CHAPTER 2

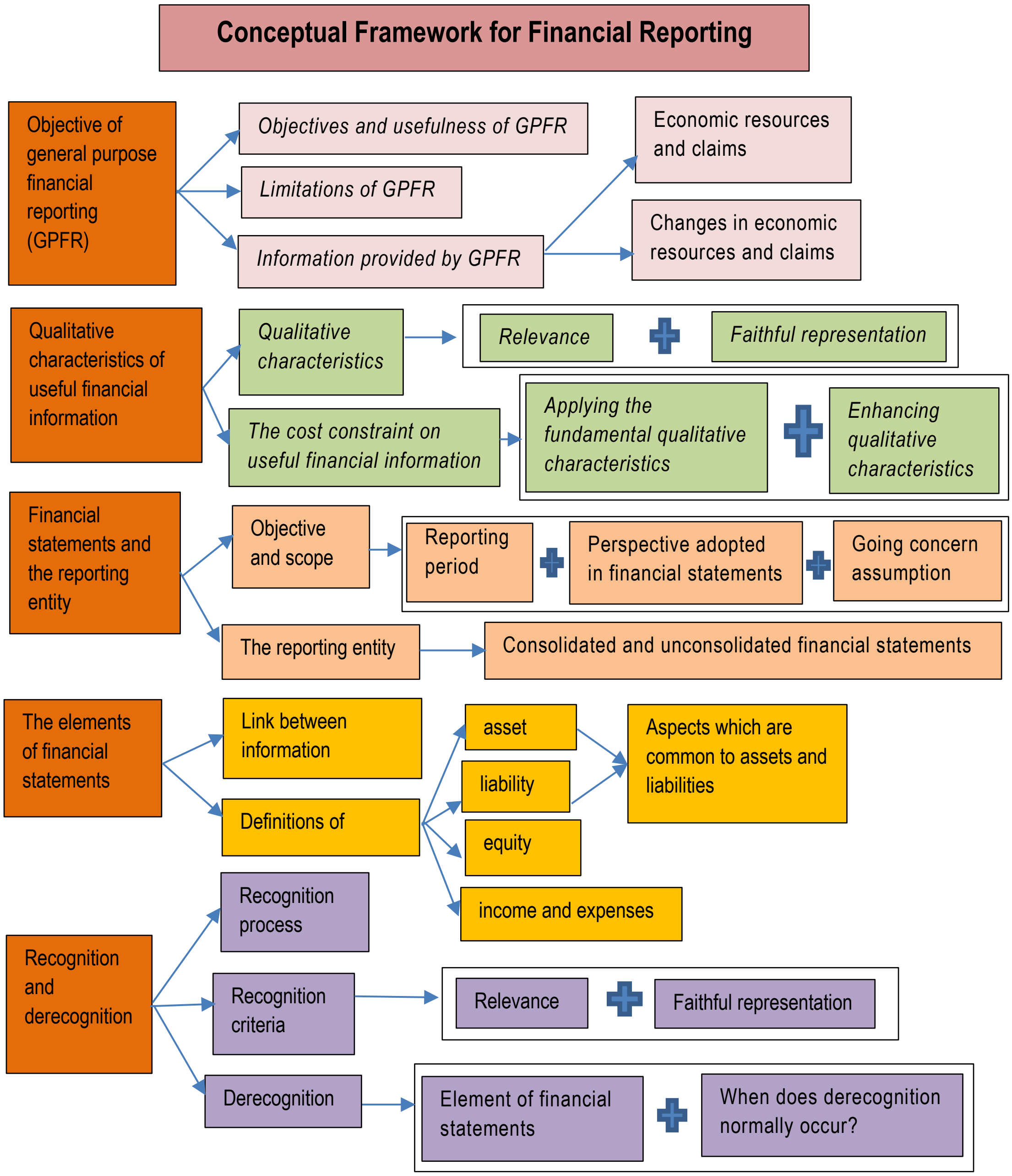
# CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING UNDER INDIAN ACCOUNTING STANDARDS (IND AS)

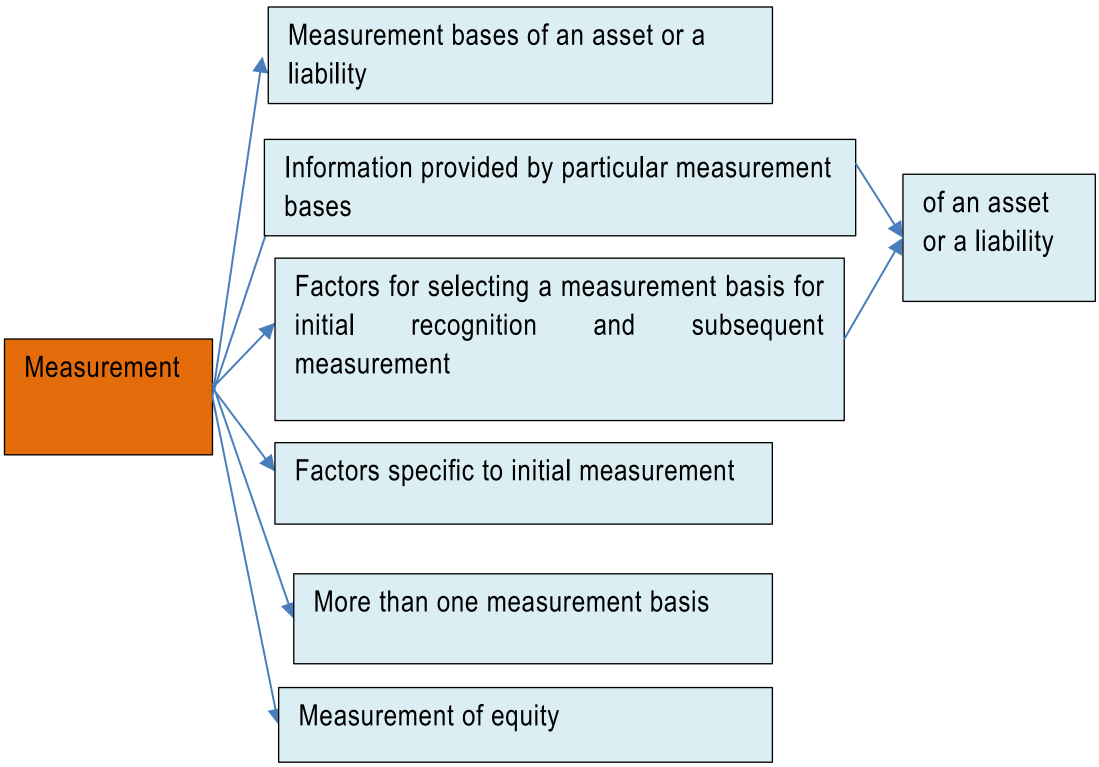
## LEARNING OUTCOMES

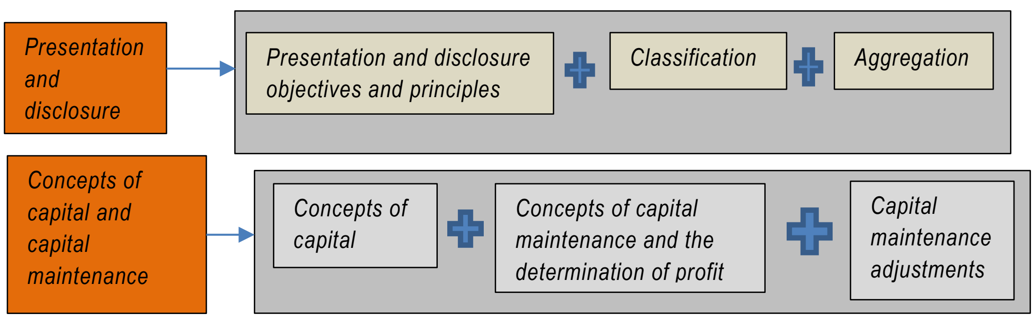
**After studying this chapter, you would be able to:**

- Identify the objectives of general purpose financial reporting.
- Apply qualitative characteristics of useful financial information
- Define the concept of financial statements and the reporting entity
- Describe the various elements of financial statements i.e. asset, liability, income and expenses
- Explain the criteria for including assets and liabilities in financial statements (recognition) and when to remove them (derecognition)
- Recognize measurement bases and when to use them
- Comprehend the concept of presentation and disclosure and its importance as communication tools
- Explain the concept of capital and capital maintenance and identify how it links to the concept of profit.

## CHAPTER OVERVIEW




Measurement
Measurement bases of an asset or a liability
Information provided by particular measurement bases
Factors for selecting a measurement basis for initial recognition and subsequent measurement
of an asset or a liability
Factors specific to initial measurement
More than one measurement basis
Measurement of equity


Presentation and disclosure
Presentation and disclosure objectives and principles
Classification
Aggregation
Concepts of capital and capital maintenance
Concepts of capital
Concepts of capital maintenance and the determination of profit
Capital maintenance adjustments

# UNIT 1: INTRODUCTION

The Conceptual Framework for Financial Reporting under Indian Accounting Standards (Ind AS) (hereinafter the '*Conceptual Framework under Ind AS*') is not a Standard and it does not override any standard or any requirement in any standard. Therefore, this does not form part of a set of standards pronounced by the standard-setters. While the *Conceptual Framework under Ind AS* is primarily meant for the standard-setter for formulating the standards, it has relevance to the preparers in certain situations such as to develop consistent accounting policies for areas that are not covered by a standard or where there is a choice of accounting policy, and to assist all parties to understand and interpret the Standards. As a result, certain individual standards e.g. Ind AS 1, Presentation of Financial Statements, Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors, Ind AS 103, Business Combinations, etc., require the preparers to follow the guidance in the *Conceptual Framework for Financial reporting under Indian Accounting Standards*.

The Institute of Chartered Accountants of India (ICAI), in the past, has issued a pronouncement with the title 'Framework for the Preparation and Presentation of Financial Statements under Indian Accounting Standards'. This framework was primarily based on the Framework issued by the International Accounting Standards Board's (IASB's) predecessor body IASC in 1989 (Framework 1989). In March 2018, the IASB issued a comprehensive revised framework titled 'Conceptual Framework for Financial Reporting'. In view of the issuance of new Conceptual Framework by the IASB and with an objective to remain converged with the global accounting framework, the ICAI has developed the *Conceptual Framework under Ind AS* corresponding to IASB's Conceptual Framework 2018.

The purpose of the *Conceptual Framework under Ind AS* can be summarised as below:

**Standard setting**
- Assist ICAI in formulation of Ind AS
- Formulation to be based on consistent concepts

**Consistent preparation**
- Assist preparers to develop consistent accounting policies when no Ind AS applies to a particular transaction or event, OR
- When an Ind AS allows a choice of accounting policy

**Interpreting Ind AS**
- Assist all parties to understand Ind AS
- Interpretation of Ind AS

Ind AS or any requirement in an Ind AS overrides the *Conceptual Framework under Ind AS*. To meet the objective of general-purpose financial reporting, the ICAI may sometimes specify requirements that depart from aspects of the Conceptual Framework. If the ICAI does so, it will explain the departure in the Appendix to the relevant Ind AS.

# UNIT 2
# OBJECTIVE OF GENERAL PURPOSE FINANCIAL REPORTING

## 2.1 OBJECTIVES AND USEFULNESS OF GENERAL PURPOSE FINANCIAL REPORTING

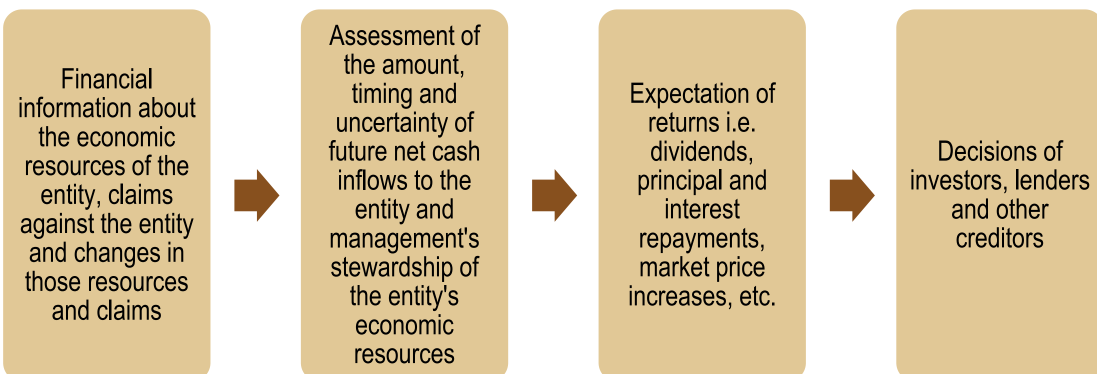
The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions involve decisions about:

(a) buying, selling or holding equity and debt instruments;

(b) providing or settling loans and other forms of credit; or

(c) exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

The chart below is intended to demonstrate the strong correlation between general purpose financial reports and decision making process of relevant stakeholders:



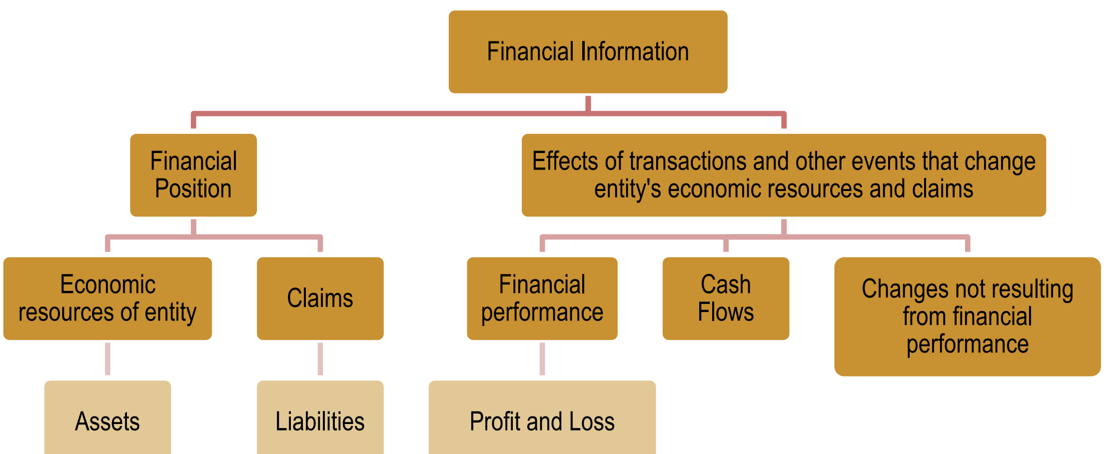
## 2.2 LIMITATIONS OF GENERAL PURPOSE FINANCIAL REPORTING

General purpose financial reports:

- do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks;
- are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity; and
- are not primarily directed to other parties, such as regulators and members of the public other than investors, lenders and other creditors.

