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CENTRE FOR DISTANCE AND ONLINE EDUCATION (CDOE)

NALSAR University of Law, Hyderabad

Reading Material

One Year Advanced Diploma in Financial Services & Legislations

1.2.4 FINANCIAL REPORTING & ANALYSIS

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Module I
Introduction to financial reporting and analysis

Introduction

Financial statements are prepared and presented for external users by many entities around the world. Although such financial statements may appear similar from country to country, there are differences which have probably been caused by a variety of social, economic and legal circumstances and by different countries having in mind the needs of different users of financial statements when setting national requirements. These different circumstances have led to the use of a variety of definitions of the elements of financial statements and also changes in the aspects of recognition, measurement, treatment, presentation, and disclosure of accounting transactions in financial statements *(for example, assets, liabilities, equity, income and expenses)*. They have also resulted in the use of different criteria for the recognition of items in the financial statements and in a preference for different bases of measurement. The scope of the financial statements and the disclosures made in them are also been affected.

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 –

1. Legal Requirements {Companies Act, 2013; Income Tax Act 1961 etc.)
2. Reporting Framework; Accounting Standards and Guidance Notes issued by ASB, ICAI
3. International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) issued by IASB
4. Requirements by Stock Exchanges in case of Listed companies

What is Accounting Standards Board (ASB)?

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.*

The ASB is entrusted with the responsibility of propagating the Accounting Standards and of persuading the concerned parties to adopt them in the preparation and presentation of financial statements. The ASB will provide interpretations and guidance on issues arising from Accounting Standards. The ASB will also review the Accounting Standards at periodical intervals and, if necessary, revise the same.

The main function of the ASB is to formulate Accounting Standards so that such standards may be established by the ICAI in India. While formulating the Accounting Standards, the ASB will take into consideration the applicable laws, customs, usages and business environment prevailing in India.

The ICAI is a full-fledged member of the International Federation of Accountants (IFAC), is expected, inter alia, to actively promote the International Accounting Standards Board‘s (IASB) pronouncements in the country with a view to facilitate global harmonisation of accounting standards. Accordingly, while formulating the Accounting Standards, the ASB will give due consideration to International Accounting Standards (IASs) issued by the International Accounting Standards Committee (predecessor body to IASB) or International Financial Reporting Standards (IFRSs) issued by the IASB, as the case may be, and try to integrate them, to the extent possible, in the light of the conditions and practices prevailing in India.

OBJECTIVES AND FUNCTIONS OF THE ACCOUNTING STANDARDS BOARD

The following are the objectives of the Accounting Standards Board:

i. To conceive of and suggest areas in which Accounting Standards need to be developed.

ii. To formulate Accounting Standards with a view to assisting the Council of the ICAI in evolving and establishing Accounting Standards in India.

iii. To examine how far the relevant International Accounting Standard/International Financial Reporting Standard (see paragraph 3 below) can be adapted while formulating the Accounting Standard and to adapt the same.

iv. To review, at regular intervals, the Accounting Standards from the point of view of acceptance or changed conditions, and, if necessary, revise the same.

v. To provide, from time to time, interpretations and guidance on Accounting Standards.

vi. To carry out such other functions relating to Accounting Standards.

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 companies. Based on this classification and the category in which they fall the Accounting standards are applicable to the enterprises

AS 17 Segment Reporting	Yes	No	No
AS 18 Related Party Disclosures	Yes	No	No
AS 19 Leases	Yes	Partial	Partial
AS 20 Earnings Per Share	Yes	Partial	Partial
AS 21 Consolidated Financial Statements	Yes	No	No
AS 22 Accounting for taxes on income	Yes	Yes	Yes
AS 23 Accounting for Investments in Associates in Consolidated Financial Statements	Yes	No	No
AS 24 Discontinuing Operations	Yes	No	No
AS 25 Interim Financial Reporting	Yes	No	No
AS 26 Intangible Assets	Yes	Yes	Yes
AS 27 Financial Reporting of Interests in Joint Ventures	Yes	No	No
AS 28 Impairment of Assets	Yes	Yes	Yes
AS 29 Provisions, Contingent Liabilities and Contingent Assets	Yes	Partial	Partial

Level I Enterprises

Enterprises which fall under any one or more category below mentioned are termed as Level I Companies

1. Enterprises whose equity or debt securities are listed whether in India or outside India
2. Enterprises which are in the process of listing their equity or debt securities. Board of directors' resolution must be available as an evidence
3. Banks including co-operative banks
4. Financial institutions
5. Enterprises carrying on insurance business
6. 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
7. 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
8. Holding and subsidiary enterprises of any one of the above at any time during the accounting period

Level II Enterprises

Enterprises which fall under any one or more category below mentioned are termed as Level II Companies

1. 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

2. 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
3. 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

What is International Accounting Standards Board (IASB) ?

The IFRS Foundation is the organisation that develops IFRS Standards for the public interest. Within the Foundation is the IASB, an independent body of accounting professionals that is responsible for the technical content of IFRS Standards. The IASB was established in 2001, replacing the International Accounting Standards Committee (IASC). The IASC, which was established in 1973, was a consensus body and its purpose was to harmonise financial reporting standards. It produced Standards called International Accounting Standards (IAS Standards) and its Interpretations were called SIC Interpretations.

IASC issued 41 numbered standards, known as International Accounting Standards (IAS), as well as a framework for the preparation and presentation of financial statements. While some of the standards issued by the IASC have been withdrawn, many are still in force. In addition, the interpretations issued by the Standing Interpretations Committee (SIC) of IASC, are still in force. In 2001, to strengthen the independence, legitimacy and quality of the international accounting standard-setting process, the IASC Board was broad based and replaced by the International Accounting Standards Board (IASB) as the body in charge of setting the international standards. It was decided by IASB that all effective IAS issued by the IASC as well as the interpretations issued by the SIC are adopted as its own standards. **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 have prefix of ‚IFRS' and new interpretations would be issued by the International Financial Reporting Interpretation Committee (IFRIC)**

The increased globalization and cross-border business relations have made it mandatory for the financial reports of different countries to communicate a similar language. As of now, it is already applicable in approximately 120 countries. As each country has its own set of accounting standards, IFRS reporting makes it easy to compare and understand the company accounts across international boundaries. The International Financial Reporting Standards (IFRS) are the accounting guidelines that are developed by the International Accounting Standards Board (IASB). It aims to provide a common accounting language globally that can be used by the companies to prepare Balance Sheets and financial statements.

IFRS principles would open more doors for public investing and trading as the companies would be clear and transparent about their global market information.

IFRS accounting demands extensive disclosures about the company‘s management and internal financial transactions. So, that the companies would be held accountable for any errors or poor judgement made on their part. Thus, IFRS system ensures a greater degree of responsibility introduced in the financial reporting and disclosure system.

Merits of IFRS:

1. IFRS brings improvement in comparability of financial information and financial performance with global peers and industry standards. This will result in more transparent financial reporting of a company‘s activities which will benefit investors, customers and other key stakeholders in India and overseas.
2. The adoption of IFRS is expected to result in better quality of financial reporting due to consistent application of accounting principles and improvement in reliability of financial statements. This, in turn, will lead to increased trust and reliance placed by investors, analysts and other stakeholders in a company‘s financial statements.
3. IFRS provide better access to the capital raised from global capital markets since IFRS are now accepted as a financial reporting framework for companies seeking to raise funds from most capital markets across the globe. Thus, IFRS increase the efficiencies of global capital management.
4. IFRS minimize the obstacles faced by Multi-national Corporations by reducing the risk associated with dual filings of accounts. A recent decision by the US Securities and Exchange Commission (SEC) permits foreign companies listed in the US to present financial statements in accordance with IFRS. This means that such companies will not be required to prepare separate financial statements under Generally Accepted Accounting Principles in the US (US GAAP). Therefore, Indian companies listed in the US would benefit from having to prepare only a single set of IFRS compliant financial statements, and the consequent saving in financial and compliance costs.
5. The impact of globalization causes spectacular changes in the development of Multi-national Corporations in India. This has created the need for uniform accounting practices which are more accurate, transparent and which satisfy the needs of the users. Implementation of uniform accounting practices i.e., IFRS will provide much better quality information.
6. Uniform accounting standards (IFRS) enable investors to understand better the investment opportunities as against multiple sets of national accounting standard.
7. With the help of IFRS, investors can increase the ability to secure cross border listing.

Limitations of IFRS:

1. The perceived benefits from IFRS‘ adoption are based on the experience of IFRS compliant countries in a period of mild economic conditions. Any decline in market confidence in India and overseas coupled with tougher economic conditions may present significant challenges to Indian companies.
2. IFRS requires application of fair value principles in certain situations and this would result in significant differences in financial information currently presented, especially in relation to financial instruments and business combinations. Given the current economic scenario, this could result in significant volatility in reported earnings and key performance measures like EPS and P/E ratios. Indian companies will have to build awareness amongst investors and analysts to explain the reasons for this volatility in order to improve understanding, and increase transparency and reliability of their financial statements.
3. This situation is worsened by the lack of availability of professionals with adequate valuation skills, to assist Indian corporate in arriving at reliable fair value estimates.

This is a significant resource constraint that could impact comparability of financial statements and render some of the benefits of IFRS‘ adoption ineffective.

4. Although IFRS are principles-based standards, they offer certain accounting policy choices to preparers of financial statements. For example, the use of a cost-based model or a revaluation model in accounting for investment properties. This could reduce consistency and comparability of financial information to a certain extent and therefore reduce some of the benefits from IFRS‘ adoption.
5. IFRS are formulated by the International Accounting Standards Board (IASB) which is an international standard body. However, the responsibility for enforcement and providing guidance on implementation vests with local government and accounting and regulatory bodies, such as the ICAI in India. Consequently, there may be differences in interpretation or practical application of IFRS provisions, which could further reduce consistency in financial reporting and comparability with global peers. The ICAI will have to make adequate investments and build infrastructure to ensure compliance with IFRS.

Practical challenges in implementing IFRS:

1. There is a need for a change in several laws and regulations governing financial accounting and reporting in India. In addition to accounting standards, there are legal and regulatory requirements that determine the manner in which financial information is reported or presented in the financial statements. For example, the Companies Act determines the classification and accounting treatment for redeemable preference shares as equity instruments of a company, whereas these may be considered to be a financial liability under IFRS. The Companies Act also prescribes the format for presentation of financial statements for Indian companies, whereas the presentation requirements are significantly different under IFRS. Similarly, the Reserve Bank of India regulates the financial reporting for banks and other financial institutions, including the presentation format and accounting treatment for certain types of transactions. In the absence of adequate clarity and assurance that Indian laws and regulations will be amended to conform to IFRS, the conversion process may not gain momentum.
2. There is a lack of adequate professionals with practical IFRS conversion experience and therefore many companies will have to rely on external advisers and their auditors. This is magnified by a lack of preparedness amongst Indian corporate as this project may be viewed simply as a project management or an accounting issue which can be left to the finance function and auditors. However, it should be noted that IFRS conversion will involve a fundamental change to an entity‘s financial reporting systems and processes. It will require a detailed knowledge of the standards and the ability to consider their impact on business transactions and performance measures.
3. Another potential pitfall is viewing IFRS accounting rules as similar to Generally Accepted Accounting Principles in India (Indian GAAP), since Indian accounting standards have been formulated on the basis of principles in IFRS. However, this view disregards significant differences between Indian GAAP and IFRS as well as differences in practical implementation and interpretation of similar standards. Further, certain Indian standards offer accounting policy choices which are not available under IFRS, for example, use of pooling of interests method in accounting for business combinations.

4. Convergence is not just a one-time technical step but will impose practical challenges of significant business and regulatory matters like structuring of ESOP schemes, training of employees, tax planning, modification of IT system, compliance with debt covenants.
5. Educating investors to understand the changed financial reporting under IFRS is challenging due to differences in various conceptual, practical, legal and implementation methods.
6. The regulatory and legal requirements in India will pose a challenge unless the same is been addressed by respective regulatory. For example the present direct tax laws do not address any tax implications likely to arise from IFRS transitions.
7. Complexities in the introduction of concepts such as present value and fair value measurement, recognition and the extent of disclosure required under IFRS are other challenges.

   Examples:

   a) Treatment of expenses like premium payable on redemption of debentures, discount allowed on issue of debentures, underwriting commission paid on issue of debentures etc are different. This would bring a change in the income statement leading to enormous confusion and complexities.

   b) Financial statements are more complex under IFRS and thereby would pose a challenge in making useful decisions.

Ind AS – The Indianised version of IFRS

Meaning of convergence with IFRS:

In general terms, convergence with IFRS means to achieve harmony with IFRS. In precise terms convergence can be considered as ‚to design and maintain national accounting standards in a way that financial statements prepared in accordance with national accounting standards draw unreserved statement of compliance with IFRS'. Thus, ‗convergence with IFRS' means adoption of IFRS with certain exceptions, wherever necessary.

Need for convergence with IFRS

In the present era of globalization and liberalization, the World has become an economic village. The globalization of the business world and the attendant structures and the regulations, which support it, as well as the development of e-commerce make it imperative to have a single globally accepted financial reporting system. A number of multi-national companies are establishing their businesses in various countries with emerging economies and vice versa. The entities in emerging economies are increasingly accessing the global markets to fulfill their capital needs by getting their securities listed on the stock exchanges outside their country. Capital markets are, thus, becoming integrated consistent with this world-wide trend. More and more Indian companies are also being listed on overseas stock exchanges. Sound financial reporting structure is imperative for economic well-being and effective functioning of capital markets.

The use of different accounting frameworks in different countries, which require inconsistent treatment and presentation of the same underlying economic transactions, creates confusion for users of financial statements. This confusion leads to inefficiency in capital markets across the world. Therefore, increasing complexity of business transactions and globalization of capital markets call for a single set of high quality accounting standards. High standards of financial reporting underpin the trust investors place in financial and non-financial information. Thus, the case for a single set of globally accepted accounting standards has prompted many countries to pursue convergence of national accounting standards with IFRS.

Benefits of achieving convergence with IFRS

There are many beneficiaries of convergence with IFRS such as the economy, investors, industry and accounting professionals.

Economy: As the markets expand globally, the need for convergence also increases. The convergence benefits the economy by increasing growth of its international business. It facilitates maintenance of orderly and efficient capital markets and also helps to increase the capital formation and thereby economic growth. It encourages international investing and thereby leads to more foreign capital flows to the country.

Investors: A strong case for convergence can be made from the viewpoint of the investors who wish to invest outside their own country. Investors want the information that is more relevant, reliable, timely and comparable across the jurisdictions. Financial statements prepared using a common set of accounting standards help investors better understand investment opportunities as opposed to financial statements prepared using a different set of national accounting standards. Investors‘ confidence would be strong if accounting standards used are globally accepted. Convergence with IFRS contributes to investors‘ understanding and confidence in high quality financial statements.

Industry: A major force in the movement towards convergence has been the interest of the industry. The industry is able to raise capital from foreign markets at lower cost if it can create confidence in the minds of foreign investors that their financial statements comply with globally accepted accounting standards. With the diversity in accounting standards from country to country, enterprises which operate in different countries face a multitude of accounting requirements prevailing in the countries. The burden of financial reporting is lessened with convergence of accounting standards because it simplifies the process of preparing the individual and group financial statements and thereby reduces the costs of preparing the financial statements using different sets of accounting standards.

Accounting professionals: Convergence with IFRS also benefits the accounting professionals in a way that they are able to sell their services as experts in different parts of the world. It offers them more opportunities in any part of the world if same accounting practices prevail throughout the world. They are able to quote IFRS to clients to give them backing for recommending certain ways of reporting. Also, their mobility to work in different parts of the world increases.

Relevance/Applicability of Ind AS (Converged IFRS) The Ministry of Corporate Affairs (MCA) notified the Companies (Indian Accounting Standards) Rules, 2015 (the ‗Rules‘) on 16th February, 2015. The Rules specify the Indian Accounting Standards (Ind AS) applicable to certain class of companies and set out the dates of applicability as follows:

1. **Voluntary adoption:** Companies may voluntarily adopt Ind AS for financial statements for accounting periods beginning on or after 1 April, 2015, with the comparatives for the periods ending 31 March, 2015 or thereafter. Once a company opts to follow the Ind AS, it will be required to follow the same for all the subsequent financial statements.

2. **Mandatory adoption:**

- The following companies will have to adopt Ind AS for financial statements from the accounting periods **beginning on or after 1 April, 2016:**

  a) Companies whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India (listed companies) and having net worth of Rs. 500 crores or more.

  b) Unlisted companies having a net worth of Rs. 500 crores or more.

  c) Holding, subsidiary, joint venture or associate companies of the listed and unlisted companies covered above. Comparatives for these financial statements will be periods ending 31 March, 2016 or thereafter.

- The following companies will have to adopt Ind AS for financial statements from the accounting periods beginning on or after 1 April, 2017:

  a) Listed companies having net worth of less than Rs. 500 crore.

  b) Unlisted companies having net worth of Rs. 250 crore or more but less than Rs. 500 crore.

  c) Holding, subsidiary, joint venture or associate companies of the listed and unlisted companies covered above. Comparatives for these financial statements will be periods ending 31 March, 2017 or thereafter.

  The above mentioned roadmap for adoption will not be applicable to:

  i. Companies whose securities are listed or in the process of listing on SME exchanges (Exchanges meant for small and medium-sized enterprises).

  ii. Companies not covered by the roadmap in the ‗Mandatory adoption' categories mentioned above.

- Insurance companies, banking companies and non-banking finance companies. In pursuance to the budget announcement by the Union Finance Minister Shri Arun Jaitley, after consultations with the Reserve Bank of India (RBI), Insurance Regulatory and Development Authority (IRDA) and Pension Fund Regulatory and Development Authority (PFRDA), the roadmap for implementation of Ind AS converged with IFRS for Scheduled Commercial Banks (excluding Regional Rural Banks), Insurers/Insurance Companies and Non-Banking Finance Companies (NBFCs) for accounting periods beginning from 1 April, 2018 onwards, with comparatives for the periods ending 31 March, 2018 has been drawn up.

- All NBFCs whose Net worth is more than or equal to INR 250 crore but less than INR 500 crore shall have IND AS mandatorily applicable to them with effect from 1st April 2019.

