide range of users and not specially directed towards the needs of a specific user to achieve a predetermined outcome or result.

  ~*Prudence:* The preparers of the financial statements must understand the uncertainties surrounding the business and its events and therefore it must exercise prudence in recording the transactions in books of accounts. According to the principle of prudence, business must make reasonable provision for any anticipated losses arising in future but should not take into account anticipated future gains. However, exercise of prudence does not allow for creation of hidden reserves or excessive provisions or deliberate understatement of assets and income, or deliberate overstatement of its liabilities.

  ~*Completeness:* The information contained in financial statements must be complete in order to be reliable. The completeness should be within the constraints of materiality and cost. Any omission would make the information misleading and deficient in its nature thereby affecting the reliability of the financial statements.

**STOP TO CONSIDER**

❖ Name the group/arm of ICAI which frames Accounting Standards in India.

- ❖ Which principle of accounting is violated if there is excessive provisions made in a year?
- ❖ How materiality and relevance characteristics of financial statements is related to each other?
- ❖ Where is Income and expenses shown in Financial Statements?
- ❖ What does the Balance Sheet of an enterprise shows? What are its elements?
- ❖ Is the *'Framework for the Preparation and Presentation of Financial Statements'* an Accounting Standard?

### 1.4 Elements of the Financial Statements

Financial Statements portray the financial effects of the transactions and events happening in a business enterprise which can be grouped into broad classes according to their economic characteristics. These broad classes are called as elements of the financial statements. These elements are broadly classified as assets, liabilities, equity, expenses and losses, income and gains, and cash flows. The elements are further sub-classified according to their nature or function for better understanding and decision-making to the users of financial statements. The *financial position* of an enterprise is reflected in its Balance Sheet which shows the assets, liabilities and equity. Similarly, the *financial performance* of an enterprise is reflected in its Statement of Profit and Loss (also known as income statement) which shows the incomeearned and expenses incurred during the reporting period. The cash inflow and outflow of business during the period is being shown by Cash-flow Statement. Ind AS 7 sets out the requirements for the presentation and disclosure of cash and cash equivalents (*cash flows*) during the period in an enterprise. Let us briefly discuss the elements of financial statements:

- **Assets:** Assets are resources which provides future economic benefits to the business. Assets are mainly employed by business for producing goods and services for satisfying the wants and needs of customers. There are certain assets which has physical form such as plant and machinery, and certain assets such as patents and copyrights which do not have physical form but still are called as assets because the firm will reap benefits from them in the future. Hence physical form of assets is not the criteria for definition of an asset.
  The future economic benefits derived out of assets can flow to the enterprise in a number of ways such as-
  - In the production of goods or services to be sold by the enterprise.
  - Exchanged for other assets
  - Used to settle a liability
  - Distributed to the owners of the business.

- **Liabilities:**Liabilities are the present obligations of the firm. An obligation is a duty or responsibility to act or perform in a certain way. Liabilities are enforceable in the court of law due to its binding contract or statutory requirement.

*Assets and liabilities are classified as Current and Non-Current assets, and Current and Non-current liabilities in the Balance Sheet as per Ind AS 1.* Ind AS 1 describes the framework for the presentation of general purpose financial statements. In many ways, Ind AS 1 tries to bridge the ways in presentation of financial statements as per Schedule III of the Companies Act, 2013. It also lays down the recognition, measurement and disclosure requirements for specific transactions and other events. Further, the standard prescribes the minimum disclosures that are to be made in the financial statements and explains the general features of the financial statements.

- **Equity:** Equity represents the contributions made by owners in an enterprise. It also includes reserves and surplus, appropriations of retained earnings, unappropriated profits etc. It is the residual interest in the assets of an entity after deducting all its liabilities.
  The creation of reserves is sometimes mandated by law for certain tax benefits in the form of reduced tax liabilities or tax-exemptions. The existence and size of such reserves is an information for decision making to some users. Sometimes transfers to reserves are made to add extra measure of protection to the creditors and suppliers of funds. Transfers to such reserves are examples of appropriations of retained earnings rather than treating as expenses.
- **Income:** Income includes both revenue and gains. Revenue arises in the normal or ordinary course of business activities from the sale of goods and services provided. It is refereed by different names as sales, royalty, fees, interest, dividend, rent etc.
  Gain is also a kind of income which may or may not arise out of ordinary activities of business enterprise. For example, profit on sale of building or machinery is income in the nature of gain to business.
- **Expenses:** The definition of expenses include both expenses and losses. Expenses are incurred in the course of ordinary business activities of an enterprise. For example, cost of goods sold, salaries, depreciation etc.
  Losses are other items which result in decrease in economic benefits to the business and therefore are very much part of expenses. For examples, goods lost in fire or theft is a loss to the business. Loss on disposal of fixed assets is categorized as losses.

### 1.5 Recognition of the elements of Financial Statements

Recognition means incorporating in the Balance sheet or in the Statement of profit and loss that meets the definition of an element and its recognition criteria. An item that meets the definition of an element should be recognised in the financial statements if-

(a) it is possible that any future economic benefits associated with the item will flow to or from the enterprise. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty attached to the flow of future economic benefits.

(b) the item has a cost or value that can be measured reliably. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and therefore it doesn't undermine reliability of financial statements.However, if a reasonable estimate cannot be made, the item is not recognised in the Balance sheet or Statement of profit and loss.

**Recognition of Assets:** An asset is recognised in the Balance sheet when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost or value that can be measured reliably.

**Recognition of liabilities:** A liability is recognised in the Balance sheet when it is probable that there is an outflow of resources representing economic benefits that will result from the settlement of present obligation and the amount of settlement can be measured reliably.

**Recognition of income:** Income is recognised in the statement of profit and loss when there is an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.

**Recognition of expenses:** Expenses are recognised in the statement of profit and loss when there is a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

**Concepts of Capital and Capital maintenance**

The concept of capital maintenance is concerned with how an enterprise defines capital that it wants to maintain. Broadly there are two concepts of capital maintenance:

*(a) Financial Capital Maintenance:* Under this concept, profit is earned only if the financial (money) amount of the net assets at the end of the period exceeds the financial (money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from owners during the period.(Framework for the Preparation and Presentation of Financial Statements, July 2000). It means capital is defined in terms of nominal monetary units and therefore profit represents the increase in *nominal money capital* over the period.

*(b) Physical capital maintenance:* Under this concept, profit is earned only if the physical productive capacity (or operating capability) of the enterprise 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.(Framework for the Preparation and Presentation of Financial Statements, July

2000). It means capital is defined in terms of *physical productive capacity* and profit represents an increase in that capital over the period.

**SELF-ASSESSMENT QUESTIONS**

- ❖ Define current and non-current assets as per Schedule III of the Companies Act, 2013 with examples.
- ❖ Is there an overriding effect of Schedule III of the Companies Act, 2013 with respect to Accounting Standards?
- ❖ What does the Statement of changes in equity shows? How is it prepared?
- ❖ Discuss the recognition of assets and liabilities in the financial statements with relevant examples.
- ❖ Explain the meaning and nature of *Income* and *Expenses* as per the regulatory framework.

## 1.6 KEY POINTS TO BE REMEMBERED

- ➢ The regulatory framework for the preparation and presentation of the financial statements is prepared by Institute of Chartered Accountants of India (ICAI) as being the statutory body for regulation and development of Accounting and the profession of Chartered Accountants in India.
- ➢ Ind AS1 is an Indian Accounting Standard which states, 'Presentation of Financial Statements'.
- ➢ The Balance Sheet of an enterprise shows its *financial position* as on a particular date while the Statement of profit and loss shows the *financial performance* over the period. The *cash flows* is being understood by preparation of Cash-flow Statement as per Ind AS7.
- ➢ The underlying assumptions of financial statements are accrual concept, going-concern and consistency.
- ➢ The qualitative characteristics of financial statements are understandability, relevance, reliability and comparability.
- ➢ The elements of financial statements are assets, liabilities, equity, income (including gains), and expenses (including losses).
- ➢ Recognition of the elements of financial statement means the process incorporating in the Balance sheet and Statement of profit and loss. Each element of financial statements has a definition and criteria for recognition in the financial statements.
- ➢ There are broadly two concepts of Capital Maintenance in financial statements- *Financial capital maintenance* and *Physical capital maintenance.*
- ➢ Under a *financial concept of capital*, such as invested money, capital is identical with the net assets or equity of the enterprise. Under a *physical*

*concept of capital,* such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

## CHECK YOUR PROGRESS

- Describe the scope and purpose of the Framework for the preparation and presentation of Financial Statements**.**
- Discuss the elements of the Financial Statements.
- What are the underlying assumptions of the Financial Statements?
- What are General purpose Financial Statements? What are its objectives?
- Elaborate the reliability characteristic of the Financial Statement.
- What is meant by recognition of the elements in the financial statements? What is the condition for recognition?
- Describe the qualitative characteristics of the financial statements?

## References and Suggested Readings


- *Framework for the Preparation and Presentation of Financial Statements,* July 2000, The Institute of Chartered Accountants of India (ICAI)
- *Study material on Financial Reporting, Ind AS1: Presentation of Financial Statements;* The Institute of Chartered Accountants of India (ICAI)
- *Contents Framework for the preparation and presentation of financial statements,* Ministry of Corporate Affairs, Retrieved on 19th Sept, 2023 https://www.mca.gov.in/XBRL/pdf/framework_fin_statements.pdf
- Bhushan Kumar Goyal and HN Tiwari, *Financial Accounting,* International Book House
- J. R Monga, *Financial Accounting: Concepts and Applications,*Mayur Paper Backs, New Delhi

# BLOCK III : Unit-2

# RELEVANT PROVISIONS OF COMPANIES ACT AND COMPLIANCE WITH THE ACCOUNTING STANDARDS AND SEBI GUIDELINES

**Unit Structure:**

1.1 Introduction

1.2 Objectives

1.3 Legal Requirements Related to Financial Statements as Provided U/S 129 of the Companies Act, 2013

1.4 General Instructions/ Rules for Preparation of Financial Statements

1.5 SEBI Regulations with Respect to Financial Results of Listed Entities.

1.6 Summary and Conclusion

1.7 References and Suggested Readings

## 1.1 INTRODUCTION

The financial statements prepared by Companies have to follow different provisions of Companies Act, 2013 read with different Accounting Standards and Rules framed by the government from time to time. It takes into account recent changes in accounting policies and accounting practices followed in India and other countries. Accounting is the language of business and therefore accounting information is communicated to different users by way of preparation and presentation of financial statements. Further, a company is an artificial person existing in the eyes of law and it is required to follow the relevant rules and regulations governing the company. By virtue of law and its nature, the company enjoys many benefits of working as a large corporation and fulfilling the needs and wants of the society by providing goods and services to its consumers. With this the role of regulators, the government, professional bodies etc. becomes pertinent in the smooth functioning of the company in the interest of the common good and public at large.

Companies get funds by issuing securities for the first time in the primary market and the secondary market (stock-exchange) provides a platform for the purchase and sale of already issued securities which are traded and listed in the stock-exchange. Hence stock-exchange provides liquidity and marketability of the securities issued in the primary market. Here the role of the capital market regulator, Securities Exchange Board of India (SEBI) plays an important part in the functioning, monitoring and protection of interests of the investors. SEBI is also responsible for the growth and development of the capital markets in India.

**1.2 OBJECTIVES:** After going through this unit, you will be able to:

**-** understand the relevant provisions of the Companies Act, 2013 for the preparation and presentation of the financial statements.

- Broad provisions of Schedule III of the Companies Act, 2013.

- SEBI Listing Regulations, 2015 applicable for financial results of listed entities.

## 1.3 LEGAL REQUIREMENTS RELATED TO FINANCIAL STATEMENTS AS PROVIDED U/S 129 OF THE COMPANIES ACT, 2013

- Sec 129(1) of the Companies Act, 2013 provides that the financial statements shall give a true and fair view of the state of affairs of the company. True and fair in respect of financial statements means—
    - ≈ the financial statements and the items contained in shall be in conformity with the Accounting Standards notified u/s 133.
    - ≈ be in the form or forms as may be provided for different class or classes of companies in Schedule III of the Companies Act, 2013.
    - ≈ However, the aforesaid provisions of sec 129(1) shall not apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of companies for which form of financial statements have been specified in or under the Act governing such class of company.
- Sec 129(2) states that financial Statements shall be placed before the Board of Directors in every annual general meeting (AGM) of a company.
- Sec 129(3) provides that where a Company has one or more subsidiaries or associate companies, in addition to standalone financial statements it shall also prepare Consolidated Financial Statements in accordance with accounting standards, as applicable and the same shall be laid before the Board in the AGM of a company.
- Sec 129(4) states that the provisions of the Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, with all necessary changes made, apply to the consolidated financial statements as referred in sec 129(3).
- Sec 129(5) states that where financial statements do not comply with the applicable accounting standards referred to in sec 129(1), the company shall disclose the following:
    - ≈ the deviation from the accounting standards.
    - ≈ the reason for such deviation.
    - ≈ the financial effects arising out of such deviation.
- Sec 129(6) empowers the Central government to exempt any class or classes of companies from complying any of the provisions of sec 129 or rules there under, either conditionally or unconditionally if it is necessary in the public interest.
- Financial statements shall include any notes annexed to or forming part of the statements.

- **Person responsible for compliance:** The persons responsible for compliance of the financial statements as per sec 129(7)are Managing Director, Whole-time director, Chief Financial Officer (CFO), other person of the Board entrusted with the duty of complying with requirements of sec 129. If the aforesaid persons are absent, all the directors shall be held responsible and punishable.
- **Penalty for non-compliance:** In case the persons referred to u/s 129(7) fails to take reasonable steps regarding the compliance of the financial statements, they shall in respect of each offence be punishable with imprisonment for a term which may extend to 1 year or with fine from Rs. 50,000 to uptoRs. 5,00,000 lakhs or both.

## 1.4 GENERAL INSTRUCTIONS/ RULES FOR PREPARATION OF FINANCIAL STATEMENTS:

Schedule III of the Companies Act, 2013 prescribes format of financial statements for the following three categories—(Goyal, 2020)

**(a)Division I:** It is applicable to a Company whose financial statements are not required to comply with Ind AS. They are required to comply with the Companies (Accounting Standards) Rules, 2006.

**(b)Division II:** It is applicable to a company whose financial statements are required to comply with Ind AS. Financial statements are prepared in compliance of the Companies (Indian Accounting Standards) Rules, 2015.

**(c) Division III:** It is applicable for a Non-Banking Finance Company whose financial statements are prepared in compliance of the Companies (Indian Accounting Standards) Rules, 2015.

**Some of the general instructions for preparation of Financial Statements are as follows:**

(i) The requirements of the Accounting Standards and other provisions of the Companies Act, 2013 would prevail over the Schedule III. In other words, Schedule III gives an overriding status to other provisions of the Companies Act, 2013 and the Accounting Standards wherever applicable.

(ii) The disclosure requirements in Schedule III are in addition to and not in substitution of disclosure requirements of the Accounting Standards. Additional disclosures specified in Accounting Standards shall be made by way of 'Notes to Accounts' or by additional statement unless required to be disclosed on the face of the Financial Statements. Similarly all other disclosures as required by the Companies Act shall be made in the Notes to Accounts in addition to the requirements laid out in the Schedule.

(iii) Notes to Accounts shall provide reference and detail information for the items presented on the face of the Balance Sheet and Statement of profit and loss.The manner of cross-reference has been changed to 'Note No' as compared to 'Schedule No'. It shall provide narrative descriptions or disaggregation of items recognized in those statements. It shall also include items that are not recognised in the financial statements such as contingent liabilities and commitments which are not shown on the face of the Balance sheet.

(iv) Figures for immediately preceding reporting period for all items shown in the financial statements including notes shall also be given except for the first Financial Statements prepared by the Company (after its incorporation).

(v) Depending upon the turnover of the company, the figures appearing in the financial statements shall be rounded off as follows:

i. If the turnover is less than one hundred crore rupees -- Rounded off to the nearest hundreds, thousands, lakhs, millions, or decimals thereof.
ii. If the turnover is one hundred crore rupees or more – Rounded off to the nearest lakhs, millions or crores, or decimals thereof.

Once a unit of measurement is used, it should be used uniformly in the financial statements.

(vi) The Schedule III of the Companies Act, 2013 sets out the minimum requirements for disclosure on the face of the Balance Sheet & Statement of profit and loss (Financial Statements) whereas Line items, sub-line items, Notes and sub-totals shall be presented as an addition or substitution on the face of the financial statements. Such presentation is relevant for understanding of the company's financial position or performance or it might cater to needs of industry-specific disclosure requirements or required for compliance to accounting standards or any amendments under the Companies Act.

(vii) **Current and Non-Current classification:** Schedule III of the Companies Act, 2013 prescribes the bifurcation of all items of assets and liabilities in the Balance Sheet as "Current and Non-current Assets" and "Current and Non-current liabilities". This is to be shown separately on the face of the Balance Sheet.

**Current & Non-Current Assets:**An asset shall be classified as current if it satisfies any of the following criteria:-

- It is expected to realize, or is intended for sale or consumption in the company's normal operating cycle.
- It is held primarily for the purpose of being traded.
- It is expected to realize within twelve months after the reporting date; or
- It is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for atleast twelve months after the reporting date.

All other assets will be classified as Non-Current. The following items shall be disclosed on the face of the balance sheet under the heading **'non-current' assets:**

(a) Property, plant and equipment (tangible assets)
(b) Intangible assets
(c ) Capital work in progress
(d) Intangible assets under development
(e ) Non-current investments
(f) Deferred tax assets (net)
(g) Long-term loans and advances
(h) Other non-current assets

**Operating cycle:** An operating cycle is the time period between acquiring of assets and its realization in cash or cash equivalents. Operating cycle may be a period of 12 months or lesser/more than 12 months. Where the normal operating cycle of a company cannot be identified, it is assumed to be a period of 12 months.

**Current and Non-Current Liabilities:** A liability shall be classified as current if it satisfies any of the following criteria-

- it is expected to settle in the company's normal operating cycle.
- It is held primarily for the purpose of being traded.
- It is due to be settled within twelve months after the reporting date; or
- The company does not have an unconditional right to defer settlement of the liability for atleast twelve months after the reporting date.

All other liabilities shall be classified as Non-Current. The following items shall be disclosed on the face of the balance sheet under the heading **'non-current' liabilities:**

(a) Long-term borrowings
(b) Deferred tax liabilities (net)
(c) Other long-term liabilities
(d) Long-term provisions

(viii) Schedule III has prescribed a format for presentation of 'Statement of profit and loss'. This format does not provide any appropriation items on the face of Statement of profit and loss. The line items has been shown under the heading 'Reserves and Surplus' in the Balance Sheet. It is to be noted that the Old Schedule VI of the Companies Act, 1956 has not prescribed any format for presentation of profit and loss account.

(ix) There has been a change in the nomenclature of the income statement which has been changed to "Statement of Profit and Loss" in place of "Profit and Loss Account".

## 1.5 SEBI REGULATIONS WITH RESPECT TO FINANCIAL RESULTS OF LISTED ENTITIES.

- In enabling investors to make well-informed decisions, preparation and presentation of financial statements in a timely, adequate and accurate disclosure is very much essential on periodical basis. At the same time, to ensure comparability, uniformity and parity in disclosures made by listed entities across stock-exchanges is necessary. For this, Regulations 33 of the SEBI LODR (Listing Obligations and Disclosure requirements) Regulations, 2015 (referred to as Listing Regulations, 2015) has prescribed various disclosures and formats to be followed under different provisions by Listed Companies.Financial Statements are prepared on annual basis; once in a financial year. However, Quarterly Financial Statements are prepared by listed companies as per SEBI requirements.

The listed entities has to follow certain guidelines while publishing financial results under SEBI which are as follows:

- **Following accounting principles:**The financial statements are to be prepared on the basis of accrual accounting policy and adoption of uniform accounting practices for all periods. Financial statements are to be prepared in accordance with Generally Accepted Accounting Principles (GAAP) in India.
- **Interim Financial Reporting:**The quarterly and half-yearly financial results shall be in accordance with the recognition and measurement principles laid down in Accounting Standards, as applicable dealing with Interim Financial Reporting (AS 25/ Ind AS34) read with relevant rules framed as specified by ICAI, whichever is applicable.
- **Submission of Consolidated Financial Statements:**The listed entities with subsidiaries, associate or joint venture companies have to submit Consolidated Financial Statements along with standalone financial statements of the Company. The consolidated financial statements have to be prepared as per the applicable accounting standards. (AS 21/Ind AS 110).
- **Certification of Financial Statements:** The approval and authentication of the financial results by listed entities are to be done in the following manner:

  (a)The quarterly financial results submitted shall be approved by the Board of Directors. It is to be noted that while placing the financial statements before the Board, the chief executive officer (CEO) and chief financial officer (CFO) of the listed entity shall certify that the financial results do not contain any material misstatements or figures and do not omit any material information relevant for the purpose of decision making.

  (b) The financial results submitted to the stock exchange shall be signed by the Chairperson or Managing Director, or a whole-time director or in the absence of all of them, it shall be signed by any other director of the listed entity authorized by the Board to sign the financial results.

  (c ) The limited review report along with financial results shall also be placed before the Board of Directors, in its meeting before being submitted to the stock exchange(s).

  (d) The annual audited financial results shall be approved by the Board of Directors in a manner as specified in clause (a) and (b) above.
- **Timelines for submitting financial statements by listed entities:**

  (a) Quarterly and year-to-date standalone/consolidated financial statements- within 45 days of end of each quarter, other than the last quarter.

  If the company opts for submitting unaudited financial results, it shall be subject to limited review by statutory auditors of the listed entity and shall be accompanied by Limited Review Report.

  If the company opts for submitting audited financial results, it shall be accompanied by an audit report.

  (b) Annual audited standalone/consolidated financial statements- within 60 days from the end of the financial year along with the audit report.

- **Limited review report:** The listed entities shall ensure that Limited Review audit reports submitted to the stock exchange on a quarterly or annual basis are to be given only by an auditor who has subjected himself/herself to the peer review process of ICAI and holds a valid certificate issued by the Peer Review Board of the ICAI. The review is in accordance with the Standard on Review Engagement (SRE) 2400, Engagements to Review Financial Statements issued by the Institute of Chartered Accountants of India. This standard requires to plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. It is lesser than an audit and therefore no audit opinion is to be provided.
- **Other reports:**The listed entities shall also submit as part of its standalone/consolidated financial results for the half year, by way of a note, a 'statement of assets and liabilities' and 'statement of cash flows'for the half-year.
- The listed entity shall ensure that for the purpose of quarterly consolidated financial results, atleast 80% of each of the consolidated revenue, assets and profits respectively, shall have been subject to audit or in case of unaudited financial results, subjected to limited review.
- **Newspaper advertisements:** The financial results of the listed entities are to be published in newspaper advertisements in the following manner:

  (a) The notice of the meetings convened for publishing financial results of the listed companies can be published in the newspaper.

  (b) The Company must publish its financial results as per SEBI regulations in a national newspaper in English daily and also in a regional language where the listed company has its head office or registered office located.

  (c) The information related to financial results must be published after 48 hours of approval in the Board meeting.

  (d) A company listed in the stock exchange must submit the financial information in the newspaper and the stock-exchange simultaneously.

  (e ) The company publishing financial results in the newspaper must provide reference link of the company website in the newspaper which has to be an operating website of the listed company.

  (f) Regulation 29 of the SEBI Listing Regulations, 2015 requires that the listed entity must intimate the stock exchange about the Board publishing financial results and it must be five clear working days excluding the dayof the Board meeting and the date of intimation. (Guidance note on Meetings of the Board of Directors, 2017)

  (g) Resolutions and outcomes of the Board meeting must be communicated to the stock-exchange within 30 minutes from the closure of the Board meeting. (Guidance note on Meetings of the Board of Directors, 2017)

  (h) **Annual Report:**The listed entity must submit the Annual Report to the stock-exchange within 21 working days of it being approved in the Annual General Meeting (AGM) of the Company. The soft copies of full annual report shall be sent to the shareholders whose email address are registered with the company. Hard copy of the annual report containing salient features of all the documents as provided in sec 136 of the Companies Act, 2013 or rules made there under to those shareholders who have not registered their email id. Shareholders can also request the hard copy of the annual report of the company. The Annual Report of the listed entity must be sent to the shareholders atleast 21 working days before the Annual General Meeting (AGM). (Disclosures in Annual Report, 2018)

The Annual Report of the Company shall contain-

- ≈ Audited standalone and consolidated financial statements, that is, Balance Sheet& Statement of Profit and Loss, Statement of changes in equity, Notes to Accounts.
- ≈ Cash flow Statement prepared only under indirect method in accordance with AS 3 or Ind AS7.
- ≈ Directors Report including Auditor's Report and Declaration from Independent Directors.
- ≈ Management Discussion & Analysis (MD &A) Report.
- ≈ Corporate Social Responsibility Policy
- ≈ Business Responsibility Report (BRR) as part of Company's environmental, social and governance (ESG) initiatives.
- ≈ The Annual Report shall contain any other disclosures as specified in Companies Act, 2013 along with SEBI Listing Obligations and Disclosure Requirements (LODR) Regulations, 2015.

In case of private and unlisted public companies, Sec 134 and other applicable provisions of the Companies Act, 2013 are applicable read with relevant Rules. In other words, SEBI Listing Regulations, 2015 is not applicable for private and unlisted public companies.

**STOP TO CONSIDER**

- ❖ What is Limited Review Report? Is it same or different from an Audit report?
- ❖ What is the purpose of SEBI Listing Regulations, 2015?
- ❖ Why there is a need for enhanced disclosure requirements in the financial statements of a company?
- ❖ Who are the persons responsible for compliance of the financial statements of a company?
- ❖ What are Consolidated Financial Statements?
- ❖ Does Accounting Standards gives an over-riding effect to the provisions of Schedule III of the Companies Act, 2013?

## 1.6 SUMMARY AND CONCLUSION

Sec 128 to 138 deals with the financial statements requirements of the Company as per Companies Act, 2013. The Schedule III of the Companies Act, 2013 provides the manner in which every company registered under the act shall prepare its Balance Sheet, Statement of Profit and Loss, and Notes to Accounts. There was also the need for enhancing the disclosure requirements and henceforth, many changes have been incorporated in the presentation of the financial statements. Each item appearing on the face of the Balance Sheet and Statement of profit and loss can be cross-referenced in the 'Notes to Accounts' by providing Note No in the statements. In addition, listed entities whose shares are actively traded and listed on the stock-exchange has to follow the SEBI Listing Regulations, 2015 to ensure uniformity and comparability of the disclosures made by listed entities across stock-exchanges. SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 requires for the compliance of financial results submitted by the Company to the stock-exchange.

**CHECK YOUR PROGRESS**

- Explain the meaning of current assets and current liabilities as per Schedule III of the Companies Act, 2013.
- Describe the salient features of SEBI Listing Regulations, 2015 for listed entities.
- Give the legal requirements related to financial statements as provided u/s 129 of the Companies Act, 2013.
- Write a short note on 'Notes to Accounts' describing its meaning and significance.
- What is an Annual Report and state the main contents of an annual report of a company?

**SELF-ASSESSMENT QUESTIONS**

- What are divisible profits? Give some examples.
- What are the statutory provisions regarding transfer of profits to reserves?
- Describe the Ind AS16 related to 'Property, plant and equipment'.
- Write a short note on Interim Dividend and Final Dividend.
- Give the format of Balance Sheet & Statement of Profit and Loss as per Division I-Non Ind AS Schedule III.
- Give the format of Balance Sheet & Statement of Profit and Loss as per Division IIInd AS.
- Give the meaning and features of financial reporting.
- Analyse an Annual Report of a Company of your choice describing its main contents and a brief summary of the main points covered.

❖ Outline the major changes related to the Balance Sheet & Statement of Profit and Loss of the Schedule III of the Companies Act, 2013 as compared to old Schedule VI of the Companies Act, 1956.

## 1.7 References and Suggested Readings


- Circular on Formats for Publishing Financial results, dated Nov 30, 2015,*Securities and Exchange Board of India (SEBI)*
- Compendium of Accounting Standards, dated July 1, 2019 , *The Institute of Chartered Accountants in India (ICAI), New Delhi*
- Guidance note on Meetings of the Board of Directors, dated October 2017, *The Institute of Company Secretaries of India (ICSI)*
- Disclosures in Annual Report, dated May 2018, *The Institute of Company Secretaries of India (ICSI)*
- Accounts of Companies Report, *The Institute of Company Secretaries of India (ICSI),* Retrieved on 27th Sept, 2023
- Financial results under SEBI Regulations, *https://enterslice.com/learning/financial-results-under-sebi-regulations-for-listed-entities/#:~:text=Financial%20statements%20and%20results%20have,be%20followed%20by%20the%20company.* Retrieved on 26th Sept, 2023.
- Bhushan Kumar Goyal,*Corporate Accounting,*Taxmann Publications, New Delhi

**BLOCK III : Unit-3**

## Comparison of Indian Accounting Standards and IFRS

**Unit Structure:**



### 3.1: Introduction

The international accounting standards setting process began decades ago as an effort by the industrialized nations to create standards that could be used by developing and smaller nations, unable to develop their own standards. But over the recent decades, the expansion of global trade resulted into the globalization of capital markets. A company in one country is borrowing in the capital markets of several other countries. Therefore, the financial statements prepared in one country are being used in other countries more and more frequently. As such, the need of the business houses to communicate successfully to the investors and other stakeholders across the national borders has become critical to their global competitiveness. However, the issuers willing to raise capital in a foreign country are faced with increased compliance costs and inefficiencies of preparing multiple sets of financial statements to comply with different jurisdictional accounting requirements. Thus, the government, market regulators, corporate accounting authorities and investors at large began to realize the need for having a common set of accounting standards. In an effort to converge with International Financial Reporting Standards (IFRS), the Ministry of Corporate Affair (MCA), Government of India released 35 India accounting standards (known as "Ind AS") on February, 25, 2011

### 3.2: Objectives

After going through this unit, you will be able to-

- Compare Indian Accounting Standards with IFRS
- Analyse the deviation of Accounting Standards from IFRS
- Understand the similarities between Indian GAAP and IFRS

## 3.3: Accounting Standards

The government, market regulators, corporate accounting authorities and investors at large began to realize the need for having a common set of accounting standards. India, the emerging economic giant, has been consistent during the past decade through planning discussion to harmonize its accounting practices with the global accounting frame work. Finally, The Union Finance Minister, Mr. Arun Jaitley, as a part of his Budget Speech on 10th July, 2014, proposed to make Ind AS the set of Indian Accounting Standards closely aligned with International Financial Reporting Standards (IFRS) mandatory for Indian companies from the financial year 2016-17. He also mentioned that the companies could opt to adopt Ind AS Voluntarily from financial year 2015-16. Later on February 16, 2015, Ministry of Corporate Affairs (MCA), Government of India, issued a notification announcing Companies (Indian Accounting Standards) Rules, 2015, mandating the application 39 new Ind ASs. Accounting to the notification, Ind AS will first apply to companies with a net worth equal to or exceeding 500 crores INR-the Phase 1 companies, beginning April 1, 2016. This will also require comparative Ind AS information for the period from April, 1, 2015 to March 31, 2016. However, given the complexity of interrelated laws and regulations prevalent in the country, it is perceived that the process of transition to the new standards while maintaining the quality of corporate disclosure would be anything but smooth and hassle free. This unit attempts to bring to light certain issues relating to the process of implementation of Ind As which, as a matter of fact, has presently engulfed the Phase 1 companies in an uncertain position with respect to reporting procedure, conflicting regulatory norms, tax implications and some other related issues.