## 2.3 INFORMATION PROVIDED BY GENERAL PURPOSE FINANCIAL REPORTS

The chart below provides an overview of the information sought to be provided in the general purpose financial reports, which will, in turn, be used by the relevant stakeholders in making their economic decisions, as presented in the flowchart above.



## 2.3.1 Economic resources and claims

Information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses. That information can help users to:

(a) assess the reporting entity's:

  (i) liquidity and solvency,

  (ii) its needs for additional financing and

  (iii) how successful it is likely to be in obtaining that financing

(b) assess management's stewardship of the entity's economic resources

(c) predict how future cash flows will be distributed among those with a claim against the reporting entity

## 2.3.2 Changes in economic resources and claims

Changes in a reporting entity's economic resources and claims result from:

- that entity's financial performance and
- other events or transactions such as issuing debt or equity instruments

To properly assess both the prospects for future net cash inflows to the reporting entity and management's stewardship of the entity's economic resources, users need to be able to identify those two types of changes.

### 2.3.2.1 Financial performance reflected by accrual accounting

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

Such information is useful in:

- assessing the entity's past and future ability to generate net cash inflows,
- indicating the extent to which the reporting entity has increased its available economic resources, and thus its capacity for generating net cash inflows through its operations,
- helping users to assess management's stewardship of the entity's economic resources, and

- indicating the extent to which events such as changes in market prices or interest rates have increased or decreased the entity's economic resources and claims, thereby affecting the entity's ability to generate net cash inflows.

### 2.3.2.2 Financial performance reflected by past cash flows

Information about a reporting entity's cash flows during a period helps in assessment of:

- entity's ability to generate future net cash inflows, by helping users:
  - understand reporting of entity's operations,
  - evaluate its financing and investing activities,
  - assess its liquidity or solvency and
  - interpret other information about financial performance
- management's stewardship of the entity's economic resources.

### 2.3.2.3 Changes in economic resources and claims not resulting from financial performance

A reporting entity's economic resources and claims may also change for reasons other than financial performance, such as issuing debt or equity instruments. Information about this type of change is necessary to give users a complete understanding of why the reporting entity's economic resources and claims changed and the implications of those changes for its future financial performance.

# UNIT 3
# QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

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

Let's look at these two fundamental qualitative characteristics in more detail.

## 3.1 QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

### 3.1.1 Relevance

The following chart will explain what is considered as "relevant financial information":

Financial information with (a) predictive value or (b) confirmatory value or both → Makes it capable of making a difference in decisions made by users → Makes it **relevant** financial information

Financial information has **predictive value** if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.

Financial information has **confirmatory value** if it provides feedback about (confirms or changes) previous evaluations.

The predictive value and confirmatory value of financial information are interrelated. Information that has predictive value often also has confirmatory value.

**Example 1**

Revenue information for the current year, which can be used as the basis for predicting revenues in future years, can also be compared with revenue predictions for the current year that were made in past years. The results of those comparisons can help a user to correct and improve the processes that were used to make those previous predictions.

The characteristic of 'relevance' also includes the concept of **materiality**. Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial reports make on the basis of those reports, which provide financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the ICAI cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

## 3.1.2 Faithful representation

To be useful, financial information must also faithfully represent the substance of the phenomena that it purports to represent. In many circumstances, the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon.

To be a perfectly faithful representation, a depiction would have following three characteristics:

- *Complete*: A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

  **Example 2**

  A complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all of the assets in the group, and a description of what the numerical depiction represents (for example, historical cost or fair value). For some items, a complete depiction may also entail explanations of significant facts about the quality and nature of the items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction (e.g. facts such as encumbrance / hypothecation / mortgage of items of Property, Plant and Equipment against secured borrowings, disclosure of fair value of Investment Property etc.).

- *Neutral*: A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users.

Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. The exercise of prudence means that assets and income are not overstated and liabilities and expenses are not understated. Equally, the exercise of prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses.

- *Free from error*: Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

**Example 3**

The use of reasonable estimates is an essential part of the preparation of financial statements. Examples of estimates could include useful life of an item of Property, Plant and Equipment, net realizable value of inventories, fair value of investment in an unlisted entity, expected credit losses etc. As long as the estimates are fair, the financial statements will be concluded to be free from error, even though the actual outcome may be different from the original estimate.

## 3.1.3 Applying the fundamental qualitative characteristics

The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows:

Identify an economic phenomenon, information about which is capable of being useful to users of the reporting entity's financial information

↓

Identify the type of information about that phenomenon that would be most relevant

↓

Determine whether that information is available and whether it can provide a faithful representation of the economic phenomenon

If faithful representation is achieved, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

In some cases, a trade-off between the fundamental qualitative characteristics may need to be made in order to meet the objective of financial reporting, which is to provide useful information about economic phenomena. For example, the most relevant information about a phenomenon may be a highly uncertain estimate. In some cases, the level of measurement uncertainty involved in making that estimate may be so high that it may be questionable whether the estimate would provide a sufficiently faithful representation of that phenomenon. In some such cases, the most useful information may be the highly uncertain estimate, accompanied by a description of the estimate and an explanation of the uncertainties that affect it. In other such cases, if that information would not provide a sufficiently faithful representation of that phenomenon, the most useful information may include an estimate of another type that is slightly less relevant but is subject to lower measurement uncertainty. In limited circumstances, there may be no estimate that provides useful information. In those limited circumstances, it may be necessary to provide information that does not rely on an estimate.

### 3.1.4 Enhancing qualitative characteristics

As mentioned at the beginning of Unit 3, the usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable. Having identified the fundamental qualitative characteristics of useful financial information, let's understand how to enhance the usefulness by applying four enhancing qualitative characteristics.

♦ *Comparability:* Users' decisions involve choosing between alternatives, for example, selling or holding an investment, or investing in one reporting entity or another. Consequently, information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

  Comparability is neither same as consistency, nor as uniformity. Comparability is the goal; consistency helps to achieve that goal. Comparability refers to the use of the same methods for the same items, and uniformity implies that like things must look alike and different things must look different.

♦ *Verifiability:* Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

Verification can be direct or indirect. Direct verification means verifying an amount or other representation through direct observation, for example, by counting cash. Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology. An example is verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (for example, using the first-in, first-out method).

- *Timeliness:* Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.
- *Understandability:* Classifying, characterising and presenting information clearly and concisely makes it understandable. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those reports would be incomplete and therefore possibly misleading. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

## 3.1.5 Applying the enhancing qualitative characteristics

- Enhancing qualitative characteristics should be maximised to the extent possible. However, the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or does not provide a faithful representation of what it purports to represent.
- Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one enhancing qualitative characteristic may have to be diminished to maximise another qualitative characteristic. For example, a temporary reduction in comparability as a result of prospectively applying a new Ind AS may be worthwhile to improve relevance or faithful representation in the longer term. Appropriate disclosures may partially compensate for non-comparability.

## 3.2 THE COST CONSTRAINT ON USEFUL FINANCIAL INFORMATION

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

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

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

# UNIT 4
# FINANCIAL STATEMENTS AND THE REPORTING ENTITY

In this unit, we will address two critical aspects:

- What are financial statements?
- What is reporting entity?

## 4.1 OBJECTIVE AND SCOPE OF FINANCIAL STATEMENTS

The objective of financial statements is to provide financial information about the reporting entity's:

- assets, liabilities and equity; and
- income and expenses

(i.e. the elements of the financial statements – we will discuss this in more detail in Unit 5) that is useful to users of financial statements in assessing:

- the prospects for future net cash inflows to the reporting entity, and
- management's stewardship of the entity's economic resources.

Such financial information is provided:

(a) in the balance sheet, by recognising assets, liabilities and equity;

(b) in the statement of profit and loss, by recognising income and expenses; and

(c) in other statements and notes, by presenting and disclosing information about:

   (i) recognised assets, liabilities, equity, income and expenses, including information about their nature and about the risks arising from those recognised assets and liabilities;

   (ii) assets and liabilities that have not been recognised, including information about their nature and about the risks arising from them;

   (iii) cash flows;

   (iv) contributions from holders of equity claims and distributions to them; and

(v) the methods, assumptions and judgements used in estimating the amounts presented or disclosed, and changes in those methods, assumptions and judgements.

### 4.1.1 Reporting period

Financial statements are prepared for a specified period of time (reporting period) and to help users of financial statements to identify and assess changes and trends; financial statements also provide comparative information for at least one preceding reporting period.

Information about possible future transactions and other possible future events (forward-looking information) is included in financial statements if it:

(a) relates to the entity's assets or liabilities—including unrecognised assets or liabilities—or equity that existed at the end of the reporting period, or during the reporting period, or to income or expenses for the reporting period; and

(b) is useful to users of financial statements.

For example, if an asset or liability is measured by estimating future cash flows, information about those estimated future cash flows may help users of financial statements to understand the reported measures. Financial statements do not typically provide other types of forward-looking information, for example, explanatory material about management's expectations and strategies for the reporting entity.

Financial statements include information about transactions and other events that have occurred after the end of the reporting period if providing that information is necessary to meet the objective of financial statements.

### 4.1.2 Perspective adopted in financial statements

Financial statements provide information about transactions and other events viewed from the perspective of the reporting entity as a whole, not from the perspective of any particular group of the entity's existing or potential investors, lenders or other creditors.

### 4.1.3 Going concern assumption

Financial statements are normally prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to enter liquidation or to cease trading. If such an intention or need exists, the financial statements may have to be prepared on a different basis. If so, the financial statements describe the basis used.

## 4.2 THE REPORTING ENTITY

A reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity.

Sometimes one entity (parent) has control over another entity (subsidiary). If a reporting entity comprises both the parent and its subsidiaries, the reporting entity's financial statements are referred to as '**consolidated financial statements**'. If a reporting entity is the parent alone, the reporting entity's financial statements are referred to as '**standalone financial statements**' or 'separate financial statements' as the case may be.

If a reporting entity comprises two or more entities that are not all linked by a parent-subsidiary relationship, the reporting entity's financial statements are referred to as '**combined financial statements**'.

*If the reporting entity is not a legal entity and does not comprise only legal entities linked by a parent-subsidiary relationship, how can the boundary of reporting entity be determined?*

In such cases, determining the boundary of the reporting entity is driven by the information needs of the primary users of the reporting entity's financial statements. Those users need relevant information that faithfully represents what it purports to represent. Faithful representation requires that:

(a) the boundary of the reporting entity does not contain an arbitrary or incomplete set of economic activities;

(b) including that set of economic activities within the boundary of the reporting entity results in neutral information; and

(c) a description is provided of how the boundary of the reporting entity was determined and of what constitutes the reporting entity.

### 4.2.1 Consolidated and unconsolidated financial statements

Consolidated financial statements provide information about the assets, liabilities, equity, income and expenses of both the parent and its subsidiaries as a single reporting entity. That information is useful for existing and potential investors, lenders and other creditors of the parent in their assessment of the prospects for future net cash inflows to the parent. This is because net cash inflows to the parent include distributions to the parent from its subsidiaries, and those distributions depend on net cash inflows to the subsidiaries.

Consolidated financial statements are not designed to provide separate information about the assets, liabilities, equity, income and expenses of any particular subsidiary. A subsidiary's own financial statements are designed to provide that information.

Unconsolidated financial statements are designed to provide information about the parent's assets, liabilities, equity, income and expenses, and not about those of its subsidiaries. That information can be useful to existing and potential investors, lenders and other creditors of the parent because:

(a) a claim against the parent typically does not give the holder of that claim a claim against subsidiaries; and

(b) in some jurisdictions, the amounts that can be legally distributed to holders of equity claims against the parent depend on the distributable reserves of the parent.

Another way to provide information about some or all assets, liabilities, equity, income and expenses of the parent alone in consolidated financial statements, is in the notes.

Information provided in unconsolidated financial statements is typically not sufficient to meet the information needs of existing and potential investors, lenders and other creditors of the parent. Accordingly, when consolidated financial statements are required, unconsolidated financial statements cannot serve as a substitute for consolidated financial statements. Nevertheless, a parent may require, or choose, to prepare unconsolidated financial statements in addition to consolidated financial statements.