List of IFRS 1 – 15

Ind AS 101 (IFRS 1) : First Time Adoption of Indian Accounting Standards

Ind AS 102 (IFRS 2) : Share Based Payments

Ind AS 103 (IFRS 3) : Business Combinations

Ind AS 104 (IFRS 4) : Insurance Contracts

Ind AS 105 (IFRS 5) : Non-Current Assets Held for Sale & Discontinued Operations

Ind AS 106 (IFRS 6) : Exploration and Evaluation of Mineral Resources

Ind AS 107 (IFRS 7) : Financial Instruments: Disclosures

Ind AS 108 (IFRS 8) : Operating Segments

Ind AS 109 (IFRS 9) : Financial Instruments

Ind AS 110 (IFRS 10) : Consolidated Financial Statements

Ind AS 111 (IFRS 11) : Joint Agreements

Ind AS 112 (IFRS 12) : Disclosure of Interests in Other Entities

Ind AS 113 (IFRS 13) : Fair Value Measurement

Ind AS 114 (IFRS 14) : Regulatory Deferral Accounts

Ind AS 115 (IFRS 15) : Revenue from Contracts with Customers

Ind AS 115 (IFRS 15) : Impact on Various Sectors

List of International Accounting Standards (IAS) issued by IASB

Ind AS 1 (IAS 1) : Presentation of Financial Statements

Ind AS 2 (IAS 2) : Inventories

Ind AS 7 (IAS 7) : Statement of Cash Flows

Ind AS 8 (IAS 8) : Accounting Policies, Changes in Accounting Estimates & Errors

Ind AS 10 (IAS 10) : Events after the Reporting Period

Ind AS 11 (IAS 11) : Construction Contracts

Ind AS 12 (IAS 12) : Income Taxes

Ind AS 16 (IAS 16) : Property, Plant & Equipment

Ind AS 17 (IAS 17) : Leases

Ind AS 18 (IAS 18) : Revenue

Ind AS 19 (IAS 19) : Employee Benefits

Ind AS 20 (IAS 20) : Government Grants & Government Assistance

Ind AS 21 (IAS 21) : The Effects of Changes in Foreign Exchange Rates

Ind AS 23 (IAS 23) : Borrowing Costs

Ind AS 24 (IAS 24) : Related Parties

Ind AS 27 (IAS 27) : Consolidated and Separate Financial Statements

Ind AS 28 (IAS 28) : Investments in Associates

Ind AS 29 (IAS 29) : Financial Reporting in Hyperinflationary Economics

Ind AS 31 (IAS 31) : Interests in Joint Ventures

Ind AS 32 (IAS 32) : Financial Instruments: Presentation

Ind AS 33 (IAS 33) : Earnings Per Share

Ind AS 34 (IAS 34) : Interim Financial Reporting

Ind AS 36 (IAS 36) : Impairment of Assets

<u>Comparative analysis of AS, IFRS And Ind AS</u>

Comparative analysis of AS, IFRS And Ind AS has been made in table given below:

BASIS	INDIAN GAAP (AS)	IFRS	IND AS
Presentation of financial statements	AS 1 disclosure of accounting policies. AS 5 net profit / loss for the period, prior period items and change in accounting policies	IAS 1 presentation of financial statements	Ind AS 1 presentation of financial statements
Components of financial statements	a. Balance sheet, b. Statement of Profit & loss c. Cash flow statement d. Explanatory notes with significant accounting policies Comparative figures for one year are also to be presented.	a. Statement of financial position. b. Statement of income with profit / loss c. Statement of cash flows d. Statement of changes in equity e. Notes with summary of significant accounting policies Comparative figures for one year are also to be presented.	a. balance sheet at the end of the period including changes in equity b. Statement of profit / loss c. Cash flow statement d. Explanatory notes with significant accounting policies Comparative figures for one year are also to be presented.
Formats of Financial statements	Under Schedule III of companies Act 2013 have provided	Only illustrative formats have been given.	No format prescribed.

Inventories	AS 2 valuation of inventories	IAS 2 inventories	Ind AS 2 inventories
Scope	No scope exemption for any inventories held by commodity traders	IAS 2 does not applies to stock of such material	Same as IFRS
Classification of inventories	Classification of inventories as per schedule III : - Raw material, - Work in progress - Finished goods - Stock in trade - Stores and spares - Loose tools -Others	No specific requirements. Classification should be appropriate to entity.	Same as IFRS
Cash flow statements	**AS 3 cash flow statements**	**IAS 7 statement of cash flows**	**Ind AS 7 statement of cash flows**
Bank overdraft	Financing activities	Cash & cash equivalents	Same as IFRS
Cash flows from extra ordinary items	To be classified as operating, financing and investing activities.	Cash flow statements do not reflect any items as extraordinary	Same as IFRS
Interest and dividend	For financial entities: Interests paid/ received are to be received as financing activities. Dividend paid to be classified as financing activities.	Maybe classified as operating/ investing/financing activities in a manner consistent from time to time.	Same as Indian GAAP
Events Occurring after the reporting period – primary literature	AS- 4 – contingencies and events occurring after the balance sheet date	IAS 10 – events after the reporting period	Ind AS 10 – events after the reporting period
Dividends	Dividends declared or proposed after balance sheet date but before approval of financial statements will have to be recorded as a liability.	Declared dividend to be recognized in the period when it is declared	Same as IFRS

Accounting policies, changes in accounting estimates and errors-primary literature	AS 5- net profit or loss for the period, prior period items and changes in accounting policies	IAS 8 – Accounting policies, changes in accounting estimates and errors	Ind AS 8 – Accounting policies, changes in Accounting Estimates and Errors
Changes in accounting policies	Changes in accounting policies should be made only if it is required by law for compliance with an AS or for appropriate presentation of the financial statements on a prospective basis.	Requires retrospective application of changes in accounting policies by adjusting the gap balance of every affected element of equity for the earliest previous amount given and therefore the different comparative amounts for each period presented as if the new accounting policy had always been applied, unless transitional provision of an AS requires otherwise.	Same as IFRS
Definition of prior period items	AS 5 covers only income and expenses in the definition of prior period items	IAS 8 covers all the items in financial statements as proper period items	Same as IFRS
Property, plant and equipment	**AS-10 Accounting for Fixed Assets**	**IAS 16 - Property, plant and equipment** **IFRIC 1 – changes in existing decommissioning, Restoration and Similar Liabilities**	**IND AS 16 - Property, plant and equipment**
Scope	There is No exemption from AS 10 for property under development for future use as property held for investment.	Property under development for future use as property held for investment is excluded from the scope of IAS 16 and covered by IAS 40, investment property.	Same as IFRS
Change in method of depreciation	Requires retrospective recomputation of depreciation and any excess or deficit is required to be adjusted in the period in which such change is affected.	It will be treated as change in accounting estimates and applied prospectively	Same as IFRS

	Such a change is treated as a change in accounting policy and its effect is quantified and disclosed		
Revaluation	No specific requirements on frequency of revaluation.	Revaluations are required to be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.	Same as IFRS
Residual value	Estimates of residual value are not required to be updated at year end	Estimates of residual values are required to be updated at least once at year end	Same as IFRS
Construction Contracts – primary literature	**AS 7 construction contracts**	**IAS 11 construction contracts**	**Ind AS - 11 construction contracts**
Measurement of construction revenue	AS 7 does not refer to fair value and states that contract revenue is measured at the consideration received	Under IAS 11, construction revenue is measured at the fair value of the consideration received or receivable.	Same as IFRS
Revenue-primary literature	**AS 9- Revenue recognition**	**IAS 18 – Revenue**	**Ind AS 18 – Revenue** **Ind AS 18 – appendix A, B, C**
Definition	Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities from sale of goods, from the use by others of enterprise resources yielding interest, royalties and dividends.	Revenue is the gross influx of economic advantages throughout the amount arising within the course of the normal activities of associate degree increase in equity, apart from will increase about contributions from equity participants. Amounts collected on behalf of third parties such as sales and service taxes and value added	Same as IFRS

		taxes are excluded from revenues.	
Revenue recognition	AS 9 does not contain any such stipulation	Under IAS 18 revenue from sale of goods cannot be recognised where entity retains continuing managerial ownership or effective control over the goods	Same as IFRS
Revenue from service rendering Interest income	AS 9 allows complete service contract method or proportionate completion method AS 9 requires interest income to be recognised on a time at proportionate basis	IAS 18 allows only percentage of completion method IAS 18 requires effective interest method prescribed in IAS 39 to be followed for interest of financial gain recognition.	Same as IFRS
Foreign exchange --- primary literature	**AS 11 - The Effects of Changes in Foreign Exchange Rates**	**IAS 21 - The Effects of Changes in Foreign Exchange Rates**	**Ind AS 21 - The Effects of Changes in Foreign Exchange Rates**
Functional and Presentation currency	Foreign currency is a currency other than the reporting currency which is the currency in which financial statements are presented. There is no concept of functional currency	Functional currency is the currency of the primary economic environment in which the entity operates. Foreign currency could be a currency aside from the purposeful currency.	Same as IFRS
Forward contracts	Forward contracts not intended for trading or speculation purposes.	Accounted for as a derivative.	Same as IFRS
Treatment for Integral and non-integral operations	AS 11 provides separate treatment for integral and non-integral operations.	Makes no distinction between an integral foreign operation and non-integral operation as done in AS 11.	Same as IFRS
Government Grants - primary literature	**AS 12 - Accounting for Government Grants**	**IAS 20 - Accounting for Government Grants and Disclosure of Government Assistance**	**Ind AS 20 - Accounting For Government Grants And Disclosure of Government Assistance**

Government assistance	Does not deal with disclosure of government assistance other than in the form of government grants.	IAS 20 Deals with government grants as well as disclosure of government assistance.	Same as IFRS
Government loans with below market rate of interest	No specific guidance.	Benefit of government loans with below market rate of interest should be accounted for as government grant- measured as the difference between the initial carrying amount of the loan determined according to IAS 39 and the resultants proceedings received.	Same as IFRS
non-monetary government grants	If the asset is given by the government at a discounted price, the asset and the grant is accounted at the discounted purchase price..	The asset and the grant may be accounted at fair value. Alternatively, these can be recorded at nominal amount	The asset and the grant should be accounted at fair value.
Investment property: primary literature	**AS 13 Accounting for investment**	**IAS 40 investment property**	**Ind AS - 40 investment property**
Measurement	Classified as long term investment and measured at cost less impairment. As per schedule III , they are classified as non –current investments.	Investment property can be measured using the cost or the fair value model, with changes in fair value recognized in profit or loss.	Investment properties are measured using cost model only.
Business combinations - primary literature	**AS 14 – Accounting for Amalgamations**	**IFRS 3 (2008) – Business Combinations**	**Ind AS 103 – Business Combinations**
Business Combinations – scope	There is no comprehensive standard dealing with all business combinations. Guidance for amalgamations is contained in AS 14. AS 21 deals with investments in subsidiaries and AS 10 deals with a demerged	Applies to a transaction or an event in which an acquirer obtains control of one or more businesses. IFRS 3 does not apply to: i) The formation of a joint arrangement in the financial statements of the joint arrangement itself	Similar to IFRS except that Ind AS103 contains guidance on common control transactions.

	unit acquired in a slump sale.	ii) Combinations of entities or business under common control iii) Acquisition of an asset or group of assets that do not constitute a business.	
Valuation of assets And liabilities	Valuation at carrying value	Valuation at fair value	Same as IFRS
Employee benefits: primary literature	**AS 15 (Revised 2005) – Employee Benefits**	**IAS 19 - Employee Benefits**	**Ind AS 19 - Employee Benefits**
Definitions	The distinction between short-term and other long-term employee benefits depends on whether they fall wholly due within 12 after the end of the reporting period in which the employees provided the related service.	The distinction between short-term and other long-term employee benefits depends on whether they are due to be settled within 12 months after the end of the reporting period in which the employees render the related service.	Same as IFRS
Borrowing costs- primary literature	**AS 16 - Borrowing Costs**	**IAS 23 - Borrowing Costs**	**Same as IFRS**
Scope	No such scope exception similar to IFRS/ Ind AS is available.	Borrowing costs need not be capitalized in respect of i. qualifying assets measured at fair value (e.g. biological assets) ii. Inventories manufactured or produced, in large quantities on a repetitive basis This is an option	Same as IFRS
Components of borrowing costs	No reference to effective interest rate. AS 16 requires amendment on AS 30 becoming mandatory.	Descriptions of specific components are linked to effective interest rate.	Ind AS 23 - Borrowing Costs
Disclosure of capitalisation rate	Does not require such disclosure	Requires disclosure of capitalization rate used to determine the amount of borrowing cost	Same as IFRS

Segments-primary literature	**AS 17 segment reporting**	**IFRS 8 operating segments**	**Same as IFRS**
Scope	Applicability of the standard is not linked to the listing status of an entity.	IFRS 8 is applicable to the separate and consolidated financial statements of an entity/group with a parent whose debt or equity instruments are traded in a public market.	Same as IFRS
Measurement	Segment information is prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. Segment revenue, segment expense, segment result, segment asset and segment liability have been defined.	Segment profit or loss is reported on the same measurement basis which is used by the chief operating decision maker. There is no definition for differential profits losses for individual segments.	Ind AS 108 - operating segments
Related Party Disclosures - Primary literature	**AS 18 – Related Party Disclosures**	**IAS 24 – Related Party Disclosures**	**Ind AS 108 is applicable to Companies to which Ind As notified under the Companies Act apply**
Definition of related party	Parties are considered to be related if at any time during the reporting period one party has the ability to control the other party .	A related party is a person or entity that is related to the entity that is preparing its financial statements (reporting entity):	Same as IFRS
Definition of close member of the family	There is no definition of close member of the family. Instead the term ―relative‖ has been defined in relation to an individual as the spouse, son, daughter, brother, sister, father, mother who may Be expected to influence, or be Influenced by, that individual in his/her	Close members of the family of a person are the family members who may be expected to influence, and be influenced by, that person in their dealings with the entity and include: a) that person‘ children and spouse or domestic partner;	Same as IFRS

	dealings with the reporting enterprise.	b) children of that person' spouse or domestic partner; and c) dependents of that person or that person' spouse or domestic partner	
Items to be disclosed	If an entity has related party transactions during the period covered by the financial statements, the enterprise should disclose the volume of transactions either as an amount or as an appropriate proportion and amounts or appropriate proportions of outstanding items.	If an entity has related party transactions during the period covered by the financial statements, the amount of such transactions and the amount of utstanding balances including commitments need to be disclosed .	Similar to IFRS with the Inclusion of father, mother, brother and sister in the definition of close members of the family
Leases – primary literature	**AS 19 – Leases**	**IAS 17 – Leases**	**Ind AS 17 –Leases**
Interest in leasehold land Operating lease rentals – recognition	Leasehold land is recorded and classified as fixed assets. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight-line basis out of lease term unless another systematic basis is the better representative of the time pattern of the user‟s benefit. Lease income from operational leases ought to be recognised with in the statement of profit and loss on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern within which profit derived from	Recognised as operational lease or finance lease as per definition and classification criteria. An important thought in such determination is that land has associate degree of indefinite economic life.	Similar to IFRS except that a property interest in an operating lease cannot be accounted for as investment property as the fair value model is not permissible by IAS 40 Ind AS 17 contains a carve out for escalation of operating lease rentals that are in line with the expected general inflation. Since these are primarily to compensate the lessor for expected

	the employment of the leased asset is diminished.		inflationary value will increase, these should not be straight-lined by the lessor as well as the lessee
Earnings Per Share - primary literature	**AS 20 – Earnings Per Share**	**IAS 33 – Earnings Per Share**	**Ind AS 33 – Earnings Per Share**
Scope	Applicability of the standard is not linked to the listing status of an entity.	IAS 33 – Earnings Per Share IAS 33 is applicable to the separate and consolidated financial statements of an entity/group with a parent: Whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or That files, or is in the process of filing, its financial Statements with a securities Commission or other regulative organization for the aim of issuing stock in a public market.	Ind AS 33 – Earnings Per Share. Ind AS 33 is applicable to companies that have issued ordinary shares to which Ind -ASs notified under the Companies Act apply.
Disclosure in separate financial statements	AS 20 requires disclosure of basic and diluted EPS information both in the separate and consolidated financial statements of the parent.	When associate degree entity presents Separate and consolidated financial statements, EPS is required to be presented only in the consolidated financial statements. An entity could disclose EPS in its separate financial statements voluntarily.	EPS is needed to be presented in each consolidated as well as separate financial statements.
Disclosure of Earnings per Share From continuing And		The statement of comprehensive income will present basic and diluted Earnings per share from continuing operations and if applicable, basic and	Same as IFRS

discontinued operations		diluted earnings per share from discontinued operations. EPS from discontinued operations may alternatively be disclosed in the notes	
Consolidated Financial Statements – primary literature	**AS 21 - Consolidated Financial Statements**	**IAS 27 (2008) - Consolidated and Separate Financial Statements** **IFRS 10 – Consolidated Financial Statements** **IFRS 12 – Disclosure of Interests in Other Entities**	**IND AS 27 - Consolidated and Separate Financial Statements** **Ind AS 110 – Consolidated Financial Statements** **Ind AS 112 – Disclosure of Interests in Other Entities**
Financial Statements – scope in which they consolidate their investments in Subsidiaries in Accordance with IAS 27.	Indian GAAP does not specify entities that are needed to present consolidated statements. If consolidated financial statements are Presented then the financial statements must be presented. The Securities and Exchange Board of India requires entities listed and to be listed to present consolidated financial statements.	A parent is required to prepare consolidated financial statements. A parent need not prepare consolidated financial statements only if all the following conditions are met: the entity is itself a wholly owned or a partially owned subsidiary and its other owners have not objected to the entity not presenting consolidated statements; The entity‟s debt or equity instruments are not traded in a public market; The entity is not in a process of filing its financial statements for the purposes of issuing any class of instruments in a public market; and The ultimate or any intermediate parent of the entity produces consolidated financial statements available for	Ind -AS does not mandate Presentation of financial statements as these are regulated by governing statutes in India.

		public use that comply with IFRSs.	
Potential voting rights	Potential voting rights are not contemplated in assessing control.	The presence and effect of potential rights that are Presently in exercise and can be converted , including potential voting rights with another entity, are contemplated when assessing control	Same as IFRS
uniform accounting policies	If not practicable to use uniform accounting policies in the preparation of consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated statements in which different accounting policies have been applied.	Consolidated financial statements should be prepared using common accounting policies. No exception is provided	Same as IFRS
reporting dates	The difference between the reporting date of the subsidiary and the parent Company shall not be more than six months.	The difference between the reporting date of the subsidiary and parent must be three months or less than three months..	Same as IFRS
Income taxes - primary literature	**AS 22: accounting for taxes on income**	**IAS 12: Income Taxes**	**Ind AS 12 income taxes**
Deferred income taxes	Deferred tax arises in respect of recognition of items of profit or loss for the purpose of financial reporting and for income tax purpose	It is computed for temporary difference between the carrying amount of an asset or liability in the statement of financial position and its tax base.	Same as IFRS
Recognition of deferred tax assets and liabilities	Deferred taxes are generally recognized for all timing differences.	Deferred tax are recognized for all Temporary difference between accounting and tax base of assets and liabilities except to the extent which arise from	Same as IFRS