## 3.4: Indian Accounting Standards and IFRS

With the whole world having become a global village, the businesses are increasingly going glocal= global +local, as these businesses speak the language of accounting, there was a compelling need that they spoke a universally common accounting language for better comparability and unambiguous understanding of financial statements across all companies and jurisdictions. The IFRS not only fulfills of benefits to the economics. India too has rightly kept pace with the global accounting revolution encompassing more than 140 countries, having largely converged with IFRS with only a few carve-outs, overcoming a range of challenges. The Ind AS converged with IFRS has put India at the centre stage of high quality and transparent financial reporting whose benefits for sure outweigh the challenges. There is an urgent need to converge current Indian standards with international accounting standards (IAS) announced by finance minister in the 2014 budget speech, acknowledging the immense underlying benefits and using India in a new era of path breaking accounting reform. Since then the process of convergence in India has come a long way, with the MCA announcing a firm roadmap for adoption of Ind AS converged with IFRS on 16th February, 2015
and notified 39 Ind AS.Later on 30 March 2016, the MCA also issued the companies (Indian Accounting Standards) (Amendment) Rules, 2016 replacing 2 Ind AS for the earlier notified Ind AS 115, Revenue from contracts with customers.

The roadmap in its first phase, requires companies with a net worth of Rs. 500 crore or more (along with their holding, subsidiary, joint venture and associate companies) to mandatorily adopt Ind

AS from or after 1st April, 2016. All the remaining listed companies, and unlisted companies with a network of Rs. 250 core or more will have to adopt Ind AS from 1st April, 2017.
According companies in the first phase, have to comply with Ind AS and most of them have already come out with their first quarterly financials based on Ind AS. Meanwhile, as series of announcements by MCA and then by RBI have set the ball rolling for the adoption of Ind AS on the reporting language for banks, NBFCs and insurance companies in the near future. The banks are required not only required to prepare the half yearly preformed Ind AS financial statement (Fs) as on 30th Sept. 2016, but also to disclose the strategy for Ind AS implementation in their Annual Report for FY 2016-17 and FY 2017-18.

Ind AS is a business imperative for Indian companies today. This is because it will not only greatly help in boosting foreign investment and making our capital market more robust, but will also benefit investors and other users of Financial Statement by refining the quality of reported information. It will also facilitate cross border acquisitions, partnership and alliances with foreign entities, thereby boosting overall economic growth. There are some challenge to come in the way forward. The Ind AS implementation in likely to have a wide ranging impact on Indian companies, including its financial results, Accounting for mergers, acquisition, consolidation, share based payment, financial instruments, revenue recognition, taxes and increased use of fair value are some of the areas that may be pose interpretation and implementation challenges under Ind AS. One of the key challenges, which may also be relevant for Indian companies is that IFRS or Ind AS are principles based standards which require transactions to be accounted for based on their economic substance. Implementing Ind AS is likely to impact key performance matrix. It has wide application on a company's processes, its systems, internal financial controls, income tax pay rate, remuneration policies and also contractual arrangement. Change in reporting brings lots of changes in the areas of provisioning, capitalization, depreciation etc which may widely affect the profitability and worth of the organisation. (Ref Editorial Board, ICAI, October, 2016). New Delhi

**STOP TO CONSIDER**

“ Ind AS convergence with IFRS and its implementation in likely to have a wide range of impact on Indian companies. The Ind AS converged with IFRS has put India at the centre stage of high quality and transparent financial reporting whose benefits for sure outweigh the challenges.”

## 3.5: Comparison of Indian Accounting Standards and IFRS :

The following table will highlight the differences between the IFRS and Ind AS in treatment of various elements.

| Topic | IFRS Treatment | Ind AS Treatment |
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| IFRS 3, Business Combinations | IFRS 3 excludes from its scope business combinations of entities under common control. In practice, such transactions are accounted for either at book values (with the difference adjusted in reserves) or by applying the acquisition method following for other business combinations. | Ind AS 103 (Appendix C) gives guidance in this regard. Use of the acquisition method (based on fair values) is not permitted under Ind AS for common control transactions. Conversely, recognition of good will, while otherwise using the book value approach, would not be permitted under IFRS. |

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| | IFRS requires that the excess of the fair value of identifiable net assets over the consideration paid should be recognized in the profit and loss account. | Ind AS 103 requires the same to be recognized in other comprehensive income and accumulated in equity as capital reserve. In cash the business combination cannot be conclusively classified as a bargain purchase. It shall be recognized directly in equity as capital reserve. |
| IAS 1, Presentation of Financial Statements | IFRS provides an option either to follow the single statement approach or to follow the two statement approach, all items of income and expense are recognized in the statement of profit and loss, in the two statement approach, two statements are prepared, one displaying components of profit or loss (separate income statement) and the other beginning with profit or loss and displaying components of other comprehensive income | Ind AS allows only the one-statement approach. |
| | IAS I requires preparation of a statement of changes in equity as a separate statement | Ind AS 1 requires the statement of changes in equity to be shown as a part of the balance sheet. |
| | Paragraph 37 of IAS 1 permits the usage of a period other than one year (e.g. of 52 weeks for preparation of financial statement) | Ind AS 1 does not permit it. |
| | IFRS requires a company to present expenses recognized in the profit and loss account using a classification based on either their nature or their function within the company. | Ind AS requires such classification by nature. |
| | In the case of companies other than financial companies. IFRS gives and option to classify the interest and divident paid and interest and devident received as items of operating cash flows. | In AS does not provide such an option and requires these items to be classified as items of financing activity and investing activity, respectively. |
| | IAS 1 contains implementation guidance | Ind AS 1 does not include implementation guidance because various enactments have prescribed formats (e.g. schedule VI to the companies Act, 1956) |

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| IAS 2, Inventories | IAS 2 requires recognition of inventories as an expense based on function-wise classification. | The paragraph has been deleted because of the removal of the option provided in IAS 1 to present as analysis of expenses recognized in profit or loss using a classification based on their function within the equity. |
| IAS 7, Statement of Cash Flows | In case of other than financial entities, IAS 7 gives an option to classify the interest paid and interest and dividends received as items of operating cash flows. IAS 7 gives an option to classify the dividend paid as an items of operating activity. | Ind AS 7 does not provide such an option and requires these items to be classified as items of financing activity and investing activity, respectively. |
| IAS 11, Construction Contracts IFRIC 12, Service Concession Arrangements SIC 29, Service Concession Arrangements : Disclosures | IAS 11 does not deal with accounting for construction contracts in respect to real estate developers. | This has been dealt with under Ind AS 11, since it has been kept out of the scope of Ind AS 18, Revenue. |
| IAS 12, Income Taxes | IFRS requires presentation of tax expense (income) in the separate income statement, where a separate income statement is presented. | Ind AS 1 requires that components of profit or loss and components of other comprehensive income shall be presented as a part of the statement of profit and loss. |
| IAS 17, Leases | IAS 17 classifies property interest held under an operating lease as an investment property, if the definition of investment property is otherwise met and the fair value model is applied. | In AS 40, Invetment property, prohibits the use of fair value model. |
| | Under IFRS, accounting prescribed for embedded leases is mandatory for all companies in transition to IFRS. | Under Ind AS, the applicability of guidance on embedded leases has been deferred. This guidance may become applicable commencing a date that may be later than the transition date to Ind AS. |
| IAS 18, Revenue | On the basis of principles of the IAS 18, IFRIC 15, Agreement for construction of Real Estate, prescribes that construction of real estate should be treated as sale of goods and revenue should be recognized when the entity has transferred significant | Provisions of IFRIC 15 do not affect INd AS 18, Revenue, and have been included in Ind AS 11, Construction Contracts. |

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| | risks and rewards of ownership and retained neither continuing managerial involvement nor effective control | |
| IAS 19, Employee Benefits | IAS 19 permits various options for treatment of actuarial gains and losses for postemployment defined benefit plans. | Ind AS 19 requires recognition of actuarial gains and losses in other comprehensive income, both for postemployment defined benefit plans and other long-term employment benefit plans. The actuarial gains recognized in other comprehensive income should be recognized immediately in retained earnings and should not be reclassified to profit or loss in a subsequent period. |
| | IAS 19 does not provide guidance for actuarial valuation of defined benefit obligations. | Ind AS 19 gives guidance and states that detailed actuarial valuation of defined benefit obligations may be made at intervals not exceeding three years. |
| | IAS 19 requires that government that government bonds can be used only where there is no deep market of high-quality corporate bonds to discount portemployment benefit obligations. | According to Ind AS 19, the rate to be used to discount postemployment benefit obligations shall be determined by reference to the market yields on government bonds. |
| IAS 20, Accounting for Government Grants and Disclosure of Government Assistance | IAS 20 gives an option to measure non-monetary government grants either at their fair value or at nominal value. | Ind AS 20 requires measurement of such grants only at their fair value. |
| | IAS 20 gives an option to present grants related to assets, including nonmonetary grants, at fair value in the balance sheet either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset. | Ind AS 20 requires presentation of such grants in the balance sheet only by setting up the grant as deferred income. Thus, the option to present such grants by deducting the grant in arriving at the carrying amount of the asset is not available under Ind AS 20. |

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| IAS 21, The Effects of Changes in Foreign Exchange Rates | IFRS requires all foreign exchange differences to be recorded immediately in the profit and loss account. | Ind AS 21 permits an option to recognize exchange differences arising from translation of certain long-term monetary item from foreign currency to functional currency directly in equity. In this situation. Ind AS 21 requires the accumulated exchange differences to be transferred to profit or loss over the period of maturity in an appropriate manner. |
| IAS 24, Related Party Disclosures | IFRS had no such provisions | In Ind AS 24, disclosures that conflict with confidentiality requirements of stature/regulations are not required to be made since According Standards cannot override legal/regulatory requirements. |
| | IFRS has no such provisions | In Ind AS 24 father, mother, brother and sister relatives as specified under meaning of "relative". Under the companies Act, 1956 are included in the definition of 'close members of the family of a person." |
| | IFRS has no such provisions | Ind AS 24 provides additional clarifying guidance regarding aggregation of transactions for disclosure. |
| IAS 28, Investments in Associates | Where the financial statements of as associate use in applying equity method are prepared as of a date different from that of the investor, IAS 28 requires that this difference should not be more than three months. | Ind AS 28 provides that this difference should not be more than three months, unless impracticable. Similarly, paragraph 26 of Ind AS 28 requires use of uniform accounting policies, unless impracticable, which IAS 28 does not provide. |
| | Standard is applicable to mutual funds, unit trusts and similar entities including investment-linked insurance funds | Paragraph 1 (d) of IAS 28 has been deleted in Ind AS 28 as the Companies Act. 1956, is not applicable to mutual funds, unit trusts, and similar entities including investment linked insurance funds. Thus, this standard would not be applicable to such entities. |

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| | IFRS requires any excess of the investor's share of net assets in an associate over the acquisitions cost to be recognized as a gain in the profit and loss account. | Ind AS 28 has been modified on the lines of Ind AS 103 to transfer excess of the investor's share of the associate's identifiable assets and liabilities over the cost of investment to capital reserve. |
| IAS 29, Financial Reporting in Hyperinflationary Economies | IFRS does not require such a disclosure | Ind AS 29 requires an additional disclosure regarding the duration of a hyperinflationary situation existing in the economy. |
| IAS 32, Financial Instruments : Presentation | This exception is not provided in IAS 32 | As an exception to the definition of "financial liability". Ind AS 32 considers the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is considered as an equity instrument if the exercise price is fixed in any currency. |
| IAS 33, Earnings per Share | IAS 33 provides that when an entity presents both consolidated financial statement and separate financial statements, it may give information related to earnings per share in consolidated financial statements only. | Ind AS 32 requires information related to earnings per share to be disclosed both in consolidated financial statements and separate financial statements. Paragraph 4 has been modified in Ind AS 33 to clarify that an entity shall not present in separate financial statements earnings per share based on the information given in consolidated financial statements. It also requires, as does, IAS 33, that earnings per share based on the information given in separate financial statements shall not be presented in the consolidated financial statements. |
| | Under IFRS, earnings per share must be disclosed by listed companies and companies in the process of listing. | Under Ind AS, earnings per share must be disclosed by all companies applying Ind AS. |
| | No such requirement under the IFRS | Ind AS 33 this paragraph has been added : "Where any item of income or expense which is otherwise required to be recognized in profit or loss in accordance with accounting standards is debited or credited to securities premium |

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| | | account/other reserves, the amount in respect thereof shall be deducted from profit or loss from continuing operations for the purpose of calcularing basic earnings per share." |
| | No such requirement under the IFRS | In Ind AS 33, paragraph 15 has been amended by adding the phrase "irrespective of whether such discount or premium is debited or credited to securities premium account" to future clarify that such discount or premium shall also be amortized to retained earnings. |
| IAS 34, Interim Financial Reporting | With regard to preparation of the statement of profit and loss, IAS 34 provides the option either to follow the single statement approach or to follow the two statement approach. | Ind AS 34 allows only the single-statement approach like Ind AS 1 |
| | IAS 34 requires preparation of a statement of changes in equity as a separate statement. | Ind AS 34 requires the statement of changes in equity to be shown as a part of the balance sheet like Ind AS 1 |
| IAS36, Impairment of Assets | IAS 36 states that the standard shall not be applied for accounting for impairment of the investment property that is measured at fair value. | In AS 36 does not so specify, as Ind AS 40 permits the cost model only. |
| IAS 38, Intangible Assets SIC 32, Intangible Assets-Website Costs | With regard to the acquisition of an intangible asset by way of a government grant, IAS 38 provides an entity the option to recognize both asset and grant initially at fair value or at a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use. | Ind AS 38 allows only fair value for recognizing the intangible asset, and the grant would be accounted for in accordance with Ind AS 20. |
| IAS 39, Financial Instruments : Recognition and Measurement | Under IFRS, in determining the fair value of financial liabilities designated as fair value through profit or loss upon initial recognition, any change in fair value due to changes in the company's own credit risk are also considered. | A provision has been added in Ind AS 39 that states that in determining fair value of the financial liabilities that upon initial recognition are designated at fair value through profit or loss, any change in fair value consequent to changes in the entity's own credit risk shall be ignored. |

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| IAS 40, Investment Property | ISA 40 permits both the cost model and the fair value model (except in some situations) for measurement of investment properties after initial recognition. | Ind AS 40 permits only the cost model. |
| | IAS 40 permits treatment of property interest held in an operating lease as investment property, if the definition of investment property is otherwise met and the fair value model is applied. In such cases, the operating lease would be accounted for as if it were a finance lease. | Under Ind AS 40, this treatment is prohibited |

## 3.6: Deviation of Accounting Standards from IFRS:

Ind AS contains a number of deviations from IFRS that may be segregated into five board categories.

**Category 1:** *Deviations from IFRS that result in Ind AS financial statements not being in compliance with IFRS.* For example, under IFRS, a foreign currency convertible bond is treated as a hybrid instrument having a liability and a derivative component. Ind AS 32 requires that the derivative component is treated as equity, if the exercise price is fixed in any currency.

**Category 2:** *Removal of Options*. Ind AS financial statements are compliant with IFRS, although accounting treatment choices are eliminated or minimized. For example, International Accounting Standard (IAS) 40 permits both the cost and the fair value model for subsequent measurement of investment properties. Ind AS 40 does not permit the use of the fair value model.

**Category 3:** *Additional options provided under Ind AS*. The financial statements do not remain compliant with IFRS if the entity has chosen these options. For example, Ind AS 101 allows a first-time adopter to use the transitional date circumstance to measure noncurrent assets held for sale and discontinued operations at the lower of carrying value and fair value less cost to sell.

**Category 4:** *Deferment of non adoption of certain IFRS*. Ind AS statements are not IFRScompliant. For example, the next IFRS pronouncements have been issued under Ind AS.

IFRS 9, Financial Instruments.

IAS 26, Accounting and Reporting by Retirement Benefit Plans.

IAS 41, Agriculture.

(IFRIC) 2, Member's Share in Cooperative Entities and Similar Instruments.

IFRIC 15, Agreement for Construction of Real Estate.

**Category 5:** *Regulatory and practice-related differences*. For example, the differences necessary to ensure conformity with Indian Companies Act, 1956 and requirement of presentation of Annual accounts under Schedule VI of the same Act.

Ind AS has maintained certain general differences with the IFRS, as described next.

1. In AS uses some terms that differ from IFRS. For example, the term "balance sheet" is used instead of "Statement of financial position," and the term "statement of profit and loss" is used instead of "Statement of comprehensive income". The word "approval of the financial statements for issue" are used instead of "authorization of the financial statements for issue" in the context of financial statements considered for the purpose of events after the reporting period.

2. Under IFRS 1, transitional provisions in other IFRS do not apply to a first-time adopter's transitional to IFRS, unless otherwise permitted by IFRS. Ind AS standards to do not contain transitional provisions of corresponding IFRS/IAS standards.

3. Notification/applicability of certain standards/appendices of standards such as IFRIC 12 (Appendix A to Ind AS 11), Standing Interpretations Committee (SIC) 29 (Appendix B to Ind AS 11), IFRIC 4 (Appendix C to Ind AS 17), IFRS 4 (Ind AS 104), and IFRS 6 (Ind AS 6) has been deferred to a later date. However, Ind AS 8 states that an entity may consider the most recent pronouncements of IAS 8 in deciding the accounting treatment for transactions not covered by Ind AS.

4. The conceptual framework for financial reporting has not been notified under Ind AS. However, certain Ind AS (e.g., Ind AS 1 and Ind AS 8) refer to the framework. Further, differences may arise, depending on the manner in which the Campanies Amendment Bill is legislated, particularly with regard to provisions relating to Section 100, Section 78, Schedule VI, Schedule XIV, consolidation requirements, etc. In addition, differences may arise due to future changes introduced in IFRS and the manner in which they are incorporated in Ind AS.

**Check your Progress**

1. What are the impact of Ind AS convergence with IFRS on Indian Companies?
2. Mention two similarities between Indian GAAP and IFRS.
3. Mention the IFRS treatment and Ind AS treatment of Income Tax .

3.7: **Differences between Indian GAAP and IFRS**: The following table will highlight the major differences between Indian GAAP and IFRS.

| Point of Difference | IFRS | Indian GAAP |
|---|---|---|
| 1. Preparation of Financial Statements | Main components of financial statements are :<br>1. Balance sheet (Fund statements)<br>2. Statement of comprehensive income<br>3. Statement of changes in equity<br>4. Cash flow statement Information about accounting policies and notes to financial statements. These components should disclose last three years information. (Ref. IndAS-1) | Components according to Indian GAAP are as follows :<br>1. Balance sheet<br>2. Cash flow statement<br>3. Profit and loss accounts<br><br>In indian GAAP they should disclose last two year's data. (Reference : AS-1) |

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| 2. Expense Recognation | While classifying the expense, IFRS gives two considerations to follow. Entities can divide expenses either by nature or by function. They can take any one of these as consideration while recognizing expenses. Even they need to make certain notes about which nethod they are following and disclose the same in financial statements.<br>(Classification of expense nature means when expenses are classified according to their nature, e.g. depreciation, transportation expense, rest expense etc. and classification of expense function means when expenses are classified according to their function, e.g. administration expenses, selling and distribution expenses. Under Ind-AS, Infosys ltd. 2014 are classiftying expenses according to function. | The recognition of expenses by nature is the only option provided according to Indian GAAP.<br>(Under Indian GAAP infosys ltd. has classified expenses according to nature) |
| 3. Other Comprehensive Income Statement | In the case of IFRS, one concept is there relating to the preparation of "Other comprehensive income" statement. Entities can add 'other comprehensive income' as a separate item under the financial statements. | There is no concept relating to 'other comprehensive income provided in Indian GAAP' |
| 4. Small sized and Medium Sized Companies | IFRS has a special set of principales and guidelines in case of small sized and medium sized companies. IFRS has certain set of financial reporting guidelines for these companies. | There are certain conditions under which certain exemptions are relazations are given to small sized and medium sized companies. For e.g. no need to prepare cash flow statements for small sized companies. |

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| 5. Consolidated Financial Statements | For both listed and unlisted companies, parents companies are required to include all subsidiary companies, both domestic and foreign, while preparing the consolidated financial statements. | Only listed companies are required to present consolifated financial statements, only it controlling interest exists (if the parent company is holding more than 50% stake in subsidiary company) |
| 6. Revenue recognition | Revenue recognition under IFRS is different. Revenue from sale can be recognized only when risk and rewards are transferred from seller to buyer. | Revenue can be recognized when arrangement of sale is made, although the goods have not been physically delivered to the buyer. It is creating risk to company in case if the company fails to sell the product. |
| 7. Cash Flow Statements | Under cash flow statement, there are a few new adjustments in IFRS that is not available in Indian GAAP. For example, under Investing activities, following adjustments are shown relating to expenditure on Property, Plant & Equipment (PPE), intangibles and other long term assets.<br>Under Financing Activities, following adjustments are available in IFRS relating to cash payments to owners, to acquire or redeem the entity's shares and cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease. | These adjustments are not available in case of IGAAP |

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| 8. Valuation of Assets | At the time of valuation of assets, the company can use only fair value method. Only fair value method is allowed. (Ind AS-16 defines fair value as the price that would be received to sell an asset, to sell an asset, or paid to transfer a liability in an orderly transaction between market participants at the measurement date). | At the time of valuation of assets, companies usually use historical value method. |
| 9. Inclusion of 'Appendix' | Under IFRS, there is a separate section as 'Appendix' at the end of the discussion relating to an accounting standard. The purpose of this Appendix is only to bring out the differences between the Indian accounting Standards and the corresponding International Accounting Standards. | 'Appendix' is not available in Indian GAAP. |
| 10. Statement of Changes in equity | The same is available under IFRS. It provides information about what owners wants. Owners have invested money in business and they are worried about their money. 'Change in equity statement' tell us the effects of business operations on their wealth. | Under Indian GAAP, no such statement is required to be prepared. |

**3.8: Similarities between Indian GAAP and IFRS:** The following table will highlight the similarities between Indian GAAP and IFRS.

| Point of Difference | IFRS | Indian GAAP |
|---|---|---|
| Contents of Cash Flow Statements | Contents of cash flow statement were :<br>1. Operating activity<br>2. Financing activity<br>3. Investing activity | Contents of cash flow statements were :<br>1. Operating activity<br>2. Financing activity<br>3. Investing activity |
| Treatment of income Taxes in Cash Flow Statements | In case of taxes paid as income tax, it is recorded as an operating activity unless there is specific guidance about investing activities and financing activities. | In case of taxes paid as income tax, it is recorded as an operating activity unless there is specific guidence about investing activities and financing activities. |
| Methods of preparing cash flow statements | Listed and other companies can prepare the cash flow statement either on the basis of direct or indirect method. | Listed and other companies can prepare the cash flow statement either on the basic of direct or indirect method. |
| Cash flow from foreign currency | Cash flow foreign currency is determined based on the exchange rate prevailing at the date of preparing the cash flow statement. | Cash flow from foreign currency is determined based on the exchange rate prevailing at the date of preparing the cash flow statement. |
| Cost of Initial Investment | At the time of initial investment, the purchase price of the property is recorded at cost price. | At the time of initial investment, the purchase price of the property is recorded at cost price. |
| Measurement of Inventories | In case of valuation of inventories, it is done either at the cost price or net realizable value, whichever is lower, (Reference : AS-2) | In case of valuation of inventories, it is done either at the cost price or net realizable value, whichever is lower, (Reference : AS-2) |

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| Method of Inventory Valuation | To calculate inventory, only weighted Average and FIFO method are considered. | To calculate inventory, only Weighted average and FIFO method are considered. |

**3.9: Summing Up:**

- Government of India released 35 India accounting standards (known as "Ind AS") on February, 25, 2011
- India, the emerging economic giant, has been consistent through planning and discussion, to harmonize its accounting practices with the global accounting frame work.
- The Ind AS converged with IFRS has put India at the centre stage of high quality and transparent financial reporting whose benefits for sure outweigh the challenges.
- Ind AS in a business imperative for Indian companies because it will not only greatly help in boosting foreign investment and making our capital market more robust, but will also benefit investors and other users of Financial Statement by refining the quality of reported information.
- One of the key challenges, which may also be relevant for Indian companies is that IFRS or Ind AS are principles based standards which require transactions to be accounted for based on their economic substance. Implementing Ind AS is likely to impact key performance matrix. It has wide application on a company's processes, It systems, internal financial controls, income tax pay rat, remuneration policies and also contractual arrangement change in reporting brings lots of changes in the areas of provisioning, capitalization, depreciation etc which may widely affect the profitability end out wroth of the organisation

**3:10: References and Suggested Readings:**


- *Framework for the Preparation and Presentation of Financial Statements,* July 2000, The Institute of Chartered Accountants of India (ICAI)
- *Study material on Financial Reporting, Ind AS1: Presentation of Financial Statements;* The Institute of Chartered Accountants of India (ICAI)
- *Contents Framework for the preparation and presentation of financial statements,* Ministry of Corporate Affairs, Retrieved on 19th Sept, 2023


**3.11: Model questions:**

1. In what way India can benefit from its Accounting Standards being converged with IFRS?

2. Why is it important for countries to converge its Accounting Standards with IFRS?

3. Give a tabular comparison of Accounting Standards with IFRS

4. How does Indian Accounting Standard deviate from IFRS?

5. Compare Indian GAAP and IFRS

**3.12: Answer to check your progress:**

1. The Ind AS will boost foreign investment and making our capital market more robust. It will also benefit investors and other users of Financial Statement by refining the quality of reported information. It will also facilitate cross border acquisitions, partnership and alliances with foreign entities, thereby boosting overall economic growth.

2. Two similarities between Indian GAAP and IFRS are as follows:

i) Indian GAAP and IFRS, both record the purchase price of the property at the Cost Price.

ii) In both of the cases, inventory calculation is done on the basis of weighted average and FIFO.

3. IFRS requires presentation of tax expense( income) in the separate income statement ,where a separate income statement is presented. Whereas, Ins AS 1 requires that the components of profit and loss and components of other comprehensive income shall be presented as a part of the statement of profit and loss.

## BLOCK III : Unit-4

### National Differences in Financial Reporting Practices; Reasons for National Differences in Financial Reporting Practices; Attempts to Reduce the Differences.

**Unit Structure:**



**4.1: Introduction** :

Acceptance of a uniform accounting standards is a step towards reducing national differences in order to establish one uniform language of business, so that all homogeneous enterprises speak in a homogeneous language. IFRS is adopted in more than 100 companies; many countries are in the process of adopting IFRS by modifying them to some extent to meet the country specific circumstances. Around 40% of the Global Fortune 500 companies use IFRS. The IFRS are required for the listed companies across all the European Union countries and majority of the countries in Asia Pacific region

Why the difference? Because, the IASC member countries did not adopt the IAS uniformly because of the following reasons; this ultimately triggers in national differences.

- The strength of the professional accounting institutions of a country guided to generate on accounting treatment that conforms to IAS.
- Acceptance of IAS depended not only on the accounting profession, but also on the attitude of the govt. and regulatory agencies.

- IASC did not have any power of enforcement and hence adherence to IAS has been far from satisfactory.
- A country having weak or a newly established accounting profession will not be able to fully develop issue and enforce domestic standards and then conform to the IAS.

Global capital markets have become increasingly integrated, and cross border investments and borrowings have increased. Multinational companies have expanded their operational base. Therefore, the accounting standard setting bodies are looking to eliminate the national differences in accounting so that the financial statements from anywhere in the world can be easily read and understood by the business and financial communities. It was felt necessary to have a transition from detailed rule-based regulations to broader principle based regulations as evolved by IASC and IASB.

## 4.2: Objectives:

After going through this unit you will be able to

- Understand the difference between IFRS and Indian GAAP
- Understand the national difference in financial reporting practices
- Explain the reasons for such differences
- Analyze the attempts made to reduce such differences.

## 4.4: Difference between some national standards and IFRS

You've probably heard the phrase 'it wouldn't do for us all to be the same'– Well that's as true for the world of accountancy as it is in real life. Many countries around the globe still use their own accounting standards (referred to as generally accepted accounting practice (GAAP). There are attempts being made by the International Accounting Standards Board (IASB) to get countries around the world to adopt International Financial Reporting Standards (IFRS), in the hope that eventually methodologies which will then improve comparability of financial statements. Because many countries use their own GAAP, there are some notable differences between what some countries do and what IFRS does.

