Financial Reporting Framework

An Overview

Key Takeaways

- **Financial Statements Reporting Framework**
  - Objectives of Preparation and Presentation of Financial statements
  - External Users, their interest and dependence on FS
  - Importance of regulatory framework of financial reporting
  - Regulatory Framework in India

- **Schedule III of Companies Act to discuss adherence to framework – Heritage Foods Annual Report**

- **Accounting Standards Board (ASB) in India**
  - Accounting Standards – Meaning & Background
  - Objectives of Accounting Standards
  - Applicability of Accounting Standards
  - Examples of Accounting Standards and their Application

Key Takeaways

- **International Accounting Standards Board(IASB)**
  - Constitution and Background
  - Objectives of IASB
  - Advantages of IFRS adoption
  - Limitations and Challenges

- **Ind-AS**
  - Objective and Background
  - Applicability and Adoption

Financial Statements Reporting - Objective

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

Financial Statements Reporting - Users

External Users, their interest and dependence on FS

Investors

- Providers of risk capital in anticipation of returns
- Interested in information which enables them to assess the ability of the enterprise

Employees

- Employees and their representative groups interested the stability and profitability
- Assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities

Lenders

- Interested in information which enables them to determine Credit Worthiness and Repayment capabilities
- Assess the repayment track record and ability to service new loans

Financial Statements Reporting - Users

External Users, their interest and dependence on FS

User	Interest and dependence on FS
Trade Suppliers	• Interested in information which enables them to determine whether amounts owing to them will be paid when due
Customers	• Information about the continuance of an enterprise to manage dependencies
Government Agencies	• Interested in the allocation of resources and therefore, the activities of enterprises • In order to regulate the activities of enterprises, determine taxation policies etc.

Financial Statements Reporting

- **Performance = Profit & Loss Statement**
- **Financial Position = Balance Sheet**
- **Cash Position = Cash Flow Statement**

Financial Statements Reporting

Seems Fairly Simple !!

So, Where seems to be the Issue??

Financial Statements Reporting

Example: **Revenue Recognition**

In case of a company shipping Goods from the factory to a Client in Singapore, When should the revenue be recognized?

- On the Date of receipt of Order
- At Factory Gate on Dispatch
- On Delivery to the Shipping Transport company
- On receipt of goods by the customer
- On collection of payment from the customer

Financial Statements Reporting

Example: **Recognition of an Asset?**

Purchased a machinery by making a payment of INR 15,00,000 for the business on 29th March 2019 and received it on premises 3rd April 2019. Costs incurred for handling, Installation and Labour is INR 15,0000…

When do we recognize the asset?

What is the Value of asset recognized?

Financial Statements Reporting

What should be the treatment of Advance Rent paid for the next 12 months?

Financial Statements Reporting

<u>Importance of regulatory framework of financial reporting</u>

- Financial statements **<u>are the windows for the world</u>** into the operations of business enterprise
- Management of an enterprise has the responsibility for the preparation and presentation of its financial statements

However,

- The interests of Management and the stakeholders can be potentially divergent
- Inconsistency in Judgments and estimations
- Inherent utility for comparison requires uniform **<u>Reporting and Presentation Framework</u>**

Financial Statements Reporting

THE PROBLEM – Asymmetric Information

- Entrepreneurs have better information
- Entrepreneurs lack credibility because they have the incentives to be over optimistic

“Classic lemons” problem,

e.g., bad ideas “crowd out” good ideas and investors lose confidence in this market. Suppose, initially there are 50% good firms and 50% bad firms. Both the types claim high prospect for the next year. Investors fail to distinguish the two types and give them average credibility. For example, 50% credibility turns up correct because 50% told lies. This demotivates the good firms and they quit the market. The market now becomes full of ‘bad firms’. In turn, among the bad firms, relatively good ones lose credibility because of bad firms, and quit the market.

At the end, it turns up that firms do not deserve perfect credibility, that essentially leads to market break-down.