# UNIT 5
# THE ELEMENTS OF FINANCIAL STATEMENTS

As explained in Unit 2, general purpose financial reports provide the information about:

- **Financial position** i.e. economic resources of the entity and claims against the entity; and
- **Effects of transactions and other events** that change entity's economic resources and claims

The elements of financial statements defined in the *Conceptual Framework under Ind AS* are:

(a) assets, liabilities and equity, which relate to a reporting entity's financial position; and

(b) income and expenses, which relate to a reporting entity's financial performance.

## 5.1 LINK BETWEEN INFORMATION IN GENERAL PURPOSE FINANCIAL REPORTS AS PER CONCEPTUAL FRAMEWORK AND ELEMENTS OF FINANCIAL STATEMENTS

In this Unit 5, we will discuss how the information in general purpose financial reports is represented by the elements of financial statements. The table below links the two:

| Information provided by general purpose financial reports | Element of financial statements | Definition or description |
|---|---|---|
| Economic Resources | Asset | A present economic resource controlled by the entity as a result of past events.<br><br>An economic resource is a right that has the potential to produce economic benefits. |
| Claim | Liability | A present obligation of the entity to transfer an economic resource as a result of past events. |
| | Equity | The residual interest in the assets of the entity after deducting all its liabilities. |

| | | |
|---|---|---|
| Changes in economic resources and claims, reflecting financial performance | Income | Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims. |
| | Expenses | Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims. |
| Other changes in economic resources and claims | - | Contributions from holders of equity claims, and distributions to them. |
| | - | Exchanges of assets or liabilities that do not result in increases or decreases in equity. |

## 5.2 DEFINITION OF AN ASSET

The definition of 'asset', which, in turn, is dependent on definition of economic resource, has three key aspects – right, potential to produce economic benefits and control.

Let us look at these three aspects in more detail.

### 5.2.1 Right

The concept of what constitutes a 'right' is a very wide subject and can be better illustrated with reference to various lenses through which it can be seen, and a couple of such lenses are explained below. It must be understood that merely having a right does not mean the entity has an 'asset'.

#### 5.2.1.1 Obligation of another party

Certain rights correspond to obligation of another party. For example:

- *Rights to receive cash* – say, when a loan or security deposit is given or debt instrument of another entity is subscribed for
- *Rights to receive goods or services* – say, when an advance for purchase of inventory or capital goods is given
- *Rights to exchange economic resources with another party on favourable terms* – say, a forward contract to buy an economic resource on terms that are currently favourable or an option to buy an economic resource

- *Rights to benefit from an obligation of another party to transfer an economic resource if a specified uncertain future event occurs* – say, an insurance claim receivable upon happening of the insured event.

However, there are cases when a right exists even when no other party has any obligation towards the entity. For example,

- Rights over physical objects, such as property, plant and equipment or inventories. Examples of such rights are a right to use a physical object or a right to benefit from the residual value of a leased object
- Rights to use intellectual property.

#### 5.2.1.2 Contract, legislation or similar means

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

However, an entity might also obtain rights in other ways, for example:

(a) by acquiring or creating know-how that is not in the public domain; or

(b) through an obligation of another party that arises because that other party has no practical ability to act in a manner inconsistent with its customary practices, published policies or specific statements, often referred to as a 'constructive obligation'.

Some goods or services—for example, employee services—are received and immediately consumed. An entity's right to obtain the economic benefits produced by such goods or services exists momentarily until the entity consumes the goods or services.

Not all of an entity's rights are assets of that entity — to be assets of the entity, the rights must have the potential to produce for the entity economic benefits beyond those available to all other parties. The concept of 'asset' can also be understood if we understand what rights **do not** constitute asset. A couple of such situations are discussed below:

(a) Rights available to all parties without significant cost — for instance, rights of access to public goods, such as public rights of way over land, or know-how that is in the public domain — are typically not assets for the entities that hold them.

(b) Similarly, an entity cannot have a right to obtain economic benefits from itself. Hence:

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

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

In principle, each of an entity's rights is a separate asset. However, for accounting purposes, related rights are often treated as a single unit of account that is a single asset. For example, legal ownership of a physical object may give rise to several rights, including:

(a) the right to use the object;

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

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

(d) other rights not listed in (a)–(c).

In many cases, the set of rights arising from legal ownership of a physical object is accounted for as a single asset. Conceptually, the economic resource is the set of rights, not the physical object. Nevertheless, describing the set of rights as the physical object will often provide a faithful representation of those rights in the most concise and understandable way.

**Example 4**

Ownership of land gives the entity the right to use the land, the right to sell the land, the right to give the land on lease, the right to pledge land to obtain a secured loan etc. However, these rights are normally bundled up as a single asset 'Land' as such classification provides a faithful representation of those rights in the most concise and understandable way.

Lastly, in some cases, it is uncertain whether a right exists.

**Example 5**

An entity and another party might dispute whether the entity has a right to receive an economic resource from that other party. Until that existence uncertainty is resolved — for example, by a court ruling — it is uncertain whether the entity has a right and, consequently, whether an asset exists.

## 5.2.2 Potential to produce economic benefits

*Role of probability*

For the potential to exist, it does not need to be certain, or even likely, that the right will produce economic benefits. It is only necessary that the right already exists and that, in at least one circumstance, it would produce for the entity economic benefits beyond those available to all other parties.

A right can meet the definition of an economic resource, and hence can be an asset, even if the probability that it will produce economic benefits is low. Nevertheless, that low probability might affect decisions about what information to provide about the asset and how to provide that information, including decisions about whether the asset is recognised and how it is measured.

**Example 6**

Receivable from a bankrupt customer is a right, even if the measurement principle renders the net carrying amount of such an asset as 'nil'.

*Role of timing*

Although an economic resource derives its value from its present potential to produce future economic benefits, the economic resource is the present right that contains that potential, not the future economic benefits that the right may produce.

For example, a purchased option derives its value from its potential to produce economic benefits through exercise of the option at a future date. However, the economic resource is the present right—the right to exercise the option at a future date. The economic resource is not the future economic benefits that the holder will receive if the option is exercised.

*Role of expenditure*

There is a close association between incurring expenditure and acquiring assets, but the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that the entity has sought future economic benefits but does not provide conclusive proof that the entity has obtained an asset. Similarly, the absence of related expenditure does not preclude an item from meeting the definition of an asset. Assets can include, for example, rights that a government has granted to the entity free of charge or that another party has donated to the entity.

### 5.2.3 Control

Control links an economic resource to an entity. Assessing whether control exists helps to identify the economic resource for which the entity accounts. For example, an entity may control a proportionate share in a property without controlling the rights arising from ownership of the entire property. In such cases, the entity's asset is the share in the property, which it controls, not the rights arising from ownership of the entire property, which it does not control.

An entity controls an economic resource if:

(a) it has the present ability to direct the use of the economic resource i.e. it has the right to deploy that economic resource in its activities, or to allow another party to deploy the economic resource in that other party's activities, and

(b) obtain the economic benefits that may flow from it. For an entity to control an economic resource, the future economic benefits from that resource must flow to the entity either directly or indirectly rather than to another party. This aspect of control does not imply that the entity can ensure that the resource will produce economic benefits in all circumstances. Instead, it means that if the resource produces economic benefits, the entity is the party that will obtain them either directly or indirectly. Having exposure to significant variations in the amount of the economic benefits produced by an economic resource may indicate that the entity controls the resource. However, it is only one factor to consider in the overall assessment of whether control exists.

An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it. Control includes the present ability to prevent other parties from directing the use of the economic resource and from obtaining the economic benefits that may flow from it. It follows that, if one party controls an economic resource, no other party controls that resource.

Control of an economic resource usually arises from an ability to enforce legal rights. However, control can also arise if an entity has other means of ensuring that it, and no other party, has the present ability to direct the use of the economic resource and obtain the benefits that may flow from it. For example, an entity could control a right to use know-how that is not in the public domain if the entity has access to the know-how and the present ability to keep the know-how secret, even if that know-how is not protected by a registered patent.

It must be remembered that if one party controls an economic resource, no other party controls that resource.

**Would control exist with the principal in a principal-agent relationship?**

Sometimes one party (a principal) engages another party (an agent) to act on behalf of, and for the benefit of, the principal. For example, a principal may engage an agent to arrange sales of goods controlled by the principal. If an agent has custody of an economic resource controlled by the principal, that economic resource is not an asset of the agent.

Furthermore, if the agent has an obligation to transfer to a third party an economic resource controlled by the principal, that obligation is not a liability of the agent, because the economic resource that would be transferred is the principal's economic resource, not the agent's.

# 5.3 DEFINITION OF A LIABILITY

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


Let us look at these three criteria in more detail.

## 5.3.1 Obligation

An obligation is a duty or responsibility that an entity has no practical ability to avoid. An obligation is always owed to another party (or parties). The other party (or parties) could be a person or another entity, a group of people or other entities, or society at large. It is not necessary to know the identity of the party (or parties) to whom the obligation is owed. However, a requirement for one party to recognise a liability and measure it at a specified amount does not imply that the other party (or parties) must recognise an asset or measure it at the same amount. For example, particular Ind AS may contain different recognition criteria or measurement requirements for the liability of one party and the corresponding asset of the other party (or parties) if those different criteria or requirements are a consequence of decisions intended to select the most relevant information that faithfully represents what it purports to represent.

Many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed. Obligations can also arise, however, from an entity's customary practices, published policies or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. The obligation that arises in such situations is sometimes referred to as a '**constructive obligation**'.

**Whether an entity's duty to transfer an economic resource, that is conditional on an action that an entity itself may choose to take, is an obligation or not?**

In such situations, the entity has an obligation if it has no practical ability to avoid taking that action. A conclusion that it is appropriate to prepare an entity's financial statements on a going concern basis also implies a conclusion that the entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade.

The factors used to assess whether an entity has the practical ability to avoid transferring an economic resource may depend on the nature of the entity's duty or responsibility. For example, in some cases, an entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself. However, neither an intention to make a transfer, nor a high likelihood of a transfer, is sufficient reason for concluding that the entity has no practical ability to avoid a transfer.

## 5.3.2 Transfer of an economic resource

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

An obligation can meet the definition of a liability even if the probability of a transfer of an economic resource is low. Nevertheless, that low probability might affect decisions about what information to provide about the liability and how to provide that information, including decisions about whether the liability is recognised and how it is measured.

Obligations to transfer an economic resource include, for example:

(a) obligations to pay cash.

(b) obligations to deliver goods or provide services.

(c) obligations to exchange economic resources with another party on unfavourable terms. Such obligations include, for example, a forward contract to sell an economic resource on terms that are currently unfavourable or an option that entitles another party to buy an economic resource from the entity.

(d) obligations to transfer an economic resource if a specified uncertain future event occurs.

(e) obligations to issue a financial instrument if that financial instrument will oblige the entity to transfer an economic resource.

Instead of fulfilling an obligation to transfer an economic resource to the party that has a right to receive that resource, entities sometimes decide to, for example:

(a) settle the obligation by negotiating a release from the obligation;

(b) transfer the obligation to a third party; or

(c) replace that obligation to transfer an economic resource with another obligation by entering into a new transaction.

It is however important to note that in the situations described above, the entity has the obligation to transfer an economic resource until it has settled, transferred or replaced that obligation.

### 5.3.3 Present obligation as a result of past events

A present obligation exists as a result of past events only if:

(a) the entity has already obtained economic benefits (for example, goods or services obtained from a supplier) or taken an action (for example, operating a particular business or operating in a particular market); and

(b) as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.

A present obligation can exist even if a transfer of economic resources cannot be enforced until some point in the future. For example, a contractual liability to pay cash may exist now even if the contract does not require a payment until a future date. Similarly, a contractual obligation for an entity to perform work at a future date may exist now even if the counterparty cannot require the entity to perform the work until that future date.

An entity does not yet have a present obligation to transfer an economic resource if it has not yet satisfied the criteria above, that is, if it has not yet obtained economic benefits, or taken an action, that would or could require the entity to transfer an economic resource that it would not otherwise have had to transfer.

**Example 7**

If an entity has entered into a contract to pay an employee a salary in exchange for receiving the employee's services, the entity does not have a present obligation to pay the salary until it has received the employee's services. Before then the contract is executory — the entity has a combined right and obligation to exchange future salary for future employee services. We will discuss more about 'executory contracts' in more detail later in this Chapter.

## 5.4 ASPECTS WHICH ARE COMMON TO ASSETS AND LIABILITIES

### 5.4.1 Unit of account

The unit of account is the right or the group of rights, the obligation or the group of obligations, or the group of rights and obligations, to which recognition criteria and measurement concepts are applied.

A unit of account is selected for an asset or liability when considering how recognition criteria and measurement concepts will apply to that asset or liability and to the related income and expenses.

In some circumstances, it may be appropriate to select one unit of account for recognition and a different unit of account for measurement. For example, contracts may sometimes be recognised individually but measured as part of a portfolio of contracts. For presentation and disclosure, assets, liabilities, income and expenses may need to be aggregated or separated into components.

A unit of account is selected to provide useful information, which implies that:

(a) the information provided about the asset or liability and about any related income and expenses must be relevant; and

(b) the information provided about the asset or liability and about any related income and expenses must faithfully represent the substance of the transaction or other event from which they have arisen.

Sometimes, both rights and obligations arise from the same source. For example, some contracts establish both rights and obligations for each of the parties. If those rights and obligations are interdependent and cannot be separated, they constitute a single inseparable asset or liability and hence form a single unit of account.

Conversely, if rights are separable from obligations, it may sometimes be appropriate to group the rights separately from the obligations, resulting in the identification of one or more separate assets and liabilities. In other cases, it may be more appropriate to group separable rights and obligations in a single unit of account treating them as a single asset or a single liability.