Here are *ten (10)* notable difference between what some countries do with their own national (GAAP) and what IFRS does so you can appreciate the difference between the two.

**1) PENSION PLANS :**

Many companies operate what are known as Defined Benefit Pension Plans which is where an employee participates in the scheme, retires and then receives a pension based on his or her final salary (you've probably heard them referred to as final salary schemes). They're becoming less common these days and are not to be confused with Defined contribution Schemes. Some GAAPs do not require the defined benefit pension plan's surplus or deficit to be recognized on the balance sheet. However, under *IAS 19 Employee Benefits* a company must recognize such a defined benefit pension plan's surplus or deficit, and this surplus or deficit is calculated by the pension plan's actuary.

**2) DEFERRED TAX :**

Deferred tax is the method of smoothing out the differences between the accounting treatment of certain items in the financial statements against the way the same items have been treated for tax purposes and the deferred tax consequences can either be a liability (future tax charges will increase in the future as a result of the difference) or they can be an asset (future tax charges will decrease as a result of the difference).

Some GAAP do not require deferred tax assets or liabilities to be recognized due to the 'timing difference' approach (which focuses on when items are eventually recognized in profit or loss). Under IAS 12 Income Taxes this focuses on the 'temporary difference' approach (which focuses on the balance sheet and the tax that would be payable it assets were sold and liabilities settled at book value). IAS 12 requires that a company recognizes deferred tax assets and liabilities in respect of all temporary differences.

3) **Intangible non-current Assets :**

An intangible non- current Assets is a long-term asset the company will use in the business for more than one year and is shown on the balance sheet. An intangible non-current asset does not have a physical form-in other words you can't kick it

Some GAAP require certain costs relating to intangible non-current assets to be written off to profit or loss as and when they're incurred. Under IAS 38 Intangible Assets a company must recognize such costs on the balance sheet if they meet the recognition criteria (which are that the costs are capable of generating revenue for the business and the cost can be measured reliably).

4) **Share-Based Payment :**

A Share-Based Payment is an agreement between a company and a third party that entitles the third party to receive shares or share options of the company, or cash (or other assets) for amounts based on the price or value of the shares of the company at a future point in time provided certain conditions are met. Some GAPP do not recognize any expense arising on a share-based Payment to be reflected in company's income statement.

5) **Provisions for liabilities :**

A Provision is a liability of uncertain timing or amount and can arise because of either a legal or constructive, obligation. A constructive obligation arises because of a history of past practice by the company (for example paying profit-related bonuses year on year).

Some GAAP do not recognize provisions because of a constructive obligation. However, IAS 37 provisions, contingent Liabilities and contingent Assets requires a provision to be recognized due to a constructive obligation if it can be demonstrated such an obligation exists, there's going to be cash changing hands to settle the obligation and the amount required to settle the obligation and the amount required to settle the obligation can be measured reliably.

6) **Finance Leases :**

A finance lease is a lease which transfer all the risks and rewards of ownership of the leased asset to the lessee (the party leasing the asset). Some GAAP do not require assets subject to finance leases to be recognized on a balance sheet. IAS 17 Leases specifically requires such leases to be recognized on the balance of companies entering into these types of lease (note IAS 17 is due to be replaced by another standard in the next couple of years).

7) **Borrowing costs :**

Borrowing costs are interest charges levied by banks and finance houses for loan taken out by companies. Some companies take out loans to construct their own assets (for example a new building). Some GAAP's permit a company to choose whether, or not, to capitalize these borrowing costs as part of the cost of constructing the asset. However, IAS 23 Borrowing Costs requires companies to recognize all such costs as part of the cost of asset- there is no option under IAS 23 to write them off to profit or loss when they are incurred.

**8) Buying another company :**

Lots of additional costs (such as legal fees, accountancy fees and due diligence fees) are incurred when a company buys another company. Some GAPP allows these types of costs (called incremental costs) to be included in the costof acquisition, IFRS 3 Business Combinations requires such incremental costs to be written off to the income statement as and when they are incurred. They cannot form part of the cost of the acquisition under IFRS.

**9) Statement of cash flows :**

Certain companies reporting under their own national GAAP do not have to produce a statement of cash flows in addition to the statement of profit or loss (sometimes called the income statement of profit and loss account) and statement of financial position (known as the balance sheet). IAS 1 Presentation of Financial Statements specifically requires a company to produce a statement of cash flows as part of the company's annual financial statements.

**10) Inventory Valuations :**

Some GAAP allow the use of the last-in-first-out(LIFO) method of valuing inventories. IAS 2 Inventories specifically prohibits this method of inventory valuation. It only allows the first-in first-out(FIFO) method or average cost method of valuation.

**Stop to Consider**

*IFRS is used in more than 110 countries around the world, including the EU and many Asian and South American countries. On the other hand, each country follows its own set of generally accepted accounting principle. Under IFRS, LIFO cannot be used, but GAAP; companies have the choice between LIFO and FIFO.*

**Check Your Progress.**

1. Why does the difference exist in adopting the IAS by member countries?
2. Why does there exist national difference in accounting practices?
3. What is Deferred tax? How is it treated by GAAP and IFRS
4. Highlight the difference in treatment of Inventory by GAAP and IFRS

## 4.5: **Reason for national differences and its impact in the financial reporting practices:**

Differences in accounting practices among nations refers to varies kind of differences in accounting rules and standards ,recording ,reporting etc. The differences can be noticed in many accounting practices such as differences in financial statement included in the business annual report, differences in the format used to present individual financial statements, differences in the level of detail provided in the financial statements, terminology differences, disclosures differences and recognition and measurement differences. The following points highlight the major reasons for the differences in accounting practices across nation:

a) ***Legal system***: The legal system adopted by any country could be the main reason behind the difference in the accounting practice across nations. Legal system not only shape the behavior of its citizen but it also prescribes accounting rules and regulates accounting and financial reporting. The degree to which government is involved in standard setting varies from country to country . There are basically two legal systems followed worldwide. The Common Law, which is used by English Speaking countries and The Codified Roman Law (Code Law) used by Non-English-Speaking countries. The countries that follow common law are more liberal and have fewer regulation prepared by professional bodies. Whereas countries following code law have more regulations which are prepared by agencies and government bodies.
b) ***Taxation:*** Taxation practices are different in different countries . In some countries, published financial statement form the basis for taxation but in some other countries financial statement are adjusted for tax purpose . This difference in practice leads to difference in Accounting Practices.
c) ***Inflation***: Countries at different times face different degree of inflation. Countries facing high degree of inflation basically feel the necessity of adjusted accounting practices that require adjustment of historical cost amounts. For countries where accounting statement serve as the basis for taxation adjusted income for inflation is necessary because otherwise companies in those countries would be paying taxes on fictitious profits.
d) ***Financers' requirement***: Financial reports provide various information to financiers and investors. Different financier seeks different information as per their requirement. Say for example ,shareholders are more interested in profits so they are more concerned with the Profit and Loss Account whereas bank are more interested in insolvency and liquidity and lays emphasis on the Balance Sheet.
e) ***Political and Economic Ties***: One of the main reason for the national difference in the preparation and presentation of financial statement between countries might be the political and economic ties of one country with other countries. This alliance and ties will certainly motivate to adopt accounting practices followed by its alliance countries.
f) ***Relation among various factors***: It is very obvious that there is a strong correlation between the country's legal system, tax conformity and source of financing. So these factors also play major role in bringing about differences in accounting and reporting practices.
g) Apart from the above discussed factors, the *following factors* also have impact on creating differences in accounting practices.
    - Nature of business ownership
    - Invasion
    - Level of Education
    - Age and size of accounting profession
    - Stage of economic development etc.

The following discussion highlights some differences in Accounting and reporting practices as per Ind AS , Indian GAAP and IFRS and the impact of such differences in reporting practices:

**IND AS 12 - INCOME TAXES : KEY DIFFERENCES**

1. AS 22 Accounting for Taxes on Income is based on the income statement liability method,which focuses on timing differences. Ind AS 12 Income Taxes is based on the balance sheet liability method, which focuses on temporary differences. Under Indian GAAP, no deferred tax is recognized on upward revaluation of fixed assets where such revaluation is credited directly to revaluation reserve. Under Ind AS, companies will recognize deferred tax on revaluation component, if other recognition criteria are met.

2. Ind AS 12 requires the recognition of deferred taxes in case of business' combinations. Under Ind AS, the cost of a business combination is allocated to the identifiable assets acquired and liabilities assumed by reference to their fair values. However, if no equivalent adjustment is allowed for tax purposes, it would give rise to a temporary difference. Under Indian GAAP, business combinations (other than amalgamation) will not give rise to such deferred tax adjustment.

3. Where an entity has a history of tax losses, the entity recognizes a deferred tax asset arising from unused tax losses or tax credits only to the extent that it has sufficient taxable temporary differences, or there is other convincing evidence that sufficient taxable profit will be available under Ind AS. Under Indian GAAP, if the entity has carried forward tax losses or unabsorbed depreciation all deferred tax assets are recognized only to the extent that there is virtual certainly supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realized. Ind AS 12 does not lay down any requirement for consideration of virtual certainty in such cases.

4. Under Ind AS, an entity should recognize a deferred tax liability in consolidated financial statements for all taxable temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures, except to the extent that the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. Under Indian GAAP, deferred tax is not recognized on such differences.

5. Under Ind AS, deferred taxes are recognized on temporary differences that arise from the elimination of profits and losses resulting from intra-group transactions. Deferred tax is not recognized on such eliminations under Indian GAAP. The deferred taxes in the CFS are a simple aggregation of the deferred tax recognized by various group entities.

6. Disclosure required for income taxes will increase on transition to Ind AS. Examples of certain critical disclosures mandated in Ind AS are : an explanation of the relationship between tax expense (income) and accounting profit; an explanation of changes in the applicable tax rate (s) compared to the previous accounting period; the amount (and expiry date, if any) of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognized in the statement of financial position.

**IMPACT ON FINANCIAL REPORTING :**

**Deferred Tax Accounting for the group :** Till date, the deferred taxes in the consolidated Financial Statement (CFS) are a simple aggregation of the deferred tax recognized by various group entities, On transition to Ind AS, deferred taxes in the CFS will be significantly defferent from that under Indian GAAP. This is because of GAAP difference explained above, especially with respect to undistributed profits of subsidiaries, associates and joint ventures and intra-group transactions.

**Acquisitions :** Deferred tax is recognized on fair value adjustment of acquired assets, liabilities and contingent liabilities as part of business combination accounting. Good will under Ind AS is determined accordingly. Reversal of deferred tax asset/liability in future years affects the tax expense or income of those years. Therefore, the effect of acquisition deferred taxes on future financial statements will differ significantly under Ind AS and Indian GAAP.

**Entities in Tax Losses :** Due to the strict principle of virtual certainty under Indian GAAP, only in very rare cases can entities recognize deferred tax assets, where they have have carried forward losses and unabsorbed depreciation. The 'convincing evidence' principle under IFRS is less stringent in comparison. Hence, the probability of recognized deferred tax asset on carried forward tax losses and unabsorbed depreciation is higher under Ind AS.

**Ind AS 110- Consolidatesd Financial Statements : Key Differences**

1. Under Ind AS, the application of the equity method to associates/joint ventures is mandatory, even for entities without any subsidiaries. Under Indian GAAP, the companiesAct, 2013 requires the application of the equity method or proportionate consolidation to account for associates/joint ventures even when the entity has no subsidiaries.

2. Under the new control model, an investor controls investee when it is exposed or has rights, to variable returns from its involvement with the investee, and has the ability to affect those returns through its power over the investee. An investor may still have power over an investee even the investor does not have a majority of the voting rights of the investee. An investor may have power over specified assets of an investee that are considered to be a separate 'deemed entity' (a silo), such that control could exist at a level below a legal entity.

3. Potential voting, which are currently exercisable, are considered for determination of control under Ind AS. Indian GAAP is silent on whether potential voting rights are to be considered for control. However, under AS 23, potential voting rights are not considered for determining significant influence in the case of an associate. Thus, an analogy can be drawn in the case of a subsidiary as well.

4. Both Ind AS and Indian GAAP require the use of uniform accounting policies for preparation of consolidated Financial Statements (CFS), However, Indian GAAP provides an exmeption on the grounds of impractically. Ind AS allows a three month gap between financial statements of a parent or investor and its subsidiary, associate or jointly-controlled entity. Indian GAAP allows a six-month gap for subsidiaries and jointly-controlled entities. For associates, there is no time gap prescribed.

5. Ind AS requires losses incurred by the subsidiary to be allocated between the controlling (parent) and non-controlling interest, even if the losses exceed the non-controlling equity investment in the subsidiary. Under Indian GAAP, excess losses attributable to minority shareholders over the minority interest are adjusted against the majority interest, unless the minority has a binding obligation to and is able to, make good the losses.

**Impact on Financial Reporting**

**Preparation of CFS :** Indian GAPP has no guidance on the consolidation of special purpose Entities. Ins AS requires SPEs satisfying certain criteria to be consolidated. Adoption of Ind AS does not always result in consolidation, but may result in de-consolidation of certain subsidiaries in some cases. Under Indian GAAP, two groups can consolidate the same entity, i.e. one group consolidates as it holds the majority ownership stake, whereas another group consolidates as it controls the board of directors. Under Ind AS, control can be held only by one entity.

**Uniform Accounting Policies :** Current Indian GAAP provides an exemption from the use of uniform accounting policies for the consolidation of subsidiaries, associates and joint ventures on the groups of impracticality. Ind AS does not provide such an exemption. This is likely to pose significant challenges, especially in the case of associates where the entity does not have control over the associate. All entities will have to gear their system, or develop systems such as preparation of group accounting manuals, to ensure compliance with this requirement. On conversion to Ind AS, many group entities will have to change their accounting policies to bring them in line with the parent entity. Financial Year-Ends of All Components in the Group : Current Indian GAAP allows a maximum of six months between the financial statements of a parent and a subsidiary, and that of a venture and a joint venture. There is no time limit prescribed between the financial statement of an investor and an associate. Ind AS allows maximum of three months for subsidiaries, associates and joint ventures. On conversion to Ind AS, many entities may be compelled to change the year-ends of their group entities to comply with this requirement and to avoid reporting results at multiple dates.

**IND AS 115-REVENUE FROM CONTRACTS WITH CUSTOMERS : KEY DIFFERENCES**

1. Ind AS 115 Revenue from Contracts with Customers is a comprehensive standard that deals with revenue recognition. It supersedes AS 9 Revenue Recognition and AS 7 Construction Contracts.

2. Ind AS 115 follows the control model where an entity shall recognize revenue when (or as) the entity satisfies a performance obligation byu transferring a promised good or service (i.e. as asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from, an asset.

3. IndAS 115 has introduced a five-step model with a single principle for recognizing revenue that applies to all contracts. AS 9 specifies different recognition and measurement criteria for varying streams of revenue. The five-step model comprises the following :

Step 1 : Identify the contract(s) with the customer.
Step 2 : Identify the separate performance obligations in the contract.
Step 3 : Determine the transaction price.
Step 4 : Allocate the transaction price to separate operformance obligations.
Step 5 : Recognize revenue when (or as) each performance obligation is satisfied.

4. IndAS 115, unlike AS 9 Revenue recognition requires revenue to be measured at the amount of consideration to which an entity expects to be entitled (rather than contractually specified) in exchange for transferring the promised goods or services.

5. IndAS 115 has introduced the concept of variable consideration. It takes various forms, including (but not limited to) price concessions, volume discounts, rebates, refunds, credits, incentives performance bonuses and royalties. An entity's past business practices can cause consideration to be variable if there is a history of providing discounts or concessions after goods are sold. AS 9

currently contains non guidance in this regard. An amount of consideration would be variable if either a products was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of specified milestone.

6. IndAS requires that revenue from rendering of services should be recognized over time by measuring progress toward completion. AS 9 provides an option to use either the proportionate completion method the completed service contract method for specified transactions for recognizing revenue from service transactions.

**IMPACT ON FINANCIAL REPORTING**

**Multiple Element Arrangements :** According to AS 9, revenue is measured by the charge made to customers or clients for goods supplied and service rendered and by the charges and rewards arising from the use of resources by them. In the absence of a fair value concept, it sometimes becomes difficult to determine revenue for a contract that contains multiple elements such as sale of goods and rendering of service. IndAS 115 prescribes that the transaction price in such arrangements must be allocated to each separate performance obligation, so that revenue is recorded at the right time and in the right amount. Under Indian GAAP, an EAC opinion deals with accounting in the case of multiple elements in a limited way.

**Control Model :** Ind AS 115 has introduced the control model to determine the point of revenue recognition. Management needs to determine, at contract inception, whether control of a good or service transfers to a customer over time or at a point in time. Arrangements where the performance obligations are satisfied over time are not limited to service arrangements. Complex assets or certain customized goods constructed for a customer, such as a complex refinery or specialized machinery, could also be transferred over time, depending on the terms of the arrangement. Revenue is recognized over time if any of the following three criteria are met :

1. The customer simultaneously receive and consumes the benefits provided by the entity's performance as the entity performs :
2. The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced, and
3. The entity's performance does not create and asset with an alternative use to the entity; and the entity has an enforceable right to payment for performance completed to date.

This model may have the highest impact for companies engaged in construction or real estate business. Since Ind AS 115 requires revenue to be recognized over time by measuring progress toward completion, entities that defer revenue based on the completed service contract method under AS 9 will experience a significant impact on their income statement. The volatility of the income statement will be streamlined by the application of Ind AS 115 and the profit or loss for the period will better represent the efforts put in by the entities during the period.

### 4.6: <u>Attempts to reduce the differences</u>:

Attempts have been made at different levels to reduce the differences-in accounting and reporting practices. This is done by harmonization and convergence of differing accounting standards. Such reconciliation would enhance uniformity, comparability of financial information and make the financial statements useful for various stakeholders. Such reconciled or converged financial statements would be useful for decision making purposes Standardization of financial reporting is the process of ensuring uniformity. Standardization of accounting procedures improves comparability of financial statements, both intra-enterprise and inter-enterprise; inter-period comparability and thus make them useful for decision making purpose. Such comparisons are effective and a widely used tool for performance evaluation, risk assessment, performance assessment of corporate entities.

International Accounting Standard Committee (IASC) had formulated IAS since 1973 and these standards were used in different ways in different countries. Either they were adopted as national standards; or they were used as a basis of comparison with the existing national standards; or they were used as inputs to the legislative process of regulating financial reporting practices.

**Stop to Consider**

As per the MCA, govt. of India, the corporate entities have been mandated to switch over from physical form of reporting and filing of returns to digital online reporting.

**4.6.1: Steps taken to resolve the national differences in accounting and reporting practices** :

International Financial Reporting Standards (IFRS) principle-based regulations are becoming globally applied set of accounting standards, these will replace local GAAP for statutory reporting purposes. IFRS is a set of accounting standards, developed by the International Accounting Standards Board (IASB), London, that is becoming the global standard for the preparation and presentation of public company financial statement. IFRS is a 'principle-based' set of standards that establish board rules rather than dictating specific accounting treatments. In April 2001 the IASB adopted all IAS and began developing new standards called IFRS. Many countries have plans to converge (eliminate significant differences) their national standards with IFRS. The integrated business world under WTO regime is transformed into an economic village urging the need for inter-dependence among the nations in respect of trade, cross border capital movement, investment, exchange of goods and services, currency exchange and securities trading. This has created an urgent need for adoption of IFRS in place of domestic GAAPs specific to a country. Multinational companies are establishing their business across the globe; the securities of corporate entities are getting listed in various world class capital markets; capital markets are gradually getting integrated with world-wide trend. Sound financial reporting acquires added dimension to satisfy the information needs of various user groups; and to help the decision making process.

**4.7: Need for preparation of uniform consolidated financial statements :**

With the absence of harmonization is accounting standards the additional cost of financial reporting along with the difficulties that multinational groups face in the manner in which they undertake transactions becomes critical. It is quite possible for a transaction to trigger profit under one accounting standard, whereas it may require a deferral under another standard. Thus, MNCs working in the USA and the UK face a great deal of complexity while preparing consolidated financial statements. When a multinational company has to report under the standards of both of the countries it might lead to some extremely odd results. Adoption of different accounting standards causes difficulties in making relative evaluation of performance of companies. This phenomenon hinders the valuation method and any financial decision relating thereto. Harmonization therefore is not an end by itself but it is a means to attain and end of uniform information system. Convergence of accounting standards yields a benefit in cross-border merger and acquisition facilitation.

## 4.8: Summing up:

- In general terms, convergence means to achieve harmony with IFRS; in precise terms convergence can be considered "to design and maintain national accounting standards in a way that financial statements prepared in accordance with national accounting standards draw unreserved statement of compliance with IFRS"
- The accounting standard setting bodies are looking to eliminate the national differences in accounting so that the financial statements from anywhere in the world can be easily read and understood by the business and financial communities
- A finance lease is a lease which transfer all the risks and rewards of ownership of the leased asset to the lessee (the party leasing the asset).
- Acceptance of a uniform accounting standards is a step towards reducing national differences in order to establish one uniform language of business so that all homogeneous enterprises speak in a homogeneous language
- Attempts have been made at different levels to reduce the differences-in accounting and reporting practices. This is done by harmonization and convergence of differing accounting standards. Such reconciliation would enhance uniformity, comparability of financial information and make the financial statements useful for various stakeholders.

## *4.9: References and Suggested Readings*


- *Framework for the Preparation and Presentation of Financial Statements,* July 2000, The Institute of Chartered Accountants of India (ICAI)
- *Study material on Financial Reporting, Ind AS1: Presentation of Financial Statements;* The Institute of Chartered Accountants of India (ICAI)
- *Contents Framework for the preparation and presentation of financial statements,* Ministry of Corporate Affairs, Retrieved on 19th Sept, 2023


## *4.10: Model Questions:*

1. Mention various factors that trigger national differences in reporting practices.

2. Discuss the attempts made to reduce such differences.

3. Highlight the needs of preparing a uniform consolidated financial statement.

4. Mention the words and terms that need to be carefully noted while attempting to reduce the national differences.

## 4.11: Answer to check your progress

1. The difference exist in adopting the IAS by member countries because of the following reason:

- The strength of the professional accounting institutions of a country guided to generate on accounting treatment that conforms to IAS.
- Acceptance of IAS depended not only on the accounting profession, but also on the attitude of the govt. and regulatory agencies.
- IASC did not have any power of enforcement and hence adherence to IAS has been far from satisfactory.
- A country having weak or a newly established accounting profession will not be able to fully develop,issue and enforce domestic standards and then conform to the IAS.

2. There exist national difference in accounting practices because of the following factors: Legal system, Taxation, Inflation, Financers' requirement, Relation among various factors, Political and Economic Ties, Nature of business ownership, Invasion, Level of Education, Age and size of accounting profession, Stage of economic development etc.

3. Deferred tax is the method of smoothing out the differences between the accounting treatment of certain items in the financial statements against the way the same items have been treated for tax purposes and the deferred tax consequences can either be a liability (future tax charges will increase in the future as a result of the difference) or they can be an asset (future tax charges will decrease as a result of the difference). Some GAAP do not require deferred tax assets or liabilities to be recognized due to the 'timing difference' approach. IAS 12 requires that a company recognizes deferred tax assets and liabilities in respect of all temporary differences.

4. Some GAAP allow the use of the last-in-first-out(LIFO) method of valuing inventories. *IAS 2 Inventories* specifically prohibits this method of inventory valuation. It only allows the first-in first-out(FIFO) method or average cost method of valuation.

**BLOCK 4: REPORTING CRITERIA**

# UNIT-I
# CRITERIA FOR INFORMATION APPEARING IN A PUBLISHED INCOME STATEMENT AND BALANCE SHEET; REPORTING COMPREHENSIVE INCOME



## 4.1: INTRODUCTION:

The published financial statements disclose the financial performance and financial position of an entity to the various stakeholders in order to help them make informed decisions on various matters of their interest. Apart from this, the regulatory and statutory requirement also makes reporting and publishing financial information, an integral part of an entity's operations. The preparation and presentation of financial statements and other relevant reports which depends on the nature and circumstances of the entity is guided by the Acts, rules and guidelines of the place where the entity is located. This unit deals with the various reporting and disclosure requirements of an organization in India in line with the relevant provisions of the Companies Act, 2013, Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) and other necessary rules and guidelines.

## 4.2: OBJECTIVES:

This unit deals with diverse areas of accounting and reporting and after going through this unit, you will be able to:

- Recognise the criteria which may be considered for proper recognition of items in the financial statements
- Explain the concept of comprehensive income

### 4.3: CRITERIA FOR INFORMATION APPEARING IN PUBLISHED INCOME STATEMENT AND BALANCE SHEET:

The ever increasing demands of globalization has thrown open challenges across the world on uniform reporting requirements. The financial reporting process is concerned with providing information that is useful in the business and economic decision making process. This information can be provided in the financial statements and additional reports of the corporate houses. The criteria for information appearing in the published Income Statement and the Balance Sheet means the basis, on which financial transactions are recorded, prepared and presented. The financial statements must present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for income, expenses assets, equity and liabilities. The criteria for information appearing in a published income statement also known as statement of profit and loss or Profit and Loss Account and balance sheet or position statement indicates the elements and the conditions to be satisfied by these elements to appear in the respective statements, that make up the financial statements complete, uniform and understandable.

**4.3.1: Elements of Financial Statements:** The financial effects of a business transaction and other events are portrayed in the financial statements by grouping these effects and events in broad categories which are known as elements of financial statements. The elements that are directly related and included in the income statement to measure the financial performance of an entity during a particular period are:

1. Income and
2. Expenses

Information about the nature and amount of assets and liabilities that an entity has assists the users to assess the financial strengths and weaknesses, liquidity and solvency of the entity and also the need and ability of the entity to get finance. It also demonstrates the distribution of future cash inflows among those with a claim on the entity. In this context, the elements that are directly related and included in the balance sheet to determine the financial position of an entity are:

1. Assets and
2. Equity and Liabilities

**STOP TO CONSIDER**

The elements of financial statements are:

1. Income
2. Expenses
3. Assets
4. Equity and Liabilities

**4.3.2: Criteria for Recognition:** Recognition is the process of incorporating in the financial statements especially, the statement of financial position or balance sheet all those items which meets the definition of that element and satisfies certain criteria for recognition. In general, such criteria are given below:

1. The value or the cost of that item can be reliably measured.
2. There should be probability that future economic benefits arising out of the item will flow to or from the entity.

The following criteria may be considered for proper recognition of the various elements of the financial statements individually:

1. ***Income:*** The concept of income recognition is central to accounting. Income is increase in economic benefits during the accounting period in the form of inflows or increase in assets or decrease in liabilities resulting in increase in equity, other than those relating to contributions from equity participants. Any item may be recognised as income in the income statement when an increase in future economic benefit related to an increase in an asset or decrease of a liability has arisen and which can be measured reliably. The recognition criterion, that says revenue should be earned, is generally accepted for recognizing income in the income statement. Income includes revenue and gains. Revenue is the receipts of the entity arising in the ordinary course of business activities of the entity like sales, fees, etc. Gains are economic benefits which may or may not arise in the ordinary course of business activities of an entity. In short, revenue and gains results in inflow of funds or enhancement in assets.
2. ***Expenses:*** Expenses are recognised when a decrease in future economic benefit related to a decrease in an asset or increase of a liability arises and which can be measured reliably. Expenses include losses also. Expenses are recognised in the determination of profit or loss if it arises in the ordinary course of business activities of an entity like purchase of raw materials, wages, rent, etc. Similarly, losses are decrease in economic benefits which may or may not arise in ordinary course of business activities of an entity. In short, expenses and losses results in outflow of funds or decrease in assets and if this condition is satisfied the items are recognised under the income statement. Expenses are recognized on the basis of a direct association between the costs incurred and the earnings of specific items of income. This process is known as matching of costs with revenues. When economic benefits are expected to arise over several accounting periods and the association with income cannot be determined directly, expenses are recognized in the income statement on the basis of systematic and rational allocation procedures. These allocation procedures are intended to recognize expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.
3. ***Assets:*** Assets are resources controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity. As such, an asset is recognised in the balance sheet when it is probable that the future economic benefits will

flow to the entity and the asset has a cost or value that can be measured in a reliable manner. For example, debtors. An asset is not recognized in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. It is because the degree of certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset.

4. ***Equity and Liabilities:*** Equity is the residual interest in the assets of the enterprise after deducting all liabilities. Liabilities are present obligation of the entity which arises from past events and is expected to result in outflow of resources from the entity. A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. For example, creditors.

**CHECK YOUR PROGRESS**

Q1. What are the elements of an income statement?

Q2. What are the criteria for recognising assets in the balance sheet?

**4.3.3: Statutory Provisions:** Financial statements of a company are prepared in accordance with Section 129 of the Companies Act, 2013 which requires the financial statements to show true and fair view of the state of affairs of the company. According to Section 2 (40) of the Act, financial statement includes Balance Sheet, Statement of Profit and Loss, Cash Flow Statement, Statement of Changes in Equity and Notes to Accounts. Schedule III of the Companies Act, 2013 (earlier Revised Schedule VI of the Companies Act, 1956) which provides the form and content of preparation and presentation of financial statements considers Shareholders' Funds, Share Application Money pending Allotment, Non-Current Liabilities and Current Liabilities as components of Equity and Liabilities.

Shareholders' Funds are further classified into Share Capital, Reserves and Surplus and Money Received against Share Warrants. Non-Current Liabilities are classified into Long-Term Borrowings, Deferred Tax Liabilities, Other Long Term Liabilities and Long Term Provisions. Similarly, Current Liabilities are also classified as Short Term Borrowings, Trade Payables, Other Current Liabilities and Short Term Provisions.