Financial Statements Reporting

Regulatory Framework in India

- The accountability of the company has two distinct aspects – Legal and Social. Under Legal obligations, the company has to submit certain information to the various users through annual report.
- The regulatory framework of financial reporting is very important in determination of the form and contents of financial statements.
- Out of the many factors, the following are the most prominent that contribute and determine the financial reporting in India are –
- Legal Requirements {Companies Act, 2013; Income Tax Act 1961 etc.)
- Reporting Framework; Accounting Standards and Guidance Notes issued by ASB, ICAI
- International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) issued by IASB
- Requirements by Stock Exchanges in case of Listed companies

Reporting Framework by ASB

The purpose of the Framework is to assist -

- Preparers of financial statements in applying Accounting Standards
- ASB in the development of future Accounting Standards and their review
- ASB in promoting harmonization of regulations, accounting standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Accounting Standards;
- Auditors in forming an opinion as to whether financial statements conform with Accounting Standards;
- Users of financial statements in interpreting the information contained in financial statements; and
- Provide those who are interested in the work of the Accounting Standards Board with information about its approach to the formulation of Accounting Standards.

Scope of the Conceptual Framework

- The Framework deals with:
  - the objective of financial statements;
  - the qualitative characteristics that determine the usefulness of information provided in financial statements;
  - definition, recognition and measurement of the elements from which financial statements are constructed; and
  - concepts of capital and capital maintenance.

- The Framework applies to the financial statements of all reporting enterprises engaged in commercial, industrial and business activities, whether in the public or in the private sector
- It however, does not over rule any specific regulations or accounting standards applicable

What are **‘accounting standards’**

Accounting Standards are written regulations/instructions issued by expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, treatment, presentation, and disclosure of accounting transactions in financial statements.

In India, the Accounting Standards are framed and issued by ASB under the authority of the Council of the ICAI.

ASB and accounting standards in India

- The main function of the ASB is to formulate Accounting Standards so that such standards may be established by the ICAI in India.

- The ICAI is a full-fledged member of the International Federation of Accountants (IFAC), is expected, inter alia, to facilitate global harmonization of accounting standards.

The Role of ASB –

- Is entrusted with the responsibility of propagating the Accounting Standards
- Persuading the concerned parties to adopt them in the preparation and presentation of financial statements.
- Provide interpretations and guidance on issues arising from Accounting Standards
- Review the Accounting Standards at periodical intervals and, if necessary, revise the same.

Applicability of Accounting Standards

- Accounting Standards as issued by ASB are applicable for all business entities having operations in India.
- However, the enterprises are classified and labeled as ***Level I, Level II and Level III*** enterprises. Applicability of Accounting standards is based on this classification
- No relaxation should be given to Level II and Level III enterprises in respect of <u>**recognition and measurement principles**</u>.
- Relaxations are provided with regard to <u>**disclosure requirements**</u>. Accordingly, Level II and Level III enterprises are fully exempted from certain accounting standards which primarily lay down disclosure requirements.

Applicability of Accounting Standards

Level I Enterprises (one or more)

- Enterprises whose **equity or debt securities are listed** whether in India or outside India
- Enterprises which are **in the process of listing** their equity or debt securities. Board of directors' resolution must be available as an evidence
- Banks including co-operative banks
- Financial institutions
- Enterprises carrying on insurance business
- All commercial, industrial and business reporting enterprises, whose turnover not including 'other income' for the immediately preceding accounting period on the basis of audited financial statements **exceeds Rs. 50 crore**
- All commercial, industrial and business reporting enterprises **having borrowings, including public deposits, in excess of Rs. 10 crores** at any time during the accounting period
- Holding and subsidiary enterprises of any one of the above at any time during the accounting period

Level II Enterprises (one or more)

- All commercial, industrial and business reporting enterprises, whose turnover (excluding 'other income') for the immediately preceding accounting period on the basis of audited financial statements **is greater than Rs. 40 lakhs but less than Rs. 50 crore**
- All commercial, industrial and business reporting enterprises having borrowings, including public deposits, **is greater Rs. 1 crore but less than Rs. 10 crores at any time during the accounting period**
- Holding and subsidiary enterprises of any one of the above at any time during the accounting period