### 5.4.2 Executory contracts

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

An executory contract establishes a combined right and obligation to exchange economic resources. The right and obligation are interdependent and cannot be separated. Hence, the combined right and obligation constitute a single asset or liability. The entity has an asset if the terms of the exchange are currently favourable; it has a liability if the terms of the exchange are currently unfavourable.

Whether such an asset or liability is included in the financial statements depends on both the recognition criteria and the measurement basis selected for the asset or liability, including, if applicable, any test for whether the contract is onerous.

### 5.4.3 Substance of contractual rights and contractual obligations

The terms of a contract create rights and obligations for an entity that is a party to that contract. To represent those rights and obligations faithfully, financial statements report their substance. In some cases, the substance of the rights and obligations is clear from the legal form of the contract. In other cases, the terms of the contract or a group or series of contracts require analysis to identify the substance of the rights and obligations.

All terms in a contract — whether explicit or implicit — are considered unless they have no substance. Implicit terms could include, for example, obligations imposed by statute, such as statutory warranty obligations imposed on entities that enter into contracts to sell goods to customers.

Terms that have no substance are disregarded. A term has no substance if it has no discernible effect on the economics of the contract. Terms that have no substance could include, for example:

(a) terms that bind neither party; or

(b) rights, including options, that the holder will not have the practical ability to exercise in any circumstances.

A group or series of contracts may achieve or be designed to achieve an overall commercial effect. To report the substance of such contracts, it may be necessary to treat rights and obligations arising from that group or series of contracts as a single unit of account. For example, if the rights or obligations in one contract merely nullify all the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that the two contracts create no rights or obligations. Conversely, if a single contract creates two or more sets of rights or obligations that could have been created through two or more separate contracts, an entity may need to account for each set as if it arose from separate contracts in order to faithfully represent the rights and obligations.

## 5.5 DEFINITION OF EQUITY

Equity claims are claims on the residual interest in the assets of the entity after deducting all its liabilities. In other words, they are claims against the entity that do not meet the definition of a liability.

Sometimes, legal, regulatory or other requirements affect particular components of equity, such as share capital or retained earnings. For example, some such requirements permit an entity to make distributions to holders of equity claims only if the entity has sufficient reserves that those requirements specify as being distributable.

## 5.6 DEFINITION OF INCOME AND EXPENSES

Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

It follows from these definitions of income and expenses that contributions from holders of equity claims are not income, and distributions to holders of equity claims are not expenses.

Income and expenses are the elements of financial statements that relate to an entity's financial performance. Users of financial statements need information about both an entity's financial position and its financial performance. Hence, although income and expenses are defined in terms of changes in assets and liabilities, information about income and expenses is just as important as information about assets and liabilities.

Different transactions and other events generate income and expenses with different characteristics. Providing information separately about income and expenses with different characteristics can help users of financial statements to understand the entity's financial performance.

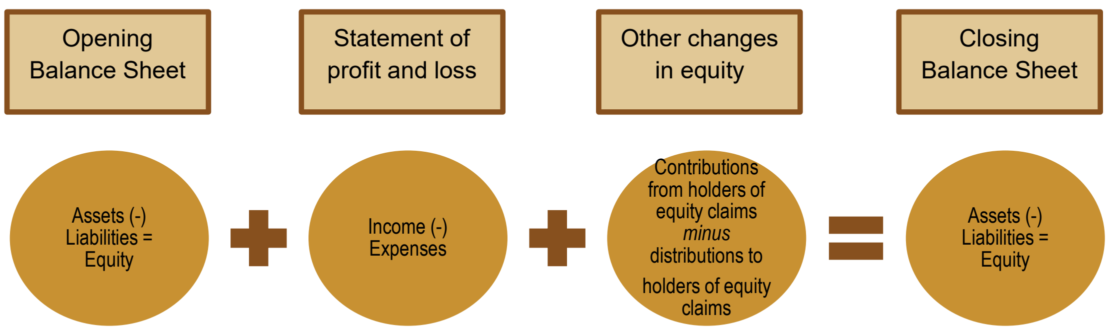
# UNIT 6
# RECOGNITION AND DERECOGNITION

## 6.1 THE RECOGNITION PROCESS

- Recognition is the process of capturing for inclusion
- in the balance sheet or the statement of profit and loss
- an item
- that meets the definition of one of the elements of financial statements—an asset, a liability, equity, income or expenses.

The amount at which an asset, a liability or equity is recognised in the balance sheet is referred to as its 'carrying amount'.

Recognition links the elements (as discussed in Unit 5), the balance sheet and the statement of profit and loss as follows:




The balance sheet and statement of profit and loss are linked because the recognition of one item (or a change in its carrying amount) requires the recognition or derecognition of one or more other items (or changes in the carrying amount of one or more other items). This principle can be explained in the form of a journal entry as below:

| Particulars | Statement of profit or loss | Balance Sheet (alternatives) | |
|---|---|---|---|
| Recognition of income | Credit Income | Debit Asset | Debit Liability |

| | | | |
|---|---|---|---|
| | | (initial recognition or increase in carrying amount) | (derecognition or decrease in carrying amount) |
| Recognition of expense | Debit Expense | Credit Asset (derecognition or decrease in carrying amount) | Credit Liability (initial recognition or increase in carrying amount) |

The initial recognition of assets or liabilities arising from transactions or other events may result in the simultaneous recognition of both income and related expenses.

**Example 8**

The sale of goods for cash results in the recognition of both income (from the recognition of one asset — the cash) and an expense (from the derecognition of another asset—the goods sold).

The simultaneous recognition of income and related expenses is sometimes referred to as the **matching of costs with income**. It may be noted that matching of costs with income is not an objective of the *Conceptual Framework under Ind AS*. The *Conceptual Framework under Ind AS* does not allow the recognition in the balance sheet of items that do not meet the definition of an asset, a liability or equity.

## 6.2 RECOGNITION CRITERIA

Only items that meet the definition of an asset, a liability or equity are recognised in the balance sheet. Similarly, only items that meet the definition of income or expenses are recognised in the statement of profit and loss. However, not all items that meet the definition of one of those elements are recognised.

Not recognising an item that meets the definition of one of the elements makes the balance sheet and the statement of profit and loss less complete and can exclude useful information from financial statements. On the other hand, in some circumstances, recognising some items that meet the definition of one of the elements would not provide useful information.

An asset or liability is recognised only if recognition provides users of financial statements with information that is useful, i.e. with:

(a) relevant information; and

(b) a faithful representation

of the asset or liability and of any resulting income, expenses or changes in equity.

What is useful to users depends on the item and the facts and circumstances. Consequently, judgement is required when deciding whether to recognise an item, and thus recognition requirements may need to vary between and within Ind AS.

It is important when making decisions about recognition to consider the information that would be given if an asset or liability were not recognised. For example, if no asset is recognised when expenditure is incurred, an expense is recognised. Over time, recognising the expense may, in some cases, provide useful information, for example, information that enables users of financial statements to identify trends.

Even if an item meeting the definition of an asset or liability is not recognised, an entity may need to provide information about that item in the notes. It is important to consider how to make such information sufficiently visible to compensate for the item's absence from the structured summary provided by the balance sheet and, if applicable, the statement of profit and loss.

Let's look at the aspects of 'relevance' and 'faithful presentation' in a bit more detail.

## 6.2.1 Relevance

Information about assets, liabilities, equity, income and expenses is relevant to users of financial statements. However, recognition of a particular asset or liability and any resulting income, expenses or changes in equity may not always provide relevant information. That may be the case if, for example:

(a) it is uncertain whether an asset or liability exists (see 6.2.1.1 below); or

(b) an asset or liability exists, but the probability of an inflow or outflow of economic benefits is low (see 6.2.1.2 below)

The presence of one or both of the factors described above does not lead automatically to a conclusion that the information provided by recognition lacks relevance. Moreover, factors other than those described above may also affect the conclusion. It may be a combination of factors and not any single factor that determines whether recognition provides relevant information.

### 6.2.1.1 Existence uncertainty

- *Asset*

  In some cases, it is uncertain whether a right exists. For example, an entity and another party might dispute whether the entity has a right to receive an economic resource from that other party. Until that existence uncertainty is resolved — for example, by a court ruling — it is uncertain whether the entity has a right and, consequently, whether an asset exists.

- *Liability*

  In some cases, it is uncertain whether an obligation exists. For example, if another party is seeking compensation for an entity's alleged act of wrongdoing, it might be uncertain whether the act occurred, whether the entity committed it or how the law applies. Until that existence uncertainty is resolved — for example, by a court ruling — it is uncertain whether the entity has an obligation to the party seeking compensation and, consequently, whether a liability exists.

In those cases, that uncertainty, possibly combined with a low probability of inflows or outflows of economic benefits and an exceptionally wide range of possible outcomes, may mean that the recognition of an asset or liability, necessarily measured at a single amount, would not provide relevant information. Whether or not the asset or liability is recognised, explanatory information about the uncertainties associated with it may need to be provided in the financial statements.

#### 6.2.1.2 Low probability of an inflow or outflow of economic benefits

If the probability of an inflow or outflow of economic benefits is low, the most relevant information about the asset or liability may be information about the magnitude of the possible inflows or outflows, their possible timing and the factors affecting the probability of their occurrence. The typical location for such information is in the notes.

However, in some cases, recognition of the asset or liability may provide relevant information beyond the disclosure in the notes.

Even if the probability of an inflow or outflow of economic benefits is low, recognition of the asset or liability may provide relevant information beyond the information described above. Whether that is the case may depend on a variety of factors. For example:

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

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

## 6.2.2 Faithful representation

Recognition of a particular asset or liability is appropriate if it provides not only relevant information, but also a faithful representation of that asset or liability and of any resulting income, expenses or changes in equity. Whether a faithful representation can be provided may be affected by the level of measurement uncertainty associated with the asset or liability or by other factors.

### 6.2.2.1 Measurement uncertainty

For an asset or liability to be recognised, it must be measured. In many cases, such measures must be estimated and are therefore subject to measurement uncertainty. The use of reasonable estimates is an essential part of the preparation of financial information and does not undermine the usefulness of the information if the estimates are clearly and accurately described and explained. Even a high level of measurement uncertainty does not necessarily prevent such an estimate from providing useful information.

In some cases, the level of uncertainty involved in estimating a measure of an asset or liability may be so high that it may be questionable whether the estimate would provide a sufficiently faithful representation of that asset or liability and of any resulting income, expenses or changes in equity. The level of measurement uncertainty may be so high if, for example, the only way of estimating that measure of the asset or liability is by using cash-flow-based measurement techniques and, in addition, one or more of the following circumstances exists:

(a) the **range of possible outcomes is exceptionally wide** and the probability of each outcome is exceptionally difficult to estimate.

(b) the measure is **exceptionally sensitive to small changes** in estimates of the probability of different outcomes — for example, if the probability of future cash inflows or outflows occurring is exceptionally low, but the magnitude of those cash inflows or outflows will be exceptionally high if they occur.

(c) measuring the asset or liability requires **exceptionally difficult or exceptionally subjective allocations of cash flows** that do not relate solely to the asset or liability being measured.

In some of the cases described above, the most useful information may be the measure that relies on the highly uncertain estimate, accompanied by a description of the estimate and an explanation of the uncertainties that affect it. This is especially likely to be the case if that measure is the most relevant measure of the asset or liability. In other cases, if that information would not provide a sufficiently faithful representation of the asset or liability and of any resulting income, expenses or changes in equity, the most useful information may be a different measure (accompanied by any necessary descriptions and explanations) that is slightly less relevant but is subject to lower measurement uncertainty.

In limited circumstances, all relevant measures of an asset or liability that are available (or can be obtained) may be subject to such high measurement uncertainty that none would provide useful information about the asset or liability (and any resulting income, expenses or changes in equity), even if the measure were accompanied by a description of the estimates made in producing it and an explanation of the uncertainties that affect those estimates. In those limited circumstances, the asset or liability would not be recognised.

Whether or not an asset or liability is recognised, a faithful representation of the asset or liability may need to include explanatory information about the uncertainties associated with the asset or liability's existence or measurement, or with its outcome — the amount or timing of any inflow or outflow of economic benefits that will ultimately result from it.

It may be noted that the level of measurement uncertainty beyond which a measure does not provide a faithful representation depends on facts and circumstances and so, the standard-setters felt, that level can be determined only when developing Standards.

#### 6.2.2.2 Other factors

Faithful representation of a recognised asset, liability, equity, income or expenses involves not only recognition of that item, but also its measurement as well as presentation and disclosure of information about it.

Hence, when assessing whether the recognition of an asset or liability can provide a faithful representation of the asset or liability, it is necessary to consider not merely its description and measurement in the balance sheet, but also:

- the depiction of resulting income, expenses and changes in equity. For example, if an entity acquires an asset for consideration, not recognising the asset would result in recognising expenses, and that result could provide a misleading representation that the entity's financial position has deteriorated.
- whether related assets and liabilities are recognised. If they are not recognised, recognition may create a recognition inconsistency (accounting mismatch). That may not provide an understandable or faithful representation of the overall effect of the transaction or other event giving rise to the asset or liability, even if explanatory information is provided in the notes.

- presentation and disclosure of information about the asset or liability, and resulting income, expenses or changes in equity. A complete depiction includes all information necessary for a user of financial statements to understand the economic phenomenon depicted, including all necessary descriptions and explanations. Hence, presentation and disclosure of related information can enable a recognised amount to form part of a faithful representation of an asset, a liability, equity, income or expenses.