		(a) initial recognition of goodwill (in case of deferred tax liability) or (b) asset or liability in a transaction which (i) is not a business combination; and (ii) at the time of the transaction, affects neither the accounting nor the tax profit	
Investments in Associates - primary literature	**AS 23 - Accounting for Investments in Associates in Consolidated Financial Statements**	**IAS 28 - Investments in Associates**	**Ind AS 28 – Investments in Associates**
Vital influence	It is the power to participate in the Financial and/or operating policy decisions of the investee but not control over those policies	It is the power for participation in the financial and operating policy decisions taken by the investee but not having control over those policies.	Same as IFRS
Potential Voting rights	Potential voting rights are not Considered in assessing significant influence.	The existence and effect of potential voting rights are considered when assessing significant influence .	Same as IFRS
Scope	Currently there is no exemption for investments made by venture capital organizations, mutual funds, unit trusts and similar entities from applying the equity method. The limited revision to AS 23, on becoming effective, eliminates this difference between AS 23 and IAS 28	Investments by venture capital organizations, mutual funds, unit trusts and similar entities including investment-linked insurance funds are exempted from applying equity method,	Investments by venture capital organizations are exempted from applying equity method, if an election is made to measure such investments at FVTPL under Ind AS 39
share of losses	Loss in excess of the carrying amount of investment is not recognized.	Losses recognized under the equity method in excess of the investor‘s investment in ordinary shares are applied to other components of the investor‘s interest such	Same as IFRS

		as long-term loans	
disposals	No specific guidance.	On disposal resulting in loss of Significant influence, the remaining investment is re-measured at fair value, with gain or loss recognized in profit or loss.	Same as IFRS
uniform accounting policies	If not practicable to use uniform accounting polices while applying the equity method, that fact should be disclosed together with a brief description of the differences between the accounting policies.	Uniform accounting policies must be followed while applying the equity method. No exception is provided.	Uniform accounting policies must be followed for like transactions and events in similar circumstances unless it is impracticable to do so
Separate financial statements of the investor	At cost less impairment loss. The limited revision to AS 23, on becoming effective, eliminates this difference between AS 23 and IAS 28.	Either at cost or at fair value as available for sale with changes in fair value recognized in other comprehensive income. If measured at cost (less impairment), on classification as held for sale, IFRS 5 will apply.	Same as IFRS
Discontinuing operations-primary literature	**AS 24 - Discontinuing Operations**	**IFRS 5 - Non-current Assets Held for Sale and Discontinued Operations**	**Ind AS 105 - Non-current Assets Held for Sale and Discontinued Operations**
Recognition and measurement	There is no standard dealing with non-current assets held for sale though AS 10 deals with assets held for disposal. Items of fixed assets which are retired from active use and be held for disposal are stated at the lower of their net book value and net	Non-current assets to be disposed of are classified as held for sale when the asset is available for immediate sale and the sale is highly probable.	Same as IFRS

	realisable value are shown separately in the financial statements.		
Non-cash assets held for distribution to owners	AS 24 have no specific guidance related to non-cash assets held for distribution to owners.	Non-cash assets are to be classified as held for distribution to owners when the transaction is highly probable, taking into account probability of shareholders‟ approval, if required in the jurisdiction..	Same as IFRS
classification	An operation is classified as discontinuing at the earlier of (a) binding sale agreement for sale of the operation and (b) on approval by the board of an in depth formal arrangements and announcement of the arrangements	An operation is classified as discontinued when it has been disposed of or classified as item for sale.	Same as IFRS
Interim Financial Reporting - primary literature	**AS 25 - Interim Financial Reporting**	**IAS 34 - Interim Financial Reporting**	**Ind AS 34 - Interim Financial Reporting**
Minimum components	No disclosure is required	Minimum components of interim financial report includes- statement showing changes in equity	Same as IFRS
Change in accounting policy	Requires statement of figures of prior interim periods of the current financial year only	Figures of prior interim periods of the current financial year and comparable figures of corresponding previous period to be restated.	Same as IFRS
Treatment for provision	AS 25 does not address such issues specifically	Separate guidance is available for treatment of provision for leave encashment, interim period manufacturing cost variances, foreign currency translation gains & losses.	Same as IFRS

Intangible asset - primary literature	**AS 26 - Intangible Assets**	**IAS 38 - Intangible Assets**	**Ind AS 38 - Intangible Assets**
measurement	Measured only at cost.	Intangible assets may be measured at either price or revalued amounts.	Same as IFRS
Useful life	The useful life may not be indefinite	Useful life may be finite or indefinite	Same as IFRS
goodwill	Goodwill arising on amalgamation in the nature of purchase is amortized over five years (as per AS 14). Goodwill arising on consolidation is not amortised but is tested for impairment.	Not amortised but subject to annual impairment test or more frequently whenever there is an impairment indication	Same as IFRS
Interests in Joint Ventures – primary literature	**AS 27 - Financial Reporting of Interests in Joint Ventures**	**IAS 31 - Interests in Joint Ventures** **IFRS 11 – Joint Arrangements**	**Ind AS 31 - Append ix A - Jointly Controlled Entities–Non monetary contribution by Venturers** **Ind AS 111 – Joint Arrangements**
Joint control	Joint control is the contractually in agreement sharing of control over an economic activity.	Joint control is the mutually agreed sharing of control of an economic activity, and exists only if there is strategic financial and operating decisions relating to the activity needed.	Same as IFRS
Scope	Currently, there is no exemption as in IFRS. The limited revision to AS 27, on becoming effective, eliminates this difference between AS 27 and IAS 31	IAS 31 is not applicable for investments made by venture capital organizations, mutual funds, unit trusts and similar entities including investment-linked insurance funds that upon	Ind AS 31 is not applicable for investments made by venture capital organizations that upon initial recognition are

		initial recognition are classified as at FVTPL under IAS 39.	classified as at FVTPL under Ind AS 39.
Separate financial statement of the venturer	At cost less impairment loss.	Either at cost or at fair value as held for sale investment with changes in fair value recognized as a component of comprehensive income.	Same as IFRS
consolidated financial statements	At cost less impairmentif consolidated financial statements are not prepared.	Even if there is no consolidated financial statements (e.g. because the venture has no subsidiaries) proportionate consolidation/equity accounting is used for jointly controlled entities.	Presentation of consolidated or separate financial statements is regulated by governing statutes in India.
Impairment of Assets - primary literature	**AS 28 impairment of assets**	**IAS 36 impairment of assets**	**Ind AS 36 impairment of Assets**
Goodwill allocated to cash generating units that are expected to benefit from the synergies of business combination	AS 28 requires goodwill to be tested for impairment using the ―bottom-up/top-down‖ approach under which the goodwill is, in effect, tested for impairment by allocating its carrying amount to each cash-generating unit or smallest group of cash-generating units to which a portion of that carrying amount can be allocated on a reasonable and consistent basis.	Allocated to the lowest level at which goodwill is internally monitored by management which should not be larger than an operating segment before aggregation of segments as defined in IFRS 8.	Same as IFRS
Reversal of impairment loss for goodwill	Impairment loss for goodwill is reversed if the impairment loss was caused by a specific external event of an exceptional nature that is not expected to occur again and subsequent external events that occurred and reversed the effect of that event.	Impairment loss recognised for goodwill is prohibited from reversal in a subsequent period. Goodwill impaired in an interim period is not subsequently reversed in subsequent interim or annual financial statements.	Same as IFRS

Provisions, Contingent Assets and Contingent Liabilities – primary literature	**AS 29 – Provisions, Contingent Liabilities and Contingent Assets**	**IAS 37 – Provisions, Contingent Liabilities and Contingent Assets**	**Ind AS 37 – Provisions, Contingent Liabilities and Contingent Assets**
recognition of provisions	Provisions are not recognized based on constructive obligations.	A provision is recognised only if a past event has created a legal or constructive obligation.	Same as IFRS
Financial Instruments – primary literature	**AS 30 – Financial Instruments: Recognition and Measurement.**	**IFRS 9 (2014) – Financial Instruments**	**Ind AS 109 – Financial Instruments**
general recognition principle	There is no definition of financial instrument.	An entity ought to recognise a financial asset or liability in its statement of financial position when, the entity becomes party for the contractual provisions of the instrument.	Same as IFRS
Initial measurement	No specific guidance.	All financial instruments are compared at fair value In the case of a financial asset or financial liability not at fair value through profit or loss. Trade receivables that do not have a significant financing component should initially be measured at transaction price as defined in IFRS 15.	Same as IFRS
Financial Instruments: Presentation - primary literature	AS 31 - Financial Instruments: Presentation	IAS 32 - Financial Instruments : Presentation	Ind AS 32 - Financial Instruments : Presentation
Classification of financial liabilities	Financial instruments are classified based on legal form – redeemable	Financial instruments are classified as a liability or equity according to the	Same as IFRS

	preference shares will be classified as equity. Preference dividends are always recognized similar to equity dividend and are never treated as interest expense.	contractual arrangement, (and not its legal form), and the definition of financial liabilities and equity instruments. Dividends on financial instruments classified as financial liability is recognized as an interest expense in the statement of comprehensive income/income statement (if presented separately).	
Treasury shares	Acquiring own shares is permitted only in limited circumstances. Shares repurchased ought to be cancelled instantly and cannot be controlled as treasury shares.	If an entity acquired its own shares again (treasury shares), these are shown as a deduction from equity	Same as IFRS
Financial Instruments: Disclosures – primary literature	AS 32 – Financial Instruments: Disclosures	IFRS 7 – Financial Instruments:	Ind AS 107 – Financial Instruments: Disclosures
Some improved disclosures	Currently there are no detailed disclosure requirements for financial instruments.	Requires disclosure of information about the significance of financial instruments on financial information and performance.	Same as IFRS
Reporting in Hyperinflationary Economies - primary literature	**There is no equivalent standard.**	**IAS 29 – Financial Reporting in Hyperinflationary Economies**	**Ind AS 29 – Financial Reporting in Hyperinflationary Economies**
Meaning of ―hyperinflationary‖	There is no equivalent standard	Generally an economy is hyperinflationary when the cumulative inflation rate over 3 years is approaching or exceeds 100%	Same as IFRS
Basic principle	There is no equivalent standard	Financial statements should be stated in terms	Same as IFRS

		of the measuring unit current at the end of the reporting period.	
Applying Restatement Approach under IAS 29	There is no equivalent standard.	When the economy of an entity‟s functional currency becomes hyperinflationary.	Same as IFRS
Agriculture – primary literature	**There is no equivalent standard**	**IAS 41 – Agriculture**	**Ind AS 41 – Agriculture**
Scope	There is no equivalent standard	Applies to biological assets with the exception of bearer plants that are used in the production or supply of agricultural produce and which will not be sold as agriculture produce and government grants related to these biological assets.	Same as IFRS
measurement	There is no equivalent standard	All biological assets are measured at fair value less costs to sell, unless fair value cannot be reliably measured.	Same as IFRS
First Time Adoption – Primary Literature	There is no equivalent standard under Indian GAAP.	IFRS 1 – First Time Adoption of International Financial Reporting Standards	Ind AS 101 – First Time Adoption of Indian Accounting Standards
date of transition	Not applicable.	The date of transition is the beginning of the earliest period for which an entity presents full comparative information under IFRS	Similar to IFRS.
Share-based Payment – primary literature	There is no equivalent standard. However, the ICAI has issued a Guidance Note on Accounting for Employee Share-based Payments.	IFRS 2 – Share-based Payment (covers share-based payments both for employees and non-employees and transactions involving receipt of goods and services)	Ind AS 102 – Share-based Payment (covers share-based payments both for employees and non- employees and transactions involving receipt of goods and services)
Recognition	Similar to IFRS.	Recognise as an expense	Same as IFRS

		over the vesting period.	
Insurance Contracts - primary literature	No equivalent standard.	IFRS 4 – Insurance Contracts.	Ind AS 104 – Insurance Contracts
General	No equivalent standard.	Applicable to insurance and reinsurance contracts and to discretionary participation features in insurance contracts	Same as IFRS

Summary and conclusion:

Newly framed Indian AS are the converged form of IFRS and ICAI and MCA has accepted most of the provisions of IFRS as it is. The table of difference shows that except few items almost all the provisions are same as IFRS. So it is a good thing about Indian AS that we have not any major changes in India GAAP. There are significant differences between IFRS and Indian-GAAP. In fact, Indian Accounting Standards have not kept pace with changes in IFRS. This is because Indian Standards remain sensitive to local conditions, including the legal and economic environment.

Reporting Framework for applying accounting standards

This Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Framework is to:

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

This Framework by itself is not an Accounting Standard and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Framework overrides any specific Accounting Standard.

The Accounting Standards Board recognizes that in a limited number of cases there may be a conflict between the Framework and an Accounting Standard. In those cases where there is a conflict, the requirements of the Accounting Standard prevail over those of the Framework. As, however, the Accounting Standards Board will be guided by the Framework in the development of future Standards and in its review of existing Standards, the number of cases of conflict between the Framework and Accounting Standards will diminish through time.

The Framework will be revised from time to time on the basis of the experience of the Accounting Standards Board of working with it.

Scope of the 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 is concerned with general purpose financial statements (hereafter referred to as _financial statements‘). Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Special purpose financial reports, for example, prospectuses and computations prepared for taxation purposes are outside the scope of this Framework. Nevertheless, the Framework may be applied in the preparation of such special purpose reports where their requirements permit.

Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, a statement of profit and loss (also known as _income statement‘), a cash flow statement and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about business and geographical segments, and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report.

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. A reporting enterprise is an enterprise for which there are users who rely on the financial statements as their major source of financial information about the enterprise.

Users and Their Information Needs

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

- **Investors** - The providers of risk capital are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. They are also interested in information which enables them to assess the ability of the enterprise to pay dividends.
- **Employees** - Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.
- **Lenders** - Lenders are interested in information which enables them to determine whether their loans, and the interest attaching to them, will be paid when due.
- **Suppliers and other trade creditors** - Suppliers and other creditors are interested in information which enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuance of the enterprise as a major customer.
- **Customers** - Customers have an interest in information about the continuance of an enterprise, especially when they have a longterm involvement with, or are dependent on, the enterprise.
- **Governments and their agencies** - Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises and determine taxation policies, and to serve as the basis for determination of national income and similar statistics.
- **Public** - Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

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

The management of an enterprise has the responsibility for the preparation and presentation of the financial statements of the enterprise. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this Framework.

5. The Objective of Financial Statements

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 prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since (a) they largely portray the financial effects of past events, and (b) do not necessarily provide non-financial information.

Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management.

Financial Position, Performance and Cash Flows

The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines, for example, the capacity of an enterprise to pay its employees and suppliers, meet interest payments, repay loans, and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and cash flows of an enterprise.

The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future. Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting how successful the enterprise is likely to be in raising further finance. Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information about performance is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the enterprise might employ additional resources.

Information concerning cash flows of an enterprise is useful in order to evaluate its investing, financing and operating activities during the reporting period. This information is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows.

Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in a statement of profit and loss. Information about cash flows is provided in the financial statements by means of a cash flow statement.

The component parts of the financial statements are interrelated because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose or to provide all the information necessary for particular needs of users.

The financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and statement of profit and loss. They may include disclosures about the risks and uncertainties affecting the enterprise and any resources and obligations not recognized in the balance sheet (such as mineral reserves). Information about business and geographical segments and the effect of changing prices on the enterprise may also be provided in the form of supplementary information.

6. Underlying Assumptions

Accrual Basis - In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognized when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

Going Concern - The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Consistency - In order to achieve comparability of the financial statements of an enterprise through time, the accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

7. Qualitative Characteristics of Financial Statements

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

a) **Understandability -** An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

b) **Relevance** **-** To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statement of profit and loss is enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

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

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

Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognise the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

e) **Faithful Representation** **-** To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

f) **Substance over Form** - If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentation and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

g) **Neutrality** - To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

h) **Prudence** - The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognized by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality of reliability.

i) **Completeness** - To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

j) **Comparability** - Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s).

8. Constraints on Relevant and Reliable Information

a) **Timeliness** **-** If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the information needs of users.

b) **Balance between Benefit and Cost** **-** The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

c) **Balance between Qualitative Characteristics** **-** In practice, a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

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

9. The Elements of Financial Statements

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of profit and loss are income and expenses. The cash flow statement usually reflects elements of statement of profit and loss and changes in balance sheet elements; accordingly, this Framework identifies no elements that are unique to this statement.

The presentation of these elements in the balance sheet and the statement of profit and loss involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial Position

The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

- **An asset** is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.
- **A liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
- **Equity** is the residual interest in the assets of the enterprise after deducting all its liabilities.

The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognized in the balance sheet.

In assessing whether an item meets the definition of an asset, liability or equity, consideration needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of hire purchase, the substance and economic reality are that the hire purchaser acquires the economic benefits of the use of the asset in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the hire purchase gives rise to items that satisfy the definition of an asset and a liability and are recognized as such in the hire purchaser‘s balance sheet.

What are Assets?

The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

An enterprise usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flows of the enterprise. Cash itself renders a service to the enterprise because of its command over other resources.

The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be:

- used singly or in combination with other assets in the production of goods or services to be sold by the enterprise;
- exchanged for other assets;
- used to settle a liability; or
- distributed to the owners of the enterprise.

Many assets, for example, plant and machinery, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them and if they are controlled by the enterprise.

Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, an item held under a hire purchase is an asset of the hire purchaser since the hire purchaser controls the benefits which are expected to flow from the item. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.

The assets of an enterprise result from past transactions or other past events. Enterprises normally obtain assets by purchasing or producing them, but other transactions or events may also generate assets; examples include land received by an enterprise from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or other events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

There is a close association between incurring expenditure and obtaining assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly, the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet.

What are Liabilities?

An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the enterprise with little, if any, discretion to avoid the outflow of resources to another party.

The settlement of a present obligation usually involves the enterprise giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:

- payment of cash;
- transfer of other assets;
- provision of services;
- replacement of that obligation with another obligation; or
- conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade creditors (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as ‗provisions'. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

What is Equity?

Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, funds contributed by owners, reserves representing appropriations of retained earnings, unappropriated retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.

The creation of reserves is sometimes required by law in order to give the enterprise and its creditors an added measure of protection from the effects of losses. Reserves may also be created when tax laws grant exemptions from, or reductions in, taxation liabilities if transfers to such reserves are made. The existence and size of such reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the enterprise as a whole on a going concern basis.

Commercial, industrial and business activities are often undertaken by means of enterprises such as sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such enterprises is often different from that applicable to corporate enterprises. For example, unlike corporate enterprises, in the case of such enterprises, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Framework that deal with equity are appropriate for such enterprises.

Performance (Measured through Profitability)

Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements.

Income and expenses are defined as follows:

The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that need to be met before they are recognized in the statement of profit and loss.

Income and expenses may be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. For example, it is a common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the enterprise and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the enterprise to generate cash and cash equivalents in the future. When distinguishing between items in this way, consideration needs to be given to the nature of the enterprise and its operations. Items that arise from the ordinary activities of one enterprise may be extraordinary in respect of another.