According to Schedule III of the Companies Act, 2013, assets consist of Non-Current Assets and Current Assets. Non-Current Assets are classified into Fixed Assets, Non-Current Investments, Long Term Loans and Advances and Other Non-Current Assets. On the other hand, Current Assets are classified as Current Investments, Inventories, Trade Receivables, Cash and Cash Equivalents, Short Term Loans and Advances and Other Current Assets.

A liability shall be recognized and classified as current when it satisfies any of the following criteria:

a. It is expected to be settled in the entity's normal operating cycle (time between the acquisition of assets for processing and their realization in cash or cash equivalents and when the normal operating cycle cannot be identified, it is assumed to have duration of 12 months);
b. It is held primarily for the purpose of being traded;
c. It is due to be settled within twelve months after the reporting date; or
d. The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date.

All other liabilities are classified as non-current.

Similarly, an asset shall be classified as current when it satisfies any of the following criteria:

a. It is expected to be realized in, or is intended for sale or consumption in, the entity's normal operating cycle ;
b. It is held primarily for the purpose of being traded;
c. It is expected to be realized within twelve months after the reporting date; or
d. It is cash or cash equivalents unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets not satisfying any of the above conditions are classified as non-current assets.

**STOP TO CONSIDER**

According to Schedule III of the Companies Act, 2013, assets are broadly classified as:

1. Current Assets and
2. Non-Current Assets

Similarly, liabilities are classified as:

1. Current Liabilities and
2. Non-Current Liabilities.

### 4.4: REPORTING COMPREHENSIVE INCOME:

The income statement provides an overview of sales, expenses and taxes. At the end of preparing the income statement one can determine the net profit or loss or income of the business but it is not necessarily all inclusive. That is, it only includes income from business operations and business activities that occur due to the company's routine and day-to-day activities. There are times when companies earn profits or incur losses from the change in value of certain assets and the net impact on earnings is found in comprehensive income and not in the statement of profit or loss.

Comprehensive income is also known as an all-inclusive concept of income. It is the change in equity or net assets of an entity during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distribution to owners.

Comprehensive Income=Revenues + Gains – Expenses - Losses

The major components of comprehensive income are:

1. Items relating to entity's ongoing major or central operations
2. Results of transactions in investments in other entities
3. Payment or recovery of taxes
4. Exchange and other transfers between the entity and other entities that are not its owners
5. Items which cannot be estimated with complete reliability
6. Unusual items occurring infrequently but are also unqualified to be extraordinary items
7. Unrealised changes in the value of assets and liabilities when these are recognised by the accounting model in use.

In other words, comprehensive income includes transactions causing a net increase or decrease in shareholder's interests during the period except transactions between the enterprise and its shareholders including dividends. For example, holding gains or losses on assets, whether realised or not. Comprehensive income is a useful measure of overall performance of an entity. It provides more useful information for the users of financial statements to evaluate the importance of the items and their effects on operating results.

**CHECK YOUR PROGRESS**

Q. What is the all-inclusive concept of income?

## 4.5: SUMMING UP:

- Recognition is the process of incorporating an item in the income statement and balance sheet that meets the definition of an element and satisfies the criteria for recognition.
- The general criteria for recognition of items in the financial statements are given below:
  1. The value or the cost of that item can be reliably measured.
  2. There should be probability that future economic benefits arising out of the item will flow to or from the entity.
- Comprehensive Income is the change in equity or net assets of an entity during a period from transactions and other events and circumstances from non-owner sources.

## 4.6: MODEL QUESTIONS:

**Short Answer Questions:**

Q1. What are the criteria for recognizing income in the income statement?

Q2. What is meant by accrual concept in accounting?

**Long Answer Questions:**

Q1. Explain the criteria for recognizing a current asset and current liability?

Q2. Explain the concept of comprehensive income.

## 4.7: ANSWERS TO 'CHECK YOUR PROGRESS':

**Q1. What are the elements of an income statement?**

**Answer to Q1:** The elements of an income statement of any entity during a particular period are:

a. Income and
b. Expenses

**Q2. What are the criteria for recognising assets in the balance sheet?**

**Answer to Q2:** Assets are recognised in the balance sheet:

a. when it is probable that the future economic benefits will flow to the entity and
b. the assets have a cost or value that can be measured in a reliable manner.

**Q3. What is the all-inclusive concept of income?**

**Answer to Q3:** Comprehensive income is also known as an all-inclusive concept of income. It is the change in equity or net assets of an entity during a period from transactions and other events and circumstances from non-owner sources.

## 4.8: REFERENCES AND SUGGESTED READINGS:


1. The Companies Act, 2013 (No. 18 of 2013). The Gazette of India Extraordinary. Part II. Section I.
2. Exposure Draft of Accounting Standard-1 issued by ICAI.
3. Exposure Draft of Accounting Standard-17 issued by ICAI.
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5. Mukherjee, Amitabha. 2011. Illustrated Guide to Indian Accounting Standards (Ind ASs and IFRSs. Taxmann Publications (P.) Ltd.
6. Sharma, D.G. 2015. Advanced Accounting Including Applicable Accounting Standards. 3rd Edition. Taxmann Publications (P.) Ltd.
7. http://www.icai.org.in
8. http://www.mca.gov.in

**BLOCK 4: REPORTING CRITERIA**

# UNIT-II
# SEGMENTAL REPORTING; ACCOUNTING POLICIES; DIRECTORS' REPORT; NOTES TO THE ACCOUNTS.



## 4.1 INTRODUCTION:

Accounting as the language of a business is ever evolving. The information that is generated from accounting is known as accounting information. Accounting information bridges the gap between business transactions and decision making. As such proper reporting of accounting information is crucial for effective decision making by various users. In this unit some important reporting aspects like segment reporting for diversified businesses, accounting policies adopted by a business and its disclosure, responsibility of the Board of Directors' reflected through the Director's Report and significant information appearing in Notes to Accounts are explained considering the relevant statutory provisions and guidelines issued in this respect. Adhering to statutes while reporting accounting information is important to aid informed decision by stakeholders.

## 4.2 OBJECTIVES:

This unit deals with diverse areas of reporting accounting information and after going through this unit, you will be able to:

- Identify reportable segments for segmental reporting
- Understand the need for disclosure of accounting policies
- Discuss the contents of a Director's Report
- Explain the significance of Notes to Accounts

## 4.3 SEGMENTAL REPORTING:

An entity may venture into diversified business activities or a new area of operation which may be significant in terms of sales, profits or losses or assets employed. The diversified nature of their operations in different industries, activities and geographical areas necessitates modifications in the nature of financial reporting practices of these entities. Each of these diversified area are considered as segments of the entity and as such reporting for each of these segments needs to be made by every such entity with different segments.

Accounting Standard-17 (AS-17), issued by the Institute of Chartered Accountants of India (ICAI), relates to segment reporting which commenced with effect from 1.4.2001. The objectives of AS-17 are to inform about the different geographical areas in which the enterprise has its operations and also to inform about the various products and services which the enterprise offers. This enables better understanding of the enterprise's performance by systematic and overall assessment of the risks and returns of the enterprise. Entities whose securities are listed in the stock exchange, or who are in the process of listing their securities in the stock exchange or all other enterprises whose turnover for the accounting period exceeds rupees fifty crores are required to adhere to segment reporting.

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. Segment information about different types of products and services of an enterprise and its operations in different geographical areas is relevant to assessing the risks and returns of a diversified or multi-locational enterprise but may not be determinable from the aggregated data. Therefore separate reporting is very necessary for separate segments.

In this backdrop it would be prudent to understand the meaning of various terms often used in segment reporting as given below:

- ***Enterprise revenue:*** It is the revenue earned from sale to external customers as reported in the Statement of Profit & Loss.
- ***Segment revenue:*** It is the revenue from transactions with other segments of the enterprise and any other portion of enterprise revenue that is directly attributable to a segment and can be allocated to a segment on a reasonable basis.
- ***Segment result:*** Segment result is the profit or loss of a segment and is the difference between segment revenue and segment expenses.
- ***Segment assets:*** Segment assets are used and employed in a segment for conducting its operating activities.
- ***Segment liabilities:*** Segment liabilities are operating liabilities that result from the operating activities of a segment, and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.
- ***Reportable Segment:*** According to AS-17, a reportable segment is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Standard.
- ***Business Segment:*** A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different

from those of other business segments. Factors that should be considered in determining whether products or services are related include: (a) the nature of the products or services; (b) the nature of the production processes; (c) the type or class of customers for the products or services; (d) the methods used to distribute the products or provide the services; and (e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

- ***Geographical segment:*** A geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include: (a) similarity of economic and political conditions; (b) relationships between operations in different geographical areas; (c) proximity of operations; (d) special risks associated with operations in a particular area; (e) exchange control regulations; and (f) the underlying currency risks.

**STOP TO CONSIDER**

- Segment information about different types of products and services of an enterprise and its operations in different geographical areas is relevant to assessing the risks and returns of a diversified or multi-locational enterprise.
- Aggregated data may not be able to determine this.
- Therefore, separate reporting is very necessary for separate segments.

### 4.3.1 Conditions for Identifying a Reportable Segment

A business segment or geographical segment should be identified as a reportable segment if it satisfies any of the following conditions:

a. Its revenue from sales to external customers and from transactions with other segments is 10 percent or more of the total revenue, external and internal, of all segments; or
b. Its segment result, whether profit or loss, is 10 percent or more of-
c. The combined result of all segments in profit, or
d. The combined result of all segments in loss, whichever is greater in absolute amount; or
e. Its segment assets are 10 percent or more of the total assets of all segments.

### 4.3.2 Benefits of Segment Reporting

Some of the benefits that segment reporting provide are:

1. It helps in taking systematic and informed decisions by the external users like the investors relating to investments, profitability and risks of various segments of the entity which otherwise would not have been highlighted in aggregated reporting alone.
2. Consumers and the general public may be able to get the right information about the range of products and areas of their operation as well as other related information on various segments. They can also check to see the presence of any price discrimination practice followed by the entity from segment information.
3. Segment information promotes better understanding of the corporate strategy of the entities and provides a more reliable base for government policy decisions at both national and international levels.
4. It also helps the internal users like the employees and trade unions for wage negotiations and wage equality along with information on their job prospects.
5. It would also help devise the best cost allocation procedures and the bases on which transfer prices are calculated between segments.
6. Internal management system, performance evaluation, managerial performance evaluation also becomes easier and perfect with the publication of segment information.

### 4.3.3 Disadvantages of Segment Reporting

Some disadvantages which may arise due to segment reporting are:

1. Sometimes it becomes difficult to allocate all types of cost used commonly by all segments.
2. Identifying the right base for segmentation is yet another problem entities face at the time of segment reporting. It may be difficult for them to choose segments in terms of organization division, industry, market, consumer, product, etc. Moreover, more than one form of diversification may be present in each of the segment.
3. The costs incurred to collect, process, audit, disseminate and maintain segment records and report segment information may be more than the benefits derived from segment reporting.
4. The management may not always be willing to divulge all information in the name of segment information. In the process of segment reporting there are always possibilities of divulging trade secrets of the entity.

Despite the above disadvantages it is important for an organization to adhere to this standard and follow the rules and guidelines provided in this context in identifying the reportable segment in a proper manner for giving maximum information to the stakeholders regarding the financial results and position of the most important operating units of the organization for decision making purpose.

**CHECK YOUR PROGRESS**

Q. What is meant by Segment Revenue?

## 4.4 ACCOUNTING POLICIES

Every entity follows certain accepted set of rules, principles and policies for recording, classifying, summarizing and presenting its financial information in order to provide uniformity in accounting and reporting their financial transactions. These rules are often termed as accounting policies which makes information comparable and leads to better analysis of performances. The environment and circumstances under which an entity operates are different for different entities. As such, an accounting policy followed by one entity may not be acceptable or suitable for another entity operating under a different circumstance. Selecting the appropriate policy and the manner of applying those policies in varying circumstances needs considerable judgment by the management of the enterprise. For example, the management needs to disclose the measurement basis used in preparing the financial statements, that is, the basis on which an entity recognizes an asset and liability at initial recognition as well as subsequent measurement (like historical cost, fair value, etc.); and also the other accounting policies used that are relevant to the understanding of the financial statements along with the judgement used by the management in the process of applying the accounting policies.

Accounting Standard 1 (AS-1) issued by the ICAI in this regard on 'Disclosure of Accounting Policies' is a mandatory requirement. It requires every company registered under the Companies Act to disclose the significant accounting policies followed in preparing and presenting their financial statements. It has also listed some of the important areas in which differing accounting policies are encountered:

1. Methods of depreciation, amortization, etc.
2. Valuation of inventories
3. Valuation of fixed assets
4. Valuation of investments
5. Recognizing capital and revenue items
6. Treatment of goodwill
7. Treatment of contingent liabilities
8. Treatment of retirement benefits
9. Recognition of profit on long-term contracts
10. Conversion of translation of foreign currency items

AS-1 also specifies three basic or fundamental assumptions to be followed by every entity. They are:

1. ***Going Concern Concept:*** The going concern assumption is that an entity will be able to continue operating for a period of time that is sufficient to carry out its commitments, obligations, objectives, and so on.

2. ***Accrual Concept:*** Accrual concept is one of the fundamental principle of accounting which requires recording revenues when they are earned and not when they are received in cash, and recording expenses when they are incurred and not when they are paid.
3. ***Consistency Concept:*** The consistency principle states that, once an accounting principle or method is adopted, it has to be followed consistently in future accounting periods. Any change in accounting principle or method as a result of regulatory requirements or which may improve the quality of reported financial results have to be properly disclosed along with its effects.

It is assumed that every entity prepares its financial statements based on these basic assumptions. In case an entity does not follow any or all of these assumptions, the fact must be disclosed. This standard also specifies the major considerations which governs the selection and application of a particular accounting policy. These are:

1. ***Prudence:*** The prudence concept is an accounting principle that requires recording liabilities and expenses as soon as they occur, but recording revenues only when they are assured or realized. This is also known as the principle of conservatism.
2. ***Substance over Legal Form:*** Substance over legal form or substance over form is an accounting concept which means that the economic substance of transactions and events must be recorded in the financial statements rather than just their legal form in order to present a true and fair view of the affairs of the entity.
3. ***Materiality:*** According to this concept all important financial information that has the ability to change the opinion of the users of financial statements should be included in the financial statements.

Accounting Standard-1 specifically mentioned the following disclosures to be made by the registered companies:

1. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed to ensure proper understanding of financial statements by the user groups.
2. All disclosures should form part of the financial statements and should be made in one place instead of being scattered over several statements, schedules and notes.
3. The policies to be disclosed are mainly related with the areas in which differing accounting policies are encountered.
4. Any change in accounting policy which has a material effect like change of depreciation method from written down value method to straight line method, change in cost formula in measuring the cost of inventories, etc. should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable, wholly or in part, and the fact should be indicated.
5. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

The disclosure of significant accounting policies is also necessary in order to promote understanding of financial statements and also to enable proper and informed decision making by the users of the financial statements. However, it is important to understand that disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

| **CHECK YOUR PROGRESS:** |
|---|
| Q. What are the three fundamental assumptions in accounting to be followed by every entity as per Accounting Standard 1? |

## 4.5 DIRECTORS' REPORT

The Board of Directors is the representative of the shareholders who conduct the activities of a business on behalf of all the shareholders. The Board of Directors is entrusted with the responsibility of running the organization and as such it is their responsibility to meet the expectations of the shareholders and present before them the financial and other useful and significant information about the organization which had taken place during a particular financial year. Apart from presenting the financial statements the Board of Directors are required to prepare and present a report called the Board of Director's Report which is informative and analytical and had a great bearing on the credibility of the annual financial statements of an entity. For example, the report explains changes in earnings in terms of volume, price, market share, raw material costs and other related factors. It also highlights significant events, their causes, results and implications for the future in addition to providing a financial summary of the operations of the entity for a particular accounting period.

According to Section 134 of the Companies Act, 2013, the financial statements, including consolidated financial statement, if any, shall be approved by the Board of Directors before they are signed on behalf of the Board at least by the chairperson of the company where he is authorized by the Board or by two directors (out of which one shall be managing director) and the Chief Executive Officer (if he is a director in the company) the Chief Financial Officer and the company secretary of the company, wherever they are appointed for submission to the auditor for his report thereon. A signed copy of every financial statement, including consolidated financial statement, if any, shall be issued, circulated or published along with a copy each of:

(a) any notes annexed to or forming part of such financial statement;

(b) the auditor's report; and

(c) the Board's report

| CHECK YOUR PROGRESS |
|---|
| Q. What information relating to risk should be provided in the Boards' Report? |

### 4.5.1 Contents of Director's Report

Some of the important provisions along with the contents of a Board of Director's Report or simply Director's Report are given below:

- There shall be attached to statements laid before a company in general meeting, a report by its Board of Directors, which shall include—
  a) the extract of the annual return as provided under Section 92 (3);
  b) number of meetings of the Board;
  c) Directors' Responsibility Statement;
  d) a statement on declaration given by independent directors under Section 149 (6);
  e) in case of a company covered under Section 178(1), company's policy on directors' appointment and remuneration including criteria for determining qualifications, positive attributes, independence of a director and other matters provided under Section 178 (3);
  f) explanations or comments by the Board on every qualification, reservation or adverse remark or disclaimer made by the auditor in his report and by the company secretary in practice in his secretarial audit report;
  g) particulars of loans, guarantees or investments under Section 186;
  h) particulars of contracts or arrangements with related parties referred to in Section 188 (1) in the prescribed form;
  i) the state of the company's affairs;
  j) the amounts, if any, which it proposes to carry to any reserves;
  k) the amount, if any, which it recommends should be paid by way of dividend;
  l) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the financial statements relate and the date of the report;
  m) the conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed;
  n) a statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the company;
  o) the details about the policy developed and implemented by the company on corporate social responsibility (CSR) initiatives taken during the year as well as the composition of CSR Committee under Section 134(3);
  p) in case of a listed company and every other public company having such paid-up share capital as may be prescribed, a statement indicating the manner in which formal annual evaluation has been made by the Board of its own performance and that of its committees and individual directors;
  q) such other matters as may be prescribed.

- The Directors' Responsibility Statement shall state that—
  a) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;
  b) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;
  c) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;
  d) the directors had prepared the annual accounts on a going concern basis; and
  e) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively. The term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information;
  f) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.
- The Board's report under Section 134(3) shall disclose the composition of an Audit Committee;
- Every contract or arrangement entered into under Section 188 (1) relating to related party transactions shall be referred to in the Board's report to the shareholders along with the justification for entering into such contract or arrangement.
- An extract of the annual return in such form (Form MGT – 9) as may be prescribed under Section 92 shall form part of the Board's report.
- The Board's report and any annexure thereto shall be signed by the chairperson of the company if he is authorised by the Board and where he is not so authorised, shall be signed by at least two directors, one of whom shall be a managing director, or by the director where there is one director.
- If a company contravenes these provisions, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

**STOP TO CONSIDER**

- Every business entity has financial and non-financial information which needs to be shared with its stakeholders.
- Board of Director's Report is a description of transactions in an entity which are basically non-financial in nature but has an important bearing on the process of informed decision making. This report is prepared by the Board of Directors of the company as per the relevant provisions of the Companies Act.

## 4.6 NOTES TO THE ACCOUNTS

Financial statements provide information on the key elements of any business. This information in quantitative form only, may not help users to get a complete and comprehensive view of the entity. Therefore, this information needs to be supported with sufficient notes regarding the certainty, timing, estimation and related aspects of management judgment.

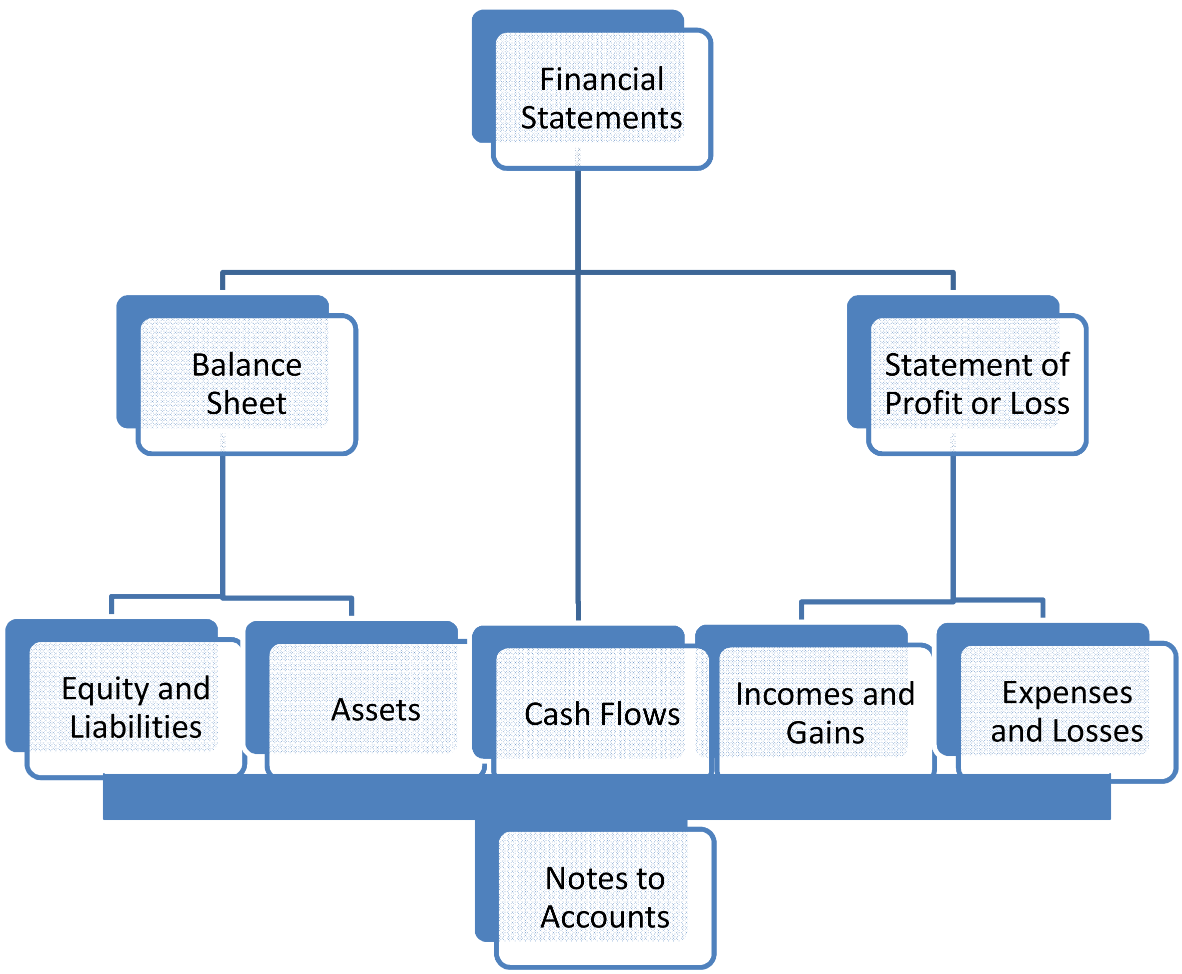
The financial statements of an organization contain various types of information which may not be easily understandable without necessary details and supporting explanations and justifications. The Companies Act, 2013 prescribes the financial reporting and disclosure requirements for all companies registered under it. All specific and necessary disclosures required to be made in accordance with different Accounting Standards or the Companies Act shall be made in Notes to Accounts.

Notes to Accounts are narrative disclosures that form part of the financial statements of a company. There may be a number of notes required that are specific to a particular industry. The list below gives some common items of Notes to Accounts and should not be considered as comprehensive:

1. Disclosures related to significant accounting policies followed
2. Contingent liabilities and capital commitment
3. Prior period and subsequent items along with their financial effect
4. Payment to auditors
5. Earnings and expenses in foreign currencies
6. Extraordinary items
7. Government Grants
8. Value of imports
9. Related Party Transactions and nature of relationship with the related party
10. Amalgamation
11. Interest in joint venture
12. Leases
13. Earnings per share
14. Reconciliation of changes in goodwill and impairment losses
15. Taxes on income

Notes to Accounts establish the linkage between the information contained in the financial statements and its significance in financial decision making. The diagram below shows the relationship between Notes to Accounts and the Financial Statements of an organization.

**Diagram showing the relationship between Notes to Accounts and Financial Statements**




Notes to Accounts shall contain information in addition to that presented in the financial statements and shall provide where required narrative descriptions or disaggregation's of items recognised in those statements and information about items that do not qualify for recognition in those statements. Each item on the face of the Balance Sheet and Income Statement shall be cross-referenced to any related information in the Notes to Accounts. For example, in case of share capital, information on shares of holding company, shares of subsidiary company, securities convertible to equity and preference shares, shares forfeited, etc. shall be provided in Notes to Accounts to facilitate better understanding of the interested stakeholders. However, in preparing the financial statements including the Notes to Accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and avoiding or missing significant information as a result of too much aggregation.

**STOP TO CONSIDER**

- All specific and necessary disclosures required to be made in accordance with different Accounting Standards or the Companies Act shall be made in Notes to Accounts.
- Notes to Accounts are narrative disclosures that form part of the financial statements of a company.

**CHECK YOUR PROGRESS**

Q. List any two items which are shown in Notes to the Accounts.

## 4.7 SUMMING UP

- A reportable segment is a business segment or a geographical segment for which segment information is required to be disclosed by an entity with diversified business operations.
- Accounting Standard 1 (AS-1) on 'Disclosure of Accounting Policies' requires every company registered under the Companies Act to disclose the significant accounting policies followed in preparing and presenting their financial statements.
- A signed copy of every financial statement shall be issued, circulated or published along with a copy of Board of Directors' Report.
- All specific and necessary disclosures are required to be made in the Notes to Accounts in accordance with different Accounting Standards or the Companies Act and this form part of the financial statements of a company.

## 4.8 MODEL QUESTIONS

**Short Answer Questions:**

Q1. What are the considerations to be kept in mind while choosing an appropriate accounting policy for an entity?
Q2. What is a reportable segment?
Q3. Why is 'Notes to Accounts' significant in financial reporting?

**Long Answer Questions:**

Q1. Explain the necessity of maintaining segment accounts by a business entity.

Q2. Discuss the contents of a Board of Directors' Report.

## 4.9 ANSWERS TO 'CHECK YOUR PROGRESS'

**Q1.** What is meant by Segment Revenue?
**Answer toQ1.** Segment revenue is the revenue from transactions with other segments of the enterprise and any other portion of enterprise revenue that is directly attributable to a segment and can be allocated to a segment on a reasonable basis.
**Q2. What are the fundamental accounting assumptions that every company must follow in preparing their financial statements?**
**Answer to Q2:** The fundamental accounting assumptions that every company must follow in preparing and presenting the financial statements are going concern, consistency and accrual.
**Q3. What information relating to risk should be provided in the Boards' Report?**
**Answer to Q3:** The Board of Directors should include a statement in the Boards' Report indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the company.
**Q4. List any two items which are shown in Notes to the Accounts.**
**Answer to Q4:** Notes to Accounts contains:

a. Prior period Items
b. Related Party Transactions

## 4.10 REFERENCES AND SUGGESTED READINGS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5. Mukherjee, Amitabha. 2011. Illustrated Guide to Indian Accounting Standards (Ind ASs and IFRSs. Taxmann Publications (P.) Ltd.
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## BLOCK V : Unit-1
## APPLICATION OF ACCOUNTING RATIOS IN DECISION MAKING; PREDICTIVE VALUE OF ACCOUNTING RATIOS;



### 1.1: Introduction:

Financial statements provide accounting information through the Statement of Profit and Loss and Balance Sheet. They provide accounting information expressed in monetary terms in respect of various elements, e.g., assets, liabilities, equities, expenses & losses and incomes & gains. These monetary values of these items are not adequate for business decision making. Because, financial statements by themselves, do not provide required information both for internal and external users. They give the results of the business in absolute figures, i.e., amount of profit or loss, assets, liabilities etc. From these figures it is not possible to find out any reasons for any good or bad performance of the business. What are the weak or strength points of the business cannot be worked out with the help of absolute figures. Therefore to get meaningful information from the financial statements to facilitate decision making by the user of these information, financial statements must be analysed and interpreted with useful tools. This unit will provide the learners with techniques of using the most important and widely used tool, i.e., ratio analysis for decision making.

### 1.2 OBJECTIVES

After going through this unit, you will be able to-

- Understand the meaning and definition of Ratio Analysis.

- Explain the advantages and disadvantages of Ratio Analysis
- Explain the application of Accounting Ratios in Decision Making
- Discuss the predictive value of Accounting Ratios.

### 1.3 Accounting Ratio: Meaning and Definition

According to J.Betty : ‘’the term accounting ratios is used to describe significant relationships which exist between figures shown in a Balance Sheet, in a profit and Loss Account, in a budgetary control system or in any other part of the accounting organization.’ Accounting ratio is calculated by taking any two variables (items) either from the balance sheet or statement of profit and loss or from both. Accounting ratio is also known as financial ratio. In fact, an accounting ratio expresses a relationship that exists between the two items of financial statements. Thus an **accounting ratio** compares two aspects of a financial statement, such as the relationship (or **ratio**) of one item to another item. If we take Sales as an item and net profit as another item with their respective money values and calculate a ratio, it will express a relationship of these two items. Suppose Sales are Rs. 5,00,000 and net profit is Rs. 1,00,000, then it is said that net profit is 20% of sales . It is calculated as follows:

When Sales are Rs. 5,00,000, Net profit is Rs.1,00,000

When Sales are Rs. Rs. 100, Net profit is Rs. (1,00,000 ÷ 5,00,000 × 100) = Rs. 20. It is expressed as 20% or 0.2 times. This means that the company is earning 20% net profit on its sales. This ratio of 20% net profit on sales may be used to compare the earning capacity of other companies in the same line of business. A ratio is a statistical yardstick that provides a measure of the relationship between two variables or figures. Ratio is a fixed relationship of two related numbers. In financial analysis ratios are used to express the financial relationship or operating relationship between any two variables of revenue statement and balance sheet. From the analytical point of view, it shows a static relationship, at a given point of time. Generally, ratios are calculated to express trend relationship or structural or operating relationship.