## 6.3 DERECOGNITION

Derecognition is the removal of all or part of a recognised asset or liability from an entity's balance sheet. Derecognition normally occurs when that item no longer meets the definition of an asset or of a liability:

| **Element of financial statements** | **When does derecognition normally occur?** |
|---|---|
| Asset | When the entity loses control of all or part of the recognised asset |
| Liability | When the entity no longer has a present obligation for all or part of the recognised liability |

The accounting requirements for derecognition are as below:

(a) derecognise any assets or liabilities that have expired or have been consumed, collected, fulfilled or transferred (referred to as 'transferred component'), and recognise any resulting income and expenses.

(b) continue to recognise the assets or liabilities retained, referred to as the 'retained component', if any. That retained component becomes a unit of account separate from the transferred component. Accordingly, no income or expenses are recognised on the retained component as a result of the derecognition of the transferred component, unless the derecognition results in a change in the measurement requirements applicable to the retained component. For example, when a parent loses control over a subsidiary and retains a minority shareholding therein, the measurement principles in Ind AS require that minority shareholding to be recognised at its fair value, the resulting gain or loss is then recognised in statement of profit or loss.

(c) applying following presentation and disclosure requirements:

(i) presenting any retained component separately in the balance sheet

(ii) presenting separately in the statement of profit and loss any income and expenses recognised as a result of the derecognition of the transferred component

(iii) providing explanatory information.

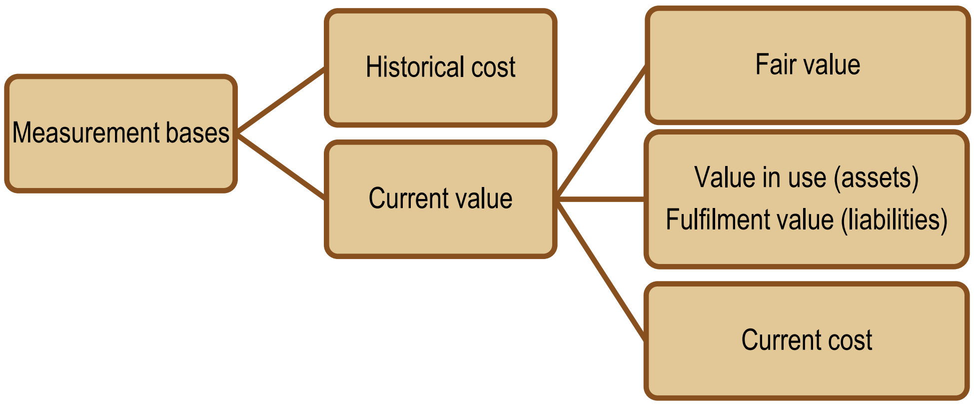
In some cases, an entity might appear to transfer an asset or liability, but derecognition of that asset or liability is not appropriate. For example,

- if an entity has apparently transferred an asset but retains exposure to significant positive or negative variations in the amount of economic benefits that may be produced by the asset, this sometimes indicates that the entity might continue to control that asset
- if an entity has transferred an asset to another party that holds the asset as an agent for the entity, the transferor still controls the asset.

# UNIT 7
# MEASUREMENT

Elements recognised in financial statements are quantified in monetary terms. This requires the selection of a measurement basis. A measurement basis is an identified feature — for example, historical cost, fair value or fulfilment value — of an item being measured. Applying a measurement basis to an asset or liability creates a measure for that asset or liability and for related income and expenses.

## 7.1 MEASUREMENT BASES OF AN ASSET OR A LIABILITY




A very broad comparison between the historical cost and current value measurement bases is given below:

| Factor | Historical cost | Current value |
|---|---|---|
| Monetary information about assets, liabilities and related income and expenses | Derived, at least in part, from the price of the transaction or other event that gave rise to them | Using information updated to reflect conditions at the measurement date |
| Changes in values | Not reflected except to the extent that those changes relate to impairment of an asset or a liability becoming onerous | Reflect changes, since the previous measurement date, in estimates of cash flows and other factors reflected in those current values |

## 7.1.1 Historical cost

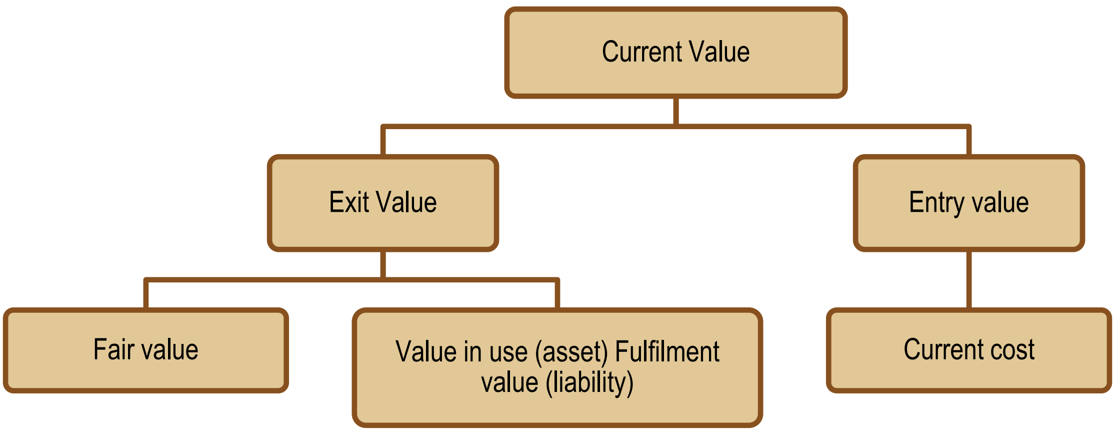
The table below summarises the concept of ‘historical cost’ in case of assets and liabilities:

| Particulars | Assets | Liabilities |
|---|---|---|
| Components | Consideration paid (+) transaction costs | Consideration received (-) transaction costs |
| Changes | • consumption of part or all of the economic resource that constitutes the asset (depreciation or amortisation) | |
| | • payments received that extinguish part or all of the asset (collection from trade receivables) | • fulfilment of the liability, for example, by making payments that extinguish part or all of the liability or by satisfying an obligation to deliver goods |
| | • effect of events that cause the historical cost of the asset to be no longer recoverable (impairment) | • effect of events that increase the value of the obligation to transfer the economic resources needed to fulfil the liability to such an extent that the liability becomes onerous. A liability is onerous if the historical cost is no longer sufficient to depict the obligation to fulfil the liability |
| | • accrual of interest to reflect any financing component | accrual of interest to reflect any financing component |

When an asset is acquired or created (say, a loan is given by a parent to a subsidiary), or a liability is incurred or taken on, as a result of an event that is not a transaction on market terms (say, at a discounted interest rate), it may not be possible to identify a cost, or the cost may not provide relevant information about the asset or liability. In some such cases, a current value of the asset (say, fair value) or liability is used as a deemed cost on initial recognition and that deemed cost is then used as a starting point for subsequent measurement at historical cost (say, amortised cost in case of the loan - see next paragraph for discussion on this).

One way to apply a historical cost measurement basis to financial assets and financial liabilities is to measure them at amortised cost. The amortised cost of a financial asset or financial liability reflects estimates of future cash flows, discounted at a rate determined at initial recognition. For variable rate instruments, the discount rate is updated to reflect changes in the variable rate. The amortised cost of a financial asset or financial liability is updated over time to depict subsequent changes, such as the accrual of interest, the impairment of a financial asset and receipts or payments.

## 7.1.2 Current value




### 7.1.2.1 Exit value – Fair value and Value in use / Fulfilment value

The following table summarises these concepts in a comparative form:

| Particulars | Fair value | Value in use / Fulfilment value |
|---|---|---|
| Definition | Price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date | Value in use - present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal.<br>Fulfilment value - present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability. |

| | | |
|---|---|---|
| Value from whose perspective? | Reflects the perspective of market participants—participants in a market to which the entity has access. The asset or liability is measured using the same assumptions that market participants would use when pricing the asset or liability if those market participants act in their economic best interest. | Reflect entity-specific assumptions rather than assumptions by market participants |
| How determined? | Directly by observing prices in an active market or using measurement techniques, for example, cash-flow-based measurement techniques | Cannot be observed directly and are determined using cash-flow based measurement techniques |
| Transaction costs considered in measurement? | Neither those costs incurred on initial recognition, nor those costs to be incurred on disposal of asset or settlement of liability are considered. | Those costs incurred on initial recognition are not considered, but the present value of those costs to be incurred on disposal of asset or settlement of liability are considered. |

### 7.1.2.2 Entry value – Current cost

Like historical cost, current cost is also an entry value. Hence, it would be appropriate to understand the concept of 'current cost' by comparing it with 'historical cost' as below:

| **Particulars** | **Historical cost** | **Current cost** |
|---|---|---|
| Value determined on | Date of acquisition of asset or incurrence of liability | Each measurement date |
| Components | Assets: Consideration paid (+) transaction costs<br>Liabilities: Consideration received (-) transaction costs | Assets: Consideration **that would be** paid (+) transaction costs **that would be** incurred<br>Liabilities: Consideration **that would be** received (-) transaction costs **that would be** incurred |

# 7.2 INFORMATION PROVIDED BY PARTICULAR MEASUREMENT BASES

When selecting a measurement basis, it is important to consider the nature of the information that the measurement basis will produce in both the balance sheet and the statement of profit and loss. The tables below summarise that information.

## 7.2.1 Assets

### 7.2.1.1 Balance Sheet

| | Historical cost | Current cost | Fair value (market participant assumptions) | Value in use (entity-specific assumptions) |
|---|---|---|---|---|
| Carrying amount – primary value | Historical cost to the extent unconsumed or uncollected, and recoverable (Includes interest accrued on any financing component) | Current cost to the extent unconsumed or uncollected, and recoverable | Price that would be received to sell the asset | Present value of future cash flows from the use of the asset and from its ultimate disposal |
| Transaction costs | Included | Included | Without deducting transaction costs on disposal | After deducting present value of transaction costs on disposal |

### 7.2.1.2 Statement of profit and loss

| Event | Historical cost | Current cost | Fair value (market participant assumptions) | Value in use (entity-specific assumptions) |
|---|---|---|---|---|
| Initial recognition – primary value | - | - | Difference between consideration paid and fair value of the asset acquired | Difference between consideration paid and value in use of the asset acquired |

<table>
<tr><th>Event</th><th>Historical cost</th><th>Current cost</th><th>Fair value (market participant assumptions)</th><th>Value in use (entity-specific assumptions)</th></tr>
<tr><td>Transaction costs – purchase</td><td>-</td><td>-</td><td>Expense</td><td>Expense</td></tr>
<tr><td rowspan="3">Sale or consumption of the asset</td><td>Expense: Historical cost of the asset sold or consumed (eg. Cost of sales of inventory or WDV of a fixed asset)</td><td>Expense: Current cost of the asset sold or consumed</td><td>Expense: Fair value of the asset sold or consumed</td><td>Expense: Value in use of the asset sold or consumed</td></tr>
<tr><td colspan="4">Income: Consideration received</td></tr>
<tr><td colspan="4">Expenses and Income could be presented gross or net</td></tr>
<tr><td>Transaction costs – sale</td><td>Included</td><td>Included</td><td>Included</td><td>Already considered in computation of value in use, hence not included</td></tr>
<tr><td>Interest income</td><td>At historical rates, updated if the asset bears variable interest</td><td>At current rates</td><td>Already included in fair value changes, could be identified separately</td><td>Already included in value in use changes, could be identified separately</td></tr>
<tr><td>Impairment</td><td>Expense</td><td>Expense</td><td>Already included in fair value changes, could be identified separately</td><td>Already included in value in use changes, could be identified separately</td></tr>
<tr><td>Value changes</td><td>None, except impairment<br>Financial assets – effect of changes in estimated cash flows is an income or expense</td><td>Effect of change in prices is income or expense</td><td>Already included in fair value changes</td><td>Already included in value in use changes</td></tr>
</table>

## 7.2.2 Liabilities

### 7.2.2.1 Balance Sheet

| | Historical cost | Current cost | Fair value (market participant assumptions) | Fulfilment value (entity-specific assumptions) |
|---|---|---|---|---|
| Carrying amount – primary value | Consideration received for taking on the unfulfilled part of the liability, increased by excess of estimated cash outflows over consideration received. | Consideration that would be currently received for taking on the unfulfilled part of the liability, increased by excess of estimated cash outflows over that consideration. | Price that would be paid to transfer the unfulfilled part of the liability | Present value of future cash flows that will arise in fulfilling the unfulfilled part of the liability |
| Transaction costs | Netted off from above | Netted off from above | Not including transaction costs that would be incurred on transfer | Including present value of transaction costs to be incurred in fulfilment or transfer |

### 7.2.2.2 Statement of profit and loss

| Event | Historical cost | Current cost | Fair value (market participant assumptions) | Fulfilment value (entity-specific assumptions) |
|---|---|---|---|---|
| Initial recognition – primary value | - | - | Difference between consideration received and the fair value of the liability | Difference between consideration received and the fulfilment value of the liability |

| Event | Historical cost | Current cost | Fair value (market participant assumptions) | Fulfilment value (entity-specific assumptions) |
|---|---|---|---|---|
| Transaction costs – purchase | - | - | Expense | Expense |
| Fulfilment or transfer of the liability | Income: historical consideration | Income: reflects current consideration | Income: fair value of the liability | Income: fulfilment value of the liability |
| | Expenses: costs incurred in fulfilling the liability or cost paid to transfer the liability | | | |
| | Could be presented net or gross | | | |
| Interest expense | At historical rates, updated if the liability bears variable interest | At current rates | Already included in fair value changes, could be identified separately | Already included in changes in fulfilment value, could be identified separately |
| Effect of events that cause a liability to become onerous | Expenses = estimated cash outflows *minus* historical cost of the liability | Expenses = estimated cash outflows *minus* current cost of the liability | Already included in fair value changes, could be identified separately | Already included in changes in fulfilment value, could be identified separately |
| Value changes | None, to the extent that the liability is onerous.<br>Financial liabilities – effect of changes in estimated cash flows is an income or expense | Effect of change in prices is income or expense | Already included in fair value changes | Already included in changes in fulfilment value |