Level III Enterprises:

Enterprises which do not fall under Level I and Level II, are considered as Level III enterprises

International Accounting Standards Board (IASB)

- IASB, a division within IFRS foundation develops and releases IFRS standards for public interest
- IASB was established in 2001, replacing the International Accounting Standards Committee (IASC). The IASC, which was established in 1973
- IASC issued 41 numbered standards, known as International Accounting Standards (IAS), as well as a framework for the preparation and presentation of financial statements.
- Those IAS continue to be in force to the extent they are not amended or withdrawn by the IASB
- New standards issued by IASB would be called International Financial Reporting Standards (IFRS)

IFRS – Scope and Objective

- IFRS aims to provide a common accounting language globally that can be used by the companies to prepare Balance Sheets and financial statements.
- IFRS accounting demands extensive disclosures about the company’s management and internal financial transactions
- **Not Mandatory** in application under Indian Regulatory Framework**.**
- **Requires adoption and convergence by companies for better disclosures, access to global markets.**
- Ind-AS is Indian version of ‘convergence with IFRS.

IFRS – Limitations and Challenges

- Regulatory and legal Challenges requiring changes in companies act 2013, Income Tax Act, 1961 etc.
- Clash of Fair Value Based Accounting Principle adopted by IFRS with conservative cost based principles of accounting adopted by AS
- Challenges on availability of trained professionals to handle migration, adoption and integration of accounting systems compliant with IFRS
- IFRS is more global and outward looking.. Suitable for companies have MNC vision in business plans.

IND-AS – Applicability & Adoption

- **Voluntary adoption:**
- For accounting periods beginning **on or after 1 April, 2015**. Once adopted, required to follow the same for all the subsequent financial statements.

- **Mandatory adoption:**
  - For companies based on their listing status and turnover criteria - **beginning on or after 1 April, 2016 (or) 1 April, 2017**
  - Insurance companies, banking companies and non-banking finance companies - **1 April, 2018**

- **Not Applicable**
  - Companies whose securities are listed or in the process of listing on SME exchanges (Exchanges meant for small and medium-sized enterprises).
  - Companies not covered by the roadmap in the 'Mandatory adoption' categories mentioned above.

Example of Convergence Gaps

Example: **Recognition of Value & Amortization of an Intangible Asset**

Should the expenditure incurred on creating a video advertisement featuring shah rukh khan be expensed or recognized as an asset?

Pepsi

Differences in IND AS 38 and AS 26

Differences in IND AS 38 and AS 26

Basis	Ind AS 38	AS 26
Definition	The requi rement of definition given by AS 26 has been removed from the definition	AS 26 defines an intangible asset as an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes
Revenue Based Amortisation Method	Ind AS 38 allows use of revenue based method of amortisation of intangible asset, in a limited way	AS 26 does not specifically deal that
Intangible assets acquired in Business Combination	Ind AS 38 deals in detail in respect of intangible assets acquired in a business combination	AS 26 refers only to intangible assets acquired in an amalgamation in the nature of purchase
Subsequent Expenditure on in Process Project	Ind AS 38 gives guidance for the treatment of such expenditure	AS 26 is silent regarding the treatment of subsequent expenditure
Useful Life of an Intangible Asset	Ind AS 38 does not define any rebuttable presumption	AS 26 define rebuttable presumption that the useful life cannot exceed ten years from the date the asset is available for use
Valuation Model as Accounting Policy	It standard allow an entity to choose either the cost or revaluation model as its accounting policy	Revaluation model is not permitted under AS 26
Contractual or Legal Rights may be Shorter than LegaL Life	Ind AS 38 acknowledges that the useful life of an intangible asset maybe shorter than the legal life	AS 26 does not include such a provision
Change in Method of Amortization:	This change consider as a accounting estimate	This change consider as a accounting policy