Ratio analysis is the process of determining and interpreting numerical relationships based on financial statements. It is one of the techniques of financial statement analysis. It is the most widely used tool to interpret quantitative relationship between two variables of one number to another.

According to Myers, ratio analysis is a 'study of relationship among the various financial factors in a business." A ratio analysis is a quantitative analysis of information contained in a company's financial statements. It is a tool used by financial analysts to carry out an evaluative analysis of information in the financial statements of a company.

Thus it may be said that ratio analysis is an accounting tool to present accounting variables in simple, concise, intelligible and understandable form. **Ratios are not an end but are media to reach the end. These are used to make decisions by various user groups of financial statements for various purposes. Therefore, users of financial statements, keeping in view their own financial interest, interpret a single ratio differently. This is called interpretational flexibility of a ratio. Again, the interpretation may vary depending upon the time horizon, present condition in the industry and the economy etc.**

### 1.4 Objectives/advantages of Ratio Analysis

The following are the objectives of ratio analysis:

(i) **Test of operational efficiency:** Ratio analysis is applied to test Operational efficiency of the business. It is done by calculating operating / activity ratios.

(ii) **Measurement the profitability:** The profit earning capacity of the business is known as Profitability. Profitability can be measured and analysed with the help of Gross Profit, Net Profit, Expenses and Other Ratios.

(iii) **Examining the financial liquidity of the firm: Ratios may be used to examine the short term financial position, I.e. liquidity of a firm by applying liquidity ratios.**

(iv) **Measuring long term financial position:** Long-term financial position of the business can be measured by calculating solvency ratios. In case of unhealthy long-term position, corrective measures can be taken.

(v) **Facilitating comparative analysis:** A comparative analysis may be carried out between present performance and past performance to discover the positive and negative points. Comparison with the performance of other competitive firms can also be made.

(vi) **Budgeting and forecasting:** Ratio analysis is of much help in financial forecasting and planning. Ratios calculated for a number of years work as a guide for the future. Meaningful conclusions can be drawn for future from these ratios.

### 1.5 Limitation of Accounting Ratios:

The following are the Limitations of Ratio Analysis**:**

(i) Ratios are based on monetary values, i.e., these are quantitative. Hence, these are tools of quantitative analysis, which ignore qualitative points of view.

(ii) Ratios are based on historical data. Hence, all of the information used in ratio analysis is derived from actual historical results. This does not guarantee that the same results will carry forward into the future.

(iii) During inflationary situation, ratios may be of little help. Ratios are generally distorted by inflation.

(iv) Ratios may give false result, if they are calculated from incorrect accounting data.

(v) Two different firms may adopt different accounting policies regarding valuation of inventories, charging depreciation etc. If this is so, it makes the accounting data and accounting ratios of two firms non-comparable.

**Check Your Progress**

1. Explain the meaning of accounting ratio.
2. Accounting ratio is also known as ......................(fill in the blank)
3. An accounting ratio expresses a relationship that exists between the two items of ........................( fill in the blank)
4. Write five benefits of ratio analysis
5. Write five disadvantages of Ratio Analysis.

### 1.6 Application of Accounting Ratios in Decision Making

Ratio analysis is the analysis of the financial statement of an enterprise. Financial statements by themselves do not provide required information both for internal and external users. To get meaningful information from the financial statements to facilitate decision making by the user of these information, financial statements must be analysed and interpreted with useful tools. Ratio analysis enlightens about the liquidity, profitability, solvency and performance of the organisation to various stakeholders such as owners, customers, managers, suppliers, vendors, lenders, regulators and competitors. *The following mentioned ratios assist the management and the external users of the financial statement in various decision making purpose.*

(I) Activity ratios,

(II) Liquidity ratios or short term solvency ratios

(III) Solvency ratios

(IV) Profitability ratios

**(I) Activity ratios:**

*Activity ratios* are those ratios which assess how effectively a company is able to generate revenue in the form of cash and sales based on its asset, liability and capital share accounts. These are also called Efficiency ratios. Activity ratios measure how well companies utilize their assets to generate income. Efficiency ratios often look at the time it takes companies to collect cash from customer or the time it takes companies to convert inventory into cash—in other words, make sales. *These ratios are used by management to help improve the company as well as outside investors and creditors looking at the operations of profitability of the company.*

The important activity ratios are:

(i) Inventory Turnover Ratio,

(ii) Debtors Turnover Ratio,

(iii) Creditors Turnover Ratio,

(iv) Total Assets Turnover Ratio,

(v) Fixed Assets Turnover Ratio,

(vi) Expense Ratios

**(II) Liquidity ratios:** In accounting, the term *liquidity* is *defined* as the ability of a company to meet its short term financial obligations as they come due. In other words liquidity represents one's ability to pay its current obligations or short-term debts within a period less than one year. Liquidity ratios, therefore, measures a company's liquidity position. *The ratios are important from the viewpoint of its creditors as well as management.*

The following are the important liquidity ratios:

(i) Current ratio

(ii) Liquid ratio or quick ratio

(iii) Absolute liquidity ratio.

Liquidity ratios provide a measure of degree to which current assets cover current liabilities. The excess of current assets over current liabilities provides a measure of safety margin available against uncertainty in realisation of current assets and flow of cash and to meet short term obligations. The margin should be reasonable. It should neither be very high or very low. A very high current ratio implies heavy investment in current assets against which the return is very low. Heavy investment in current assets reflects under utilisation or improper management of resources. A low ratio endangers the business and puts it at risk of facing a technical insolvency where it will not be able to pay its short-term liabilities on time. If this problem persists, it may affect firm's credit worthiness adversely. Normally, it is safe to have this ratio within the range of 2:1.

**(III) Solvency ratios:**

**Solvency ratio** is one of the various **ratios** used to measure the ability of a company to meet its long term debts. Solvency ratios are also called leverage ratios, measure a company's ability to sustain business operations indefinitely by comparing debt levels with equity, assets and debt-service capacity. In other words, solvency ratios identify going concern issues and a firm's ability to pay its long term debts.

The creditors who have advanced money to the business on long-term basis are interested in safety of their periodic payment of interest as well as the repayment of principal amount at the end of the loan period. Therefore, solvency ratios are calculated to determine the ability of the firm to service its debt in the long run. The following ratios are normally computed for evaluating solvency of the business.

1. Debt-Equity Ratio;
2. Debt to Capital Employed Ratio;
3. Proprietary Ratio;
4. Total Assets to Debt Ratio;
5. Interest Coverage Ratio.

This ratio measures the degree of indebtedness of firm and gives an idea to the long-term creditors regarding extent of security of the debt. A low debt equity ratio reflects more security. A high ratio, on the other hand, is considered risky as it may put the firm into difficulty in meeting its obligations to long term financiers. But at the same time, from the view point of the owners, use of reasonable amount of debt may help in ensuring higher returns for them, provided the rate of earnings on capital employed is higher than the rate of interest payable.

### (IV) Profitability ratios

Profitability means the capacity to earn profit. A profitability ratio is a measure of profitability, which measures a company's performance in earning income. Profitability is simply the capacity to make a profit, and a profit is what is left over from income earned after deduction of all costs and expenses related to earning the income.

The profitability or financial performance is mainly summarised in the statement of profit and loss. Profitability ratios are calculated to analyse the earning capacity of the business. It is an important efficiency ratio. It reflects the utilisation of resources employed in the business. There is a close relationship between the profit and the efficiency with which the resources employed in the business are utilised. The various ratios which are commonly used to analyse the profitability of the business are:

(a) Return on investment (ROI)
(b) Return on Assets ratio
(c) Earnings Per Share (EPS)
(d) Dividend Per Share (DPS)
(e) Price Earnings Ratio
(f) Dividend Payout Ratio

## 1.7 Predictive value of Accounting Ratios

One of the important characteristics of accounting information is relevance. It refers to how relevant it is in decision making purpose. For accounting information to be relevant, it must possess: *confirmatory value* and *predictive value*. Confirmatory value is the ability to provide information about the past and predictive value is the ability to predict the possible future outcome or events.

Predictive value means that the information can be used to predict future outcomes. The financial information itself does not need to be a prediction or a forecast, but can be interpreted by users to allow them to make their own predictions. Predictive value refers to the fact that quality financial information can be used to base predictions, forecasts, and projections on. Financial analysts and investors can use past financial statements to chart performance trends and make predictions about future performance and profitability.

There are various ways that can be used to assess the financial health of an organization. Basically, they can be divided into financial and non-financial measures. Financial measures would involve the use of accounting and other numerical data such as ratios and trends to measure a company's growth, profitability, efficient use of its assets and its financial standing at different points in time. Ratio analysis involves comparing the inter-relationships between accounting figures in the financial statements in relative terms. Different user groups of financial reports will focus on different aspects of a company's performance depending on their relationship and involvement with the company. For example, a long term investor will be interested in returns and the level of risks of the company compared to other potential investments, while a trade creditor will be interested in whether goods supplied will be paid in the short term or within the credit period

**1.8: Summary**

- The term accounting ratios is defined by J. Betty as ' significant relationships which exist between figures shown in a Balance Sheet, in a profit and Loss Account, in a budgetary control system or in any other part of the accounting organization'
- An accounting ratio compares two aspects of a financial statement, such as the relationship (or ratio) of one item to another item. It is the most widely used tool to interpret quantitative relationship between two variables of one number to another.
- Financial Ratios help in measuring operational efficiency, liquidity, profitability and solvency of a firm.
- Ratio analysis helps in comparative analysis between present performance and past performance to discover the positive and negative points. Comparison with the performance of other competitive firms can also be made. Ratio analysis is of much help in financial forecasting and planning.
- *Activity ratios* are those ratios which assess how effectively a company is able to generate revenue in the form of cash and sales based on its asset, liability and capital share accounts. They are also called Efficiency ratios. The important activity ratios are:

  **a.** Inventory Turnover Ratio,
  **b.** Debtors Turnover Ratio,
  **c.** Creditors Turnover Ratio,
  **d.** Total Assets Turnover Ratio,
  **e.** Fixed Assets Turnover Ratio,
  **f.** Expense Ratios

- Liquidity ratios provide a measure of degree to which current assets cover current liabilities. The excess of current assets over current liabilities provides a measure of safety margin available against uncertainty in realisation of current assets and flow of cash and to meet short term obligations. The following are the important liquidity ratios:
    a. Current ratio
    b. Liquid ratio or quick ratio
    c. Absolute liquidity ratio
- **Solvency ratio** is one of the various ratios used to measure the ability of a company to meet its long term debts. Solvency ratios are calculated to determine the ability of the firm to service its debt in the long run
- Profitability ratios are calculated to analyse the earning capacity of the business. It reflects the utilisation of resources employed in the business. There is a close relationship between the profit and the efficiency with which the resources employed in the business are utilised.
- For accounting information to be relevant, it must possess: *confirmatory value* and *predictive value*. Confirmatory value is the ability to provide information about the past and predictive value is the ability to predict the possible future outcome or events.

### 1.9 Suggested Readings and References

https://www.researchgate.net/publication/286575407_The_predictive_abilities_of_financial_ratios_in_predicting_company_failure_in_Malaysia_using_a_classic_Univariate_approach

https://www.myaccountingcourse.com/accounting-principles/relevance

### 1.10 Model Question

1. Discuss the advantages and disadvantages of Accounting Ratios

2. Discuss the application of accounting ratio in decision making.

3. Discuss the predictive value of accounting ratio.

**1.11 Answer to Check your Progress**

1. Accounting ratio is calculated by taking any two variables (items) either from the balance sheet or statement of profit and loss or from both. Accounting ratio is also known as financial ratio. In fact, an accounting ratio expresses a relationship that exists between the two items of financial statements
2. financial ratio
3. financial statements
4. The following are the advantages of ratio analysis:

**(i) Test of operational efficiency:** Ratio analysis is applied to test Operational efficiency of the business. It is done by calculating operating / activity ratios.

**(ii) Measurement the profitability:** The profit earning capacity of the business is known as Profitability. Profitability can be measured and analysed with the help of Gross Profit, Net Profit, Expenses and Other Ratios.

**(iii) Examining the financial liquidity of the firm: Ratios may be used to examine the short term financial position, I.e. liquidity of a firm by applying liquidity ratios.**

**(iv) Measuring long term financial position:** Long-term financial position of the business can be measured by calculating solvency ratios. In case of unhealthy long-term position, corrective measures can be taken.

**(v) Facilitating comparative analysis:** A comparative analysis may be carried out between present performance and past performance to discover the positive and negative points. Comparison with the performance of other competitive firms can also be made.

**(vi) Budgeting and forecasting:** Ratio analysis is of much help in financial forecasting and planning. Ratios calculated for a number of years work as a guide for the future. Meaningful conclusions can be drawn for future from these ratios.

5. The following are the Limitations of Ratio Analysis**:**

(i) Ratios are based on monetary values, i.e., these are quantitative. Hence, these are tools of quantitative analysis, which ignore qualitative points of view.

(ii) Ratios are based on historical data. Hence, all of the information used in ratio analysis is derived from actual historical results. This does not guarantee that the same results will carry forward into the future.

(iii) During inflationary situation, ratios may be of little help. Ratios are generally distorted by inflation.

(iv) Ratios may give false result, if they are calculated from incorrect accounting data.

(v) Two different firms may adopt different accounting policies regarding valuation of inventories, charging depreciation etc. If this is so, it makes the accounting data and accounting ratios of two firms non-comparable.

## BLOCK-V : UNIT-II

## RATIO ANALYSIS FOR PERFORMANCE EVALUATION ( ACTIVITY AND PROFITABILITY) ; RATIO ANALYSIS FOR FINANCIAL HEALTH ( SOLVENCY AND STRUCTURAL ANALYSIS)



### 1.1 Introduction

Ratio analysis is an accounting tool to present accounting variables in simple, concise, intelligible and understandable form. Ratios are not an end but are media to reach the end. These are used to make decisions by various user groups of financial statements for various purposes. Therefore, users of financial statements, keeping in view their own financial interest, interpret a single ratio differently. This is called interpretational flexibility of a ratio. Again, the interpretation may vary depending upon the time horizon, present condition in the industry and the economy etc. Financial statements provide accounting information through the Statement of Profit and Loss and Balance Sheet. Financial statements by themselves do not provide required information both for internal and external users. Therefore to get meaningful information from the financial statements to facilitate decision making by the user of these information, financial statements must be analysed and interpreted with useful tools. Activities ratios help evaluate a business's operating efficiency by analyzing fixed assets, inventories, and accounts receivables. It expresses a business's financial health and indicates the utilization of the balance sheet components. In general, profitability ratios measure the efficiency with which your company turns business activity into profits. Profit margins assess your ability to turn revenue into profits. Return on assets measures your ability to use assets to produce net income. Return on equity compares your net income to shareholder equity.

### 1.2 Objectives

After going through this unit you will be able to

- Understand how to evaluate performance with the help of activity ratio
- Understand how to evaluate performance with the help of Profitability ratio
- Understand the importance of solvency ratio in measuring financial health.

### 1.3 Ratio analysis for Performance Evaluation

#### 1.3.1 Performance evaluation with the help of Activity Ratios

Activity ratios are those, which are related to sales or main operation of the business and working capital. These ratios show the effectiveness of the firm in utilising its assets and working capital. These are, therefore, known as 'activity ratios'. **The following important activity ratios are generally computed to evaluate operational efficiency of a business firm**.

(i) Inventory Turnover Ratio,
(ii) Debtors Turnover Ratio,
(iii) Creditors Turnover Ratio,
(iv) Total Assets Turnover Ratio,
(v) Fixed Assets Turnover Ratio,
(vi) Expense Ratios

**(i) Inventory Turnover Ratio:** This ratio indicates the speed at which the inventory is tuned into sales. The inventory turnover ratio is calculated by dividing the cost of goods sold for a period by the average inventory for that period. Average inventory is used instead of ending inventory because many companies' merchandise fluctuates greatly throughout the year.

**Inventory Turnover Ratio = Cost of Goods Sold ÷ Average Inventory**

A higher ratio indicates operating efficiency of the firm.

***Illustration:***

From the following information, calculate inventory turnover ratio :

| | Rs. |
|---|---|
| Inventory in the beginning: | 20,000 |
| Inventory at the end: | 10,000 |
| Net purchases: | 90,000 |
| Wages: | 5,000 |
| Revenue from operations: | 2,00,000 |
| Carriage inwards: | 1,000 |

Inventory Turnover Ratio = Cost of Goods Sold ÷ Average Inventory

Cost of Goods Sold = 20,000 + 90,000 + 5,000 + 1,000 – 10,000 = 1,06,000

Average Inventory = (20,000 + 10,000) ÷ 2 = 15,000

Inventory Turnover Ratio = 1,06,000 ÷15,000 = 7.06

**(ii) Debtors' Turnover:** This ratio indicates the speed at which the debtors pay their dues to the firm. Turnover is generally expressed as number of times. Debtors' turnover is calculated as:

**Debtors Turnover Ratio = Credit Sales ÷ Average Debtors**

This ratio provides information on how many times per year do the debtors pay on average?

Suppose, Credit Sales Rs. 9,000 ÷ Average Debtors Rs. 2,000

Debtors Turnover Ratio = 4.5 times

The Debtors have turned over is four and half times in one year. In other words the debtors have paid you four and half times in the year. Four and half times in the year means 365 days ÷ 4.5 = 81 days. This means the debtors paid you in 81 days since you made a sale to them.
A lower ratio indicates the firm is efficient to collect cash at a shorter period. A higher ratio indicates that there is overdue from the debtors.

**(iii) Creditors' Turnover:** This ratio indicates the speed at which the creditors are paid. Turnover is generally expressed as number of times. Creditors' turnover is calculated as:

**Creditors' Turnover = Credit Purchases ÷ Average Creditors**

Another form of creditor's turnover ratio is average payment period which is calculated as under:

**Average payment period = Days in a year / Creditors' Turnover**

**(i) Assets Turnover Ratio:** The efficiency in utilising the firm's assets is reflected in assets turnover ratio. This ratio is an efficiency ratio. It measures a firm's ability to generate sales from its assets by comparing net sales with average or total assets. In other words, this ratio shows how efficiently a company can use its assets to generate sales.

Higher the asset turnover ratio, the more efficient is the management in utilising the assets. Since higher ratios imply that the company is generating more revenue per rupee of assets. There is no 'rule of thumb' or standard for Assets turnover ratio. A ratio higher than one is preferred. As a measure of efficiency, comparison of five to six years' ratio will serve the purpose in a better way.

**(v) Fixed Assets Turnover Ratio:** It is variant of Assets turnover ratio. The efficiency in utilising the firm's fixed assets is reflected in this ratio. This ratio is an efficiency ratio. It measures a firm's ability to generate sales from its fixed assets by comparing net sales with average or total fixed assets. In other words, this ratio shows how efficiently a company can use its fixed assets to generate sales. A higher the fixed asset turnover ratio signifies more efficiency in utilising the assets.

**(ii) Expense Ratios:** Expense ratios are calculated to express a particular expense as a percentage of sales. Sales are taken as base since all the business expenses are met from the revenue generated from sales. A higher expense ratio indicates that there is something wrong which needs a thorough examination.

The following are some important expense ratios.

(i) Cost of Goods Sold Ratio: Cost of Goods Sold/Net Sales

Salary to Sales Ratio: Salary to Sales Ratio = Salary/Net Sales

Selling and Distribution Expenses Ratio: Selling & Distribution Expenses /Net Sales

Office and Administrative Expenses Ratio = Office and Administrative Expenses /Net Sales

Operating Ratio = Operating Expenses /Net Sales

Non-operating Expenses Ratio = Non-operating Expenses /Net Sales

**Interpretation of Operating and Expenses Ratios:**

Operating ratio is an important tool of analysing operating leverage. It is a test of operational efficiency. A high operating and expenses ratios imply lower profit, and *vice versa*. Use of operating ratio along with expenses ratios is very much useful for detecting the weak and inefficient areas and for taking corrective actions. A systematic and minute study of each expense ratios enables the management to exercise effective control over cost.

**Check your Progress**

1. What is Activity Ratio?
2. What are different types of Activity ratio?
3. How is Debtor Turnover Ratio calculated?
4. What is Expense Ratio ?
5. What does high operating ratio indicate ?

### 1.3.2 Performance evaluation with the help of profitability Ratios

Profitability ratios are another set of ratios which help to evaluate the performance of a firm from the view point of earnings. Profitability is the capacity to earn profit. Capacity to earn profit can be related with two variables - sales and investment. Relationship between profit and sales is shown by computing 'profit margin ratios', whereas relationship between profit and investment is shown through 'rate of return ratios'.

**A. Important Profitability Ratios relating to Sales:**

a) Gross Profit Ratio

b) Operating Profit Ratio

c) Net Profit Ratio

d) Cash Profit to Cash Sales Ratio

**B. Important Profitability Ratios Relating to Investment:**

a) Return on investment (ROI)

b) Return on Total Assets

c) Earning Per Share (EPS)

d) Dividend Per Share (DPS)

e) Price Earning Ratio

f) Dividend Pay out Ratio

A. Important Profitability Ratios relating to Sales are explained below:

a) Gross Profit Ratio: It is calculated as under**.**

Gross Profit Ratio= Gross Profit /Net Sales

If G/P ratio is 25 p.c. it means 75 p.c. is the cost of goods sold and remaining 25 p.c. is the margin towards administrative and selling expenses and profit. Generally a G/P ratio of 20 to 30 p.c. is desirable.

b) **Operating Profit Ratio:** It is a ratio between operating profit and net sales. It is worked out as under.

Operating Profit Ratio = Operating Profit /Net Sales

Operating profit is the profit from business operations (gross profit minus operating expenses) before deduction of interest and taxes. It is the profit earned from a firm's normal core business operations. This does not include any profit earned from the firm's outside investments, such as dividend from investment in other company's shares or any other income from external investments.

**c) Net Profit Ratio:**

This ratio is the percentage of sales value left after subtracting the cost of goods sold and all expenses, except income taxes. It provides a good opportunity to compare company's "return on sales" with the performance of other companies in the industry. It is calculated before income tax because tax rates and tax liabilities vary from company to company for a wide variety of reasons, making comparisons after taxes much more difficult. The Net Profit Margin Ratio is calculated as follows:

**Net Profit Ratio = Net Profit before Tax / Net Sales**

**(d) Cash Profit to Cash Sales Ratio:**

**It is calculated to see the cash earnings of the company. It is calculated as below:**

Cash Profit to Cash Sales Ratio = Cash Profit/ Net Sales

Normally, Cash profit = Net profit + Depreciation

B. Important Profitability Ratios Relating to Investment are discussed below:

(a) Return on investment (ROI)
(b) Return on Assets ratio
(c) Earnings Per Share (EPS)
(d) Dividend Per Share (DPS)
(e) Price Earnings Ratio
(f) Dividend Pay out Ratio

**(a) Return on Investment Ratio (ROI)**

The ROI is the most important ratio of all profitability ratios. It is the percentage of return on funds invested in the business by its owners. In short, this ratio tells the owner whether or not all the effort put into the business has been worthwhile. The ROI is calculated as follows:

**Return on Investment = Net Profit before Tax ÷ Net Worth**

It may be calculated as under also.

**ROI = Net Profit ÷ Total Investment**

**ROI** is performance measure used to evaluate the efficiency of investment. It compares gains from investment with investment costs. It is one of most commonly used approaches for evaluating the financial consequences of business investments, decisions, or actions. If an investment has a positive ROI and there are no other opportunities with a higher ROI, then the investment should be undertaken. A higher ROI means that investment gains compare favorably to investment costs.

ROI is an important tool for making the following decisions:

- asset purchase decisions
- approval and funding decisions for projects and programs of different types
- traditional investment decisions

**(b) Return on Assets Ratio**

This measures how efficiently profits are being generated from the assets employed in the business when compared with the ratios of firms in a similar business. A low ratio in comparison with industry averages indicates an inefficient use of business assets. The Return on Assets Ratio is calculated as follows: **Return on Assets = Net Profit Before Tax ÷Total Assets**

**(c) Earning Per Share (EPS):**

This is a measure of earnings to the Equity Shareholders. It is also called net income per equity share. It measures the amount of net income earned per share of equity stock outstanding. Earning per share is a profitability ration on shareholder basis. It is generally used by the management to decide the capital structure of a public limited company. Prospective shareholders may use to make an investment decision.

It is calculated as under:

**EPS = Profit after preference Dividend ÷ No. of Equity Shares Outstanding**

**(d) Dividend Per Share (DPS):**

This is a measure of dividend earnings to the equity shareholders on their investment. Prospective shareholders may use to make an investment decision. It is used by individuals who are evaluating various stocks to invest in equity shares and prefer companies who pay a higher dividend.

**DPS = Amount of Equity Dividend ÷ No. of Outstanding Equity Shares**

**(e) Price Earnings Ratio (P/E ratio):**

This ratio shows the relationship between the market price of equity share and the earnings to the Equity shareholders. It is generally expressed as P/E ratio. P/E ratio is a ratio between market price of a share and EPS. The price earnings ratio shows what the market is willing to pay for a stock based on its current earnings. Investors often use this ratio to evaluate what a share's fair market value should be by predicting future earnings per share. Companies with higher future earnings are usually expected to issue higher dividends or have appreciating stock in the future.

P/E ratio is calculated as under:

**Price Earnings Ratio = Market price per equity share ÷ Earnings Per Share**

**(f) Dividend Pay Out Ratio**:

This ratio shows the amount of dividend paid to the Equity shareholders out of the profit available to them. Those shareholders who prefers cash income generally examine this ratio of different companies before making investment. This ratio is calculated as below:

**Dividend Pay Out Ratio = Total dividend paid to the Equity Shareholders ÷ Profit available to them.**

### 1.4 Measuring Financial Health through Solvency Ratios and Structural Analysis

Financial health of the company is determined by various factors such as the ability to repay its debt, its profitability, liquidity and its operating efficiency. A company's ability to meet its long term obligation is calculated by the solvency ratio. Solvency ratios are key ratios for determining company's capacity to service its long term debt and it provides insight into company's overall financial position. Solvency ratio is very useful to lenders and other external investors because it helps to analyse the financial health of the organization. The ratio usually compares the enterprise's profitability with its obligations to determine whether it is financially sound. A higher solvency ratio determines better financial health of the enterprise.

**Solvency ratio** is one of the various **ratios** used to measure the ability of a company to meet its long term debts. Solvency ratios are also called leverage ratios, measure a company's ability to sustain business operations indefinitely by comparing debt levels with equity, assets and debt-service capacity. In other words, solvency ratios identify going concern issues and a firm's ability to pay its long term debts.

The creditors who have advanced money to the business on long-term basis are interested in safety of their periodic payment of interest as well as the repayment of principal amount at the end of the loan period. Therefore, solvency ratios are calculated to determine the ability of the firm to service its debt in the long run. The following ratios are normally computed for evaluating solvency of the business.

1. Debt-Equity Ratio;
2. Debt to Capital Employed Ratio;

3. Proprietary Ratio;
4. Total Assets to Debt Ratio;
5. Interest Coverage Ratio.

This ratio measures the degree of indebtedness of firm and gives an idea to the long-term creditors regarding extent of security of the debt. A low debt equity ratio reflects more security. A high ratio, on the other hand, is considered risky as it may put the firm into difficulty in meeting its obligations to long term financiers. But at the same time, from the view point of the owners, use of reasonable amount of debt may help in ensuring higher returns for them, provided the rate of earnings on capital employed is higher than the rate of interest payable.

**Check your Progress**

6. What is profitability ratio?
7. What are the important profitability ratio related to sales?
8. What is RIO?
9. What is EPS?
10. What is Dividend Payout Ratio?

### 1.5: Illustration

I. From the following information calculate (i) Gross profit Ratio, (ii) Return on Investment, (iii) Current Ratio, (iv) Stock Turnover, (v) Assets Turnover, (vi) EPS

Share Capital: 10,000 equity shares of Rs. 10 each

| | |
|---|---|
| Sales: | Rs.12,00,000 |
| Inventory: | Rs. 50,000 |
| Current Assets; | Rs.1,50,000 |
| Current Liabilities: | Rs. 90,000 |
| Profit after Tax | Rs. 1,20,000 |
| Cost of goods sold: | Rs. 7,00,000 |
| Fixed Assets | Rs. 2,50,000 |
| Tax | Rs. 80,000 |

(i) Gross Profit Ratio:

Gross Profit Ratio= Gross Profit ÷Net Sales

Gross Profit = Rs. 12,00,000 – Rs. 7,00,000 = Rs. 5,00,000

Gross Profit Ratio + (5,00,000 ÷ 12,00,000) x 100 = 41.67%

If G/P ratio is 41.67%it means 58.33% is the cost of goods sold and remaining 41.67%is the margin towards administrative and selling expenses and profit. **Generally a G/P ratio of 20 to 30 p.c. is desirable.**

**(ii) Return on Investment Ratio (ROI)**

Return on Investment = Net Profit before Tax ÷ Total Assets

[ 2,00,000 ÷ (1,50,000 + 2,50,000)] x 100 = 50.00

**(iii) Current Ratio:**

Current Ratio =
Current Assets ÷ Current Liabilities

(1,50,000 ÷ 90,000) = 5:3

(iv) Inventory Turnover Ratio:

Inventory Turnover Ratio =

Cost of Goods Sold ÷ Average Inventory

(7,00,000 ÷ 50,000) = 14

(v) Assets Turnover Ratio:

Assets Turnover Ratio = Sales /Total Assets

(12,00,000 ÷ 4,00,000) = 3

(vi) Earning Per Share (EPS):

This is a measure of earnings to the Equity Shareholders.