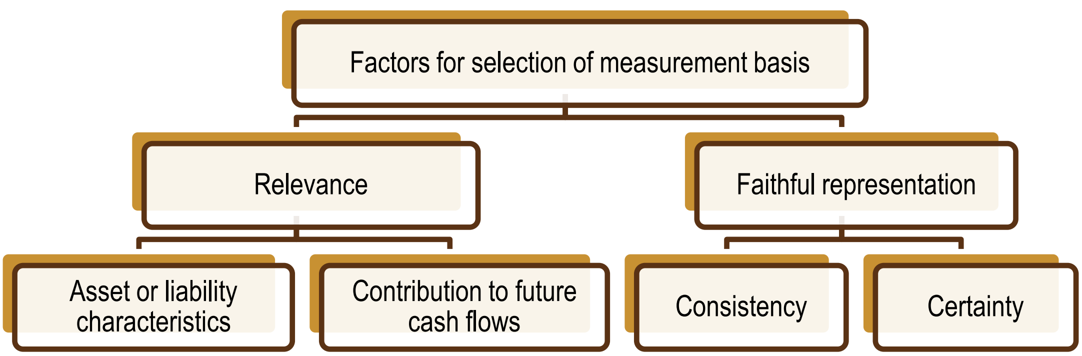
## 7.3 FACTORS TO CONSIDER WHEN SELECTING A MEASUREMENT BASIS FOR INITIAL RECOGNITION AND SUBSEQUENT MEASUREMENT OF AN ASSET OR A LIABILITY

In section 7.2, we have discussed the information that various measurement basis will produce in both the balance sheet and the statement of profit and loss. While selecting a measurement basis, it is necessary to consider such information.

Additionally, certain other factors must also be considered while selecting a measurement basis for initial recognition and subsequent measurement and this section 7.3 focuses on the same. Section 7.4 will focus on certain additional factors to be considered when selecting measurement basis for initial measurement only.

In most cases, no single factor will determine which measurement basis should be selected. The relative importance of each factor will depend on facts and circumstances. As discussed in Unit 3, the information provided by a measurement basis must be useful to users of financial statements. To achieve this, the information must be relevant and it must faithfully represent what it purports to represent. In addition, the information provided should be, as far as possible, comparable, verifiable, timely and understandable.

The following chart lays down the overall scheme of factors relevant for selection of measurement basis, besides the information provided by the same:



## 7.3.1 Relevance

### 7.3.1.1 Characteristics of the asset or liability

The relevance of information provided by a measurement basis depends partly on the characteristics of the asset or liability, in particular, on:

- Variability of cash flows, and
- Sensitivity of the value of the asset or liability to market factors or other risks

*Asset or liability carried at historical cost*

If the value of an asset or liability is sensitive to market factors or other risks, its historical cost might differ significantly from its current value and hence may not provide relevant information if information about changes in value is important to users of financial statements.

As an example, amortised cost cannot provide relevant information about a financial asset or financial liability that is a derivative.

Furthermore, if historical cost is used, changes in value are reported not when that value changes, but when an event such as disposal, impairment or fulfilment occurs. This could be incorrectly interpreted as implying that all the income and expenses recognised at the time of that event arose then, rather than over the periods during which the asset or liability was held.

Moreover, because measurement at historical cost does not provide timely information about changes in value, income and expenses reported on that basis may lack predictive value and confirmatory value by not depicting the full effect of the entity's exposure to risk arising from holding the asset or liability during the reporting period.

*Asset or liability carried at fair value*

Changes in the fair value of an asset or liability reflect changes in expectations of market participants and changes in their risk preferences. Depending on the characteristics of the asset or liability being measured and on the nature of the entity's business activities, information reflecting those changes may not always provide predictive value or confirmatory value to users of financial statements. This may be the case when the entity's business activities do not involve selling the asset or transferring the liability.

As an example, if the entity holds assets solely for use or solely for collecting contractual cash flows or if the entity is to fulfil liabilities itself, information reflecting changes in the fair value of an asset or liability may not always provide predictive value or confirmatory value to users of financial statements.

#### 7.3.1.2 Contribution to future cash flows

How economic resources are used, and hence how assets and liabilities produce cash flows, depends in part on the nature of the business activities conducted by the entity.

When a business activity of an entity involves the use of several economic resources that produce cash flows indirectly, by being used in combination to produce and market goods or services to customers, historical cost or current cost is likely to provide relevant information about that activity.

For example, property, plant and equipment is typically used in combination with an entity's other economic resources. Similarly, inventory typically cannot be sold to a customer, except by making extensive use of the entity's other economic resources (for example, in production and marketing activities). Paragraphs 6.24–6.31 and 6.40–6.42 of the Conceptual Framework explain how measuring such assets at historical cost or current cost can provide relevant information that can be used to derive margins achieved during the period.

For assets and liabilities that produce cash flows directly, such as assets that can be sold independently and without a significant economic penalty (for example, without significant business disruption), the measurement basis that provides the most relevant information is likely to be a current value that incorporates current estimates of the amount, timing and uncertainty of the future cash flows.

As discussed in more detail in the chapter on financial instruments, when a business activity of an entity involves managing financial assets and financial liabilities with the objective of collecting contractual cash flows, amortised cost may provide relevant information that can be used to derive the margin between the interest earned on the assets and the interest incurred on the liabilities. However, in assessing whether amortised cost will provide useful information, it is also necessary to consider the characteristics of the financial asset or financial liability. Amortised cost is unlikely to provide relevant information about cash flows that depend on factors other than principal and interest.

### 7.3.2 Faithful representation

#### 7.3.2.1 Consistency

When assets and liabilities are related in some way, using different measurement bases for those assets and liabilities can create a measurement inconsistency (accounting mismatch). If financial statements contain measurement inconsistencies, those financial statements may not faithfully represent some aspects of the entity's financial position and financial performance.

Therefore, when the cash flows from one asset or liability are directly linked to the cash flows from another asset or liability, using the same measurement basis for related assets and liabilities may provide users of financial statements with information that is more useful than the information that would result from using different measurement bases. This may be particularly likely when the cash flows from one asset or liability are directly linked to the cash flows from another asset or liability.

### 7.3.2.2 Certainty

When a measure cannot be determined directly by observing prices in an active market and must instead be estimated, measurement uncertainty arises. The level of measurement uncertainty associated with a particular measurement basis may affect whether information provided by that measurement basis provides a faithful representation of an entity's financial position and financial performance. A high level of measurement uncertainty does not necessarily prevent the use of a measurement basis that provides relevant information. However, in some cases the level of measurement uncertainty is so high that information provided by a measurement basis might not provide a sufficiently faithful representation. In such cases, it is appropriate to consider selecting a different measurement basis that would also result in relevant information.

Measurement uncertainty is different from both outcome uncertainty and existence uncertainty, but their presence may sometimes contribute to measurement uncertainty.

(a) outcome uncertainty arises when there is uncertainty about the amount or timing of any inflow or outflow of economic benefits that will result from an asset or liability.

(b) existence uncertainty arises when it is uncertain whether an asset or a liability exists.

The presence of outcome uncertainty or existence uncertainty may sometimes contribute to measurement uncertainty. However, outcome uncertainty or existence uncertainty does not necessarily result in measurement uncertainty. For example, if the fair value of an asset can be determined directly by observing prices in an active market, no measurement uncertainty is associated with the measurement of that fair value, even if it is uncertain how much cash the asset will ultimately produce and hence there is outcome uncertainty.

**Illustration 1: Derecognition vs. Faithful Representation**

*As at 31st March 20X2, Natasha Ltd. carried trade receivables of ₹ 280 crores in its balance sheet. At that date, Natasha Ltd. entered into a factoring agreement with Samantha Ltd., a financial institution, according to which it transferred the trade receivables in exchange for an immediate cash payment of ₹ 250 crores. As per the factoring agreement, any shortfall between the amount collected and ₹ 250 crores will be reimbursed by Natasha Ltd. to Samantha Ltd. Once the trade* *receivables have been collected, any amounts above ₹ 250 crores, less interest on this amount, will be repaid to Natasha Ltd. The directors of Natasha Ltd. are of the opinion that the trade receivables should be derecognized.*

*You are required to explain the appropriate accounting treatment of this transaction in the financial statements for the year ending 31st March 20X2, and also evaluate this transaction in the context of the Conceptual Framework.*

**Solution:**

**Accounting Treatment:**

Trade Receivables fall within the ambit of financial assets under Ind AS 109, Financial Instruments. Thus, the issue in question is whether the factoring arrangement entered into with Samantha Ltd. requires Natasha Ltd. to derecognize the trade receivables from its financial statements.

As per Para 3.2.3, 3.2.4, 3.2.5 and 3.2.6 of Ind AS 109, Financial Instruments, an entity shall derecognise a financial asset when, and only when:

(a) the contractual rights to the cash flows from the financial asset expire, or

(b) it transfers the financial asset or substantially all the risks and rewards of ownership of the financial asset to another party.

In the given case, since the trade receivables are appearing in the Balance Sheet of Natasha Ltd. as at 31st March 20X2 and are expected to be collected, the contractual rights to the cash flows have not expired.

As far as the transfer of the risks and rewards of ownership is concerned, the factoring arrangement needs to be viewed in its substance, rather than its legal form. Natasha Ltd. has transferred the receivables to Samantha Ltd. for cash of ₹ 250 crores, and yet, it remains liable for making good any shortfall between ₹ 250 crores and the amount collected by Samantha Ltd. Thus, in substance, Natasha Ltd. is effectively liable for the entire ₹ 250 crores, although the shortfall would not be such an amount. Accordingly, Natasha Ltd. retains the credit risk despite the factoring arrangement entered.

It is also explicitly stated in the agreement that Samantha Ltd. would be liable to pay to Natasha Ltd. any amount collected more than ₹ 250 crores, after retaining an amount towards interest. Thus, Natasha Ltd. retains the potential rewards of full settlement.

A perusal of the above clearly shows that substantially all the risks and rewards continue to remain with Natasha Ltd., and hence, the trade receivables should continue to appear in the Balance

Sheet of Natasha Ltd. The immediate payment (i.e. consideration as per the factoring agreement) of ₹ 250 crores by Samantha Ltd. to Natasha Ltd. should be regarded as a financial liability, and be shown as such by Natasha Ltd. in its Balance Sheet.

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According to the Conceptual Framework, an asset should be derecognized when control of all, or part of an asset is lost.

As discussed in Section 6.3 above, in some cases, an entity might appear to transfer an asset or liability, but derecognition of that asset or liability is not appropriate. For example, if an entity has apparently transferred an asset but retains exposure to significant positive or negative variations in the amount of economic benefits that may be produced by the asset, then this sometimes indicates that the entity might continue to control that asset, which appears to be the case in the current scenario.

The accounting requirements for derecognition aim to faithfully represent both:

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

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

Meeting both the above requirements becomes difficult if there is only a part disposal of an asset, or there is a retention of some exposure to that asset. It is difficult to faithfully represent the legal form (which is, in this scenario, a decrease in trade receivables under the factoring arrangement) with the substance of retaining the corresponding risks and rewards.

In view of the difficulties in practical scenarios in meeting the two aims, the Conceptual Framework does not advocate the use of a control approach or a risk-and-rewards approach to derecognition in every circumstance.

As such, the treatment as per Ind AS 109, as well as the principles laid down in the Conceptual Framework do not appear to be in conflict with each other in this case.

**Illustration 2:**

*Explain the criteria in the Conceptual Framework for Financial Reporting for the recognition of an asset and discuss whether there are inconsistencies with the criteria in Ind AS 38, Intangible Assets.*

**Solution:**

The Conceptual Framework defines an asset as a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. Assets should be recognized if they meet the Conceptual Framework definition of an asset and such recognition provides users of financial statements with information that is useful (i.e. it is relevant as well as results in faithful representation). However, the criteria of a cost-benefit analysis always exists i.e. the benefits of the information must be sufficient to justify the costs of providing such information. The recognition criteria outlined in the Conceptual Framework allows for flexibility in the application in amending or developing the standards.

Para 8 of Ind AS 38, Intangible Assets defines an intangible asset as an identifiable non-monetary asset without physical substance. Further, Ind AS 38 defines an asset as a resource:

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

Furthermore, Para 21 of Ind AS 38 states that an intangible asset shall be recognised if, and only if:

(a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

(b) the cost of the asset can be measured reliably.

This requirement is applicable both in case of an externally acquired intangible asset or an internally generated intangible asset. The probability of expected future economic benefits must be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset. Further, as per Para 33 of Ind AS 38, the probability recognition criterion is always considered to be satisfied for intangible assets acquired in business combinations. If the recognition criteria are not satisfied, Ind AS 38 requires the expenditure to be expensed as and when it is incurred.

It is notable that the Conceptual Framework does not prescribe a 'probability criterion'. As long as there is a potential to produce economic benefits, even with a low probability, an item can be recognized as an asset according to the Conceptual Framework. However, in terms of intangible assets, it could be argued that recognizing an intangible asset having low probability of generating economic benefits would not be useful to the users of financial statements given that the asset has no physical substance.