Distinguishing between items of income and expense and combining them in different ways also permits several measures of enterprise performance to be displayed. These have differing degrees of inclusiveness. For example, the statement of profit and loss could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit.

Income

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

The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an enterprise. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as a separate element in this Framework.

The definition of income includes unrealised gains. Gains also include, for example, those arising on the disposal of fixed assets. When gains are recognized in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result in the settlement of liabilities. For example, an enterprise may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

Expenses

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

The definition of expenses encompasses those expenses that arise in the course of the ordinary activities of the enterprise, as well as losses. Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of goods sold, wages, and depreciation. They take the form of an outflow or depletion of assets or enhancement of liabilities.

Losses represent other items that meet the definition of expenses and may or may not, arise in the course of the ordinary activities of the enterprise. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.

Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of fixed assets. The definition of expenses also includes unrealised losses. When losses are recognized in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

10. Recognition of the Elements of Financial Statements

Recognition is the process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisfies the criteria for recognition set out below. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the totals of balance sheet or statement of profit and loss.

Items that satisfy the recognition criteria should be recognized in the balance sheet or statement of profit and loss. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

An item that meets the definition of an element should be recognized if:

- it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
- the item has a cost or value that can be measured with reliability.

In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the *materiality* considerations. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

The Probability of Future Economic Benefits - The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterizes the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable will be realized, it is then justifiable, in the absence of any evidence to the contrary, to recognize the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence, an expense representing the expected reduction in economic benefits is recognized.

Reliability of Measurement - The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs 31 to 38 of this Framework. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made, the item is not recognized in the balance sheet or statement of profit and loss. For example, the damages payable in a lawsuit may meet the definitions of a liability and an expense as well as the probability criterion for recognition; however, if it is not possible to measure the claim reliably, it should not be recognized as a liability or as an expense.

An item that, at a particular point in time, fails to meet the recognition criteria may qualify for recognition at a later date as a result of subsequent circumstances or events.

An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and cash flows of an enterprise by the users of financial statements. The existence of the claim would need to be disclosed in the notes, explanatory material or supplementary schedules.

Recognition of Assets	An asset is recognized in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably. An asset is not recognized in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the statement of profit and loss. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset.
Recognition of Liabilities	A liability is recognized in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognized as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.
Recognition of Income	Income is recognized in the statement of profit and loss when increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable). The procedures normally adopted in practice for recognizing income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.

Recognition of Expenses	Expenses are recognized in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees‘ salaries or the depreciation of plant and machinery). Many expenses are recognized in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognized at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities. When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognized in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognizing the expenses associated with the using up of assets such as plant and machinery, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortization. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire. An expense is recognized immediately in the statement of profit and loss when expenditure produces no future economic benefits. An expense is also recognized to the extent that future economic benefits from expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset. An expense is recognized in the statement of profit and loss in those cases also where a liability is incurred without the recognition of an asset, for example, in the case of a liability under a product warranty.

11. Measurement of the Elements of Financial Statements

Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognized and carried in the balance sheet and statement of profit and loss. This involves the selection of the particular basis of measurement.

A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

Historical cost - Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition.

Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Current cost - Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

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

Present value - Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value and pension liabilities are carried at their present value. Furthermore, the current cost basis may be used as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

12. Concepts of Capital and Capital Maintenance

Concepts of Capital

Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

Concepts of Capital Maintenance and the Determination of Profit

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

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

(b) **Physical capital maintenance**. Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.
The concept of capital maintenance is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital can be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income, the residual amount is a net loss.

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

The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the enterprise. In general terms, an enterprise has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

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

Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the enterprise are viewed as changes in the measurement of the physical productive capacity of the enterprise; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

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

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Module II
Components of Financial Statements

Process and Mechanism of Accounting

Book Keeping and Accounting

Most of us do maintain some kind of a written record of our income and expenditure. The idea behind maintaining such record is to know the correct position regarding income and expenditure. The need for keeping a record of income and expenditure in a clear and systematic manner has given rise to the subject of **"bookkeeping".**

Let us consider the example of an individual household; some individuals do not recognize the necessity of keeping accounts of their day to day expenditure, since they spend their own income and are not required to account for it to anybody. However the idea is flawed and a family, however, small it may be, must exercise proper control over its expenditures to satisfy two-fold responsibilities - one is that of ensuring all round welfare of the family and the other is the social responsibility. Needless to say, money is the most essential pre-request for ensuring peace and happiness of a family, which each and every member desires. The quantum of money must be adequate in relation to the needs. But mere adequacy of money is inadequate; one has to take care of its proper utilization. For this it would be necessary to exercise economy and maintain proper books of accounts. On the other hand each and every family must save a portion of its income for future contingencies. It is possible to increase the amount of savings through proper management and effective control of the family expenses. Through such saving the family helps materializing the economic planning of the country.

It is all the more necessary for an organization (or) a concern to keep proper accounts. At the end of the year the true result of the economic activities of a concern must be made available otherwise it will not be possible to run the concern efficiently. In case of a business concern the profit or loss at the end of a year must be ascertained, because, the amount of profit must be adequate in relation to that of investment made in the business. If it is not so or if there is a loss, it is an indication of some defects existing somewhere in the management of the business. All such defects need to be detected and analysed and appropriate measures taken for their rectification. But it is only possible, if proper books of accounts are maintained in the business concern.

Moreover, if proper books of accounts are not kept in a business, the amount of profit cannot be ascertained and it will not be possible to distribute the profit among the owners of the business. The income tax dues to the government cannot also be paid. In the absence of books of accounts misuse or defalcation of money will remain undetected. The owner and other parties interested will not be able to have any information about the condition of the business.

Thus we see that the necessity of keeping accounts is not only confined to business concerns but it is also useful for all classes and grades of people and organizations.

Bookkeeping Versus Accounting:

The functions of Bookkeeping is to properly record the financial transactions in the books of account. But the function of accounting is more extensive. It has many other functions to do except recording transactions, e.g. classification, summarization and interpretation of transactions. Thus we see the Bookkeeping is confined to recording aspect of accounting. It is a small and simplest part of accounting. Both represent two different phases of the main subject "accountancy".

Bookkeeping is the first stage, while accounting is the final stage. Hence, it is said that accounting starts where bookkeeping ends. The function of bookkeeping ends with the recording of transactions in the books of accounts. But the function of accounting is to classify the recorded transactions, summarize them, interpret them, and collect and communicate necessary information to the management and other interested persons.

Management performs its function on the basis of this information, e.g. laying down rules and regulations, taking so many vital decisions etc. Thus we may say that the function of bookkeeping is primarily of clerical in nature, while that of accounting is concerned with organizational and administrative matters. It is more important and responsible.

Apparently, the functions of bookkeeping seem to be less important than accounting, but its necessity can hardly be denied. Just an article cannot be produced without raw material; similarly accounting function cannot be done without obtaining necessary data from bookkeeping. If there is any defect in raw material the article produced out of it will also be defective. Similarly, if there be any error or mistake in bookkeeping, the accounting job will also be wrong and create anomalous situation. Thus we can conclude that bookkeeper performs the routine, repetitive tasks of collecting and processing financial information. Accountants are responsible for designing the systems within which bookkeepers work; supervising the day to day work of bookkeepers; recording unusual and complex transactions, preparing, analysing and interpreting accounting reports; verifying the records; and performing a variety of other complex accounting activities.

Branches of Accounting

In order to meet the ever increasing demands made on accounting by different interested parties (such as owners, management, creditors, taxation authorities and other govt. agencies etc.) the various **Branches of Accounting** have come into existence.

1. Financial Accounting:

The main **purpose of financial accounting** is to ascertain the true result (profit or loss) of the business operations during a particular period of time and to state the financial position of the business on a particular point of time.

Financial accounting produces general purpose reports for the use by the great variety of people who are interested in the organization but who are not actively engaged in its day-to-day operation.

2. Cost Accounting:

The main **object of cost accounting** is to determine the cost of goods manufactured or produced by the business. It also helps the management of the business in controlling the costs by indicating avoidable losses and wastes.

In order to set prices of the products of the companies, correct calculation of all manufacturing as well as non-manufacturing costs is necessary. Cost accounting is also helpful to accomplish this task.

3. Managerial Accounting:

The **object of managerial accounting** is to communicate the relevant information periodically to the management of the business to enable it to take suitable decisions.

Financial accounting is the oldest and the other branches have developed from it according to the need of different parties. The objects of financial accounting can only be achieved by recording business transactions in a systematic manner according to a set of principles.

Basic Principles of Financial Accounting

A number of basic accounting principles have been developed through common usage. They form the basis upon which accounting is based. Some of these key principles are as follows:

- **Accrual principle -** This concept states that accounting transactions should be recorded in the accounting periods when they actually occur, rather than in the periods when there are cash flows associated with them. This is the foundation of the accrual basis of accounting. It is important for the construction of financial statements that show what actually happened in an accounting period, rather than being artificially delayed or accelerated by the associated cash flows. ***For example,*** *if you ignored the accrual principle, you would record an expense only when you paid for it, which might incorporate a lengthy delay caused by the payment terms for the associated supplier invoice.*

- **Prudence principle -** This concept states that you should record expenses and liabilities as soon as possible, but to record revenues and assets only when you are sure that they will occur. This introduces a conservative slant to the financial statements that may yield lower reported profits, since revenue and asset recognition may be delayed for some time. Conversely, this principle tends to encourage the recordation of losses earlier, rather than later. This concept if taken too far will result in businesses persistently misstating its results to be worse than is the case.

- **Consistency principle -** This concept states that, once you adopt an accounting principle or method, you should continue to use it until a demonstrably better principle or method comes along. Not following the consistency principle means that a business could continually jump between different accounting treatments of its transactions that make its long-term financial results extremely difficult to discern.

- **Historical Cost principle -** This concept states that a business should only record its assets, liabilities, and equity investments at their original purchase costs. This principle is becoming less valid, as a host of accounting standards are heading in the direction of adjusting assets and liabilities to their fair values.

- **Economic entity principle -** This concept states that the transactions of a business should be kept separate from those of its owners and other businesses. This prevents intermingling of assets and liabilities among multiple entities, which can cause considerable difficulties when the financial statements of a fledgling business are first audited.

- **Full disclosure principle -** This is the concept that you should include in or alongside the financial statements of a business all of the information that may impact a reader's understanding of those financial statements. The accounting standards have greatly amplified upon this concept in specifying an enormous number of informational disclosures.
- **Going concern principle -** This is the concept that a business will remain in operation for the foreseeable future. This means that you would be justified in deferring the recognition of some expenses, such as depreciation, until later periods. Otherwise, you would have to recognize all expenses at once and not defer any of them.
- **Matching principle -** This concept states that when you record revenue, you should record all related expenses at the same time. Thus, you charge inventory to the cost of goods sold at the same time that you record revenue from the sale of those inventory items. This is a cornerstone of the accrual basis of accounting. The cash basis of accounting does not use the matching the principle.
- **Materiality principle -** This is the concept that you should record a transaction in the accounting records if not doing so might have altered the decision making process of someone reading the company's financial statements. This is quite a vague concept that is difficult to quantify, which has led some of the more picayune controllers to record even the smallest transactions.
- **Monetary unit principle -** This is the concept that a business should only record transactions that can be stated in terms of a unit of currency. Thus, it is easy enough to record the purchase of a fixed asset, since it was bought for a specific price, whereas the value of the quality control system of a business is not recorded. This concept keeps a business from engaging in an excessive level of estimation in deriving the value of its assets and liabilities.
- **Reliability principle -** This concept states that only those transactions that can be proven should be recorded. For example, a supplier invoice is solid evidence that an expense has been recorded. This concept is of prime interest to auditors, who are constantly in search of the evidence supporting transactions.
- **Revenue recognition principle** - This concept states that you should only recognize revenue when the business has substantially completed the earnings process. So many people have skirted around the fringes of this concept to commit reporting fraud that a variety of standard-setting bodies have developed a massive amount of information about what constitutes proper revenue recognition.
- **Time period principle -** This is the concept that a business should report the results of its operations over a standard period of time. This may qualify as the most glaringly obvious of all accounting principles, but is intended to create a standard set of comparable periods, which is useful for trend analysis.

These principles are incorporated into a number of accounting frameworks, from which accounting standards govern the treatment and reporting of business transactions.

Business Transaction

Business Transaction is an event. All events are not accounting transactions. An event must have the following features to become a transaction:

- **<u>There must be two parties:</u>** No transaction is possible without two parties. There cannot be a *„giver"* unless there is a *„receiver"*. Suppose, Mr. X borrows INR 10,000 from a bank. This is a transaction, since there are two parties here – Mr. X and Bank.
- **<u>The event must be measurable in terms of money:</u>** An event will not be regarded as a transaction, unless it is capable of being measured in terms of money.
- **<u>The event must result in transfer of property or service:</u>** Suppose, we buy a motor-car from Mr. S for INR 500000. This results in transfer of property from Mr.S to us, so it is a transaction. Payment of salary of INR 20000 to employee results in transfer of service - the employee renders service and we receive it. So it is a transaction.
- **<u>The event must change the financial position of the business:</u>** Transaction takes place only when there is a change in the financial position of the business. The change in financial position may be of two kinds:
  - **Quantitative change:** This changes the total value of assets and liabilities of a business concern. Suppose, machinery of INR 50,000 is destroyed. This reduces the total value of the assets of the business. As a result, the financial position changes and hence it is a transaction.
  - **Qualitative change:** This causes increase or decrease in the different elements of assets or liabilities, but the value of total assets and total liabilities remains unchanged. Suppose, we buy machinery worth INR 50,000. This results in exchange of properties - cash of INR 50,000 goes out of our possession and at the same time machinery of an equal value comes into our possession. This does not change the total value of our assets, but this causes a qualitative change in our financial position, hence it is a transaction.

<u>Cash and Credit Transaction</u>

*A transaction is regard as a **cash transaction** if;*

- "Cash/Bank" is mentioned in the transaction. Ex: bought goods for cash INR 5000 from Mr.A.
- The name of the seller or buyer is not mentioned in the transaction. Ex: Bought goods INR 5000.

*A transaction is regarded as a **credit transaction** if:*

- The words "on credit" or "on account" are mentioned in the transaction. Ex: Bought goods worth INR 5000 on credit.
- The name of the seller or buyer is mentioned in the transaction and the word "Cash" is not mentioned. Ex: Bought goods from A worth $5000.

Every business transaction brings a 'double change' in the financial position of the business. It brings a change in the assets, liabilities, owner's equity, expenses or revenues of a business.

<u>Accounting through Double Entry System</u>

<u>Definition and Explanation of Double Entry System:</u>

Every business transaction causes at least two changes in the financial position of a business concern at the same time - hence, both the changes must be recorded in the _Books of

Accounts‘. Otherwise, the books of accounts will remain incomplete and the result ascertained therefore will be inaccurate.

For example, we buy machinery for INR 500,000. Obviously, it is a business transaction. It has brought two changes - machinery increases by INR 500,000 and cash decreases by an equal amount. While recording this transaction in the books of accounts, both the changes must be recorded. In accounting language these two changes are termed as "a debit change" and "a credit change" The detail about these terms is given under the topic account.

Thus we see that for every transaction there will be two entries - one debit entry and another credit entry. For each debit there will be a corresponding credit entry of an equal amount. Conversely, for every credit entry there will be a corresponding debit entry of an equal amount.

The system under which the changes in a transaction are recorded together - one change is debited, and the other change is credited with an equal amount - is known as double entry system.

The fundamental principle of double entry system lies in analysing the two changes (parties) involved in business transactions and properly recording of both the changes in the books of accounts. There is no exception to this principle. If a complete picture of the transactions is to be reflected through books of accounts, the double entry system must be duly observed.

Processes of the accounting in Double Entry System:

Following are the successive processes of the double entry system:

Journal: All transactions are recorded in chronological order in a book known as **journal.**

Ledger: In the second process, the transactions are classified in a suitable manner and recorded in another book known as ledger.

Trial Balance: In the third process, the arithmetical accuracy of the books of account is tested by means of trial balance.

Final Accounts: In the fourth and final process the result of the accounting period working is determined through final accounts.

Advantages of Double Entry System:

Double entry system is acknowledged as the best method of accounting in the modern world. Following are the main **advantages of double entry system**:

- Under this method, both the aspects of each and every transaction are recorded. So it is possible to keep a complete account.
- For each debit there must be a corresponding credit of an equal amount. Therefore, total debits must be equal to total credits. Hence, it is possible to verify the arithmetical accuracy of the _Books of Accounts‘ by ascertaining whether the two sides are balanced through a process known as _Trial Balance‘.
- Under this system, a _Profit & Loss Account‘ can be prepared easily by taking together all the accounts relating to income or revenue and expenses or losses and **thereby the result of the business can be ascertained**.

- A ‗Balance Sheet‘ can be prepared by taking together all the accounts relating to assets and liabilities and **thereby the financial position of the business can be assessed**.
- Under this system mistakes and deflections can be detected - this exerts a moral pressure on the accountant and his staff.
- Under this system necessary statistics are easily available so that the management can take appropriate decision and run the business efficiently.
- All the necessary details about a transaction can be obtained quickly and easily.
- Total amount owed by debtors and the total amount owed to creditors can be ascertained easily.
- Sale, purchase of goods, stock, revenue, expenses and profit or loss of different years can be compared and the success or failure of the business measured. Thereafter the causes of failure can be found out and necessary remedial measures taken to ensure success of the business.

Disadvantages of Double Entry System:

Despite many advantages, double entry system has some disadvantages which are as follows:

- Under this method each transaction is recorded in books in two stages (journal and ledger) and two sides (debit and credit). This results in increase of number and size of books of account and creation of complications.
- It involves time, labor and money. So it is not possible for small concerns to keep accounts under this system.
- It requires expert knowledge to keep accounts under this system.
- As the system is complex, there is greater possibility of committing errors and mistakes.

It is clear from the above discussion that the advantages of double entry system far outweigh its disadvantages. So, it is regarded as the best system in the modern world.

Journal & Ledger Accounts

As discussed, transactions are recorded in the books of accounts in two stages under double entry system of book keeping:

- First stage - Journal
- Second stage - Ledger

The flow of accounting information from the time a transaction takes place to its recording in the ledger may be illustrated as follows:

Business Transaction

↓

Business Document Prepared

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Entry Recorded in Journal

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Entry Posted to Ledger

The initial record of each transaction is evidenced by a business document such as invoice, cash, voucher etc. Transactions are first recorded in journal and there after posted to two or three concerned accounts in the ledger.

Journal Book

Introduction: The word journal has been derived from the French word "Jour" Jour means day. So, journal means daily. Transactions are recorded daily in journal and hence it has named so. As soon as a transaction takes place its debit and credit aspects are analysed and first of all recorded chronologically (in the order of their occurrence) in a book together with its short description called the _Narration‘.