EPS =

Profit after preference Dividend /No. of Outstanding Equity Shares

(1,20,000 ÷ 10,000) = Rs. 4

**II. From the following information extracted from the annual accounts of Assam Limited. You are required to calculate the following ratios:**

(i) Gross profit percentage,

(ii) Net profit percentage,

(iii) Return on total assets,

(iv) Quick asset ratio,

(v) Debtors collection period,

(vi) Stock turnover,

(vii) Fixed assets turnover,

(viii) Return on shareholders' funds,

(ix) Current ratio, and

**Balance Sheet as at 31st December, 2007**

| | (Rs. 000) |
|---|---|
| Share Capital | 450 |
| Retained Profits | 240 |
| | 690 |
| 12% Debentures | 700 |
| Trade creditors | 620 |
| Proposed dividend | 45 |
| | 2,055 |
| Fixed assets net of depreciation | 875 |
| Stocks | 310 |
| Debtors | 770 |
| Bank balance | 100 |
| | 2,055 |

**Extracts from Year's Profit and Loss Account**

| | (Rs.) |
|---|---|
| Sales for the year | 31,00,000 |
| Gross profit | 17,25,000 |
| Expenses | 8,05,000 |
| Depreciation | 2,50,000 |

**SOLUTION**

(i) Gross profit percentage $= \frac{1725}{3100} \times 100\% = 55.6\%$

(ii) Net profit percentage $= \frac{670}{3100} \times 100\% = 21.6\%$

(iii) Return on total assets $= \frac{670}{2055} \times 100\% = 32.6\%$

(iv) Quick ratio $= \frac{870}{665} = 1.3 : 1$

(v) Debtors collection period $= \frac{770}{3100} \times 365 = 91$ days

(vi) Stock : turnover $= \frac{3100}{310} = 10$ times

(vii) Fixed assets : turnover $= \frac{3100}{875} = 3.5$ times

(viii) Return on shareholders' funds $= \frac{586}{690} \times 100\% = 84.9\%$

(ix) Current ratio $= \frac{1180}{665} \times 1.8 : 1$

(x) Debt ratio $= \frac{1365}{2055} \times 100\% = 66.4$

## 1.6 Summary

- Activity ratios are those, which are related to sales or main operation of the business and working capital. These ratios show the effectiveness of the firm in utilising its assets and working capital.

- Expense ratios are calculated to express a particular expense as a percentage of sales. Sales are taken as base since all the business expenses are met from the revenue generated from sales.
- Operating ratio is an important tool of analysing operating leverage. It is a test of operational efficiency. A high operating and expenses ratios imply lower profit, and *vice versa*
- The creditors who have advanced money to the business on long-term basis are interested in safety of their periodic payment of interest as well as the repayment of principal amount at the end of the loan period. Therefore, solvency ratios are calculated to determine the ability of the firm to service its debt in the long run.
- **ROI** is performance measure used to evaluate the efficiency of investment. It compares gains from investment with investment costs. It is one of most commonly used approaches for evaluating the financial consequences of business investments, decisions, or action
- Earning per share is a profitability ration on shareholder basis. It is generally used by the management to decide the capital structure of a public limited company. Prospective shareholders may use to make an investment decision.

**1.7 Suggested Readings and References**


1. **https://www.wallstreetmojo.com/activityratios/#:~:text=Activity%20ratios%20help %20evaluate%20a,of%20the%20balance%20sheet%20components.**
2. **https://smallbusiness.chron.com/profitability-ratios-measure-evaluation-company 56023.html**


**1.8 Model Question**

1. Explain the advantages of Ratio Analysis.
2. Give an account of the various ratios used to measure the operating efficiency of a business firm?
3. Give an account of the various ratios used to measure the profitability of a business firm?

**1.9 Answer to Check your Progress**

1. Activity ratios are those, which are related to sales or main operation of the business and working capital. These ratios show the effectiveness of the firm in utilising its assets and working capital.

2. The following important activity ratios are generally computed to evaluate operational efficiency of a business firm.
    1. Inventory Turnover Ratio,
    2. Debtors Turnover Ratio,
    3. Creditors Turnover Ratio,
    4. Total Assets Turnover Ratio,
    5. Fixed Assets Turnover Ratio,
    6. Expense Ratios
3. This ratio indicates the speed at which the debtors pay their dues to the firm. Turnover is generally expressed as number of times. Debtors' turnover is calculated as:

    **Debtors Turnover Ratio =Credit Sales ÷ Average Debtors**
4. Expense ratios are calculated to express a particular expense as a percentage of sales. Sales are taken as base since all the business expenses are met from the revenue generated from sales. A higher expense ratio indicates that there is something wrong which needs a thorough examination
5. A high operating and expenses ratios imply lower profit, and *vice versa*
6. Profitability ratios are set of ratios which help to evaluate the performance of a firm from the view point of earnings. Profitability is the capacity to earn profit.
7. Important Profitability Ratios relating to Sales are**:**
    a) Gross Profit Ratio
    b) Operating Profit Ratio
    c) Net Profit Ratio
    d) Cash Profit to Cash Sales Ratio
8. The ROI is the most important ratio of all profitability ratios. It is the percentage of return on funds invested in the business by its owners. The ROI is calculated as follows:

    **Return on Investment = Net Profit before Tax ÷ Net Worth**
9. It measures the amount of net income earned per share of equity stock outstanding. Earning per share is a profitability ration on shareholder basis. It is generally used by the management to decide the capital structure of a public limited company. It is calculated as under:

    **EPS = Profit after preference Dividend ÷ No. of Equity Shares Outstanding**

10. Dividend Payout ratio shows the amount of dividend paid to the Equity shareholders out of the profit available to them. It is calculated as

**Dividend Pay Out Ratio = Total dividend paid to the Equity Shareholders ÷ Profit available to them.**

# BLOCK V : UNIT-III

## Application of Accounting Ratios in the analysis of Working Capital



### 3.1 Introduction:

It is well known to all that finance is the first requirement of business. Economic activity of any nature involves finance. Without finance one cannot think of starting business activities. However, finance may take the shape of cash or credit; it may be required for short term or long term or for both. Hence, working capital is called the life blood and nerve centre of business. Working capital is essential to maintain smooth running of a business. No business can run successfully without an adequate amount of working capital. Without adequate working capital it is impossible to operate the business smoothly. It facilitates to run the business without any financial problem for making the payment of short-term liabilities. Purchase of raw materials and payment of salary, wages and overhead can be made without any delay. Sufficient working capital enables a business concern to make prompt payments and thus it helps in creating and maintaining goodwill. Quick payment to the suppliers of raw materials ensures the regular supply of raw materials from suppliers. If suppliers are satisfied by the payment on time, the regular supply of raw materials and continuous production are ensured. This will ultimately help in the overall progress of the firm

## 3.2 Objectives

**After going through this unit, you will be able to:**

- Know the meaning of working capital,
- Know the importance of working capital.
- Understand the different concepts of Working Capital.
- Acquaint with the application of Ratio for analysing working capital

## 3.3 Meaning of Working Capital:

In the previous units, we have discussed the application of Accounting Ratios in decision making. In this unit we will put an effort to make you understand the intricacies of working capital analysis and the utility of inter firm comparison for decision making. Working capital analysis and inter firm comparison are generally done with the help of some relevant accounting ratios. Hence, we will use these ratios in this unit to analyse working capital and inter firm comparison.

Working Capital means the capital available for meeting the day-to-day expenses of a business firm. In the words of Shubin, "Working Capital is the amount of funds necessary to cover the cost of operating the enterprise". This capital is the amount used in the normal course of business and does not include the amount blocked in the assets of permanent nature. This fund required for current operation has been termed as 'short-term financing', 'short-term funds', 'revolving capital', 'circulating capital' or 'Working Capital' by different authors. Fixed capital portrays that part of business finance, which is invested in fixed assets. Working Capital, on the other hand indicates that part of business finance which helps in meeting working expenses and day-to-day operations. According to some authors, viz. Field, Baker Mead, Cohers and Robbins, Working Capital comprises of the total current assets; while to other authors, Guthmann and Dougall, Weston and Brigham and VL Gole, Working Capital represents the difference between the current assets and current liabilities. One significant implication of Working Capital is the amount of rupees worth of current assets including cash and earmarked or required for paying off current liabilities. According to Genestenberg "Circulating capital means current assets of a company that are changed in the ordinary course of business from one form to another. As for example, from cash to inventories, inventories to receivables, receivables into cash".

Working Capital in simple terms means Current Assets minus Current Liabilities (CA - CL). Working capital is also defined as Long Term Fund minus Long Term Assets (LTF -.LTA). The result of (CA – CL) or (LTF - LTA) is considered a prime measure of the short-term liquidity of a business firm. A strongly positive working capital balance indicates healthy short term financial position, while negative working capital is considered an indicator of impending technical bankruptcy. Sufficent working capital allows management to take advantage of unexpected opportunities, and to qualify for bank loans and favorable trade credit terms.

A 2:1 ratio of current assets to current liabilities is considered healthy from the liquidity point of view, though the ratio may vary from industry to industry. The ratio may also be reviewed on a trend line, with the intent of spotting any declines or sudden drops that could indicate liquidity problems.

**Example:** A business firm has Rs. 200,000 of accounts receivable, Rs. 80,000 of inventory, and Rs. 70,000 of accounts payable. Its working capital is:

**Current Assets minus Current Liabilities.**

= Rs.( 2,80,000 Current assets - 70,000 Current liabilities) = Rs. 2,10,000

### 3.4 Different Concepts of Working Capital:

The popular term 'working Capital' may be conceptualised in various terms in financial management. These are listed below:

(i) Gross Working Capital,
(ii) Net Working Capital,
(iii) Negative working Capital,
(iv) Permanent Working Capital,
(v) Circulating or Variable Working Capital,
(vi) Cash working Capital, and
(vii) Balance Sheet Working Capital.

**Gross Working Capital (GWC):** The sum total of all components of Current Assets is called Gross Working Capital. Total of cash and bank, receivables, inventory and all other current assets is together called Gross Working Capital.

**Gross Working Capital**

**=**

**Total of all Current Assets**

**Net Working Capital (NWC):** When the amount of total current liabilities is deducted from Gross Working Capital it is termed as Net Working Capital. In other words, the difference between the Gross Working Capital (total current assets) and total current liabilities is called Net Working Capital.

**Net Working Capital**

**=**

**Total Current Assets *minus* total Current Liabilities**

In common parlance and in accounting and financial literature, the term 'Net Working Capital' is rarely used. Instead, to mean this, the simple and easily understandable term 'Working Capital' is used to mean Net Working Capital. ***While considering the total current assets for the calculation of Net working capital, the amount of pre-paid expenses like pre-paid insurance, are excluded***.

**Negative working Capital:** When the total amount of current assets of a firm is less than its current liabilities it is known as Negative Working Capital. Under such situation the balance of working capital shows a negative balance. In other words negative working capital is a situation when current liabilities are more than current assets.

**Negative Working Capital is a situation when**

**Current Liabilities are *more than* Current**

**OR**

**Negative Working Capital**

**=**

**Excess of Current Liabilities *over* Current Assets**

**Permanent Working Capital:** If the Balance Sheets of a company for several years are examined we find that some amount of current assets and current liabilities are always there all through these years. If we prepare a balance sheet at any point of time in a year, then also we get certain balance of current assets and current liabilities. This means that though there are changes in the amount i.e., money value, from time to time, there remains a balance of working capital (current assets minus current liabilities). The operating cycle may not require the full amount of working capital through out the year. Thus a certain amount of working capital remains unutilized all through the year. Again a firm is required to maintain a minimum balance of working capital, especially cash and inventory all the time with a view to run the firm smoothly. This part of working capital is termed as Permanent Working Capital.

**Circulating or Variable working Capital:** The variation in the amount of working capital is always there depending upon the factors in operating cycle. The amount of variation in working capital below or above the permanent working capital is termed as circulating or Variable Working Capital.
Permanent working capital does not imply that the amount is not fixed or static all the time or years. It simply implies that it is the minimum amount of working capital which is required at any point of time. This concept helps in planning and in the management of working capital more efficiently. The amount of permanent working capital may increase or decrease annually depending upon the growth or decline of business.

**Circulating Working Capital**

**=**

**Net Working Capital *minus* Permanent Working**

**Cash Working Capital:** Cash working capital denotes the cash component of working capital. Cash includes cash at bank and in hand.
**Balance Sheet Working Capital:** B/S working capital is derived from the figures given in the Balance Sheet, i.e., current assets minus current liabilities. This concept is derived at the end of financial year after the preparation of Balance Sheet and is a historical concept.

## 3.5 Components of Working Capital

Working capital is influenced by the amount of current assets and current liabilities. Generally the current assets and current liabilities are composed of the following items:

A. **Current Assets:** (i) Inventory of raw materials
(ii) Inventory of work-in-progress,
(iii) Inventory of finished goods,
(iv) Inventory of spare parts, loose tools, stationeries etc,
(v) Inventory of merchandise (in case of trading concerns),
(vi) Trade Debtors,
(vii) Bills Receivables,
(viii) Marketable securities
(ix) Cash at bank (in current account)
(x) Cash in hand, etc.

B. **Current Liabilities:** (i) Trade creditors,
(ii) Bills payables,
(iii) Short term loans,
(iv) Bank overdraft,
(v) Bills for outstanding expenses,
(vi) Tax payable,
(vii) Dividends payable
(ix)Any other dues outstanding

For easy understanding explanations of some items are given below.

**1. Cash and bank balances:** This is the most liquid form of working capital and requires constant supervision. A good cash budgeting and forecasting system provides answers to key questions such as: Is the cash level adequate to meet current expenses as they come due? What is the timing relationship between cash inflow and outflow? When there will be maximum need of cash? When and how much bank borrowing will be needed to meet any cash shortfalls? When will repayment be expected and will the cash flow cover it?

**2. Trade Debtors and Bills receivables:** Trade Debtors and Bills receivables are commonly known as Accounts Receivables. Many business firms extend credit to their customers. If it is done, then it should be kept in mind that whether the amount of accounts receivable is reasonable in comparison to sales? How rapidly are receivables being collected? Which customers are slow to pay and what should be done about them?

**3. Inventory.** Inventory is one of the most important components of working capital . In some cases it is often as much as 50 percent of firm's current assets, so naturally it requires continual scrutiny. Is the inventory level reasonable compared with sales and the nature of your business? What's the rate of inventory turnover compared with other companies in your type of business?

**4. Trade creditors and Bills payable (Accounts Payables):** Financing by suppliers is common in small business; it is one of the major sources of funds for entrepreneurs. Is the amount of money owed suppliers reasonable relative to what you purchase? What is your firm's payment policy doing to enhance or detract from your credit rating?

**5. Accrued expenses and taxes payable.** These are obligations of the business firm at any given point of time and represent a future outflow of cash.

## 3.6 Need for Working Capital

From the above discussion you have come to know different concepts of working capital and its forms. Now we shall discuss the various purpose of working capital for which it is utilised in a business firm.

The very purpose of working capital is to finance the deficit in the operating cycle. The Time Gap between (a) the purchase of raw materials (goods), processing and production on the one hand and (b) realization of cash from sales, debtors and receivables on the other, gives rise to the need for working capital. The expenditure required for (a) are met from revenue earned from (b) above. But the time scheduling for these two types of activities are such that there always remains a gap. Sales do not convert into cash instantly. There is invariably time-lag between sales of goods and the receipt of cash. In order to sustain sales activity therefore sufficient amount of working capital is required.

Various activities for which working capital is needed are:

1. Acquisition of raw-material;
2. Purchase of components and spare-parts;
3. Recurring expenses and overhead cost like office expenses, rent, fuel, power etc.;
4. Payment of wages and salaries;
5. Distribution and selling expenses, packaging, publicity after-sales service etc;
6. Warehousing expenses;
7. Collection charges from debtors, bank charges for realization of cheques;
8. Cash discount, bad debt etc;

| **Check your Progress** |
|---|
| 1. Explain the term 'working capital'. |
| 2. What are the different forms of 'working capital'? |
| 3. What are the needs of working capital? |
| 4. How is net working capital calculated? |
| 5. What is negative working capital? |

**3.7 Working Capital Leverage**

The amount of working capital provided by the current sources (current liabilities) is known as Working Capital Leverage**.** Most of this amount is contributed by the sundry creditors. If the whole of gross working capital is financed by the current liabilities, it leads to the situation of Current Assets = Current Liabilities and the ratio of CA to CL will be 1:1. This means that the entire amount of working capital is financed by cost-free funds. It raises the profitability of the firm. The more the rate of contribution of current liabilities to the working capital, the more will be the profitability. This is called working capital leverage. Such situation will raise the productivity of working capital. Working capital leverage is tool to measure the productivity of working capital.

**3.8 Relevant accounting ratios for working capital analysis:**

In section 6.4 above we have mentioned the various components of working capital. The relevant accounting ratios for working capital analysis are computed from these items of working capital. Generally the following accounting ratios are used to analyse working capital.

(a) Current Ratio or Working capital Ratio,
(b) Liquid Ratio,
(c) Absolute Liquid Ratio,
(d) Overdue Liability Ratio,
(e) Defensive Interval Ratio,
(f) Inventory Turnover Ratio.

**Current Ratios:**

The Working capital Ratio, popularly known as Current Ratio is one of the best-known ratio which measures the quantum of margin between current assets and current liabilities. It is the relative proportion of an entity's current assets to its current liabilities, and is intended to show the ability of a business to pay for its current liabilities with its current assets. Current assets are those assets which, in the ordinary course of business, can be converted into cash within a short period of time. This short period of time normally consists of twelve months. Currents assets normally include cash and bank balances, marketable securities, debtors, bills receivables, inventory, and accrued income. Current liabilities are obligations payable within a year. These are the liabilities which include trade creditors, bills payable, outstanding liabilities, advance income received, dividend payable contingent liabilities, and normally bank overdraft also. Moreover, provisions for taxation and other short-term provision for unseen liabilities are also classified as current liabilities.

. A working capital ratio of less than 1.0 is a strong indicator that there will be liquidity problems in the future, while a ratio in the vicinity of 2.0 is considered to represent good short-term liquidity.

## Check Your Progress

**6.** The ratio of CA to CL is 1:1. What does it means ?

7. What is Current Ratio?

8. What is liquid ratio?

**Example 1:**

From the following information calculate the amount of working capital and working capital ratio.

| Item | Rs. |
|---|---|
| Inventory | 54,000 |
| Trade Debtors | 35,000 |
| Bills receivables | 10,000 |
| Cash | 5,000 |
| Bank over draft | 15,000 |
| Trade Creditors | 32,000 |
| Outstanding bills | 11,000 |
| Bills Payables | 15,000 |

:

Computation of Working Capital:

Current Assets = Inventory + Trade Debtors + Bills Receivables + Cash

= Rs. (54,000 +35,000 +10,000 + 5,000 )= Rs.1,04,000

Current Liabilities = Bank overdraft +Trade creditors + Outstanding Bills + Bills payables

= Rs. (15,000+ 32,000+ 11,000 +15,000) = Rs. 73,000

Working Capital: R. 1,04,000 – Rs. 73,000 = Rs.33,000.

Working Capital Ratio: Current Assets ÷ Current Liabilities

= 1,04,000 ÷. 73,000 = 1.42 or 1.42 : 1

But so far as financial management is concerned, frequent rolling of current assets is better for a healthy financial position which will push up the profitability. Therefore, more amounts blocked in current assets results in loss in profits. On the one hand, low level of current assets will have a negative impact on the liquidity position. So, **there is the need for striking balance between these two extremes- profitability and liquidity, while deciding upon an ideal current ratio.**

When the firm's current ratio is too low, its short-term liquidity is at risk. This may be corrected by:

- Paying some debts,
- Increasing current assets from loans or other borrowings with a maturity of more than one year,
- Converting non-current assets into current assets,

- Increasing current assets from new equity contributions,
- Putting profits back into the business,

**Liquid Ratio or Quick Ratio:**

The Liquid Ratio **or** Quick Ratio is sometimes called the "acid-test" ratio and is one of the best measures of very short-term liquidity.

Many of the limitations of current ratio may be corrected through the use of liquid ratio. As against the liberal test of liquidity by the current ratio, liquid ratio gives a stringent measure of liquidity. Because, comparatively less liquid assets are excluded in calculating this ratio. The slowest moving current asset is inventory hence this item is excluded from current assets to get liquid assets. Current liability is also adjusted sometimes.

The two components of ***liquid ratio (acid test ratio or quick ratio)*** are liquid assets and liquid liabilities. Liquid assets normally include cash, bank, sundry debtors, bills receivable and marketable securities or temporary investments. In other words they are current assets minus inventories. Inventories cannot be termed as liquid assets because it cannot be converted into cash immediately without a loss of value. Similarly, Liquid liabilities means current liabilities i.e., sundry creditors, bills payable, outstanding expenses, short term advances, income tax payable, dividends payable, and bank overdraft (only if payable on demand). Some time bank overdraft is not included in current liabilities for computing quick ratio, on the argument that bank overdraft is generally permanent way of financing and is not subject to be called on demand. In such cases overdraft will be excluded from current liabilities.

**Liquid Ratio or Quick Ratio = Liquid Assets ÷ Current Liabilities**

**Example 1:**

From the following information calculate Liquid ratio.

| Item | Rs. |
|---|---|
| Inventory | 54,000 |
| Trade Debtors | 35,000 |
| Bills receivables | 10,000 |
| Cash | 5,000 |
| Bank over draft | 15,000 |
| Trade Creditors | 30,000 |
| Outstanding bills | 5,000 |
| Bills Payables | 10,000 |

:

Liquid Assets = Trade Debtors + Bills Receivables + Cash

= Rs. (35,000 +10,000 + 5,000 )= Rs.50,000

Current Liabilities = Trade creditors + Outstanding Bills + Bills payables

= Rs. (30,000+ 5,000 +10,000) = Rs. 45,000

(Note: Bank over draft is not considered assuming it is permanent feature)

Liquid ratio: Liquid Assets ÷ Current Liabilities

= 50,000 ÷. 45,000 = 1.11 or 1.11 : 1

**Exercise 3:**

**Comment on the working capital position of X Ltd from the following information.**

| Items | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Inventory | 1,00,000 | 1,80,000 | 2,40,000 |
| Accounts Receivables | 2,00,000 | 2,50,000 | 3,00,000 |
| Cash and Bank balances | 50,000 | 50,000 | 1,00,000 |
| Other Current assets | 50,000 | 50,000 | 50,000 |
| Accounts payables | 1,50,000 | 2,50,000 | 3,50,000 |
| Bank Overdraft | 50,000 | 50,000 | 50,000 |
| Other Current liabilities | 40,000 | 40,000 | 40,000 |

**Solution:**

| Items | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Inventory | 1,00,000 | 1,80,000 | 3,40,000 |
| Accounts Receivables | 2,00,000 | 2,50,000 | 3,00,000 |
| Cash and Bank balances | 50,000 | 1,50,000 | 2,00,000 |
| Other Current assets | 50,000 | 50,000 | 50,000 |
| **Total Current Assets (I)** | **4,00,000** | **6,30,000** | **8,90,000** |
| Accounts payables | 1,50,000 | 3,50,000 | 5,50,000 |
| Bank Overdraft | 50,000 | 1,50,000 | 1,80,000 |
| Other Current liabilities | 40,000 | 40,000 | 40,000 |
| **Total Current Liabilities (II)** | **2,40,000** | **5,40,000** | **7,70,000** |
| **Working Capital (I) – (II)** | **1,60,000** | **90,000** | **1,20,000** |
| **Working Capital Ratio** | **1.67** | **1.17** | **1.16** |

The working capital ratio has decreased from 1.67 to 1.16. This trend is unfavourable for the smooth running of the company. The trend of Inventory position implies that the inventory turnover is deteriorating. There shall be rigorous effort to enhance sales of the company. Accounts receivables have also increased significantly. This is also not a comfortable trend. There is no scope to raise current assets. So, measures must be taken to liquidate the liabilities. Cash and bank balances may be used to to pay the bank overdraft. This will also reduce the burden of interest.

**Exercise : 1**

The following balances are extracted from the books of Rohan Limited as on 31/03/2016

| **Items** | **Rs.** | |
|---|---|---|
| Trade Creditors (Gross) | Rs. | 44,000 |
| Bills Payable | Rs. | 14,000 |
| Bank Overdraft | Rs. | 12,000 |
| Provision for Discount on Creditors | Rs. | 1,000 |
| Liabilities for expenses | Rs. | 4,000 |
| 10% Bank Loan for 5 yrs. | Rs. | 25,000 |
| Municipality dues | Rs. | 6,000 |
| Inventory | Rs. | 38,000 |
| Trade Debtors (Gross) | Rs. | 35,000 |
| Provisions for doubtful debts | Rs. | 2,000 |
| Investment in 8% Debenture | Rs. | 20,000 |
| Prepaid Insurance | Rs. | 3,000 |
| Bills Receivable (Net) | Rs. | 15,000 |
| Bills receivable Discounted | Rs. | 5,000 |
| Office equipment | Rs. | 55,000 |
| Cash at Bank | Rs. | 20,000 |

**You are required to-**

(i) Calculate Net Working Capital and Working Capital Ratio

**Solution :**

Computation of Net Working Capital

| **Currents Assets :** | | **Rs.** |
|---|---|---|
| Inventory | | Rs. 38,000 |
| Trade Debtors (Gross) | 35,000 | |
| | 2,000 | |
| Less, Provisions | | Rs. 33,000 |
| Bills Receivables | | Rs. 15,000 |
| Cash at Bank | | Rs. 20,000 |
| Total | | Rs. 1,06,000 |

| **Current liabilities** | | **Rs.** |
|---|---|---|
| Trade Creditors (Gross) | 44,000 | |
| | 1,000 | |
| Less, provision | | Rs. 43,000 |
| Bills Payable | | Rs. 14,000 |
| Bank overdraft | | Rs. 12,000 |
| Liabilities for expenss | | Rs. 4,000 |
| Municipalities Dues | | RS. 6,000 |
| **Total** | | **Rs. 79,000** |

**Working Capital**

= Current Assets-Current liabilities

= Rs. 106,000- Rs. 79,000 = Rs. 27,000

**Working Capital Ratio**

$$= \frac{\text{Current Assets}}{\text{Current liabilities}} = \frac{\text{Rs. } 106,000}{\text{Rs. } 79,000}$$

= 1.38:1

Note : Prepaid Insurance is not considered as current asset for the purpose of computing working capital.

**Exercise : 2**

Considering the balances as given in exercise 1 compute liquid Ratio :

**Solution :**

| **Liquid Assets :** | Rs. | |
|---|---|---|
| Trade Debtors (Net) | Rs. | 33,000 |
| Bills Receivable (Net) | Rs. | 15,000 |
| Cash at Bank | Rs. | 20,000 |
| **Total** | **Rs.** | **68,000** |

| **Current Liabilities :** | Rs. | |
|---|---|---|
| Trade Creditoes (Net) | Rs. | 43,000 |
| Bills payable | Rs. | 14,000 |
| Liabilities for expenss | Rs. | 4,000 |
| Municipality Dues | Rs. | 6,000 |
| **Total** | **Rs.** | **67,000** |

**Liquid Ratio**

$$= \frac{\text{Liquid Assets}}{\text{Current liabilites}}$$

$$= \frac{\text{Rs. } 68{,}000}{\text{Rs. } 67{,}00}$$

= 1.01 or 1.01:1

**Exercise:3**

Current Assets : Rs. 10,00,000

Current Liabilities : Rs. 8,000,000

Working out the working capital ratio from the above inpermation and also state the impact of the following transations, individually, on the working capital ratio as calculated above.

**Transactions :**

i) Cash Sale : Rs. 1,00,000 at a profit of Rs. 25

ii) Payment to trade creditors : Rs. 2,00,000

iii) Credit purchase of goods : Rs. 1,50,000

iv) Sale of old Furniturs : Rs. 50,000

v) Issue of 8% Debentures : Rs. 2,00,000

**Solution :**

Present current Assets : Rs. 10,00,000

Present current liabilities Rs. 8,00,000

Present working capital Ratio 10:8 ro 1.25

Impact of each transaction on working capital ratio 1.25

**Impact of each transaction on the present W.C. ratio :**

i) Each sales Rs. 1,00,000 Profit Rs. 25,000

| | C.A | CL |
|---|---|---|
| Present | 10,00,000 | 8,00,000 |
| (–) Sale of Stock | (–) 75,000 | – |
| (+) Cash inflow | (+) 1,00,000 | – |
| | 10,25,000 | 8,00,000 |
| W.C. Ratio | 1025:800 or 1.28 | |

Therefore, improve in W.C. Ratio from 1.25 to 1.28

(ii) Payment to trade creditors : Rs. 2,00,000

| | C.A. | CL |
|---|---|---|

| | | |
|---|---|---|
| Present | 10,00,000 | 8,00,000 |
| (–) Decreasein Trade Credibos | – | (–) 2,00,000 |
| (–) Decreas in cash | (–) 2,00,000 | – |
| | 8,00,000 | 6,00,000 |

W.C. Ratio : 8:6 or = 1.33

Therefore, improve in W.C. ratio from 1.25 to 1.33

(iii) Credit purchose of goods : Rs. 1,50,000

| | C.A | C.L. |
|---|---|---|
| Present | 10,00,000 | 8,00,000 |
| Increase in Stock | (+) 1,10,000 | – |
| Increase liability | – | (+) 1,50,000 |
| | 11,50,000 | 9,50,000 |

W.C. Ratio = 1150 : 950 or 1.21

Therefore W.C. ration worsen from 1.25 to 1.21

(iv) Salep of old furniture Rs. 50,00

| | C.A | C.L. |
|---|---|---|
| Present | 10,00,000 | 8,00,000 |
| Increase in cash | (+) 50,000 | – |
| | 10,50,000 | 8,00,000 |

W.C. Ratio in 1050:800 or 1.31

Therefore, W.C. ratio improved from 1.25 to 1.31

(v) Issue of 8% Debenture : 2,00,000

| | C.A | C.L |
|---|---|---|
| Present | 10,00,000 | 8,00,000 |
| Increasim Bank balance | (+)2,00,000 | – |
| | 12,00,000 | 8,00,000 |

W.C Ratio 12:8 ro 1.5

Therefore W.C. ratio improved to 1.5 from 1.25

## 3.9 Summary

- Working Capital means the capital available for meeting the day-to-day expenses of a business firm. This capital is the amount used in the normal course of business and does not include the amount blocked in the assets of permanent nature. This fund required for current operation has been termed as 'short-term financing', 'short-term funds', 'revolving capital', 'circulating capital' or 'Working Capital'
- The sum total of all components of Current Assets is called Gross Working Capital. Total of cash and bank, receivables, inventory and all other current assets is together called Gross Working Capital.
- Cash working capital denotes the cash component of working capital. Cash includes cash at bank and in hand.
- The amount of working capital provided by the current sources (current liabilities) is known as Working Capital Leverage. Most of this amount is contributed by the sundry creditors. If the whole of gross working capital is financed by the current liabilities, it leads to the situation of Current Assets = Current Liabilities and the ratio of CA to CL will be 1:1.
- If huge amount is blocked in current assets, it will result in loss in profits. On the one hand, low level of current assets will have a negative impact on the liquidity position. So, there is the need for striking balance between these two extremes- profitability and liquidity, while deciding upon an ideal current ratio.
- A working capital ratio of less than 1.0 is a strong indicator that there will be liquidity problems in the future, while a ratio in the vicinity of 2.0 is considered to represent good short-term liquidity.
- The Liquid Ratio **or** Quick Ratio is sometimes called the "acid-test" ratio and is one of the best measures of very short-term liquidity.