The recognition criteria and definition of an asset under Ind AS 38 are different as compared to those outlined in the Conceptual Framework. To put in simple words, the criteria in Ind AS 38 are more specific, but definitely do provide information that is relevant and a faithful representation. When viewed from the prism of relevance and faithful representation, the requirements of Ind AS 38 in terms of recognition appear to be consistent with the Conceptual Framework. Further, in case of differences between conceptual framework and Ind AS, Ind AS would prevail.

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**Illustration 3:**

*The directors of Hind Ltd. are particular about the usefulness of the financial statements. They have opined that although Ind AS implement a fair value model, Ind AS are failing in reflecting the usefulness of the financial statements as they do not reflect the financial value of the entity.*

*Discuss the views of the directors as regards the use of fair value in Ind AS and the fact that the Ind AS do not reflect the financial value of an entity, making special reference to relevant Ind AS and the Conceptual Framework.*

**Solution:**

Usage of Fair Value in Ind AS:

*Treatment under Ind AS:*

The statement of the directors regarding Ind AS implementing a fair value model is not entire accurate. Although Ind AS do use fair value (and present value), it is not a complete fair value system. Ind AS are often based on the business model of the entity and on the expectations of realizing the asset- and liability-related cash flows through operations and transfers.

It is notable that what is preferred is a mixed measurement system, with some items being measured at fair value while others measured at historical cost.

*About Fair Value (Ind AS 113)*

Ind AS 113 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This price is an exit price.

Ind AS 113 has given consistency to the definition and application of fair value, and this consistency is applied across other Ind AS, which are generally required to measure fair value in accordance with Ind AS 113. However, it cannot be implied that Ind AS requires all assets and liabilities to be measured at fair value. Rather, many entities measure most items at depreciated historical costs, although the exception being in the case of business combinations, where assets and liabilities are recorded at fair value on the date of acquisition. In other cases, usage of fair value is restricted.

Examples of use of fair value in Ind AS:

(a) Ind AS 16 Property, Plant and Equipment permits revaluation through other comprehensive income, provided it is carried out regularly.

(b) Disclosure of fair value of Investment Property in Ind AS 40, while the companies account for the same under the cost model.

(c) Ind AS 38 Intangible Assets allows measurement of intangible assets at fair value with corresponding changes in equity, but only if the assets can be measured reliably by way of existence of an active market for them.

(d) Ind AS 109 Financial Instruments requires some financial assets and liabilities to be measured at amortized cost and others at fair value. The measurement basis is largely determined by the business model for that financial instrument. Where the financial instruments are carried at fair value, depending on the category and circumstances, the movement in the fair value (gain or loss) is either recognized in profit or loss or in other comprehensive income.

*Financial value of an entity*

Although Ind AS makes use of fair values in the measurement of assets and liabilities, the financial statements prepared under Ind AS are not intended to reflect the aggregate value of the entity, as could be the notion among people. As discussed in 2.2 above, the Conceptual Framework specifically states that general purpose financial statements are not intended to show the value of a reporting entity. Furthermore, such an attempt would not be fruitful as certain internally generated intangible assets cannot be recognized under Ind AS. Instead, the objective of general purpose financial reports is to provide financial information about the reporting entity which would be useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

It is only in the case of acquisition of an entity by another entity and subsequent consolidation in group accounts that an entity's net assets are reported at fair value.

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### 7.3.3 Implications of enhancing qualitative characteristics for the selection of measurement basis

As per Section 3.1.4, the usefulness of financial information is enhanced by applying four enhancing qualitative characteristics – comparability, verifiability, timeliness and understandability. Of these, timeliness has no specific implications for measurement. Let's briefly discuss the implications of the other three:

***Comparability***: Consistently using the same measurement bases for the same items, either from period to period within a reporting entity or in a single period across entities, can help make financial statements more comparable. A change in measurement basis can make financial statements less understandable. However, a change may be justified if other factors outweigh the reduction in understandability, for example, if the change results in more relevant information. If a change is made, users of financial statements may need explanatory information to enable them to understand the effect of that change.

***Understandability***: Understandability depends partly on how many different measurement bases are used and on whether they change over time. In general, if more measurement bases are used in a set of financial statements, the resulting information becomes more complex and, hence, less understandable and the totals or subtotals in the balance sheet and the statement of profit and loss become less informative. However, it could be appropriate to use more measurement bases if that is necessary to provide useful information.

***Verifiability***: Verifiability is enhanced by using measurement bases that result in measures that can be independently corroborated either directly, for example, by observing prices, or indirectly, for example, by checking inputs to a model. If a measure cannot be verified, users of financial statements may need explanatory information to enable them to understand how the measure was determined. In some such cases, it may be necessary to specify the use of a different measurement basis.

## 7.4 FACTORS SPECIFIC TO INITIAL MEASUREMENT OF AN ASSET OR A LIABILITY

As a general principle, the entities should use the same measurement basis for initial recognition and subsequent measurement. Let's look at the two possible scenarios of "at-market" transactions and "off-market" transactions.

### 7.4.1 Transactions on market terms

*Transactions using currency (i.e. cash):*

At initial recognition, the cost of an asset acquired, or of a liability incurred is normally similar to its fair value at that date, unless transaction costs are significant. Therefore, whether historical cost or current value is used as a measurement basis subsequently, the same basis is also normally appropriate at initial recognition.

*Exchange of asset or liability*

When an entity acquires an asset, or incurs a liability, in exchange for transferring another asset or liability, the initial measure of the asset acquired, or the liability incurred, determines whether any income or expenses arise from the transaction.

For example, if the asset transferred is carried for ₹ 100 in the books and the asset acquired is initially measured at fair value (because it is subsequently measured at fair value), of say ₹ 120, the difference of ₹ 20 is recognised in statement of profit and loss as an income. The reverse will apply for a liability.

Continuing with the example above, if the asset acquired is subsequently measured at cost, no income or expenses arise at initial recognition since the asset acquired is initially measured at cost which is the fair value of the asset transferred i.e. given up, unless income or expenses arise from the derecognition of the transferred asset or liability, or unless the asset is impaired or the liability is onerous.

### 7.4.2 Transactions not on market terms (or off-market transactions)

Assets may be acquired, or liabilities may be incurred, as a result of an event that is not a transaction on market terms. For example:

(a) the transaction price may be affected by relationships between the parties;

(b) an asset may be granted to the entity free of charge by a government or

(c) an asset may be donated to the entity by another party;

(d) a liability may be imposed by legislation or regulation; or

(e) a liability to pay compensation or a penalty may arise from an act of wrongdoing.

In such cases, measuring the asset acquired, or the liability incurred, at its historical cost may not provide a faithful representation of the entity's assets and liabilities and of any income or expenses arising from the transaction or other event. Hence, it may be appropriate to measure the asset acquired, or the liability incurred, at deemed cost. In some such cases, a current value of the asset or liability is used as a deemed cost on initial recognition and that deemed cost is then used as a starting point for subsequent measurement at historical cost. Any difference between that deemed cost and any consideration given or received would be recognised as income or expenses at initial recognition.

**Example 9**

If a parent provides an interest free loan to its subsidiary, it is an off-market transaction. The loan, in parent's books, should be initially measured at its fair value and the difference between the loan given and its fair value should be appropriately accounted for (refer Ind AS 109).

When assets are acquired, or liabilities incurred, as a result of an event that is not a transaction on market terms, all relevant aspects of the transaction or other event need to be identified and considered. For example, it may be necessary to recognise other assets, other liabilities, contributions from holders of equity claims or distributions to holders of equity claims to faithfully represent the substance of the effect of the transaction or other event on the entity's financial position and any related effect on the entity's financial performance.

In the example given above, the difference shall be accounted for as an equity contribution (classified as "investments") in the books of the parent.

## 7.5 MORE THAN ONE MEASUREMENT BASIS

In some cases, consideration of the factors described in sections 7.3 and 7.4 above may lead to the conclusion that more than one measurement basis is needed for an asset or liability and for related income and expenses in order to provide relevant information that faithfully represents both the entity's financial position and its financial performance.

In most cases, the most understandable way to provide that information is:

(a) to use a single measurement basis both for the asset or liability in the balance sheet and for related income and expenses in the statement of profit and loss ; and

(b) to provide in the notes additional information applying a different measurement basis.

However, in some cases, that information is more relevant, or results in a more faithful representation of both the entity's financial position and its financial performance, through the use of:

(a) a current value measurement basis for the asset or liability in the balance sheet; and

(b) a different measurement basis for the related income and expenses in the profit or loss section of statement of profit and loss

**Example 10**

An entity may choose to measure an interest bearing financial asset at fair value through other comprehensive income. In this case, the total fair value change is separated and classified so that:

(a) the profit or loss section of statement of profit and loss includes the interest income applying the amortised cost as the measurement basis; and

(b) other comprehensive income includes all the remaining fair value changes.

For more details on the principles used in this example, refer to chapter on financial instruments.

Therefore, the principle for all such cases is stated as below:

The total income or total expenses arising in the period from the change in the current value of the asset or liability is separated and classified so that:

(a) the profit or loss section of statement of profit and loss includes the income or expenses measured applying the measurement basis selected for that statement; and

(b) other comprehensive income includes all the remaining income or expenses.

As a result, the accumulated other comprehensive income related to that asset or liability equals the difference between:

(1) the carrying amount of the asset or liability in the balance sheet; and

(2) the carrying amount that would have been determined applying the measurement basis selected for the profit or loss section of statement of profit and loss.

## 7.6 MEASUREMENT OF EQUITY

The total carrying amount of equity (total equity) is not measured directly. It equals the total of the carrying amounts of all recognised assets less the total of the carrying amounts of all recognised liabilities.

*What 'equity' in the financial statements does not represent?*

The general purpose financial statements are not designed to show an entity's value. Hence, the total carrying amount of equity will not generally equal:

(a) the aggregate market value of equity claims on the entity;

(b) the amount that could be raised by selling the entity as a whole on a going concern basis; or

(c) the amount that could be raised by selling all of the entity's assets and settling all of its liabilities.

Although total equity is not measured directly, it may be appropriate to measure directly the carrying amount of some individual classes of equity and some components of equity. Nevertheless, because total equity is measured as a residual, at least one class of equity cannot be measured directly. Similarly, at least one component of equity cannot be measured directly.

The total carrying amount of an individual class of equity or component of equity is normally positive but can be negative in some circumstances. Similarly, total equity is generally positive, but it can be negative, depending on which assets and liabilities are recognised and on how they are measured.

# UNIT 8
# PRESENTATION AND DISCLOSURE

A reporting entity communicates information about its assets, liabilities, equity, income and expenses by presenting and disclosing information in its financial statements.

## 8.1 PRESENTATION AND DISCLOSURE OBJECTIVES AND PRINCIPLES

To facilitate effective communication of information in financial statements, when developing presentation and disclosure requirements in Ind ASs a balance is needed between:

(a) giving entities the flexibility to provide relevant information that faithfully represents the entity's assets, liabilities, equity, income and expenses; and

(b) requiring information that is comparable, both from period to period for a reporting entity and in a single reporting period across entities.

Effective communication in financial statements is also supported by considering the following principles:

(a) entity-specific information is more useful than standardised descriptions; and

(b) duplication of information in different parts of the financial statements is usually unnecessary and can make financial statements less understandable.

## 8.2 CLASSIFICATION

Classification is the sorting of assets, liabilities, equity, income or expenses on the basis of shared characteristics for presentation and disclosure purposes. Such characteristics include — but are not limited to — the nature of the item, its role (or function) within the business activities conducted by the entity, and how it is measured.

Classifying dissimilar assets, liabilities, equity, income or expenses together can obscure relevant information, reduce understandability and comparability and may not provide a faithful representation of what it purports to represent.

## 8.2.1 Classification of assets and liabilities

Classification is applied to the unit of account selected for an asset or liability. However, it may sometimes be appropriate to separate an asset or liability into components that have different characteristics and to classify those components separately. That would be appropriate when classifying those components separately would enhance the usefulness of the resulting financial information. For example, it could be appropriate to separate an asset or liability into current and non-current components and to classify those components separately.

## 8.2.2 Offsetting

Offsetting occurs when an entity recognises and measures both an asset and liability as separate units of account, but groups them into a single net amount in the balance sheet. Offsetting classifies dissimilar items together and therefore is generally not appropriate.

Offsetting assets and liabilities differs from treating a set of rights and obligations as a single unit of account.

## 8.2.3 Classification of equity

To provide useful information, it may be necessary to classify equity claims separately if those equity claims have different characteristics.

Similarly, to provide useful information, it may be necessary to classify components of equity separately if some of those components are subject to particular legal, regulatory or other requirements. For example, in some jurisdictions, an entity is permitted to make distributions to holders of equity claims only if the entity has sufficient reserves specified as distributable. Separate presentation or disclosure of those reserves may provide useful information.

## 8.2.4 Classification of income and expenses

Classification is applied to:

(a) income and expenses resulting from the unit of account selected for an asset or liability; or

(b) components of such income and expenses if those components have different characteristics and are identified separately. For example, a change in the current value of an asset can include the effects of value changes and the accrual of interest (see tables in section 7.2). It would be appropriate to classify those components separately if doing so would enhance the usefulness of the resulting financial information.

### 8.2.5 Profit or loss and other comprehensive income

Income and expenses are classified and included either:

(a) in the profit or loss section of statement of profit and loss; or

(b) outside the profit or loss section of statement of profit and loss, in other comprehensive income.