This book is known as journal. Thus we see that the most important function of journal is to show the relationship between the two accounts connected with a transaction. This facilitates writing of ledger. **Since transactions are first of all recorded in journal, so it is called book of original entry or prime entry or primary entry or preliminary entry, or first entry**.

Journal Entry: Recording a transaction in a journal is called **journal entry** or **journalizing**.

Narration for the Entry: A short explanation of each transaction is written under each entry which is called narration. The subject matter of the transaction can be ascertained through narration. Besides this, if there be any mistake in determining debit or credit aspect of a transaction, it can be easily detected from narration. *"A journal entry is not complete without narration"*.

Characteristics of a Journal:

Journal has the following features:

- Journal is the first successful step of the double entry system. A transaction is recorded first of all in the journal. So, journal is called the book of original entry.
- A transaction is recorded on the same day it takes place. So, journal is also called a day book.
- Transactions are recorded chronologically. So, journal is called **chronological book**.
- For each transaction the names of the two concerned accounts indicating which is debited and which is credited, are clearly written into consecutive lines. This makes ledger - posting easy. That is why journal is called **"assistant to ledger"** or **"subsidiary book".**
- Narration is written below each entry.
- The amount is written in the last two columns - debit amount in debit column and credit amount in credit column.

Advantages of Journal:

The following are the advantages of journal:

- Each transaction is recorded as soon as it takes place. So there is no possibility of any transaction being omitted from the books of account.
- Since the transactions are kept recorded in journal chronologically with narration, it can be easily ascertained when and why a transaction has taken place.

- For each and every transaction which of the two concerned accounts will be debited and which account credited, are clearly written in journal. So, there is no possibility of committing any mistake in writing the ledger.
- Since all the details of transactions are recorded in journal, it is not necessary to repeat them in ledger. As a result ledger is kept tidy and brief.
- Journal shows the complete story of a transaction in one entry.
- Any mistake in ledger can be easily detected with the help of journal.

Format of Journal:

Date	Particulars	L.F	Amount	Amount
	Account to be debited ....Dr. Account to be credited (Narration)		XXX	 XXX

<u>Classification of Accounts – Credit & Debit Rules</u>

Accounts are primarily classified into three types. They are:

- Personal accounts
- Real accounts
- Nominal accounts

Personal Accounts: ***[Debit the Receiver, Credit the Giver]***

The transactions with **real and artificial persons are recorded in personal accounts**. These accounts show the transactions with the customers, suppliers, money lenders, the bank and the owner.

A business may have many credit transactions with the above persons or organizations. A separate account is to be prepared for each of them. Persons or organizations with whom the business has credit transactions are either debtors or creditors. **If they owe money to the firm, they are called debtors. Conversely, if the firm is to pay them some money they are known as creditors.** The main purpose of preparing personal accounts is to ascertain the summary balances due to or due from persons or organizations.

Real Accounts: ***[Debit what comes in, Credit what goes out]***

These are **accounts of assets and liabilities**. Properties such as land, building, plant, machinery, patent, cash, investment, inventory, etc. When machinery is purchased for cash, the two accounts involved are machinery and cash - both are real accounts. But if the same machine is purchased from Z & Co. on credit, the two accounts involved will be those of machinery and Z & Co., the former being a real account and the latter being a personal account.

Nominal Accounts: ***[Debit all expenses and losses, Credit all incomes and gains]***

These are the accounts of incomes, expenses, gains and losses. Examples of nominal accounts are wages paid, discount allowed or received, purchases, sales, etc. These accounts generally accumulate the data required for the preparation of income statement or trading and profit and loss account.

Example 1:

Examples of real, nominal and personal accounts:

Plant and machinery	Real account
Purchases	Nominal account
Investment	Real account
Bank	Personal account
Tata Iron & steel Co.	Personal account
Rent	Nominal account
Land and Building	Real account
Carriage outward	Nominal account
Capital	Real account
Leasehold	Real account
Trademark	Real account
Return outwards	Nominal Account
Import duty	Nominal Account

Example 2

1. **The Business is proposed to be started.**
   This transaction has no monetary effect and hence will not be recorded in books of accounts based on _Monetary Unit Principle'

2. **Commenced Business with a capital of INR 1,00,000.**
   Capital being in the nature of cash/money is being brought into the business. i.e. Capital goes up by INR 1,00,000 and cash goes by INR 1,00,000.

   Elements affected by the transaction are –
   Capital Account – Owners Equity account – **Real Account**
   Cash Account – No Person involved - Asset to the Company – **Real Account**

3. **Brought Furniture for Cash worth INR 10,000.**
   Furniture is being brought for cash. The value of Furniture goes up by INR 10,000 and the amount of Cash comes down by INR 10,000.

   Elements affected by the transaction are –
   Furniture Account - No Person involved - Asset to the Company – **Real Account**
   Cash Account – No Person involved - Asset to the Company – **Real Account**
4. **Purchased Stock from Star Limited worth INR 25,000.**
   Goods are being purchased for cash. The Value of goods increases by INR 25,000 and the amount of cash comes down by INR 25,000.

   Elements affected by the transaction are –
   Goods Account - No Person involved – Asset to company – **Nominal Account**
   Cash Account – No Person involved - Asset to the Company – **Real Account**

Example – 3

From the following transactions, state the nature of accounts and state which account will be debited and which account will be credited.

1. Mr. A started business with INR 50,000
2. Purchased goods for cash INR 10,000.
3. Sold goods for cash INR 15,000
4. Purchased goods from X for cash INR 5,000
5. Sold goods to B for INR 6,000.
6. Purchased furniture for INR 40,000.
7. Purchased plant or INR 10,000.
8. Paid wages INR 4,000

SN.	Accounts Involved	Nature of Accounts	Debit or Credit
1.	Cash account Capital account	Real Personal	Debit (incomings) Credit (giver)
2.	Purchases account Cash account	Nominal Real	Debit (expenses) Credit (outgoings)
3.	Cash account Sales account	Real Nominal	Debit (incomings) Credit (income)
4.	Purchases account Cash account	Nominal Real	Debit (expenses) Credit (outgoings)
5.	B account Sales account	Personal Nominal	Debit (receiver) Credit (income)
6.	Furniture account Cash account	Real Real	Debit (incomings) Credit (outgoings)
7.	Plant account Cash account	Real Real	Debit (incomings) Credit (outgoings)
8.	Wages account Cash account	Nominal Real	Debit (expenses) Credit (outgoings)

Ledger

Introduction: The journal provides a complete listing of the daily transactions of a business. But it does not provide information about a specific account in one place. For example, to know how much cash balance we have, the accounting clerk would have to check all journal entries in which cash is involved, and this is very laborious job; because there are hundreds or even thousands of cash transactions recorded on different pages of journal.

To avoid this difficulty, the debit and credit of journalized transactions are transferred to ledger accounts. Thus all the changes for a single account are located in one place - in a ledger account. This makes it easy to determine the current balance of any account.

Explanation of Ledger: The book in which accounts are maintained is called **ledger**. Generally, one account is opened on each page of this book, but if transactions relating to a particular account are numerous, it may extend to more than one page.

All transactions relating to that account are recorded chronologically. From journal each transaction is posted to at least two concerned accounts - debit side of one account and credit side of another account. Remember that, if there are two accounts involved in a journal entry, it will be posted to two accounts in the ledger and if the journal entry consists of three accounts (compound entry) it will be posted to three different accounts in the ledger.

Ledger Posting: Recording a transaction from journal to the concerned account in the ledger is called **ledger posting.**

Characteristics of Ledger Account:

- It has two identical sides - left hand side (debit side) and right hand side (credit side).
- Debit aspect of all the transactions are recorded on the debit side and credit aspects of all the transactions are recorded on credit side according to date.
- The difference of the totals of the two sides represents balance. The excess of debit side over credit side indicates debit balance, while excess of credit side over debit side indicates the credit balance. If the two sides are equal, there will be no balance.
- Generally the balance is drawn at the year end and recorded on the lesser side to make the two sides equal. This balance is known as closing balance.
- The closing balance of the current year becomes the opening balance of the next year.

Standard Form of Ledger Account:

To understand clearly as to how to write the accounts in ledger, the standard form of an account is given below with two separate transactions:

Date	Particulars	J.R	Amount	Date	Particulars	J.R	Amount

It appears that each account in the ledger has two similar sides - left hand side is called debit side (briefly Dr.) and right hand side (briefly Cr.) side.

Posting Procedure:

Transferring information i.e. entries from journal to ledger accounts is called posting. The procedure of posting from journal to ledger is as follows:

- Locate the ledger account from the first debit in the journal entry.
- Record the date in the date column on the debit side of the account. The date is the date of transaction rather than the date of the posting.
- Record the name of the opposite account (account credited in entry) in the _particulars‘ (also known as reference column, description column etc.) column.

- Record the page number of the journal in the journal reference (J.R) column from where the entry is being posted.
- Record the amount of the debit in the "amount column"
- Locate the ledger account for the first credit in the journal and follow the same procedure.

Balancing an Account:

The difference between the two sides of an account is its balance. The balance is written on the lesser side to make the two sides equal. **The process of equalizing the two sides of an account is known as balancing**.

Accounting Equation

The three basic elements of accounting are **assets, liabilities and owners' equity (capital)**.

- **The assets** represent the things of value that a business owns.
- **The liabilities** are the claims of the creditors against those assets.
- **The owner's equity (capital)** is the claim of the owner against those assets. Whatever is not claimed by the creditors belongs to the owner.

As a result, the total claims against the assets are always equal to the total assets. This equality between the assets and the liabilities and the owner's equity is expressed by the **"accounting equation"**.

The two sides of the accounting equation must always be equal because the rights, to all the assets of a business are owned by someone. The creditors have a claim against the assets of a business until the liabilities have been paid. The owner has a claim against the remaining assets of the business. If no liabilities exist, then the owners' equity will equal to the total assets.

A clear understanding of the accounting equation is essential, because most of accounting systems based on it. The equation actually identifies the claims (or rights) against the assets held by a business. The two sides represent different versions of the same thing. The left side of the equation, assets, consists of the "resources" (properties) held by the business; the right side of the equation, (creditor's claim and owner's claim against the assets) consists of the "sources".

"The expression of the equality of an entity's assets with the claims against them is referred to as the accounting equation."

It should be remembered that the two sides of the equation are always equal because these two sides are merely two views of the same business resources. The assets side shows us **"what resources" the business owns**, the other side (liabilities and owner's equity) tells us **"who supplied these resources"** to the business and how much each group supplied.

Effect of Business Transactions on Accounting Equation:

Regardless of whether a business grows or contracts this equality between the assets and the claims against the assets is always maintained. Any increase in the amount of total assets is necessarily accompanied by an equal increase on the other side of the equation, that is, by an increase in either the liabilities or the owner's equity. Any decrease in the amount of total assets is necessarily accompanied by an equal decrease in liabilities or owner's equity. Any expense incurred will decrease the owner's equity on one side and decrease cash on the other side of the equation. Any revenue earned will increase the owner's equity on one side and increase assets on the other side. The effect of transactions upon the accounting equation can best be illustrated by taking new business as an **Example:**

Assume that Mr. Rana decided to start a "shoes business" of his own, to be known as Rana Shoes Company". The new business was started on 1st January, 2015, when Mr. Rana invested INR 5,00,000 in his business.

Recall that the business entity is kept separate from its owner. The business unit has borrowed INR 5,00,000 from its owner. This is a first transaction of the business. It brought a double change in the financial position of the business — an asset (cash) increased by INR 5,00,000 and a liability (owner's equity or capital) increased also by INR 5,00,000. This transaction is consisting of two elements:

1. The receipt of INR 500,000 cash. 2. Supplied by the owner of the business.

The initial accounting equation of the new business then appeared as follows:

Assets	**=**	**Liabilities**	**+**	**Owner's equity**
Cash	=			Capital
INR 5,00,000	=	Nil	+	INR 5,00,000

Transaction No. 2:

Mr. Rana purchased a building for INR 2,00,000. This transaction brought two changes—cash (asset) decreased by INR 2,00,000 and Building (a new asset) increased by INR 2,00,000. Now the equation will be;

Assets			**=**	**Liabilities**	**+**	**Owner's equity**
Cash	+	Building	=			Capital
INR 3,00,000	+	INR 2,00,000	=	Nil	+	INR 5,00,000

It may be noted that there is no change on the right side of the equation. Simply one asset (cash) has been converted into another asset (Building). The two sides of the equation remain equal.

Transaction No. 3:

He purchased furniture for INR 30,000. This transaction brought two changes—cash (asset) decreased by INR 30,000 and furniture (a new asset) increased by INR 30,000. The equation will be;

Assets					=	Liabilities	+	Owner's equity
Cash	+	Building	+	Furniture	=			Capital
INR 270,000	+	INR 2,00,000	+	INR 30,000	=	Nil	+	INR 5,00,000

Again there is no change on the right side of the equation and cash (asset) is converted into a new asset, furniture.

Transaction No. 4:

He purchased goods (shoes) for INR 1,50,000 to stock up the business. This transaction brought two changes - cash (asset) decreased by INR 1,50,000 and goods (stock) increased by INR 1,50,000. Again, there is no change on the right side of the equation. The equation will be:

Assets							=	Liabilities	+	Owner's equity
Cash	+	Building	+	Furniture	+	Goods	=			Capital
120000	+	200000	+	30000	+	150000	=	Nil	+	INR 5,00,000

Transaction No. 5:

He sold goods costing INR 60,000 for INR 80,000 for cash. This transaction has brought three changes (a) cash (asset) increased by INR 80,000; (b) stock of goods decreased by INR 60,000; (c) the difference between sale price of goods (80,000) and cost price of goods (60,000) is profit of INR 20,000, it would increase the owner's equity by INR 20,000. The equation will be:

Assets					=	Liabilities	+	Owner's equity
Cash	+ Building	+ Furniture	+	Goods	=			Capital
INR 120000	+ 200000	+ 30000	+	150000	=			500,000
+80000			-	60000		Nil	+	20,000
200000	+ 200000	+ 30000	+	90000	=	Nil	+	520000

Transaction No. 6:

He purchased goods (shoes) for INR 30,000 on credit basis. This transaction has brought two changes Goods (stock) increased by INR 30,000 and a liability (creditor) is created, as goods have been purchased on credit basis: The equation will be as follows:

Assets					=	Liabilities + Owner's equity		
Cash	+ Building	+ Furniture	+	Goods		Creditors	+	Capital
INR 200000	+ 200000	+ 30000	+	90000	=	Nil	+	520,000
			+	30000		30000		
200000	+ $200000	+ 30000	+	120000	=	30000	+	520,000

Transaction No. 7:

He sold goods costing INR 50,000 for INR 70,000 on credit basis. The result of this transaction is (a) Stock of goods is reduced by INR 50,000; (b) A new asset (debtor) is increased by INR 70,000, as goods have been sold on credit basis; (c) The owner's equity is increased by INR 20,000 as a credit to the P&L A/c (the profit) The equation will be:

Assets					=	Liabilities + Owner's equity		
Cash	+ Building	+ Furniture	+ Goods	+ Debtors	=	Creditors	+	Capital
200000	+ 200000	+ 30000	+ 120000	+ Nil	=	30000	+	520,000
			- 50000	+ 70000				20000
200000	+ 200000	+ 30000	+ 70000	+ 70000	=	30000	+	540000

Transactions No. 8:

Creditor was paid INR 30,000. The result of this transaction is - a liability (creditor) is decreased by INR 30,000 and cash (asset) is also decreased by INR 30,000. Now the equation is:

Assets					=	Liabilities + Owner's equity		
Cash	+ Building	+ Furniture	+ Goods	+ Debtors	=	Creditors	+	Capital
200000	+ 200000	+ 30000	+ 70000	+ 70000	=	30000	+	540000
- 30000						- 30000		
170000	+ 200000	+ 30000	+ 70000	+ 70000	=	Nil	+	540000

Transaction No. 9:

Cash received from the debtor INR 40,000. The result of this transaction is - cash (asset) increased by INR 40,000 and debtor (asset) decreased by INR 40,000. The equation is:

Assets					=	Liabilities + Owner's equity		
Cash	+ Building	+ Furniture	+ Goods +	Debtors	=	Creditors	+	Capital
170000 +	200000 +	30000	+ 70000 +	70000	=	Nil	+	540,000
+ 40000			-	40000				
210000 +	200000 +	30000	+ 70000 +	30000	=	Nil	+	540000

Transaction No. 10:

Goods costing INR 25,000 were lost by fire. The result of this transaction is - stock of goods is reduced by INR 25,000 and owner's equity is also decreased by INR 25,000 as a charge to the P&L A/c (as loss will be borne by the owner). The equation is:

Assets					=	Liabilities + Owner's equity		
Cash	+ Building	+ Furniture	+ Goods +	Debtors	=	Creditors	+	Capital
210000 +	200000 +	30000	+ 70000 +	30000	=	Nil	+	540,000
			- 25000				-	25000
210000 +	200000 +	30000	+ 45000 +	30000	=	Nil	+	515000

Transaction No. 11:

He paid salaries and telephone bill INR 7,000. The result of this transaction is - cash (asset) is decreased by INR 7,000 and owner's equity is also decreased by 7,000 (the expenses reduced the owner's equity as a charge to the P&L A/c). The equation is:

Assets					=	Liabilities + Owner's equity		
Cash	+ Building	+ Furniture	+ Goods +	Debtors	=	Creditors	+	Capital
210000 +	200000 +	30000	+ 45000 +	30000	=	Nil	+	515000
- 7000							-	7000
203000 +	200000 +	30000	+ 45000 +	30000	=	Nil	+	508000

Transaction No. 12:

He borrowed money from a bank (as bank loan) INR 50,000. The result of this transaction is - cash (asset) is increased by INR 50,000 and a new liability (bank loan) is created (increased) by INR 50,000. The accounting equation is:

Assets					=	Liabilities + Owner's equity			
Cash	+ Building	+ Furniture	+ Goods +	Debtors	=	Creditors	Bank Loan	+	Capital
203000 +	200000 +	30000	+ 45000 +	30000	=	Nil	0	+	508000
+ 50000							+ 50000		
253000 +	200000 +	30000	+ 45000 +	30000	=	Nil	50000	+	508000

Resources	=	Sources
(Assets)	**=**	**(Equities)**
INR 558000	**=**	**INR 558000**

It may be noted that equality of the two sides was maintained throughout the recording of the transactions.

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Financial Statements

The financial statements are the end product of an accounting process. They are prepared consistent with the accounting policies, principles, concepts and procedures and also the legal environment in which the company operates. The statements are the outcome of summarizing the data generated during the process of accounting and hence are sources of information for determining the basis of profitability and financial position of the company. The basic components of financial statements as given in the definition under Section 2(40) of the companies act, 2013 include –

a) Balance sheet as at the end of the accounting period disclosing the financial position of the company;
b) Profit and loss account/income and expenditure account disclosing the results of operations for a given accounting period;
c) Cash flow statement disclosing the movement of cash and cash equivalents during the period of operations;
d) Statement of changes in equity; and
e) Any explanatory note annexed to the above.