## 3.10 Suggested Readings and References

## 3.11 Model Question

1. Explain the meaning and different concepts of working capital.
2. Highlight the needs of working capital.
3. Discuss the relevant accounting ratios for the working capital analysis.

### 1.12 Answer to *Check your Progress*

1. Working Capital means the capital available for meeting the day-to-day expenses of a business firm. This capital is the amount used in the normal course of business and does not include the amount blocked in the assets of permanent nature

2. The popular term 'working Capital' may be conceptualised in various terms in financial management. These are listed below:

    (i) Gross Working Capital,

    (ii) Net Working Capital,

    (iii) Negative working Capital,

    (iv) Permanent Working Capital,

    (v) Circulating or Variable Working Capital,

    (vi) Cash working Capital, and

    (vii) Balance Sheet Working Capital.

3. Various activities for which working capital is needed are:

    Acquisition of raw-material;

    1. Purchase of components and spare-parts;
    2. Recurring expenses and overhead cost like office expenses, rent, fuel, power etc.;
    3. Payment of wages and salaries;
    4. Distribution and selling expenses, packaging, publicity after-sales service etc;
    5. Warehousing expenses;
    6. Collection charges from debtors, bank charges for realization of cheques;
    7. Cash discount, bad debt etc;

4. When the amount of total current liabilities is deducted from Gross Working Capital it is termed as Net Working Capital **.** It is calculated as :

    **Net Working Capital=Total Current Assets *minus* total Current Liabilities**

5. When the total amount of current assets of a firm is less than its current liabilities it is known as Negative Working Capital

6. This means that the entire amount of working capital is financed by cost-free funds. It raises the profitability of the firm. The more the rate of contribution of current liabilities to the working capital, the more will be the profitability. This is called working capital leverage**.**

7. Current Ratio is one of the best-known ratios which measure the quantum of margin between current assets and current liabilities. It is the relative proportion of an entity's

current assets to its current liabilities, and is intended to show the ability of a business to pay for its current liabilities with its current assets

8. The Liquid Ratio **or** Quick Ratio is sometimes called the "acid-test" ratio and is one of the best measures of very short-term liquidity. The two components of ***liquid ratio (acid test ratio or quick ratio)*** are liquid assets and liquid liabilities. Liquid assets normally include cash, bank, sundry debtors, bills receivable and marketable securities or temporary investments. In other words they are current assets minus inventories

## BLOCK-V : UNIT IV
## INTER-FIRM COMPARISON

**Unit Structure**



### 4.1 Introduction

The process of modernization, liberalization and globalization has paved the way for more and more investment from the people inside and outside the country. Such investment is primarily decided on the basis of information and the possibility of comparison of firms. It is here lies the importance of Inter-firm comparison (IFC).

### 4.2 Objectives

After going through this unit you shall be able

- Know the meaning of inter firm comparison,
- Understand the objectives of inter firm comparison.
- Acquaint with the technique of inter firm comparison
- Discuss the advantages and limitations of inter firm comparison.

### 4.3 Meaning of Inter Firm Comparison

IFC is the technique by which the operating and financial results of one firm is compared with another firm in the same line of trade and industry. It is a technique by which the performance, costs, profits, efficiencies and productivity of firms in the same line of business in the same industry are evaluated and compared. It is a study of similar firms on a voluntary basis by exchange of information with a view to assess strength, opportunities and weakness of each firm.

### 4.4 Origin of Inter-firm Comparison

The idea of Inter-firm comparison is not new. It was first felt in the USA when the National Association of Stove Manufacturer first introduced the scheme of Uniform Costing.

Inter-firm Comparison in an organised way was started in 1959 in England. The British Institute of Management in that year, in collaboration with the British Productity Council set up a body known as Inter-firm comparison. The objectives of this organisation was to assess the performances of similar firms. It is a non-profit motive organisation. Its field of activity is spread not only in England but it carries out its investigations in other countries of Europe and in the USA also.

**Check your Progress**

1. Note down the meaning of Inter firm Comparison.
2. Inter firm Comparison was started in in organised way in ............ ........

### 4.5 Objectives of Inter-Firm comparison

The following are the objectives of IFC.

1. Inter-firm comparison is carried out to find out the weak points and strong points of a business firm in comparison to other firms and on this basis, to improve the efficiency in future.
2. Another objective is to locate or find out the cost centres which are uneconomic and to take effective action to make these centres productive.
3. To know whether the profits of the firm are adequate or not, is another objective of IFC. After knowing the state of current profitability, appropriate action may be taken.
4. Inter-firm Comparison is also undertaken by the prospective investors to choose the companies into which funds are to be invested.
5. It is also undertaken by the associations of an industry to award best-company prizes on product quality, energy conservation, least polluter etc.

### 4.6 Methodology or Approaches of IFC:

Following are the important steps or requirements of an Inter-firm comparison scheme.

1. Data collection: All necessary information are collected from the participating firm. The nature and extent of such information depend on the needs and objective of management, comparability of information and the efficiency of the central organization responsible for data collection. There are varieties of data to be collected which may vary according to the objective of IFC. In general, information on the following lines are collected:

i) costs and cost structure.
ii) Labour efficiency and utilization
iii) Machine efficiency and utilization.
iv) Material utilization.
v) Inventory of Raw materials,
vi) Inventory of finished product.
vii) Wastage
viii) Profitability
ix) Liquidity and cash generation.
x) Credit policy, creditors and debtors,
xi) Dividend policy
xii) Production techniques
xiii) Distributi8on channel
xiv) Human Resource
xv) Assets and liabilities.
xvi) Capital structure

2. Application of Uniform definitions

Data Collected age processed on the basis of uniform definitions of terms, procedures, methods and accounting period. If uniformity is not brought in the processing of data, Comparison is not possible.

3. Tools generally applied in inter-firm comparison are comparative statements prepared with the help of accounting ratios. These ratios are selected so to suit each individual firm on a group of firms for purposes of comparison.

4. After a preliminary comparison each firm is provided with question arises requiring confirmation and additional information.

5. After confirmation from individual firm is received and after incorporating any additional information, the final comparative statements are prepared.
6. Comparison of different firms on the basis of ratios reveals many short comings and also the clues for efficiencies and inefficiencies.
7. All such reports are confidential and are kept secretly, While making comparison names of firms are not disclosed, rather code Nos. are used for each firm.

**Ratios for Comparison or Types of Comparison:**

There are generally three types of Comparison.

a) Comparison of management ratios,
b) Comparison of Cost ratios, and
c) Comparison of technical data.

a) **Comparison of Management ratios:** These ratios are meant to provide management with a comparative picture of operating performance, financial performance, liquidity and growth as compared to other firms in the trade or industry. These ratios are basically related to earning capacity, assets turnover, liquidity and solvency. Details ratios are related with costs aspect.

b) **Comparison of Cost ratios:** These ratios are related with costs aspect of the firms. Cost efficiency and cost effectiveness of a firm may be compared with that of other firms. Costs ratios covered prime cost, factory overhead, office overhead and selling and distribution overhead. Cost reduction and cost control schemes may be adopted after comparing and studying cost ratios of own firm with those of other firms.

**c) Comparison of Technical Data:** In a highly competitive market and in the era of liberalization and globalization, comparison of technical data of various firms is of special interest for external investors and a necessity for management.

Management will certainly be happy if they can adopt better technology to reduce cost, improve quality and distribution. It is visualized that technical processing utilization and loss, machine utilization and other production techniques.

Below are given the ratios used in inter-firm comparison.

**Cost Ratios**

1. Operating Cost ratios or Operating Expenses Ratios
2. Financial Cost Ratios.

1. (a) Prime Cost + Sales,

(b) Works cost _ Sales,

(c) Cost of Production _ Sales,

(d) Selling cost + Sales,

(e) Cost of Sales + Sale,

(f) Administration Cost + Sales.

(g) material Cost + Prime cost/works cost.

(h) labour cost + prime cost/works cost

(i) Directo expenses + Prime cost/works cost.

2(a) Interest expenses + sales

(b) Interest expenses + profit

© Interest expenses + cash profit

(d) Cost of capital + Profit before interest.

**Technical Ratios**

a) Raw materials consumed + man/Machine Hours,

b) Value added + cost of Raw material

c) Value added _ Cost of production

d) Scrape (value) + Value of Raw material used,

e) Quantity Produced + Rated capacity

f) Quantity produced + Man/Machine Hours,

g) Loss on process + Cost of raw material

h) Idle time hours + total labour cost

i) Cost of overtime + total labour cost

j) Cost of idle time + total laobur cost

k) Power Units consumed +machine hours

l) Cost of production + main/machine hours,

m) Cost of Machine Maintenance + cost of production etc.

n) **Equity valuation Ratios**

1. Earnings per share = $\dfrac{\text{Profit after tax}}{\text{No . of outstanding equity shares.}}$

**Requisites of Inter-Firm Comparison or Applicability of Inter-Firm Comparison:**

Inter-firm comparison cannot be applied in all situations. It can be applied if the following conditions are fulfilled.

1. Firms are in the same industry and trade.
2. All firms participating in the IFC are operating under Uniform Costing.
3. Firms are more or less in the same age group and size.

### 4.7 Advantages of Inter-Firm Comparison:

The following are the main advantages derived from the IFC.

1. It encourages managerial efficiencies in the organization. It is done by sporting the inefficiencies and weaknesses of the management in operating and financial activities.
2. It brings stability and balance in cost structure and presentation of information.
3. Cost consciousness, cost efficiency and cost effectiveness can be created among the participating firms.
4. Cost reduction and cost control programmes can be launched after comparing the structure of other firms.
5. Productivity can be raised by eliminating unproductive expenses and by bringing economics in expenditure.
6. Information, statistics and ratios available from IFC can be used for various other purposes.
7. It enables the management to review the operations and policies on continuous basis.
8. IFC creates self criticism by comparing its data with other firms which help to rectify the errors already committed.
9. In IFC only significant variances are reported to the management. It helps the organization to operate on Management by Exception (MBE).
10. It helps the government, regulatory agencies and researchers in getting useful data and information to improve policies and to conduct in-depth studies and research work for suggesting further improvement.

In the words of Prof. Nigam, "It is not only useful for management, it also acts as a tool for decision making by bankers, shareholders, institutional investors, licensing authorities, price control organizations, creditors, consumers trade unions, organizations and other social and economic interests. It is also useful in evaluating business results and return on capital invested which in turn, helps in project appraisal and evaluation, conducting feasibility studies, capital budgeting, investment decisions etc." (Inter firm comparison-An aid to management decision making'; chartered Secretary, Dec, 1978; P.A. 265).

### 4.8 Limitations of Inter-Firm Comparison:

The following are the main limitations of inter firm comparison:

**1. Differences in individual units:**

The main limitation of inter-firm comparison is differences in the nature of individual units. There are variance in the application of accounting principles, costing methods, in the size and age of each unit of firms. The condition and situation of plant, location, nature of labour force etc. differ from firm to firm. These make it difficult to practice inter-firm comparison.

**2.** Dissemination of supply of information by each individual firm is not above doubt. It is difficult to get all relevant data which are true and correct and transparent.

**3.** Basis of information may differ from firm to firm. The closing date of accounts of some firms may be $31^{st}$ March and of some firms. It is $31^{st}$ December. Again some may maintain accounts on cash basis, some may maintain on accrual basis while some may follow the mixture of the two. These make comparison a difficult task.

**4.** The basis for calculating ratios may vary from firm to firm.

**5.** Cost and time are other factors which may render problems. Cost of collection of data and their timeliness are important factors fro the usefulness of inter-firm comparison.

**6.** Uniform costing is a difficult practice for many firms due to the very nature of its business.

**7.** If the management is satisfied with the present level of performance, inter-firm comparison may not deliver benefits.

**Check your Progress**

3. What are the objective of inter firm comparison.
4. Under what condition can inter firm comparison be done?

**4.9 Summary:**


- Inter Firm Comparison is the technique by which the operating and financial results of one firm is compared with another firm in the same line of trade and industry. It is a technique by which the performance, costs, profits, efficiencies and productivity of firms in the same line of business in the same industry are evaluated and compared.
- Inter-firm Comparison in an organised way was started in 1959 in England. The British Institute of Management in that year, in collaboration with the British Productity Council set up a body known as Inter-firm comparison

- Inter-firm comparison is carried out to find out the weak points and strong points of a business firm in comparison to other firms and on this basis, to improve the efficiency in future.
- Inter firm comparison can be applied if the following conditions are fulfilled.

i) Firms are in the same industry and trade.

ii) All firms participating in the IFC are operating under Uniform Costing.

iii) Firms are more or less in the same age group and size.

### 4.10 Suggested Readings and References

### 4.11 Model Questions:

1. What is inter firm comparison? Discuss the origin and objectives of inter firm comparison.
2. What are the advantages and disadvantages of Inter-firm Comparison?

### 4.12 Answer to Check your progress

1. IFC is the technique by which the operating and financial results of one firm is compared with another firm in the same line of trade and industry. It is a technique by which the performance, costs, profits, efficiencies and productivity of firms in the same line of business in the same industry are evaluated and compared. It is a study of similar firms on a voluntary basis by exchange of information with a view to assess strength, opportunities and weakness of each firm.
2. Inter firm Comparison was started in in organised way in 1959 in England
3. **The following are the objectives of IFC.**

- Inter-firm comparison is carried out to find out the weak points and strong points of a business firm in comparison to other firms and on this basis, to improve the efficiency in future.
- Another objective is to locate or find out the cost centres which are uneconomic and to take effective action to make these centres productive.
- To know whether the profits of the firm are adequate or not, is another objective of IFC. After knowing the state of current profitability, appropriate action may be taken.
- Inter-firm Comparison is also undertaken by the prospective investors to choose the companies into which funds are to be invested.

- It is also undertaken by the associations of an industry to award best-company prizes on product quality, energy conservation, least polluter etc.

4. Inter-firm comparison cannot be applied in all situations. It can be applied if the following conditions are fulfilled.

- Firms are in the same industry and trade.
- All firms participating in the IFC are operating under Uniform Costing.
- Firms are more or less in the same age group and size.

## BLOCK VI : UNIT 2

## APPLICATIONS OF RELEVANT ACCOUNTING STANDARD IN THE VALUATION OF ASSETS, LIABILITIES AND OWNERS' EQUITY

**Unit Structure:**



### 2.1 Introduction

Asset valuation is one of the most important things that need to be done by companies and organizations**.** Valuation of Assets or asset valuation is a process of determining the present market value of the assets of the business as shown in the balance sheet of the company based on universally accepted accounting principles. Accounting Standards are the written form of statements which consists of rules, principles and guidelines to be used consistently and uniformly for the preparation and presentation of financial statements by a business entity. These Accounting Standards lay down the accounting policies and practices explaining as to when and how the financial transactions should be measured, recognized and disclosed in the books of accounts of an entity. The application of Accounting Standards (AS) not only ensures the transparency, reliability and consistency but also sets the formal boundaries within which the financial transactions should be reported by any business entity.

### 2.2 Objectives

After going through this unit, you will be able to appreciate:

- *concept* of Accounting standard
- *definition* of different assets as per Accounting standard.
- *describe* the relevant accounting standard for valuation of assets and liabilities.
- *definition* of Liabilities as per accounting standard.
- *explain* the valuation of different assets as per accounting standard.
- *describe* the valuation of liabilities as per accounting standard.

### 2.3 Accounting Standard

Accounting Standards are the written form of statements which consists of rules, principles and guidelines to be used consistently and uniformly for the preparation and presentation of financial statements by a business entity. These Accounting Standards lay down the accounting policies and practices explaining as to when and how the financial transactions should be measured, recognized and disclosed in the books of accounts of an entity. The Accounting Standard Board (ASB) of the Institute of Chartered Accountants of India (ICAI) has framed and issued these set of standards. The application of Accounting Standards (AS) not only ensures the transparency, reliability and consistency but also sets the formal boundaries within which the financial transactions should be reported by any business entity. It is the responsibility of management to prepare and present financial statements in compliance with the relevant applicable accounting standards.

**STOP TO CONSIDER**

The Accounting Standards (AS) provides us with a framework to regulate the financial statements of the companies or business organization so that they do not report misleading information in their financial statements. The main aim of accounting standard is to ensure transparency, reliability, consistency, and comparability of the financial statements.

**CHECK YOUR PROGRESS**

1. What is accounting standard?
2. Describe the meaning of valuation of assets and liabilities.

### 2.4. Valuation of Different Assets and application of Relevant Accounting Standard:

**2.4.1 Valuation of Inventories**: AS-2 (Ind AS-2) deals with the determination of value at which inventories are carried in the financial statements, including the ascertainment of cost of inventories and any write-down thereof to net realisable value.

Accounting Standard 2 is applicable in accounting for inventories other than:

- work in progress arising under construction contracts, including directly related service contracts.
- work in progress arising in the ordinary course of business of service providers;
- shares, debentures and other financial instruments held as stock-in-trade; and
- producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

As per Accounting standard definition of the inventory includes:

- Held for sale in the ordinary course of business i.e. finished goods.
- Goods which are in the production process i.e. work in progress.
- Raw material which are consumed during production process or rendering of services.

**Valuation of Inventories:**

Inventories should be valued at lower of cost and net realizable value.

Following are the steps for valuation of Inventories:

a) Determine the cost of inventories
b) Determine the net realizable value of inventories
c) Comparison between the cost and net realizable value, the lower of the two is considered as the value of inventory.

Cost of Inventories:

The cost of inventories should comprise the following:

a. All costs of purchase,
b. Costs of conversion, and
c. Other costs incurred in bringing the inventories to their present location and condition.

a. **Costs of purchase:** The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

b. **Costs of conversion:** The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.

The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products as well as scrap or waste materials, by their nature, are immaterial, when this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

c. **Other cost:** Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example design cost which is incurred for the specific customer order.

**Exclusions from the Cost of Inventories:**

In determining the cost of inventories excludes the following costs:

(a) Abnormal amounts of wasted materials, labour, or other production costs;

(b) Storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) Selling and distribution costs.

**Cost Formulas/ Methods of Inventory Valuation:**

The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs. All other should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

**Techniques for the Measurement of Cost:**

For convenience, techniques for calculating inventory costs, such as the standard cost method or the retail method, can be employed if the results are close to the real cost. Standard costs account for normal levels of material and supply consumption, labour, efficiency, and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions. The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used.

**Net Realisable Value (NRV):**

Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. An assessment is made of net realisable value of inventory as at each balance sheet date.

Inventories are usually written down to net realisable value on an item by-item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a classification of inventory, for example, finished goods, or all the inventories in a particular business segment. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date. Estimates of net realisable value also take into consideration the purpose for which the inventory is held.

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

**STOP TO CONSIDER**

Inventories generally constitute the second largest item after fixed assets in the financial statement. Accounting Standard-2 deals with the valuation of inventories. As per this standard Inventories should be valued at lower of cost and net realisable value. Cost of inventories includes all costs of purchase, Costs of conversion, other costs incurred in bringing the inventories to their present location and condition.

**2.4.2 Valuation of Intangible Assets:**

AS 26 is applied for accounting of Intangible Assets. As per this standard an intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. As per this accounting standard an intangible asset should be recognised if, and only if:

a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
b) the cost of the asset can be measured reliably.

An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

Initially an intangible asset should be measured at cost. After initial recognisation, an intangible asset should carried at its cost less any accumulated impairment losses. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use. If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:

i. the legal rights are renewable; and
ii. renewal is virtually certain.

If any Subsequent expenditure on an intangible asset after its purchase or its completion should be added to the cost of the intangible assets when it is incurred unless:

a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and
b) the expenditure can be measured and attributed to the asset reliably.

**Measurement of Cost of an intangible asset in different situation:**

**Separate Acquisition:** If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

**Acquisition as Part of an Amalgamation:** If an asset is acquired in a business combination, the cost of that asset should be its fair value at the acquisition date which depends on market expectations.

**Acquisition of Intangible Assets by way of a Government Grant:** When an intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

**Exchanges of Assets:** An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10, Accounting for Fixed Assets.

**Internally generated intangible assets:**
The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use. The cost includes, if applicable:

a) expenditure on materials and services used or consumed in generating the intangible asset,
b) the salaries, wages and other employment related costs of personnel directly engaged in generating the asset;
c) Any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset; and
d) Over heads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset (for example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocations of over heads are made on bases similar to those used in allocating over heads to inventories (see AS 2, Valuation of Inventories). AS 16, Borrowing Costs, establishes criteria for the recognition of interest as a component of the cost of a qualifying asset. These criteria are also applied for the recognition of interest as a component of the cost of an internally generated intangible asset.

The following are not components of the cost of an internally generated intangible asset:

- selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use;
- clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance; and
- expenditure on training the staff to operate the asset.

Example of valuation of some Intangible Assets discussed below:

**Valuation of Goodwill:** As per this accounting standard (AS-26) only purchase goodwill will be recorded in the books of accounts when goodwill is purchase by the firm in a consideration in cash or kinds. Self generated goodwill is not recorded in the books of account of a firm. Initially goodwill is measured on its cost price. After initial valuation it should be valued at its cost less written off amount of goodwill from its actual or opening value or price. Goodwill arising on amalgamation should be to amortised over a period not exceeding five years unless a somewhat longer period can be justified (AS-14).
**Valuation of Patents:** Patents should be measured initially at its cost. The cost includes its purchase price and registration cost. If the institution is the one that develops or manufactures

the patents, all development costs, registration fees, and other direct costs should be capitalised. Its cost should be written off throughout the period of its legal existence.

**Valuation of Trademarks:** It is measured and shown balance sheet at cost price less written off value. If it is purchased, the cost price includes the purchase price plus registration fees and if it is developed or designed in the organization, the cost includes all the costs related to its development and design. The cost of trademark should be written off within its legal period or during its useful life, whichever is less.

**STOP TO CONSIDER**

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. As per Accounting Standard-26 initially an intangible asset should be measured at cost. After initial recognisation, an intangible asset should be carried at its cost less any accumulated impairment losses. Examples of intangible assets- goodwill, trademark, etc.

Self generated goodwill is not recorded in the books of account of a firm. Only purchase goodwill will be recorded in the books of accounts when goodwill is purchase by the firm in a consideration in cash or kinds (AS-26).

### 2.4.3 Valuation of Plant, Property and equipment: (Accounting standard-10)

Accounting Standard 10 should be applied in accounting for property, plant and equipment except when another Accounting Standard requires or permits a different accounting treatment.

In following cases this standard does not apply

- Biological assets related to agricultural activity other than bearer plants. This Standard applies to bearer plants but it does not apply to the produce on bearer plants; and
- Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

As per accounting standard 10 Property, plant and equipment are tangible items that:

a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
b) are expected to be used during more than a period of twelve months.

An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost.

The cost of an item of property, plant and equipment comprises:

1. its purchase price, including import duties and non –refundable purchase taxes, after deducting trade discounts and rebates.
2. any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as decommissioning, restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

After initial measurement of property, plant and equipment an enterprise can choose the revaluation model or the cost model as the accounting policy and employ the same to the entire class of its properties, plant and equipment.

**Cost Model**

After recognition as an asset, an item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

**Revaluation Model**

After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued.

**2.4.4 Investment**

**AS** 13 deals with accounting for investments in the financial statements of enterprises and related disclosure requirements except the followings:

a) the bases for recognition of interest, dividends and rentals earned on investments which are covered by Accounting Standard 9 on Revenue Recognition;
b) operating or finance leases;
c) Investments of retirement benefit plans and life insurance enterprises; and
d) Mutual funds and venture capital funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 2013.

**Definition of Investment as per AS-13** "Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not 'investments'."

**Classification of Investments:**

1. **Current Investment-** A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.
2. **Long Term Investment:** A long term investment is an investment other than a current investment.

**Valuation of Investment:** Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

**Cost of Investment:** The cost of an investment should include acquisition charges such as brokerage, fees and duties. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

**As per AS-13 Fair value** is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

**Check Your Progress**

1. Definition of inventories as per AS-2.
2. What is an intangible asset?
3. Describe valuation of inventories as per Accounting standard.
4. Give examples of Intangible assets and explain their valuation process as per Accounting standard.
5. Discuss the valuation of Investment as per AS.

### 2.5 Provisions, Contingent Liabilities and Contingent Assets

**Definition as Per AS-29**

1. A provision is a liability which can be measured only by using a substantial degree of estimation.
2. A contingent liability is:
   ***a.*** a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the enterprise; or
   ***b.*** a present obligation that arises from past events but is not recognised because:
      **i)** it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
      **ii)** a reliable estimate of the amount of the obligation cannot be made.

3. A contingent asset is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the enterprise.

**Measurement as per AS 29:**

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value. (Ind AS 37 requires discounting the amounts of provision, if the effect of time value of money is material.)

The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

If some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

**Re-measurement of Provision:**

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

**Valuation of Current Liabilities:** Current liabilities are those liabilities which are payable within a period of one year. Current liabilities include such as trade creditors, bills payables, short term loan, etc. These liabilities are valued at their actual cost. Lliabilities are originally measured and recorded according to the cost principle. That is, when incurred, the liability is measured and recorded at the current market value of the asset or service received. Current liabilities are measured or recorded at their face value since they are due in a relatively short period of time.

## 2.6 Summing Up

- Accounting standard are the written form of statements which consists of rules, principles and guidelines to be used consistently and uniformly for the preparation and presentation of financial statements by a business entity.
- Inventories should be valued at lower cost and net realizable value. Accounting Standard 2 deals with the determination of value at which inventories are carried in the financial statements.
- Valuation of intangible assets are done as per of Accounting standard 26.
- An enterprise can choose the revaluation model or the cost model as the accounting policy and employ the same to the entire class of its properties and Plant and Equipment for measurement.
- Accounting Standard 13 deals with accounting of investment. Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.
- The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate.
- Current liabilities are valued at their actual cost

## 2.7 References and Suggested Readings:

**Books:**


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**Websites:**


- https://www.mca.gov.in/content/mca/global/en/acts-rules/ebooks/accounting-standards.html
- https://cleartax.in/s/accounting-standards

- https://www.mca.gov.in/Ministry/notification/pdf/AS_26.pdf
- https://cleartax.in/s/as-2-inventoriesvaluation

**2.8 Model Questions**

**Short Questions:**

1. Define valuation of assets and liabilities.
2. What is accounting standard?
3. What is an intangible asset as per AS-26?
4. Define Inventories as per AS-2.
5. What is the meaning of Contingent Liabilities and contingent assets?
6. How valuation of investment is carried out?

**Long Questions:**

1. Explain the steps of valuation of Inventories as per AS-2.
2. Explain the relevant accounting standards in valuation of Different Assets.
3. Discuss the Accounting standard -26 in valuation of Intangible Assets.
4. Define plant, property and Equipment and explain how it is measured and recognised in the financial statement of a company as per Accounting Standard- 10.

**2.9 Answer to Check Your Progress**

1. Valuation of Assets or asset valuation is a process of determining the present market value of the assets of the business as shown in the balance sheet of the company based on universally accepted accounting principles.
2. These Accounting Standards lay down the accounting policies and practices explaining as to when and how the financial transactions should be measured, recognized and disclosed in the books of accounts of an entity.
3. AS-2 (Ind AS-2) deals with the determination of value at which inventories are carried in the financial statements. Inventories should be valued at lower of cost and net realizable value.
4. Initially an intangible asset should be measured at cost. After initial recognisation, an intangible asset should carried at its cost less any accumulated impairment losses. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life (AS-26)
5. As per Accounting Standard 26 Self generated goodwill is not recorded in the books of account of a firm.
6. As per Accounting Standard-10 an item of property, plant and equipment should be measured at its cost. As per this standard 10 Property, plant and equipment are tangible items that:
   - are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
   - are expected to be used during more than a period of twelve months.

7. Current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.
8. long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.
9. Provision recognized in the financial statements should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value.

# BLOCK VI : UNIT-I

# VALUATION OF ASSETS, LIABILITIES AND OWNERS' EQUITY

**Unit Structure**



## 6.1 Introduction

The correctness of a company's balance sheet is dependent on accurate asset, liability, and equity valuations. The valuation was completed by an expert for the aim of making a decision. Management must determine if assets are valued in accordance with Generally

Accepted Accounting Principles. To put it another way, knowing the financial status of a company necessitates asset, liability, and equity appraisal.

### 6.2 Objectives

This unit basically focused on

1. How to valuation of fixed assets
2. How to valuation of liabilities
3. How to valuation of equity shares
4. How to valuation of inventories, goodwill, fictitious assets, etc.