Because the profit or loss section of statement of profit and loss is the primary source of information about an entity's financial performance for the period, all income and expenses are, in principle, included in that statement. However, in formulating Ind AS, the ICAI may decide in exceptional circumstances that income or expenses arising from a change in the current value of an asset or liability are to be included in other comprehensive income when doing so would result in the profit or loss section of statement of profit and loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that period.

In principle, income and expenses included in other comprehensive income in one period are reclassified from other comprehensive income into the profit or loss section of statement of profit and loss in a future period when doing so results in the profit or loss section of statement of profit and loss providing more relevant information or providing a more faithful representation of the entity's financial performance for that future period. However, if, for example, there is no clear basis for identifying the period in which reclassification would have that result, or the amount that should be reclassified, the ICAI may, in formulating Ind AS, decide that income and expenses included in other comprehensive income are not to be subsequently reclassified.

## 8.3 AGGREGATION

Aggregation is adding together of assets, liabilities, equity, income or expenses that have shared characteristics and are included in the same classification.

Aggregation makes information more useful by summarising a large volume of detail. However, aggregation conceals some of that detail. Hence, a balance needs to be found so that relevant information is not obscured either by a large amount of insignificant detail or by excessive aggregation.

Different levels of aggregation may be needed in different parts of the financial statements. For example, typically, the balance sheet and the statement of profit and loss provide summarised information and more detailed information is provided in the notes.

**Illustration 4:**

*Everest Ltd. is a listed company having investments in various subsidiaries. In its annual financial statements for the year ending 31st March 20X2 as well as 31st March 20X3, Everest Ltd. classified Kanchenjunga Ltd. a subsidiary as 'held-for-sale' and presented it as a discontinued operation. On 1st November 20X1, the shareholders had authorized the management to sell all of its holding in Kanchenjunga Ltd. within the year. In the year to 31st March 20X2, the management made a public announcement of its intention to sell the investment but did not actively try to sell the subsidiary as it was still operational within the Everest group.*

*Certain organizational changes were made by Everest Ltd. during the year to 31st March 20X3, thereby resulting in additional activities being transferred to Kanchenjunga Ltd. Additionally, during the year ending 31st March 20X3, there had been draft agreements and some correspondence with investment bankers, which showed in principle only that Kanchenjunga was still for sale.*

*Discuss whether the classification of Kanchenjunga Ltd. as held for sale and its presentation as a discontinued operation is appropriate, by referring to the principles of the relevant Ind AS and evaluating the treatment in the context of the Conceptual Framework for Financial Reporting.*

**Solution:**

Kanchenjunga Ltd. is a disposal group in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations. Disposal group can be defined as a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

Para 6 of Ind AS 105 provides that a disposal group shall be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. Ind AS 105 is particularly strict as far as the application of held for sale criteria is concerned, and often the decision to sell an asset or a disposal group is made well before the criteria are met.

Thus, as per Ind AS 105, for the asset (or disposal group) to be classified as held for sale, it must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable.

For the sale to be highly probable:

- The appropriate level of management must be committed to a plan to sell the asset (or disposal group).
- An active programme to locate a buyer and complete the plan must have been initiated.

- The asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.
- The sale should be expected to qualify for recognition as a completed sale within one year from the date of classification.
- It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

In the given case, the draft agreements and correspondence with investment bankers are not specific enough to fit in the points above to prove that the criteria for held for sale was met at that date. Additional information would be needed to confirm that the subsidiary was available for immediate sale, and that it was being actively marketed at an appropriate price so as to satisfy the criteria in the year to 31st March 20X2.

Further, the organizational changes made by Everest Ltd. in the year 20X2-20X3 are a good indicator that Kanchenjunga Ltd. was not available for immediate sale in its present condition at the point of classification. The fact that additional activities have been given to Kanchenjunga Ltd. indicate that the change wasn't insignificant. The shareholders had authorized for a year from 1st November 20X1. There is no evidence that this authorization extended beyond 1st November 20X2.

**Conclusion:**

Based on the information provided in the given case, it appears that Kanchenjunga Ltd. should not be classified by Everest Ltd. as a subsidiary held for sale. Instead, the results of the subsidiary should be reported as a continuing operation in the financial statements for the year ending 31st March 20X2 and 31st March 20X3.

**Evaluation of treatment in context of the Conceptual Framework**

The Conceptual Framework states that the users need information to allow them to assess the amount, timing and uncertainty of the prospects for future net cash inflows. Highlighting the results of discontinued operations separately equips users with the information that is relevant to this assessment as the discontinued operation will not contribute to cash flows in the future.

If a company has made a firm decision to sell the subsidiary, it could be argued that the subsidiary should be classified as discontinued operation, even if the criteria to classify it as 'held for sale' as per Ind AS 105 have not been met, because this information would be more useful to users. However, Ind AS 105 criteria was developed with high degree of strictness on classification. Accordingly, this decision could be argued to be in conflict with the Conceptual Framework.

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# UNIT 9 CONCEPTS OF CAPITAL AND CAPITAL MAINTENANCE

## 9.1 CONCEPTS OF CAPITAL

**Concepts of capital**

- **Financial concept**
  [Invested money / purchasing power]
  *Net assets or Equity*
- **Physical concept**
  [Operating capability]
  *Productive capacity*

The selection of the appropriate concept of capital by an entity 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 entity, 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.

## 9.2 CONCEPTS OF CAPITAL MAINTENANCE AND THE DETERMINATION OF PROFIT

The concept of capital maintenance is concerned with how an entity 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. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

There are two concepts of capital maintenance:

- 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.
- Physical capital maintenance: Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) 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 principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity.

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

## 9.3 CAPITAL MAINTENANCE ADJUSTMENTS

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

**Example 11**

A trader commenced business on 1.1.20X1 with ₹ 12,000 represented by 6,000 units of a certain product at ₹ 2 per unit. During the year 20X1, he sold these units at ₹ 3 per unit and had withdrawn ₹ 6,000. Thus:

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

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

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

The trader can start year 20X2 by purchasing 6,000 units at ₹ 2 per unit once again for selling them at ₹ 3 per unit. The whole process can repeat endlessly if there is no change in purchase price of the product.

**Example 12**

In the previous example, suppose that the average price indices at the beginning and at the end of year are 100 and 120 respectively.

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

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

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

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

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

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

**Example 13 (Physical Capital Maintenance)**

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

Current cost of opening stock = (₹ 12,000 / 100) x 125 = 6,000 x ₹ 2.50 = ₹ 15,000

Closing cash after adjustment of stock at current costs = ₹ 9,000 [(₹ 6,000 x 2.5) – ₹ 6,000]

Opening equity at closing current costs = ₹ 15,000

Closing equity at closing current costs = ₹ 9,000

Retained Profit = ₹ 9,000 – ₹ 15,000 = (-) ₹ 6,000

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund ₹ 9,000 is not sufficient to buy 6,000 units again at increased price ₹ 2.50 per unit. There should not be any drawings in the year.

Had the trader withdrawn nothing during the year instead of ₹ 6,000, he would have left with ₹ 15,000, the fund required to buy 6,000 units at ₹ 2.50 per unit.

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

**Financial Capital Maintenance at historical costs**

| | ₹ | ₹ |
|---|---|---|
| Closing Capital (at historical cost) | | 12,000 |
| *Less*: Capital to be maintained | | |
| Opening capital (At historical cost) | 12,000 | |
| Introduction (At historical cost) | NIL | (12,000) |
| Retained profit | | 12,000 |

**Financial Capital Maintenance at current purchasing power:**

| | ₹ | ₹ |
|---|---|---|
| Closing Capital (at closing price) | | 12,000 |
| *Less*: Capital to be maintained | | |
| Opening capital (at closing price) | 14,400 | |
| Introduction (at closing price) | NIL | (14,400) |
| Retained profit | | (2,400) |

**Physical Capital Maintenance:**

| | ₹ | ₹ |
|---|---|---|
| Closing Capital (at current cost) | | 9,000 |
| *Less*: Capital to be maintained | | |
| Opening capital (at current cost) | 15,000 | |
| Introduction (at current cost) | NIL | (15,000) |
| Retained profit | | (6,000) |

# TEST YOUR KNOWLEDGE

## Questions

1. The directors of Jayant Ltd. have received the following email from its majority shareholder:

   To: Directors of Jayant Ltd.

   Re: Measurement

   I recently read an article published in the financial press about the 'mixed measurement approach' that is used by lots of companies. I hope Jayant Ltd. does not follow such an approach because 'mixed' seems to imply 'inconsistent'. I believe that consistency is of paramount importance, and hence feel it would be better to measure everything in a uniform manner. It would be appreciated if you could provide further information at the next annual general meeting on measurement bases, covering what approach is taken by Jayant Ltd. and why, and the potential effect such an approach has on the investors trying to analyse the financial statements.

   Prepare notes for the directors of Jayant Ltd. to discuss the issue raised in the shareholders' email with reference to the Conceptual Framework wherever appropriate.

2. Defense Innovators Limited is a public sector undertaking and is engaged in the construction of warships and submarines. XYZ Private Limited approached Defense Innovators Limited for construction of "specially designed" ships for it, which will be used by XYZ Private Limited for transportation of specific goods. The offer was accepted by the Defense Innovators Limited and both the companies entered into an agreement for the construction and delivery of 3 specially designed ships on 'Fixed Price' basis with variable component in respect to certain items.

   Base and depot (B & D) spares for all three ships shall be procured by Defense Innovators Limited and will be paid on the cost of the item with certain percentage.

   The contract states that "certain equipment" out of variable cost items, will be supplied by XYZ Private Limited at 'free of cost' for installation on board of ship. It is, therefore, to be noted as under:

   (i) Some equipment are procured by Defense Innovators Limited in the presence of the XYZ Private Limited's representative for technical scrutiny as well as negotiating the prices. The vendors of these equipment are paid by Defense Innovators Limited. The cost of the equipment along with the cost of installation and profit thereon is claimed and reimbursed by XYZ Private Limited to Defense Innovators Limited.

(ii) There are certain other equipment for which orders are directly placed and also paid by the XYZ Private Limited. These equipment are known as 'Buyer Furnished Equipment (BFE)' and are delivered to the company 'free of cost' for installing in the ship. The labour cost of Installation of these are already included in the price component of the contract. BFEs are returned to the buyer after completion of the ship.

The period required for construction of one ship was approximately four years.

Whether the cost of Buyer Furnished Equipment's (BFE's) supplied by XYZ Private Limited to Defense Innovators Limited for-installing the same in the ships can be considered as 'inventory' by Defense Innovators Limited and then on delivery of ship will be recognised as revenue in its books of account? Elaborate.

## Answers

**1.** 'Mixed measurement' approach implies that a company selects different measurement bases (e.g. historical cost or fair value) for its various assets and liabilities, rather than using one single measurement basis for all items. The measurement basis so selected should reflect the type of entity and the sector in which it operates and the business model that the entity adopts.

There are criticisms of the mixed measurement approach, particularly under the IFRS regime, because investors think that if different measurement bases are used for assets and liabilities, the resulting figures could lack relevance or exhibit little meaning.

It is however important to note that figures of items in the financial statements cannot be derived by following a one-size-fits-all approach. Such an approach may not provide relevant information to users. A particular measurement basis may be easier to understand, more verifiable and less costly to implement. Therefore, to state that 'mixed measurement' approach is 'inconsistent' is a poor argument. A mixed approach may actually provide more relevant information to the stakeholders.

The Conceptual Framework confirms the allowance of the usage of a mixed measurement approach in developing standards. The measurement methods included in the standards are those which the standard-setters believe provide the most relevant information and which most faithfully represent the underlying transaction or event. Based on the reactions to the convergence to Ind AS, it feels that most investors feel this approach is consistent with their analysis of financial statements. Thus, the arguments against a mixed measurement are far outweighed by the greater relevance achieved by such measurement bases.

Jayant Ltd. prepares its financial statements under Ind AS, and therefore applies the measurement bases permitted in Ind AS. Ind AS adopt a mixed measurement basis, which includes current value (fair value, value in use, fulfilment value and current cost) and historical cost.

Where an Ind AS allows a choice of measurement basis, the directors of Jayant Ltd. must exercise judgment as to which basis will provide the most useful information for its primary users. Furthermore, when selecting a measurement basis, measurement uncertainty should also be considered. The Conceptual Framework states that for some estimates, a high level of measurement uncertainty may outweigh other factors to such an extent that the resulting information may be of little relevance.

2. Before any item can be recognised as an inventory, it should meet the definition of 'asset' as given in the Conceptual Framework for Financial Reporting under Ind AS, issued by the Institute of Chartered Accountants of India as follows:

"An asset is a present economic resource controlled by the entity as a result of past events and economic resource is a right that has the potential to produce economic benefits".

The orders in respect of Buyer Furnished Equipment's (BFEs) are directly placed by the buyer and payment in respect of them is made by the buyer. These are then supplied to the company for installing in the ship and the buyer pays installation charges which are included in the contract price. Thus, the company has neither incurred any cost on BFEs nor any amount is recoverable on account of such equipment except installation charges. Accordingly, such equipment are not 'assets' that may be considered as a part of its contract work-in progress.

In fact, after installation in the ship, BFEs are returned to the buyer after completion of the ship. Thus, these are only held by the company in the capacity of a bailee. Since, it cannot be considered as an 'asset', therefore, it can neither be considered as 'inventory' nor as 'work-in-progress'.

Further, it can also not be considered as a part of sale value or revenue of the company as no consideration would be receivable with respect to the cost of such equipment.

On the basis of the above, it can be concluded that:

(i) The BFEs cannot be considered as inventories / Work-in-progress for Defense Innovators Limited.

(ii) The BFE's cost cannot be considered as part of sales value / contract revenue to Defense Innovators Limited.