Section 129 of companies act 2013, lays down that the financial statements shall give a true and fair view of the state of affairs of the Company or Companies comply with the

Accounting Standards and the format of those financial statements shall be as per Schedule III of CA, 2013.

As ‗Accounting Standards' including ―Ind AS‖ as applicable have become mandatory, Schedule III to the Companies Act, 2013 became an important piece of document with a format aligned with that of Accounting Standards. The Schedule III to the Companies Act, 2013 became applicable to all companies for the preparation of Financial Statements beginning on or from 1.4.2014.

Schedule III of the companies Act, 2013 - Form; Format and Content of the Balance Sheet and Profit & Loss Account

The Structure of Schedule III is as under:

I. General Instructions

II. Part I – Form of Balance Sheet

III. General Instructions for Preparation of Balance Sheet

IV. Part II – Form of Statement of Profit and Loss

V. General Instructions for Preparation of Statement of Profit and Loss

VI. General Instructions for the Preparation of Consolidated Financial Statements

GENERAL INSTRUCTIONS

1. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head or sub-head or any changes, *inter se*, in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly.

2. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

3. (*i*) Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (*a*) narrative descriptions or disaggregations of items recognised in those statements; and (*b*) information about items that do not qualify for recognition in those statements.

   (*ii*) Each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts. In preparing the Financial Statements including the notes to accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and no providing important information as a result of too much aggregation.

4. (*i*) Depending upon the turnover of the company, the figures appearing in the Financial Statements may be rounded off as given below:—

5.

Turnover	Rounding off
(*a*) less than one hundred crore rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
(*b*) one hundred crore rupees or more	To the nearest lakhs, millions or crores, or decimals thereof.

(*ii*) Once a unit of measurement is used, it shall be used uniformly in the Financial Statements.

6. Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.

7. For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards.

Note:—This part of Schedule sets out the minimum requirements for disclosure on the face of the Balance Sheet, and the Statement of Profit and Loss (hereinafter referred to as ―Financial Statements‖ for the purpose of this Schedule) and Notes. Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company‘s financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Accounting Standards.

PART I — BALANCE SHEET
Name of the Company…………………….
Balance Sheet as at ………………………
(Rupees in… ....)

Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
1	2	3	4
I. EQUITY AND LIABILITIES			
(1) Shareholders‘ funds			
(a) Share capital			
(b) Reserves and surplus			
(c) Money received against share warrants			
(2) Share application money pending allotment			
(3) Non-current liabilities			
(a) Long-term borrowings			
(b) Deferred tax liabilities (Net)			
(c) Other Long term liabilities			
(d) Long-term provisions			
(4) Current liabilities			

(a) Short-term borrowings
(b) Trade payables
(c) Other current liabilities
(d) Short-term provisions

TOTAL

II. ASSETS

Non-current assets

(1) (*a*) Fixed assets
(i) Tangible assets
(ii) Intangible assets
(iii) Capital work-in-progress
(iv) Intangible assets under development
(b) Non-current investments
(c) Deferred tax assets (net)
(d) Long-term loans and advances
(e) Other non-current assets

(2) Current assets

(a) Current investments
(b) Inventories
(c) Trade receivables
(d) Cash and cash equivalents
(e) Short-term loans and advances
(f) Other current assets

TOTAL

See accompanying notes to the Financial Statements.

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:—

   (a) it is expected to be realised in, or is intended for sale or consumption in, the company‘s normal operating cycle;

   (b) it is held primarily for the purpose of being traded;

   (c) it is expected to be realised within twelve months after the reporting date; or

   (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

   All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have duration of twelve months.

3. A liability shall be classified as current when it satisfies any of the following criteria:—

   (a) it is expected to be settled in the company‘s normal operating cycle;

   (b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a –trade receivable‖ if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a –trade payable‖ if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

A company shall disclose the following in the notes to accounts.

A. Share Capital

For each class of share capital (different classes of preference shares to be treated separately):

(a) the number and amount of shares authorised;

(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(c) par value per share;

(d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;

(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;

(f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by

subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

(g) shares in the company held by each shareholder holding more than 5% shares specifying the number of shares held;

(h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;

(i) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:

(A) Aggregate number and class of shares allotted as fully paid-up pursuant to contract(s) without payment being received in cash.

(B) Aggregate number and class of shares allotted as fully paid-up by way of bonus shares.

(C) Aggregate number and class of shares bought back.

(j) terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date;

(k) calls unpaid (showing aggregate value of calls unpaid by directors and officers);

(l) forfeited shares (amount originally paid-up).

B. Reserves and Surplus

(i) Reserves and Surplus shall be classified as:

(a) Capital Reserves;

(b) Capital Redemption Reserve;

(c) Securities Premium Reserve;

(d) Debenture Redemption Reserve;

(e) Revaluation Reserve;

(f) Share Options Outstanding Account;

(g) Other Reserves–(specify the nature and purpose of each reserve and the amount in respect thereof);

(h) Surplus *i.e*., balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/ from reserves, etc.;

(Additions and deductions since last balance sheet to be shown under each of the specified heads);

(ii) A reserve specifically represented by earmarked investments shall be termed as a –fund‖.

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head –Surplus‖. Similarly, the balance of –Reserves and Surplus‖, after adjusting negative balance of surplus, if any, shall be shown under the head –Reserves and Surplus‖ even if the resulting figure is in the negative.

C. Long-Term Borrowings

(i) Long-term borrowings shall be classified as:

(a) Bonds/debentures;
(b) Term loans:
(A) from banks.
(B) from other parties.
(c) Deferred payment liabilities;
(d) Deposits;
(e) Loans and advances from related parties;
(f) Long term maturities of finance lease obligations;
(g) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.

(v) Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed.

(vi) Terms of repayment of term loans and other loans shall be stated.

(vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest shall be specified separately in each case.

D. Other Long-term Liabilities

Other Long-term Liabilities shall be classified as:

(a) Trade payables;
(b) Others.

E. Long-term provisions

The amounts shall be classified as:

(a) Provision for employee benefits;
(b) Others (specify nature).

F. Short-term borrowings

(i) Short-term borrowings shall be classified as:

(a) Loans repayable on demand;
- (A) from banks.
- (B) from other parties.

(b) Loans and advances from related parties;
(c) Deposits;
(d) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Period and amount of default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

G. Other current liabilities

The amounts shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends;

(g) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorised capital to cover the share capital amount resulting from allotment of shares out of such share application money.

Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable, *i.e.*, the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under ―Other current liabilities‖;

(h) Unpaid matured deposits and interest accrued thereon;
(i) Unpaid matured debentures and interest accrued thereon;
(j) Other payables (specify nature).

H. Short-term provisions

The amounts shall be classified as:

(a) Provision for employee benefits.
(b) Others (specify nature).

I. Tangible assets

(i) Classification shall be given as:

(a) Land;
(b) Buildings;
(c) Plant and Equipment;
(d) Furniture and Fixtures;
(e) Vehicles;
(f) Office equipment;
(g) Others (specify nature).

(ii) Assets under lease shall be separately specified under each class of asset.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

(iv) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

J. Intangible assets

(i) Classification shall be given as:

(a) Goodwill;
(b) Brands /trademarks;
(c) Computer software;
(d) Mastheads and publishing titles;
(e) Mining rights;
(f) Copyrights, and patents and other intellectual property rights, services and operating rights;
(g) Recipes, formulae, models, designs and prototypes;
(h) Licences and franchise;
(i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

(iii) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

K. Non-current investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

(a) Investment property;
(b) Investments in Equity Instruments;
(c) Investments in preference shares;
(d) Investments in Government or trust securities;
(e) Investments in debentures or bonds;
(f) Investments in Mutual Funds;
(g) Investments in partnership firms;
(h) Other non-current investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof;

(iii) The following shall also be disclosed:

(a) Aggregate amount of quoted investments and market value thereof;
(b) Aggregate amount of unquoted investments;

(c) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

(i) Long-term loans and advances shall be classified as:

(a) Capital Advances;
(b) Security Deposits;
(c) Loans and advances to related parties (giving details thereof);
(d) Other loans and advances (specify nature).

(ii) The above shall also be separately sub-classified as:

(a) Secured, considered good;
(b) Unsecured, considered good;
(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

M. Other non-current assets

Other non-current assets shall be classified as:

(i) Long-term Trade Receivables (including trade receivables on deferred credit terms);

(ii) Others (specify nature);

(iii) Long term Trade Receivables, shall be sub-classified as:

(A) Secured, considered good;
(B) Unsecured, considered good;
(C) Doubtful.

- Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

N. Current Investments

(i) Current investments shall be classified as:

(a) Investments in Equity Instruments;
(b) Investment in Preference Shares;
(c) Investments in Government or trust securities;
(d) Investments in debentures or bonds;
(e) Investments in Mutual Funds;
(f) Investments in partnership firms;
(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are: (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) The following shall also be disclosed:

(a) The basis of valuation of individual investments;
(b) Aggregate amount of quoted investments and market value thereof;
(c) Aggregate amount of unquoted investments;
(d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as:

(a) Raw materials;
(b) Work-in-progress;
(c) Finished goods;
(d) Stock-in-trade (in respect of goods acquired for trading);
(e) Stores and spares;
(f) Loose tools;
(g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

P. Trade Receivables

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:

(a) Secured, considered good;
(b) Unsecured, considered good;
(c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q. Cash and cash equivalents

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;
(b) Cheques, drafts on hand;
(c) Cash on hand;

(d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than twelve months maturity shall be disclosed separately.

R. Short-term loans and advances

(i) Short-term loans and advances shall be classified as:

(a) Loans and advances to related parties (giving details thereof);
(b) Others (specify nature).

(ii) The above shall also be sub-classified as:

(a) Secured, considered good;
(b) Unsecured, considered good;
(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

S. Other current assets (specify nature)

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities and commitments (to the extent not provided for)

(i) Contingent liabilities shall be classified as:

(a) Claims against the company not acknowledged as debt;

(b) Guarantees;

(c) Other money for which the company is contingently liable.

(ii) Commitments shall be classified as:

(a) Estimated amount of contracts remaining to be executed on capital account and not provided for;

(b) Uncalled liability on shares and other investments partly paid;

(c) Other commitments (specify nature).

U. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on preference shares shall also be disclosed separately.

V. Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilised amounts have been used or invested.

W. If, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated.

PART II – STATEMENT OF PROFIT AND LOSS

Name of the Company…………………….

Profit and loss statement for the year ended ………………………

(Rupees in… ....)

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
I	Revenue from operations		xxx	xxx
II	Other income		xxx	xxx
III	Total Revenue (I + II)		xxx	xxx
IV	Expenses: Cost of materials consumed Purchases of Stock-in-Trade Changes in inventories of finished goods work-in-progress and Stock-in-Trade Employee benefits expense Finance costs Depreciation and amortization expense Other expenses Total expenses		Xxx Xxx Xxx xxx	Xxx Xxx Xxx Xxx
V	Profit before exceptional and extraordinary items and tax (III - IV)		xxx	xxx
VI	Exceptional items		xxx	xxx

VII	Profit before extraordinary items and tax (V - VI)		xxx	xxx
VIII	Extraordinary items		xxx	xxx
IX	Profit before tax (VII-VIII)		xxx	xxx
X	Tax expense: (1) Current tax (2) Deferred tax		 Xxx Xxx	 Xxx Xxx
XI	Profit (Loss) for the period from continuing operations (VII-VIII)		xxx	xxx
XII	Profit/(loss) from discontinuing operations		xxx	xxx
XIII	Tax expense of discontinuing operations		xxx	xxx
XIV	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)		xxx	xxx
XV	Profit (Loss) for the period (XI + XIV)		xxx	xxx
XVI	Earnings per equity share: (1) Basic (2) Diluted		Xxx xxx	Xxx xxx

See accompanying notes to the financial statements.

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-clause (*ii*) of clause (*40*) of section 2 in like manner as they apply to a statement of profit and loss.

2. (*A*) In respect of a company other than finance company revenue from operations shall disclose separately in the notes revenue from—

(a) Sale of products;
(b) Sale of services;
(c) Other operating revenues;

Less:

(d) Excise duty.

(B) In respect of a finance company, revenue from operations shall include revenue from—

(a) Interest; and

(b) Other financial services.

Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

3. Finance Costs

Finance costs shall be classified as:

(a) Interest expense;

(b) Other borrowing costs;

(c) Applicable net gain/loss on foreign currency transactions and translation.

4. Other income

Other income shall be classified as:

(a) Interest Income (in case of a company other than a finance company);

(b) Dividend Income;

(c) Net gain/loss on sale of investments;

(d) Other non-operating income (net of expenses directly attributable to such income).

5. Additional Information

A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:—

General Expenditure

(a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].

(b) Depreciation and amortisation expense;

(c) Any item of income or expenditure which exceeds one per cent. of the revenue from operations or Rs.1,00,000, whichever is higher;

(d) Interest Income;

(e) Interest expense;

(f) Dividend income;

(g) Net gain/loss on sale of investments;

(h) Adjustments to the carrying amount of investments;

(i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

(j) Payments to the auditor as (a) auditor; (b) for taxation matters; (c) for company law matters; (d) for management services; (e) for other services; and (f) for reimbursement of expenses;

(k) In case of Companies covered under section 135, amount of expenditure incurred on corporate social responsibility activities;

(l) Details of items of exceptional and extraordinary nature;

(m) Prior period items;

In the case of manufacturing companies,—

(1) Raw materials under broad heads.
(2) goods purchased under broad heads.

In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.

In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered are shown under broad heads.

In the case of other companies, gross income derived under broad heads.

In the case of all concerns having works in progress, works-in-progress under broad heads.

(a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(c) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(d) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

Expenditure incurred on each of the following items, separately for each item:—

(a) Consumption of stores and spare parts;

(b) Power and fuel;

(c) Rent;

(d) Repairs to buildings;

(e) Repairs to machinery;

(f) Insurance;

(g) Rates and taxes, excluding, taxes on income;

(h) Miscellaneous expenses,

(i) Dividends from subsidiary companies.

(j)Provisions for losses of subsidiary companies.

The profit and loss account shall also contain by way of a note the following information, namely:—

(a) Value of imports calculated on C.I.F basis by the company during the financial year in respect of—

I. Raw materials;

II. Components and spare parts;

III. Capital goods;

(b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;

(c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

(e) Earnings in foreign exchange classified under the following heads, namely:—

I. Export of goods calculated on F.O.B. basis;

II. Royalty, know-how, professional and consultation fees;

III. Interest and dividend;

IV. Other income, indicating the nature thereof.

Note:— Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of financial statements.

GENERAL INSTRUCTIONS FOR THE PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS

1. Where a company is required to prepare Consolidated Financial Statements, *i.e.*, consolidated balance sheet and consolidated statement of profit and loss, the company shall *mutatis mutandis* follow the requirements of this Schedule as applicable to a company in the preparation of balance sheet and statement of profit and loss. In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Accounting Standards including the following:

(i) Profit or loss attributable to ―minority interest‖ and to owners of the parent in the statement of profit and loss shall be presented as allocation for the period.

(ii) ―Minority interests‖ in the balance sheet within equity shall be presented separately from the equity of the owners of the parent.

3. All subsidiaries, associates and joint ventures (whether Indian or foreign) will be covered under consolidated financial statements.

4. An entity shall disclose the list of subsidiaries or associates or joint ventures which have not been consolidated in the consolidated financial statements along with the reasons of not consolidating.

Illustration: Standalone Balance Sheet Excerpts from annual report of Heritage Food Limited

Heritage

Heritage Foods Limited | 26th Annual Report 2017-18

Standalone Balance Sheet as at 31 March 2018

(All amounts in ₹ lakhs, except share data and where otherwise stated)

	Note	As at		
		31 March 2018	31 March 2017	1 April 2016
ASSETS				
Non-current assets				
(a) Property, plant and equipment	6	39,353.75	27,817.97	30,785.62
(b) Capital work-in-progress		872.71	750.43	958.80
(c) Investment property	8	397.21	124.15	121.00
(d) Other intangible assets	7	1,847.64	48.40	164.12
(e) Investment in subsidiaries, joint venture and associate	9	1,695.68	101.20	72.69
(f) Financial assets				
(i) Investments	10	100,115.41	47,744.57	31.12
(ii) Loans	16	394.72	1,449.59	2,200.05
(iii) Other financial assets	11	75.22	72.53	63.07
(g) Other non-current assets	12	402.66	208.76	176.76
Total non-current assets		145,155.00	78,317.60	34,573.23
Current assets				
(a) Inventories	13	15,051.89	11,648.50	14,491.11
(b) Financial Assets				
(i) Investments	10	0.42	1.17	1.65
(ii) Trade receivables	14	1,010.40	1,129.47	2,871.06
(iii) Cash and cash equivalents	15(i)	5,985.69	4,485.57	4,440.19
(iv) Bank balances other than (iii) above	15(ii)	116.91	111.34	82.52
(v) Loans	16	436.15	448.89	458.30
(vi) Other financial assets	11	17.47	11.35	13.39
(c) Current tax assets (net)		46.45	109.09	-
(d) Other current assets	12	721.17	329.65	429.33
Total current assets		23,386.55	18,275.03	22,787.55
Total assets		168,541.55	96,592.63	57,360.78
EQUITY AND LIABILITIES				
Equity				
(a) Equity share capital	17	2,319.90	2,319.90	2,319.90
(b) Other equity	18	75,480.76	57,002.43	22,434.05
Total equity		77,800.66	59,322.33	24,753.95
Liabilities				
Non-current liabilities				
(a) Financial liabilities				
(i) Borrowings	19	13,830.74	6,877.05	6,527.86
(ii) Other financial liabilities	20	42,611.74	3,854.86	-
(b) Provisions	21	584.30	489.58	551.54
(c) Government grant		8.76	37.67	44.85
(d) Deferred tax liabilities (net)	22	1,820.75	1,878.00	1,837.91
Total non-current liabilities		58,856.29	13,137.16	8,962.16
Current liabilities				
(a) Financial liabilities				
(i) Borrowings	19	10,222.90	6,587.71	3,925.16
(ii) Trade payables	24	6,629.11	5,075.98	8,467.46
(iii) Other financial liabilities	20	13,656.61	11,135.37	9,695.13
(b) Other current liabilities	23	669.45	726.41	805.13
(c) Government grant		1.61	9.40	7.29
(d) Provisions	21	704.92	598.27	579.47
(e) Current tax liabilities (net)		-	-	165.03
Total current liabilities		31,884.60	24,133.14	23,644.67
Total equity and liabilities		168,541.55	96,592.63	57,360.78

The accompanying notes referred to above form an integral part of the standalone financial statements.