### 6.3 Valuation of Assets

The phrase "Valuation of Assets" is made up of two words: valuation and assets. The definition of valuation is an estimate of a thing's worth or a price placed on it, especially by a professional valuer. The phrase value refers to the amount of a product, money, or other item that may be exchanged for something else. A resource with economic worth that an individual, organisation, or country possesses or controls with the hope of future benefits is referred to as an asset. Assets are purchased or developed to raise a company's value or benefit its operations and are reported on the Balance Sheet. An asset is anything that can generate cash flow, cut expenses, or increase sales in the future, regardless of whether it's tangible or intangible.

**Stop to consider**

As per Accounting Standard issued by ICAI Property, Plant and Equipment has been specified in AS 10 and as per Ind Accounting Standard Property, plant and Equipment has been given in Ind AS 16.

#### 6.3.1 Objectives and Necessity of Valuation of Assets:

1. To provide the user with information on the accounting value of the firm's assets as of a specific date (balance sheet date).
2. To meet the requirements of Indian Accounting Standard 16 Property, Plant, and Equipment, as notified by the MCA.
3. Asset valuation is necessary for determining the entity's worth.

4. A valuation of assets is essential for obtaining a loan from a financial institution for a going concern.

5. Asset appraisal is required by many credit rating organisations such as CRISIL, CARE, and others.

6. Asset valuation is essential for a company's reconstruction or reorganisation procedure.

7. Proper valuation is required to assess the sale value of the concern or unit of the concern that is being sold.

### 6.3.2. Methods of Assets Valuation:

Several methods are applied to different assets, and in some circumstances, many methods are applied to a single asset for various objectives by different people. The following are some of the methods:

1. Historical Cost Method/Cost Method- The cost method is the most straightforward method for valuing assets. It is done on the basis of the asset's value based on the historical price at which it was purchased.

2. Market Value Technique- The market value method determines the asset's value based on its current or predicted market price when sold on the open market. The replacement cost approach, also known as the net realisable value method, is utilised when there are no comparable assets on the open market.

3. Replacement Cost Method -The replacement cost approach includes determining the value of an asset by comparing it to the current cost of replacing it with a similar asset in similar condition in an arms-length transaction. This strategy is founded on the idea that a buyer will not pay more for an asset than the price of a similar asset, and a seller will not take less. This strategy is used to value the complete company as well as its individual assets.

4. The net realisable value Method- The net realisable value method is a typical approach for determining the value of an asset in inventory accounting. It is calculated by subtracting the estimated selling price of an asset from all costs involved with the asset's future sale, and then computing the difference.

5. Base Stock Method- The base stock method requires a corporation to maintain a set number of stocks whose value is determined by a base stock's value.

Check Your Progress

1. What is meant by asset?
2. What is valuation of assets?
3. What are the significances of valuation of assets?
4. What are the different methods used for valuation of assets?

**6.4. Valuation of Inventories**

Inventory refers to the stock of raw materials used to manufacture goods for sale, the stock of semi-finished and finished goods destined for sale, and other items in the shop that are commonly used in the manufacturing and sale process. The monetary value associated with the goods in inventory at the end of an accounting period is known as inventory valuation. The price is determined by the costs of acquiring the goods and preparing it for sale. Inventories are the most valuable current assets of a firm. Inventory valuation aids in determining the cost of goods sold (COGS) and, ultimately, the firm's profitability.

Stop to Consider

Valuation of Inventories is done as per AS 2 and inventories are mentioned IND AS 2.

**6.4.1 Significance of Inventory Valuation**

1. Assists in calculating genuine profit: Inventory valuation is crucial in deciding a company firm's profit over a given time period. If inventory is not valued correctly, profit determination is incomplete.
2. Importance for Liquidity Analysis: Net working capital is necessary to determine a company's liquidity status, which is defined as the difference between current assets and current liabilities. Inventory is a large component of current assets, hence correct inventory value is essential.
3. Impact on the Balance Sheet: If inventory is not properly valued, the balance sheet will not reflect the actual and fair state of the company.
4. Statutory Compliance: It is a legal need to follow Indian Accounting Standard 2 Inventories, which states that financial statements must disclose the accounting policies used to measure inventories.

### 6.4.2 Methods of valuation of inventory:

1. First In, First Out (FIFO): When valuing inventory, the FIFO method is utilised to price both the issue of materials to production and the cost of goods sold. This strategy is used for sending supplies to the plant or valuing the cost of goods sold when actual sales occur, and earlier purchase prices are used in chronological sequence. After the first batch of materials purchased in the first issues has been used, the price of the second batch of purchases is applied to the succeeding issues.
2. Last in First Out (LIFO): LIFO is the polar opposite of FIFO when it comes to inventory value. The prices of recent acquisitions are applied in chronological order when issuing materials to the factory or calculating the cost of goods sold using this approach. After the first issue of the last lot of material purchased, the price of the previous lot of material purchased is used for the next issue
3. Simple Average Method: This is an inventory valuation or delivery cost calculation method in which the average unit cost is computed by multiplying the total of these unit costs by the number of receivings, even if the inventory goods have various unit costs.
4. Weighted Average Cost Method: The weighted average is used to establish the amount that goes into the cost of products sold and inventories in the weighted average cost method. The following formula is used to compute the weighted average cost per unit: Total Cost of Goods in Inventory / Total Units in Inventory

   This method is typically used to calculate the cost of units that are indistinguishable from one another and when tracking individual prices is challenging.

**Check Your Progress**

5. What is inventory?
6. Valuation is necessary for inventory?
7. State the different methods of valuation of inventory.

### 6.5 Valuation of Other Fixed Assets

Other fixed nature assets are divided into two categories: wasted assets and fictitious assets in terms of valuation. Wasted assets, often known as diminishing assets, exist on both a physical and legal level. Wasting assets have a fixed value but are gradually diminished or consumed. The process of earning money causes the value of the assets to deplete or exhaust. Mines, oil wells, and quarries are examples of wasting assets. The expected amount of yearly depletion is deducted from the value of the wasting assets in the Balance Sheet. In other words, the anticipated lowered value of a wasted asset appears on the Balance Sheet.

Fictitious assets are assets that do not exist in the physical existence. Preliminary Expenses incurred at the time of the company's establishment, Development Expenses, Debenture Discount, Amount spent on special promotional campaign, Brokerage, Underwriting Commission, and deferred revenue expenditure are all examples of fictitious assets. Deferred revenue expenditure is applied to fictitious assets. Deferred Revenue Expenditure refers to the temporary capitalization of revenue expenditure with the goal of spreading the cost over multiple future years. In the Balance Sheet, the asset is valued at the amount of expenditure incurred less the amount written off.

### 6.6 Valuation of Goodwill

Goodwill is an intangible asset that cannot be seen or felt, but which can be bought and traded and is genuine. Some examples of goodwill include a company's brand name, a strong consumer base, functioning consumer relationships, positive employee affiliations, and any patents or proprietary technology.

In other words, goodwill is a long-term value or reputation. The value of goodwill in a partnership is quite important. The valuer's assumption is used to determine the value of goodwill. Unlike new businesses, a successful company establishes a reputation in the market, builds trust with its customers, and has a larger network of business contacts. All of these factors add to a customer's willingness to evaluate the firm and its financial worth.

Customers who purchase a firm based on its goodwill expect to make huge gains. As a result, goodwill only applies to companies that make super-profits, not to those that make normal losses or profits.

**Stop to consider**

Valuation of intangible assets are given in Accounting Standard 26 and as per Indian Accounting Standard it has given in Ind AS 38

### 6.6.1 Need for Valuation of Goodwill

The need for goodwill value varies by company. This indicates that the necessity for goodwill appraisal varies based on the type of corporate organisation. When a company is sold, the only time it is necessary to value its goodwill is when it is sold. The following are some of the situations in which goodwill is required:

1. In a partnership, there is a requirement for goodwill appraisal if partners retire, expire, or are newly admitted.
2. In a company-Valuation of goodwill is required in the event of a merger or the acquisition of a controlling interest.
3. In a sole proprietorship, purchase considerations and the sale of a business are examples of instances where goodwill value is essential.

### 6.6.2 Methods of Valuation of Goodwill

1. Arbitrary Method: When two parties agree on a value for goodwill, it is referred to as the arbitrary method of goodwill valuation.
2. Average Profit Method: In this method, the average profit of the previous few years is multiplied by one or more years to determine the firm's goodwill value. The average profit which is multiplied by the number of years for ascertaining the value of goodwill is known as Years Purchase. It's also known as the Average Profit Basis Method or the Purchase of Past Profit Method. it is called arbitrary method of valuation of goodwill.

   The value of Goodwill =( total profits of all concerned past year ÷ Number of years) × year’s purchase

3. Weighted Average Profit Method: This method is a modified version of Years' Purchase of Average Profit Method . In this method, each year's profit is multiplied by the appropriate number of weights, such as 1, 2, 3, and so on, to determine the value of the product, which is then divided by the total number of weights to determine the weighted average profit. In order to determine the value of goodwill, the weighted average profit is multiplied by the years of purchase. This strategy is particularly useful when profits are on the rise.

Weighted Average Profit= Total Profit for the all the years÷ Number of Years

Value of Goodwill= Weighted Average Profit x Years Purchase

4. Capitalisation Method: This method determines the worth of the entire firm based on regular profit. The difference between the business's values minus Net Tangible Assets is referred to as goodwill.
   Value of Goodwill= (Net Profit ÷ Normal Rate of Return) ×100 – Net Assets
5. Capitalisation of Weighted Average Profit Method: This method is similar to the capitalisation method discussed before, only weighted average is used instead of simple average. Weights are assigned to each year's profit on a rational basis. Weights are usually assigned in the following order: first year 1, second year 2, third year 3, and so on.
6. Super Profit Method: The difference between the average profit made by the business and the normal profit (based on the normal rate of return for representative firms in the industry), i.e. the firm's expected excess earnings, is referred to as super-profit. As a result, there will be no goodwill if there is no predicted extra earnings over regular earnings.
   Super-Profit = Average Profit (Adjusted) – Normal Profit

   Value of Goodwill = Super-Profit x Years' Purchase

7. Capitalisation of Super-Profit Method:
   Under the method, we are to consider super-profit in place of ordinary profit against the normal rate of return.
   Value of Goodwill = Super-Profit/Normal Rates of Returns x 100
8. Weighted Average Super Profit Method: This method is similar to the super profit method, with the exception that super profit is calculated using weighted averages of historical profits. Super profit is the difference between weighted average profit and regular profit. Value of Goodwill: Weighted Average Super Profit × Number of years' purchase
9. Sliding Scale Valuation Method: With this method, the profit distribution connected to super-profit might vary from year to year. In other words, sliding scale valuation of an enterprise's super-pr8fits may be examined in order to determine the value of goodwill.

10. Annuity Method: Annuity tables are used to calculate the value of goodwill in this method. An annuity is a set of equal periodic payments that are made at regular intervals. To calculate the value of goodwill, take the value of the annuity and multiply it by the annuity factor at a specific rate of interest for a certain number of years.

**Illustration 1:**

The profits of a firm for the last four years were as follows: 2016: Rs. 70,000, 2017: Rs. 90,000, 2018: Rs. 1,00,000 and 2019: Rs. 1,00,000.

Calculate the goodwill of the firm taking 5 year's purchase of the average profits.

**Solution:**

Average Profit= (Rs. 70,000+ Rs. 90,000 + Rs. 1,00,000 + Rs. 1,00,000) ÷4= Rs. 90,000

Therefore, Value of goodwill at 5 years purchase of average profit= average profit× 5

90,000×5= Rs. 4,50,000

**Illustration 2:**

The profit of B.H. Ltd for the last five years and the corresponding weights are as follows.

| | | | | | |
|---|---|---|---|---|---|
| Year: | 2014 | 2015 | 2016 | 2017 | 2018 |
| Profit: | 70,000 | 90,000 | 1,00,000 | 1,20,000, | 1,40,000 |
| Weight: | 1 | 2 | 3 | 4 | 5 |

Calculate the value of goodwill on the basis of 3 years' purchase consideration of the weighted average profit.

**Solution:**

| Year | Profit | Weight | Product |
|---|---|---|---|
| 2014 | 70,000 | 1 | 70,000 |
| 2015 | 90,000 | 2 | 1,80,000 |
| 2016 | 1,00,000 | 3 | 3,00,000 |
| 2017 | 1,20,000 | 4 | 4,80,000 |
| 2018 | 1,40,000 | 5 | 7,00,000 |
| | | 15 | 17,30,000 |

Weighted Average Profit: 17,30,000÷15 = Rs. 1,15,333

**Illustration 3:**

A firm's normal return is 15%., of its net assets. The actual profit earned Rs. 75,000. Its value of net assets is Rs. 3,00,000. What is the value of goodwill?

**Solution:**

Value of the goodwill = Capitalised value of profit- Net Tangible Assets

Capttalised value of profit = (Net Profit÷ Normal Rate of Return) × 100

(75,000÷15)×100 = Rs. 5,00,000

Value of Goodwill= 5,00,000-3,00,000 = Rs. 2,00,000

**Illustration 4:**

M/s Jugal & sons Ltd. earned the following profits for the last five years: Rs. 30,000, Rs. 41,000, Rs. 42,000, Rs. 51,000 and Rs. 57,000. The Normal rate of Return is 15% . Ascertain the value of Goodwill when net assets are Rs. 3,00,000( assume suitable weights).

**Solution:**

Since profits are rising, so weights are assumed as 1,2,3,4 and 5 for consecutive five years.

Calculation of weighted average profit

| **Profits** | **Weights** | **Product** |
|---|---|---|
| 30,000 | 1 | 30,000 |
| 41,000 | 2 | 82,000 |
| 42,000 | 3 | 1,26,000 |
| 51,000 | 4 | 2,04,000 |
| 57,000 | 5 | 2,85,000 |
| | 15 | 7,27,000 |

Weighted Average Profit= 7,27,000÷15= Rs. 48,467

Capitalised value of weighted average at 15 % rate of return=
(Weighted Average Profit÷ Rate of Return)×100
=(48467÷15)×100 = Rs. 3,23,113.33
Value of Goodwill= Captalised value of weighted average profit- Actual value of net assets
3,23,113.33-3,00,000 = Rs. 23,113.33

**Illustration 5:**

From the following particulars of M/s Paul Ltd., calculate the value of goodwill for 3 years purchase of the super profit:
Net Profit Rs. 50,000
Capital Employed Rs. 2,00,000
Normal Rate of Return 10%

**Solution:**

Return on Capital Employed = (10÷100)×2,00,000 = Rs. 20,000
Super Profit = net profit- return on capital employed = 50,000- 20,000 = Rs. 30,000
Therefore, Value of Goodwill = Super Profit × 3

= 30,000× 3 = Rs. 90,000

**Check Your Progress**

8. Write a short note on wasting assets and fictitious assets.
9. What is goodwill?
10. State the circumstances in which there may be need for valuation of goodwill.
11. Write short notes on different methods of valuation of goodwill.

**6.7. Valuation of Liabilities:**

The entire left hand side of the position statement might be regarded as liabilities according to entity theory: Assets = Liabilities, however proprietary theory considers liabilities to be significantly different from ownership, which is the owners' residual stake in the assets after liabilities have been deducted.

Liabilities are defined by the Accounting Principle Board as "economic obligations of an enterprise that are reorganised and measured in accordance with generally accepted accounting principles," while the FASB of the United States defines liabilities as "possible future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of a past transaction or event."

Liabilities are unique from ownership interests in that they only cover responsibilities to third parties and must exist at the present moment as a result of previous transactions. The term "present obligations" encompasses not only legal responsibilities, but also any constructive liabilities incurred by the firm as a result of dealings with third parties. The maturity dates of liabilities should be specified.

Any liability can be shown as a liability in a balance sheet if it meets and conforms to the definition of a liability, is measurable, relevant, and reliable. In terms of valuation, because liabilities are future sacrifices of economic benefits, their true values should be discounted present values, but other valuation bases such as replacement value, realisable value, and so on can also be used. Because the amount of payment is known with certainty and the time period involved is almost negligible, the discounted technique should not be used in the case of current liabilities.

**6.7.1. Measurement of Liabilities and Standards:**

ICAI in India has issued AS-29 titled provisions, contingent liabilities and contingent assets and IASC has issued 1AS-37 with the same title. FASB of 45 A has issued FAS 157 with the title “Fair value Measurement” which defines the fair Value of a liability as the price that would be paid to shift the liability in a proper transaction between participants of the market at the date of measurement.

An exposure draft of FASB of USA staff position no 157-C was issued on 18th Jan. 2008 and revised on 1 June 2009 as FSP 157-f which concentrated on the question of how to measure fair value of liabilities. FSP-157-f requires that fair value of liabilities be measured by using one of the following mentioned approaches which should maximize the use of relevant observable inputs and minimize the unobservable inputs.

1. When traded as an asset in the active market, the quoted price of an equivalent liability.

2. The quoted price of an identical liability or the quoted price of an identical liability when exchanged as an asset in the market.

3. In an active market, the quoted price of equivalent liabilities or similar obligations when traded as assets.

4. Another valuation technique that violates FAS 157 is the present value technique, sometimes known as the income approach.

**Stop to Consider**

ICAI in India has issued AS-29 titled provisions, contingent liabilities and contingent assets and IASC has issued 1AS-37 with the same title.

**6.7.2. Valuation of Current Liabilities and Contingent Liabilities**

Current liabilities are those that will be paid or need the use of current assets within a year (or the operating cycle, if longer), or that will result in the formation of new current obligations. Liabilities, like assets, are initially measured and documented using the cost principle. That is, the liability is quantified and recorded at the current market value of the asset or service received at the time it is incurred. Current liabilities are recorded at their face value because they are due in a short period of time. This is the amount of money required to pay off the debt's principle.

A contingent liability is a possible liability that may or may not materialise based on the outcome of a future event that is unpredictable. The significance of a contingent liability is determined by the likelihood of the contingency becoming an actual liability, the timing of the contingency, and the precision with which the amount connected with it can be calculated. The amount of contingent liabilities is not included in the balance sheet total. Contingent liabilities are represented in the liability side of the balance sheet. These liabilities must be reported in the financial statements' footnotes.

**Check your Progress**

12. What is meant by liabilities?
13. How Current liabilities and contingent liabilities are valued?

### 6.8. Valuation of Share:

A component unit of a joint stock or common stock is termed as share. A share reflects a member's stake in the company, which is a movable property that can be transferred in accordance with the firm's Articles of Association.

According to section 2(84) of the Companies Act, 2013, "Share" means a share in the share capital of the company and includes stock.

The monetary value of a share is referred to as its value. It could be the book value or the price at which it can be purchased or sold.

#### 6.8.1. Need for Valuation of Share:

In most situations, shares are quoted on the stock exchange, and the price prevailing on the stock exchange can be used as the suitable value for regular transactions in shares, debentures, or government securities.

For very large quantities, the stock market price does not hold up. Furthermore, not all shares are traded on a stock exchange. Private company shares will not be quoted in any case. As a result, if shares in such a corporation to be traded, the value of such shares must be determined.

The following are the situation where share need to valuation-

1. For Amalgamation- When two or more companies decide to merge, a fair share valuation is required.
2. For Reconstruction- When a firm decides to reconstruct, it is necessary to value its stock.
3. For Conversion into Equity Shares- When preference shares and debentures are converted into equity shares, a new value of the shares should be used.
4. Controlling Interest Acquisition- When controlling shares or majority shares are sold or purchased, a new valuation of shares is required because Stock Exchange quotations are only valid for small quantities of shares.
5. For security reasons- When a company's shares are used as collateral for a loan, a share valuation is required.

6. For Government Acquisition of Shares- When the government takes over the shares of a limited company under a nationalisation scheme, the company's shares must be valued.

### 6.8.2. Methods of Valuation of Equity Shares:

In practice, the following methods of valuation of shares are in use. These are

1. Assets Backing Method (also known as Intrinsic Value Method, Net Assets Methods, or Assets Valuation Method): This method is also known as Intrinsic Value Method, Net Assets Methods, or Assets Valuation Method. The value of one equity share is computed as follows: Equity Shares= Net Assets ÷Number of Equity Shares.

   Deducting liabilities from the total realisable assets yields an estimate of net asset value. The value of the net assets is divided by the number of outstanding shares to get the net backing for each share.
2. Capitalisation of Profit Method or Yield Method: Yield refers to a company's earnings or productivity in relation to its investments. In the context of equity share pricing, yield refers to the gains accessible to equity shareholders. The reward to equity stockholders could be in the form of a higher earning yield. The profit attributable to each equity share is referred to as the earning yield.

   Value of each equity share= (Expected Rate of Earnings/ Normal Rate of Return) x Paid up value of a share
3. Fair Value Method/Hybrid Method: Some accountants prefer not to employ Intrinsic Value or Yield Value when determining the exact share value. They do, however, recommend the Fair Value Method, which is a combination of the Intrinsic and Yield Value Methods. The last method gives a better indicator of the value of shares than the first two.

   Value of share= (Intrinsic value per share+ Yield Value per share)÷2

### 6.8.3. Factors Affecting the Value of Share:

The factors which affect the valuation of shares are classified into two groups:

**A) Internal factors include:**

a) Asset net worth

b) Asset earning capacity

c) Return on Investment

d) Earnings per share

e) Dividend per share

**B) External factors include:**

a) Country's general economic situation

b) Political and social environment

c) International economic scenario

d) International political environment

e) Share demand

f) Insider trading

g) Industry growth prospects

**Illustration 1:**

The following particulars are available in relation to a company:

| | |
|---|---|
| Total Assets | Rs. 18,50,000 |
| 8% Debentures of Rs. 10 each | Rs. 4,80,000 |
| Other External Liabilities | Rs. 1,50,000 |
| Share Capital: | |
| 40,000 Equity Shares of Rs. 10 each fully paid | Rs. 4,00,000 |
| 50,000 Equity Shares of Rs. 10 each, Rs. 7.50 paid | Rs. 3,75,000 |

Calculate the value of each category of equity shares of the company.

**Solution: Assets Backing Method:**

| | | |
|---|---|---|
| Computation of net worth- | | |
| Total Assets | | Rs. 18,50,000 |
| Less: Liabilities | | |
| 8% Debentures | 4,80,000 | |
| Other external Liabilities | 1,50,000 | Rs. 6,30,000 |
| | | Rs. 12,20,000 |
| Add: Notional Call on Equity Shares | | |
| 50,000 equity shares @ Rs. 2.50 | | Rs. 1,25,000 |
| Net Assets available to Equity Shareholders | | Rs. 13,45,000 |
| Value of 1) Fully paid up share 13,45,000÷90,000 | | = Rs. 14.94 |
| Partly paid up share | (14.94-2.50) | =Rs. 12.44 |

**Illustration 2:**

The following particulars are available in relation to a company:

Share capital: 450, 6% preference shares of Rs. 100 each fully paid; 4,500 Equity Shares of Rs. 10 each fully paid.

Other Equity: General Reserve Rs. 3,500:

External Liabilities Rs. 7,500;

The average profit (after taxation) earned every year by the company Rs. 8,505;

The normal profit earned on the market value of equity shares fully paid of the same type of companies is 9%.

Calculate the fair value of equity shares assuming that out of the total assets worth Rs. 350 are fictitious. Transfer Rs. 1,000 to general Reserve.

**Solution:**

A) Calculation of Intrinsic value of Equity Shares

| | | |
|---|---|---|
| Equity Share Capital | | Rs. 45,000 |
| Preference Share Capital | | Rs. 45,000 |
| General Reserve | | Rs. 3,500 |
| External Liabilities | | Rs. 7,500 |
| Total Liabilities= | | Rs. 1,01,000 |
| Total Assets= | | Rs. 1,01,000 |
| Less: Fictitious Assets | Rs 350 | |
| External Liabilities | Rs. 7,500 | Rs. 7,850 |
| Net Assets available to Equity shareholders | | Rs. 93,150 |
| Less: Preference Share Capital | | Rs. 45,000 |
| Net Assets available to Equity Shareholders | | Rs. 48,150 |

Therefore, intrinsic value of Equity Share= Rs. 48150÷4,500

Rs. 10.70

B) Calculation of value of Equity Shares on Earning Yield Basis

| | |
|---|---|
| Average Profit (after tax) | Rs. 8,505 |
| Less: Preference Dividend 6% on 45,000 | Rs. 2,700 |
| | Rs. 5,805 |
| Less: Transfer to Reserve | Rs. 1,000 |
| Average Profit available to Shareholders | Rs. 4,805 |

Capitalised value at 9% = (Rs. 4,805×100) ÷9 = Rs. 53,389

Therefore Value Per share= Rs. 53,389÷ 4,500 Equity Shares

= Rs. 11.86

C) Calculation of fair value of share

(Intrinsic value of share + Yield value of share) ÷2

= (10.70+11.86)÷2

= Rs. 11.28

**Check your Progress**

14. What is meant by valuation of share? Mention the situations where the need for valuation of share arises.
15. Write a short note on various methods of valuation of shares.

## 6.9. Summing Up

- The reliability of a company's balance sheet is dependent on accurate asset, liability, and equity valuations.
- Valuation of Assets is composite of two words namely valuation and assets. The definition of valuation is an estimate of a thing's worth or a price placed on it, especially by a professional valuer. The phrase value refers to the amount of a product, money, or other item that may be exchanged for something else. A resource with economic worth that an individual, organisation, or country possesses or controls with the hope of future benefits is referred to as an asset.
- The Historical Cost Method/Cost Approach, Market Value Method, Replacement Cost Method, Net realisable value method, and Base stock method have all been used to value assets.The accuracy of the balance sheet of a company depends upon the accurate valuation of assets, liabilities and equities.
- The monetary value associated with the goods in inventory at the end of an accounting period is known as inventory valuation.
- Inventory is valued using a variety of methodologies, including FIFO, LIFO, Simple Average Method, and Weighted Average Method.
- Other fixed nature assets are divided into two categories: wasted assets and fictitious assets in terms of valuation.

- The projected lowered value of a wasted asset appears on the Balance Sheet.
- The fictional asset is shown in the Balance Sheet at the amount spent less the amount written off.
- Goodwill is an intangible asset that cannot be seen or felt, but which can be bought and traded and is genuine.
- The valuer's assumption is used to determine the value of goodwill.
- Arbitrary Method, Average Profit Method, Weighted Average Average Profit Method, Capitalisation Method, Capitalisation of Weighted Average Profit Method, Super Profit Method, Capitalisation of Super-Profit Method, Weighted Average Super Profit Method, Sliding Scale Valuation Method, and Annuity Method are some of the methods used for valuation goodwill.
- In terms of liability valuation, because liabilities are future sacrifices of economic benefits, their true values should be discounted present values; nevertheless, other valuation bases such as replacement value, realisable value, and so on might be used.
- "Share" refers to a share of the company's share capital, which includes stock.
- The monetary value of a share is referred to as its value.
- For the valuation of shares, the Assets Backing Method, Yield Method or Capitalisation of Profit Method, and Fair Value Method/Hybrid Method are implemented.

**6.10. References Suggested Readings:**

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**6.11. Model Questions**

1. State the circumstances in which there may be need for valuation of goodwill.
2. What is goodwill? Write short notes on different methods of valuation of goodwill.
3. What is meant by asset? What are the significances of valuation of assets?
4. What are the different methods used for valuation of assets?
5. What is inventory? Why valuation is necessary for inventory?
6. State the different methods of valuation of inventory.
7. Write a short note on wasting assets and fictitious assets.
8. What is meant by liabilities?
9. What is meant by valuation of share? Mention the situations where the need for valuation of share arises.
10. Mention the factors which influence the valuation of a company’s share.
11. Write a short note on various methods of valuation of shares.

**6.12. Answer to Check Your Progress**

1. An asset is a valuable resource that a person, company, or country possesses or manages with the prospect of future benefits. Assets are bought or developed to raise a company's value or benefit its operations and are reported on the Balance Sheet.

2. The term "asset valuation" is made up of two words: "asset" and "value." The term valuation refers to an assessment of a thing's worth or a price placed on it, especially by a professional valuer.

3. Provide the user with information on the accounting value of the firm's assets on a specific date (balance sheet date).

4. The Historical Cost Method/Cost Approach, Market Value Method, Replacement Cost Method, Net realisable value method, and Base stock method have all been used to value assets.

5. Inventory valuation is the monetary value assigned to products in inventory at the end of an accounting period.

6. Inventory valuation has important implications for genuine profit determination, liquidity analysis, balance sheet impact, and regulatory compliance.

7. Inventory is valued using a variety of methods, including FIFO, LIFO, Simple Average Method, and Weighted Average Method.

8. Wasting assets have a fixed value but are gradually diminished or consumed. Fictitious assets are assets that do not have a physical existence.

9. Goodwill is an intangible asset that cannot be seen or touched, but which can be bought and sold and is genuine.

10. The need for goodwill valuation is unique to each firm. This indicates that the necessity for goodwill appraisal varies based on the type of corporate organisation. When a company is sold, the only time it is necessary to value its goodwill is when it is sold.

11. Arbitrary Method, Average Profit Method, Weighted Average Profit Method, Capitalisation Method, Capitalisation of Weighted Average Profit Method, Super Profit Method, Capitalisation of Super-Profit Method, Weighted Average Super Profit Method, Sliding Scale Valuation Method, and Annuity Method are some of the methods used for valuation of goodwill.

12. Liabilities are unique from ownership interests in that they only cover responsibilities to third parties and must exist at the present moment as a result of previous transactions.

13. Current obligations are those that are due within a short period of time and are reported at face value. The amount of contingent liabilities is not included in the balance sheet total. Contingent liabilities are represented in the liability side of the balance sheet. These liabilities must be reported in the financial statements' footnotes.

14. The monetary value of a share is referred to as its value. The following are the situations in which shares must be valued: for amalgamation, reconstruction, conversion into equity shares, purchase of controlling interest and security purposes-for government acquisition of shares.

15. For the valuation of shares, the Assets Backing Method, Yield Method or Capitalisation of Profit Method, and Fair Value Method/Hybrid Method are used.