This is the Standalone Balance sheet referred to in our report of even date.

For **Walker Chandiok & Co LLP**
Chartered Accountants

per Sanjay Kumar Jain
Partner

Place : Hyderabad
Date : May 24, 2018

For and on behalf of the Board of Directors of
Heritage Foods Limited

N. Bhuvaneswari
Vice Chairperson & Managing Director
DIN : 00003741

N Brahmani
Executive Director
DIN : 02338940

M Sambasiva Rao
President

A Prabhakara Naidu
Chief Financial Officer
M.No. FCA 200974

Umakanta Barik
Company Secretary
M.No. FCS 6317

Place : Hyderabad
Date : May 24, 2018

Illustration: Standalone Profit & Loss Statement: Excerpts from annual report of Heritage Food Limited

Standalone Statement of Profit and Loss

for the year ended 31 March 2018

(All amounts in ₹ lakhs, except share data and where otherwise stated)

	Notes	For the year ended	
		31 March 2018	31 March 2017
Revenue from operations	25	234,401.10	183,383.94
Revenue from transactions with discontinued operations		-	3,759.63
Other income	26	716.95	360.68
Fair value gain on FVTPL equity securities		39,537.07	24,681.01
Total income		274,655.12	**212,185.26**
Expenses			
Cost of materials consumed	27	181,869.02	137,682.12
Purchase of Stock-in-Trade		13,017.18	3,053.10
Purchase transactions with discontinued operations		-	3,913.54
Excise duty	28	33.26	87.23
Changes in inventories of finished goods, semi finished goods, stock-in- trade and work-in-progress	29	(4,305.13)	3,342.25
Employee benefit expenses	30	12,014.23	9,791.22
Finance costs	31	1,745.45	963.24
Depreciation and amortisation expense	6, 7 & 8	3,698.54	2,487.07
Impairment losses	6	40.28	70.26
Other expenses	32	19,031.11	14,609.00
Loss due to changes in fair value of derivative liabilities		38,703.86	3,854.87
Total expenses		265,847.80	**179,853.90**
Profit before tax from continuing operations		**8,807.32**	**32,331.36**
Tax expense	33		
Current tax		2,829.39	2,600.07
Deferred tax expense/(benefit)		(60.23)	471.15
Profit for the year from continuing operations		6,038.16	**29,260.14**
Discontinued operations			
Loss before tax	42	-	(1,772.30)
Tax income	33	-	(15.06)
Loss for the year from discontinued operations		**-**	**(1,757.24)**
Profit for the year		6,038.16	**27,502.90**
Other comprehensive income			
Items that will not be reclassified to profit or loss			
(i) Re-measurement gains/(losses) on defined benefit plans, net of taxes		(77.82)	4.69
(ii) Net gain on FVTOCI equity securities		13,182.25	8,229.95
Total other comprehensive income for the year		13,104.43	**8,234.64**
Total comprehensive income for the year		19,142.59	**35,737.54**
Earnings per equity share (EPES) (in absolute ₹ terms)	34		
Par value per share		5	5
EPES for continuing operations			
Basic and Diluted EPES		13.01	63.06
EPES for discontinued operations			
Basic and Diluted EPES		-	(3.78)
EPES for continuing and discontinued operations			
Basic and Diluted EPES		13.01	59.28

The accompanying notes form an integral part of the standalone financial statements.
This is the Standalone Statement of Profit and Loss referred to in our report of even date.

For **Walker Chandiok & Co LLP**
Chartered Accountants

per Sanjay Kumar Jain
Partner

Place : Hyderabad
Date : May 24, 2018

For and on behalf of the Board of Directors of
Heritage Foods Limited

N. Bhuvaneswari
Vice Chairperson & Managing Director
DIN : 00003741

N Brahmani
Executive Director
DIN : 02338940

M Sambasiva Rao
President

A Prabhakara Naidu
Chief Financial Officer
M.No. FCA 200974

Umakanta Barik
Company Secretary
M.No. FCS 6317

Place : Hyderabad
Date : May 24, 2018

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Illustration: Standalone Cash Flow Statement: Excerpts from annual report of Heritage Food Limited

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Standalone Cash Flow Statement for the year ended 31 March 2018

(All amounts in ₹ lakhs, except share data and where otherwise stated)

	For the year ended	
	31 March 2018	31 March 2017
Cash flow from operating activities		
Profit before tax from continuing operations	**8,807.32**	**32,331.36**
Adjustments:		
Fair value gain on FVTPL equity securities	(39,537.07)	(24,681.01)
Loss due to changes in fair value of derivative liabilities	38,703.86	3,854.87
Depreciation and amortization	3,698.54	2,487.07
Impairment losses	40.28	70.26
Provision for doubtful advances	71.00	5.00
Provision for doubtful debts	12.63	58.63
Loss on sale of property, plant and equipment	85.64	-
Impairment of investment in subsidiary	257.77	-
Provisions no longer required/ credit balances written back	(213.37)	(118.12)
Interest income	(23.24)	(27.38)
Interest expenses	1,659.63	886.56
Guarantee income	(14.53)	-
Dividend income on long term investments	(4.02)	(4.00)
Operating cash flow before working capital changes	**13,544.44**	**14,863.24**
Decrease/ (increase) in inventories	1,358.55	(2,088.35)
Decrease/ (increase) in trade receivables	106.44	(438.82)
Decrease/ (increase) in loans	1,067.61	(130.02)
Increase in other assets	(460.82)	(113.14)
Increase in other financial assets	(6.12)	(4.42)
Increase in trade payables	455.92	592.46
Increase/(decrease) in provisions	123.55	(90.70)
Decrease in Government grant	(36.70)	(1.87)
Increase in other financial liabilities	95.24	311.92
Increase in other liabilities	300.88	424.43
Cash generated from operating activities	**16,548.99**	**13,324.73**
Income-taxes paid, net	(2,777.25)	(2,910.00)
Net cash generated from operating activities of continuing operations	**13,771.74**	**10,414.73**
Net cash used in operating activities of discontinued operations	**-**	**(1,575.99)**
Net cash generated from operating activities (A)	13,771.74	**8,838.74**
Cash flow from investing activities		
Purchase of property, plant and equipment and other intangible assets including Capital work in progress	(14,227.94)	(7,684.80)
Proceeds from sale of property, plant and equipment	409.59	250.65
(Purchase)/ sale of investments	(0.11)	2.28
Investment in a joint venture	(10.00)	-
Investment in a subsidiary	(1,757.82)	(0.06)
Interest received	28.12	27.38
Movement in other bank balances, net	3.66	(38.95)
Consideration paid towards Business combination (refer note 43)	(6,151.00)	-
Dividend income	4.02	4.00
Net cash used in investing activities of continuing operations	**(21,701.48)**	**(7,439.50)**
Net cash used in investing activities of discontinued operations	**-**	**(1,559.26)**
Net cash used in investing activities (B)	(21,701.48)	**(8,998.76)**

Module III
Understanding of Financial Statements

Introduction

In the previous modules we discussed on how to record the business transactions in various books of accounts and posting into ledger. We also discussed about balancing the account and preparing the trial balance. One of the most important purposes of accounting is to ascertain financial results, i.e., profit or loss of the business operations of a business enterprise after a certain period and the financial position of it on a particular date. We discussed the various components and frameworks and guidelines laid out in the law for preparation and presentation of the financial statements viz. income statement (i.e. Trading and Profit & Loss Account) to know what the business has earned during a particular period and the Position Statement (i.e. Balance Sheet) to know the financial position of the business enterprise on a particular date.

In this Module lets‘ discuss the meaning, purpose and the objectives of financial statements and classification of different types of receipts and payments.

Financial Statements: Meaning

Every business enterprise wants to know the result of its activities of a particular period which is generally one year and what is its financial position on a particular date which is at the end of this period. For this, it prepares various statements which are called the financial statements.

Financial statements are the statements that are prepared at the end of the accounting period, which is generally one year. These include income statement i.e. Trading and Profit & Loss Account and Position statement i.e. Balance Sheet.

Objectives of Financial Statements

Financial statements are prepared to ascertain the profits earned or losses incurred by a business concern during a specified period and also to ascertain its financial position at the end of that period.

It may be noted that the formats for financial statements as prescribed in Schedule 3 of the companies act 2013 are statutory formats that require compliance when presenting the financial statements. For general purpose understanding, Financial Statements are generally of two types –

(a) Income statement which comprises of Trading Account and Profit & Loss Account, and

(b) Net worth Position Statement i.e., the Balance Sheet.

(c) Cash flow position statement

Following are the objectives of preparing financial statements:

1. **Ascertaining the results of business operations -** Every businessman wants to know the results of the business operations of his enterprise during a particular period in terms of profits earned or losses incurred. Income statement serves this purpose.
2. **Ascertaining the financial position -** Financial statements show the financial position of the business concern on a particular date which is generally the last date of the accounting period. Position statement i.e. Balance Sheet is prepared for this purpose.
3. **Source of information -** Financial statements constitute an important source of information regarding finance of a business unit which helps the finance manager to plan the financial activities of the business and making proper utilisation of the funds.
4. **Helps in managerial decision making -** The Manager can make comparative study of the profitability of the concern by comparing the results of the current year with the results of the previous years and make his/her managerial decisions accordingly.
5. **An index of solvency of the concern -** Financial statements also show the short term as well as long term solvency of the concern. This helps the business enterprise in borrowing money from bank and other financial institutions and/or buying goods on credit.

Capital Expenditure and Revenue Expenditure, Capital Receipts and Revenue Receipts

The preparation of Trading Account and Profit and Loss Account requires the knowledge of revenue expenditure, revenue receipts and capital expenditure and capital receipts. The knowledge shall facilitate the classification of revenue items and put them in the Trading account and Profit and Loss Account on one hand and prepare Balance Sheet based on capital items (expenditure as well as receipts) on the other hand.

Capital Expenditure refers to the expenditure incurred for acquiring fixed assets or assets which increase the earning capacity of the business. The benefits of capital expenditure to the firm extend to number of years. Examples of capital expenditure are expenditure incurred for acquiring a fixed asset such as building, plant and machinery etc.

Revenue expenditure, on the other hand, is an expenditure incurred in the course of normal business transactions of a concern and its benefits are availed of during the same accounting year. Salaries, carriage etc. are examples of revenue expenditure.

There is another category of expenditure called **deferred revenue expenditure**. These are the expenses incurred during one accounting year but are applicable wholly or in part in future periods. These expenditures are otherwise of a revenue nature. Example of deferred revenue expenditure are heavy expenditure on advertisement say for introducing a new product in the market, expenditure incurred on research and development, etc.

Basis of Difference	**Capital Expenditure**	**Revenue Expenditure**
Purpose	It is incurred for the acquiring of fixed assets.	It is incurred for utilization & maintenance of fixed assets.
Earnings	It helps in maintaining capacity capacity of the business.	It increases the earning the earning capacity of the business intact.
Periodicity of Benefit	Its benefits accrue over a number	Its benefits are spread only in one

	of years.	accounting year.
Placement in the financial statements	It is an item of balance sheet and is shown as an Asset	It is an item of trading and profit & loss statement and is shown on the debit side
Occurrence of expenditure	It is non-recurring in nature	It is usually a recurring expenditure

Capital and Revenue Receipts

Capital receipts are receipts which do not arise out of normal course of business. Examples of such receipts are sale of fixed assets, and raising of loans etc. Such receipts are not treated as income of the enterprise.

Revenue receipts are receipts which arise during the normal course of business, Sale of goods, rent from tenants, dividend received, etc. are some of the examples of revenue receipts. They are the items of incomes of the business entity

.**Basis of Difference**	**Capital Expenditure**	**Revenue Expenditure**
Source	Receipts that do not arise during the normal course of business.	Receipts that arise during the normal course of business
Nature	These are of capital nature and hence are not treated as items of income of the business	These are of revenue nature and hence are treated as items of income of the business.
Occurrence	These are of non-recurring in nature	These are recurring in nature

TRADING ACCOUNT

Income statement consists of Trading and Profit and Loss Account.

Trading Account - A business firm either purchases goods from others and sells them or manufactures and sells them to earn profit. This is known as trading activities. A statement is prepared to know the results in terms of profit or loss of these activities. This statement is called Trading Account.

Trading Account is prepared to ascertain the results of the trading activities of the business enterprise. It shows whether the selling of goods purchased or manufactured has earned profit or incurred loss for the business unit. Cost of goods sold is subtracted from the net sales of the business of that accounting year. In case the total sales value exceeds the cost of goods sold, the difference is called Gross Profit. On the other hand, if the cost of goods sold exceeds the total net sales, the difference is Gross Loss. All accounts related to cost of goods sold such as opening stock, net purchases i.e. purchase less returns outward, direct expenses such as wages, carriage inward etc. and closing stock with net sales (i.e. Sales minus Sales returns). are taken to the Trading Account. Then this account is balanced. Credit balance shows the gross Profit and debit balance shows the gross loss.

NEED OF TRADING ACCOUNT

Trading Account serves the following purposes:

1. **Knowledge of Gross Profit -** Trading Account gives information about Gross Profit. It is the profit earned by a business enterprise from its trading activities. The percentage of gross profit on sales reflects the degree of success of business.
2. **Knowledge of All Direct expenses -** All direct expenses are taken to trading Account. Direct expenses are the expenses that can be directly attributed to purchase or manufacturing of goods for sale. Percentage of Direct expenses on sales of current year when compared with the same of previous years helps the manager to exercise control over direct expenses.
3. **Precaution against future losses -** Trading Account, if shows gross loss, reasons for this loss can be found out and necessary corrective steps can be taken.

It is necessary to understand the meaning of Cost of Goods Sold before preparing Trading Account.

COST OF GOODS SOLD AND GROSS PROFIT

A business enterprise either purchases goods or manufactures goods to sell in the market. Cost of goods sold is computed to know the profit earned (Gross Profit) or loss incurred (Gross Loss) from the trading activities of a business unit for a particular period.

Cost of goods sold = the amount of goods purchased + expenses incurred in bringing the goods to the place of sale or expenses incurred on manufacturing the goods (called direct expenses).

In case there is a stock of goods to be sold in the beginning of the year or at the end of the year, the cost of goods is calculated as follows.

Illustration

Calculate the cost of goods sold from the following information:

Opening stock	10000
Closing stock	8000
Purchases	80000
Carriage on purchases	2000
Wages	6600

Solution:

Cost of Goods Sold = opening stock + purchases + direct expenses (carriage on purchases + wages) – closing stock

= Rs. [10000 + 80000 + 8600 (i.e. 2000 + 6600) – 8000]

= Rs. 90600

Illustration 2

Calculate cost of goods sold and gross profit from the following information.

Sales	62500
Sales Returns	500
Opening Stock	6400
Purchases	32000
Direct Expenses	4200
Closing Stock	7200

Solution:

Net Sales (Sales-Sales Returns)	= (62500 – 500)	= 62000
Cost of goods sold	= (6400 + 32000+ 4200 -7200)	= 35400
Gross Profit	= Net sales – cost of goods sold	
	= 62000 – 35400 = **26600**	

Format of Trading Account for the period ended ___________

Particulars	**Amount**
Sales	XXXX
Less: Sales Returns	(XX)
Closing stock	XXXX
Gross loss transferred to Profit & Loss Account	(XX)
Opening Stock	XXX
Purchases	XX
Less Purchase Returns	(XX)
Direct Expenses :	
Carriage Inward	XX
Freight	XX
Wages	XX
Fuel & Power	XX
Excise Duty	XX
Factory Rent	XX
Heating & Lighting	XX
Factory Rent & Insurance	XX

Work Managers Salary	XX
Gross Profit transferred to Profit & Loss Account	XXX

Important items of Trading account

Important items of Trading account are:

1. **Stock**
   Stock refers to the goods lying unsold on a particular date. It can be of two types: (a) Opening stock and (b) Closing stock

   Opening stock - Opening stock refers to the value of goods lying unsold at the beginning of the accounting year. It is shown on the debit side of the Trading Account. In the first year of business there is no opening stock

   Closing Stock - It is the value of goods lying unsold at the end of the accounting year. It is valued at the cost price or market price whichever is less. It is shown on the credit side of the Trading Account.

2. **Purchases**
   Purchases mean total items purchased for resale during the year. It can be both in cash and on credit. Purchases are shown on the debit side of the Trading account. These are always shown as net purchases i.e. amount of purchases returned (Purchase returns or return outwards) is deducted from the total amount of purchases made. Goods received on consignment basis are never treated as purchases. Similarly, goods received on ‗sale or return‘ basis are never treated as purchases.

3. **Sales**
   Sales refer to the total revenue from sale of goods of the business enterprise for which the Trading account is being prepared. It includes both cash sales and credit sales. These are recorded on the credit side of the Trading Account. Sales are shown at their net value i.e. sales return or returns inward is deducted from the total sales. Cash sales plus credit sales minus sales returns constitute net sales. Goods sent on ‗sale or approval‘ are not part of sales until approval is received.

4. **Direct Expenses**
   Direct expenses are the expenses that can be attributed directly to the purchase of goods or goods manufactured. These are shown on the debit side of the Trading Account. These are shown at the amount as shown in the Trial balance. For example, wages are recorded on the debit side of Trading Account at the amount shown in the Trial balance.

   Important items of direct expenses

   a) Wages i.e. wages relate to production. If amount under this head includes wages paid for construction of building or manufacturing of furniture for office it will be subtracted from the amount of wages.
   b) Carriage Cartage Freight i.e. amount paid for carriage of goods purchased for sale or raw material purchased for manufacturing.

c) Other such direct expenses are customs and import duty, packing materials, gas, electricity water, fuel, oil, gas grease, heating and lighting, factory rent and insurance and many more such items.

5. Gross Profit/Gross Loss

It is the excess of net sales revenue over cost of goods sold. Gross Profit is equal to net sales minus cost of goods sold. If total of the credit side exceeds the total of debit side, the excess amount is termed as ‗gross profit' and is shown on the debit side of Trading Account. On the other hand if debit side is more than the credit side, the difference in amount is called gross loss and is shown on the credit side of the Trading Account.

Gross profit = Net sales – Cost of goods sold

Gross loss = Cost of goods sold – Net sales

PROFIT & LOSS ACCOUNT

As stated earlier, income statement consists of two accounts: Trading Account and Profit & Loss Account. You have seen that Trading account is prepared to ascertain the Gross profit or Gross loss of the trading activities of the business. But these are not the final results of business operations of an enterprise. Apart from direct expenses, there are indirect expenses also. These may be conveniently divided into office and administrative expenses, selling and distribution expenses, financial expenses, depreciation and maintenance charges etc.

Similarly, there can be income from sources other than sales revenue. These may be interest on investments, discount received from creditors, commission received, etc. Another account is prepared in which all indirect expenses and revenues from sources other than sales are written. This account when balanced shows profit (or loss). This account is termed as Profit and Loss Account. The profit shown by this account is called ‗net profit' and if it shows loss it is known as ‗net loss'.

Format of Profit & Loss Account for the period ended ____________

Particulars	**Amount**
Gross Profit b/d	XXXX
Discount Received	XX
Commission Received	XXX
Dividend Received	XX
Interest on Investment	XXX
Rent Received —	XX
Net Loss transferred to capital account	XXX
Gross loss b/d	XXX
Salaries	XX
Rent, Rates & taxes	(XX)
Insurance Premium	
Advertising	XX

Commission paid	XX
Discount Allowed	XX
Repairs & Renewals	XX
Bad Debts	XX
Establishment charges	XX
Travelling Expenses	XX
Bank Charges	XX
Sales Tax/Value added Tax	XX
Depreciation on fixed assets	XXX
Net Profit transferred to Capital Account	

Some important items of Profit and Loss Account

Credit items

On the credit side of Profit and Loss Account, items of revenue and incomes are written. The first item on this side of Profit and Loss Account is the gross profit transferred from trading account. Other items of the credit side are: (i) Interest on investment, fixed deposits etc. Rent Received, Commission Received, Discount Received, Dividend on shares

Debit items

As stated earlier Indirect expense are written on the debit side of Profit and Loss A/c. These can be classified under the following heads:

1. **Selling and distribution expenses**
   To materialise sales, the expenses incurred are called selling and distribution expenses. Examples are : Carriage on sales/carriage outwards, advertisement, selling expenses, travelling expenses and salesman commission, depreciation of delivery van, salary of driver of the delivery van, etc.

2. **Office and administration expenses**
   These are the expenses incurred on establishment and maintenance of office. Some of the expenses that may be under this head are: rent, rates and taxes, postage, printing and stationery, insurance, legal charges, audit fees, office salaries, etc.

3. **Financial expenses**
   Finances are to be arranged for business. Expenses that are incurred in this connection are called financial expenses. Some of the financial expenses are: interest on loan, interest on capital, discount on bills, etc.

4. **Depreciation and maintenance charges**
   The total value of a fixed asset like machinery, building, furniture, etc. is not charged to profit and loss account in the year in which it is purchased. Such assets help running business for a number of years to come. Therefore, only a part of the value of such assets is treated as an expense and is charged to Profit and Loss A/c as depreciation.

Depreciation means decline in the value of fixed asset due to wear and tear, lapse of time, obsolescence, etc. Expense incurred on repairs and renewals and maintenance of assets are expenses other than depreciation under this category.

5. **Other expenses**
   These are the expenses which are not included under the above mentioned heads of expenses for example, losses and expenses due to fire, theft etc.

NEED OF PREPARING PROFIT AND LOSS ACCOUNT

Need of preparing profit and loss account by a business concern may be stated as follows :

a) Knowledge of the net profit or net loss of a business for an accounting year.

b) Net profit of one year can be compared with net profits of previous year or years. It helps in ascertaining whether the business is being conducted efficiently or not.

c) Different expenses which are taken to Profit & Loss A/c in one year can be compared with the amounts incurred in previous year or years. This helps in ascertaining the need of applying control over such expenses.

Position Statement/Balance Sheet

Position Statement or Balance Sheet is another basis of financial statement. Balance Sheet is a statement prepared on a particular date, generally at the end of accounting year to ascertain the financial position of the entity. It consists of assets on the one hand and liabilities on the other.

In the words of Francis R Steal, –Balance Sheet is a screen picture of the financial position of a going business at a certain moment.‖ In the words of Freeman, –A Balance Sheet is an item wise list of assets, liabilities and proprietorship of a business at a certain date.‖

Financial position of a business is the list of assets owned by the business and the claims of various parties against these assets. The statement prepared to show the financial position is termed as Balance Sheet.

Some important items of Balance Sheet

ASSETS: Assets are the resources of the business enterprise, such as plant and equipment that are used to generate future benefits. If a company owns plant and equipment that will be used to produce goods for sale in the future, the company can expect these assets (the plant and equipment) to generate cash inflows in the future.

There are two major categories of assets viz. current assets and noncurrent assets, where noncurrent assets include plant assets, intangibles, and investments. Assets that do not fit neatly into these categories may be recorded as either other assets, deferred charges, or other noncurrent assets.

Current assets (also referred to as circulating capital and working assets) are assets that could reasonably be converted into cash within one operating cycle or one year, whichever takes longer. An operating cycle begins when the firm invests cash in the raw materials used to produce its goods or services and ends with the collection of cash for the sale of those same goods or services. For example, if Frictitious manufactures and sells candy products, its operating cycle begins when it purchases the raw materials for the products (e.g., sugar) and ends when it receives cash for selling the candy to retailers. Because the operating cycle of most businesses is less than one year, we tend to think of current assets as those assets that can be converted into cash in one year.

Current assets consist of cash, marketable securities, accounts receivable, and inventories. Cash comprises both currency and assets that are immediately transformable into cash, such as deposits in bank accounts. *(Marketable securities are securities that can be readily sold when cash is needed)*. Every company needs to have a certain amount of cash to fulfill immediate needs, and any cash in excess of immediate needs is usually invested temporarily in marketable securities.

Investments in marketable securities are simply viewed as a short term place to store funds; marketable securities do not include those investments in other companies stock that are intended to be long term. Some financial reports combine cash and marketable securities into one account referred to as cash and cash equivalents or cash and marketable securities.

Accounts receivable are amounts due from customers who have purchased the firm‗s goods or services but haven't yet paid for them. To encourage sales, many firms allow their customers to ―buy now and pay later perhaps at the end of the month or within 30 days of the sale. Accounts receivable therefore represents money that the firm expects to collect soon. Because not all accounts are ultimately collected, the gross amount of accounts receivable is adjusted by an estimate of the uncollectible accounts, the allowance for doubtful accounts, resulting in a net accounts receivable figure.

Inventories represent the total value of the firms raw materials, work-in- process, and finished (but as yet unsold) goods. A manufacturer of toy trucks would likely have plastic and steel on hand as raw materials, work-in-process consisting of truck parts and partly completed trucks, and finished goods consisting of trucks packaged and ready for shipping. There are three basic methods of accounting for inventory, including:

- FIFO (first in, first out), which assumes that the first items purchased are the first items sold,
- LIFO (last in, first out), which assumes that the last items purchased are the first items sold, and
- Average cost, which assumes that the cost of items sold, is the average of the cost of all items purchased.

Non-current Assets are the assets where the cost is allocated over the life of the asset; the reported value is the original cost of the asset, less whatever has been amortized. The number of years over which a long term asset is depreciated/ amortized depends on the particular asset and its perceived useful life.

For example, a patent is the exclusive right to produce and sell a particular, uniquely defined good and has a legal life of 17 years, though the useful life of a patent—the period in which it adds value to the company-may be much less than 17 years. Therefore the company may choose to amortize a patents cost over a period less than 17 years. As another example, a copyright is the exclusive right to publish and sell a literary, artistic, or musical composition, and is granted for 50 years beyond the author‗s life, though its useful life in terms of generating income for the company may be much less than 50 years.

A company may have additional noncurrent assets, depending on their particular circumstances. A company may have a noncurrent asset referred to as investments, which are assets that are purchased with the intention of holding them for a long term, but which do not generate revenue or are not used to manufacture a product. Examples of investments include equity securities of another company and real estate that is held for speculative purposes. Long-term investment in securities of other companies may be recorded at cost or market value, depending on the type of investment; investments held to maturity are recorded at cost, whereas investments held as trading securities or available for sale are recorded at market value. The unrealized gains or losses affect earnings on the income statement depend on whether the securities are deemed trading securities or available for sale.

Other noncurrent assets include long term prepaid expenses, arising from prepayment for which a benefit is received over an extended period of time, and deferred tax assets, arising from timing differences between reported income and tax income, whereby reported income exceeds taxable income.

LIABILITIES: Liabilities are obligations of the business. They represent commitments to creditors in the form of future cash outflows. When a firm borrows, say, by issuing a long-term bond, it becomes obligated to pay interest and principal on this bond as promised. Equity, also called shareholders equity or stockholders equity, reflects ownership. The equity of a firm represents the part of its value that is not owed to creditors and therefore is left over for the owners.

Current liabilities are obligations that must be paid within one operating cycle or one year, whichever is longer. Current liabilities include: Accounts payable, which are obligations to pay suppliers. They arise from goods and services that have been purchased but not yet paid. Accrued expenses, which are obligations such as wages and salaries payable to the employees of the business, rent, and insurance. Current portion of long-term debt or the current portion of capital leases. Any portion of long-term indebtedness— obligations extending beyond one year—due within the year. Short-term loans from a bank or notes payable within a year.

The reliance on short-term liabilities and the type of current liabilities depends, in part, on the industry in which the firm operates.

Long-term liabilities are obligations that must be paid over a period beyond one year. They include loans, notes, bonds, capital lease obligations etc. Notes and bonds both represent loans on which the borrower promises to pay interest periodically and to repay the principal amount of the loan. A lease obligates the lessee—the one leasing and using the leased asset—to pay specified rental payments for a period of time. Whether the lease obligation is recorded as a liability or is expensed as lease payments made depends on whether the lease is a capital lease or an operating lease.

Module IV
Analysis of Financial Statements

Introduction

We know business is mainly concerned with the financial activities. In order to ascertain the financial status of the business every enterprise prepares certain statements, known as financial statements. Financial statements are mainly prepared for decision making purposes. But the information as is provided in the financial statements is not adequately helpful in drawing a meaningful conclusion. Thus, an effective analysis and interpretation of financial statements is required.

Analysis means establishing a meaningful relationship between various items of the two financial statements with each other in such a way that a conclusion is drawn. These are prepared at the end of a given period of time. They are the indicators of profitability and financial soundness of the business concern.

The term financial analysis is also known as analysis and interpretation of financial statements. It refers to the establishing meaningful relationship between various items of the two financial statements i.e. Income statement and position statement. It determines financial strength and weaknesses of the firm.

Analysis of financial statements is an attempt to assess the efficiency and performance of an enterprise. Thus, the analysis and interpretation of financial statements is very essential to measure the efficiency, profitability, financial soundness and future prospects of the business units. Financial analysis serves the following purposes:

A. Measuring the profitability

The main objective of a business is to earn a satisfactory return on the funds invested in it. Financial analysis helps in ascertaining whether adequate profits are being earned on the capital invested in the business or not. It also helps in knowing the capacity to pay the interest and dividend.

B. Indicating the trend of Achievements

Financial statements of the previous years can be compared and the trend regarding various expenses, purchases, sales, gross profits and net profit etc. can be ascertained. Value of assets and liabilities can be compared and the future prospects of the business can be envisaged.

C. Assessing the growth potential of the business

The trend and other analysis of the business provide sufficient information indicating the growth potential of the business.

D. Comparative position in relation to other firms

The purpose of financial statements analysis is to help the management to make a comparative study of the profitability of various firms engaged in similar businesses. Such comparison also helps the management to study the position of their firm in respect of sales, expenses, profitability and utilising capital, etc.

E. **Assess overall financial strength**

The purpose of financial analysis is to assess the financial strength of the business. Analysis also helps in taking decisions, whether funds required for the purchase of new machines and equipments are provided from internal sources of the business or not if yes, how much? And also to assess how much funds have been received from external sources.

F. **Assess solvency of the firm**

The different tools of an analysis tell us whether the firm has sufficient funds to meet its short term and long term liabilities or not.

VARIOUS STAKEHOLDERS INTERESTED

Analysis of financial statements has become very significant due to widespread interest of various parties in the financial results of a business unit. The various parties interested in the analysis of financial statements are:

i. **Investors :** Shareholders or proprietors of the business are interested in the well being of the business. They like to know the earning capacity of the business and its prospects of future growth.

ii. **Management :** The management is interested in the financial position and performance of the enterprise as a whole and of its various divisions. It helps them in preparing budgets and assessing the performance of various departmental heads.

iii. **Trade unions:** They are interested in financial statements for negotiating the wages or salaries or bonus agreement with the management.

iv. **Lenders:** Lenders to the business like debenture holders, suppliers of loans and lease are interested to know short term as well as long term solvency position of the entity.

v. **Suppliers and trade creditors:** The suppliers and other creditors are interested to know about the solvency of the business i.e. the ability of the company to meet the debts as and when they fall due.

vi. **Tax authorities:** Tax authorities are interested in financial statements for determining the tax liability.

vii. **Researchers:** They are interested in financial statements in undertaking research work in business affairs and practices.

viii. **Employees:** They are interested to know the growth of profit. As a result of which they can demand better remuneration and congenial working environment.

ix. **Government and their agencies:** Government and their agencies need financial information to regulate the activities of the enterprises/ industries and determine taxation policy. They suggest measures to formulate policies and and regulations.

x. **Stock exchange:** The stock exchange members take interest in financial statements for the purpose of analysis because they provide useful financial information about companies.

Thus, we find that different parties have interest in financial statements for different reasons.

Tools & Techniques Used for Financial Analysis

Financial statements give complete information about assets, liabilities, equity, reserves, expenses and profit and loss of an enterprise. They are not readily understandable to interested parties like creditors, shareholders, investors etc. Thus, various techniques are employed for analysing and interpreting the financial statements. Techniques of analysis of financial statements are mainly classified into three categories:

i. Cross-sectional analysis

It is also known as inter firm comparison. This analysis helps in analysing financial characteristics of an enterprise with financial characteristics of another similar enterprise in that accounting period. For example, if company A has earned 15% profit on capital invested. This does not say whether it is adequate or not. If we analyse further and find that a similar company has earned 16% during the same period, then only we can make a conclusion that company B is better. Thus, it turns into a meaningful analysis.

ii. Time series analysis

It is also called as intra-firm comparison. According to this method, the relationship between different items of financial statement is established, comparisons are made and results obtained. The basis of comparison may be :

– Comparison of the financial statements of different years of the same business unit.

– Comparison of financial statement of a particular year of different business units.

iii. Cross-sectional cum time series analysis

This analysis is intended to compare the financial characteristics of two or more enterprises for a defined accounting period. It is possible to extend such a comparison over the year. This approach is most effective in analysing of financial statements.

The analysis and interpretation of financial statements is used to determine the financial positon. A number of tools or methods or devices are used to study the relationship between financial statements. However, the following are the important tools which are commonly used for analysing and interpreting financial statements:

A. Comparative financial statements
B. Common size statements
C. Trend analysis
D. Ratio analysis

E. Funds flow analysis
F. Cash flow analysis

A. Comparative financial statements

In brief, comparative study of financial statements is the comparison of the financial statements of the business with the previous year‘s financial statements. It enables identification of weak points and applying corrective measures. Practically, two financial statements (balance sheet and income statement) are prepared in comparative form for analysis purposes.

1. Comparative Balance Sheet

The comparative balance sheet shows the different assets and liabilities of the firm on different dates to make comparison of balances from one date to another. The comparative balance sheet has two columns for the data of original balance sheets. A third column is used to show change (increase/decrease) in figures. The fourth column may be added for giving percentages of increase or decrease.

While interpreting comparative Balance sheet the interpreter is expected to study the following aspects:

i. **Current financial position and Liquidity position -** For studying current financial position or liquidity position of a concern one should examine the working capital in both the years. Working capital is the excess of current assets over current liabilities.

ii. **Long-term financial position -** For studying the long-term financial position of the concern, one should examine the changes in fixed assets, long-term liabilities and capital.

iii. **Profitability of the concern -** The next aspect to be studied in a comparative balance sheet is the profitability of the concern. The study of increase or decrease in profit will help the interpreter to observe whether the profitability has improved or not.

After studying various assets and liabilities, an opinion should be formed about the financial position of the concern.

2. Comparative Income statement

The income statement provides the results of the operations of a business. This statement traditionally is known as trading and profit and loss A/c. Important components of income statement are net sales, cost of goods sold, selling expenses, office expenses etc. The figures of the above components are matched with their corresponding figures of previous years individually and changes are noted. The comparative income statement gives an idea of the progress of a business over a period of time. The changes in money value and percentage can be determined to analyse the profitability of the business. Like comparative balance sheet, income statement also has four columns. The first two columns are shown figures of various items for two years. Third and fourth columns are used to show increase or decrease in figures in absolute amount and percentages respectively.

The analysis and interpretation of income statement will involve the following:

i. The increase or decrease in sales should be compared with the increase or decrease in cost of goods sold.

ii. To study the operating profits

iii. The increase or decrease in net profit is calculated that will give an idea about the overall profitability of the concern.

B. Common Size Statements

The common size statements (Balance Sheet and Income Statement) are shown in analytical percentages. The figures of these statements are shown as percentages of total assets, total liabilities and total sales respectively. Take the example of Balance Sheet.

The total assets are taken as 100 and different assets are expressed as a percentage of the total. Similarly, various liabilities are taken as a part of total liabilities.

1. **Common size balance sheet**

A statement where balance sheet items are expressed in the ratio of each asset to total assets and the ratio of each liability is expressed in the ratio of total liabilities is called common size balance sheet.

Thus the common size statement may be prepared in the following way.

i. The total assets or liabilities are taken as 100
ii. The individual assets are expressed as a percentage of total assets i.e. 100 and different liabilities are calculated in relation to total liabilities.

For example, if total assets are Rs10 lakhs and value of inventory is Rs 100,000, then inventory will be 10% of total assets *(1,00,000 / 10,000,000) X 100*

2. **Common size income statement**

The items in income statement can be shown as percentages of sales to show the relations of each item to sales.

For example,

	FY 2018	**% to Sales**	**FY 2019**	**% to Sales**
Sales	5,00,000	100%	7,00,000	100%
Cost of Sales	3,00,000	66%	5,10,000	73%
Office expenses	20,000	4%	30,000	4.29%

- The increase in **cost of sales as a % of sales** is 66% in FY 2018 to 73% in FY 2019
- The increase in **cost of sales as a % of sales** is 4% in FY 2018 to 4.29% in FY 2019

C. Trend percentage analysis (TPA)

The trend analysis is a technique of studying several financial statements over a series of years. In this analysis the trend percentages are calculated for each item by taking the figure of that item for the base year taken as 100. Generally the first year is taken as a base year. The analyst is able to see the trend of figures, whether moving upward or downward.

In brief, the procedure for calculating trends is as:

i. One year is taken as a base year which is generally is the first year or last year.
ii. Trend percentages are calculated in relation to base year.

Particulars	**2014**	**2015**	**2016**	**2017**
Net sales	200,000	190,000	249,000	260,000
Less : Cost of Goods	120,000	117,800	139,200	145,600

For example:

Trend percentages				
Particulars	**2014**	**2015**	**2016**	**2017**
Net sales	100	95	124.5	130
Less : Cost of Goods Sold	100	98.2	116	121.3
Gross profit	100	90.3	126	143
Less : Expenses	100	97	110	120
Net profit	100	88	131.3	150.6

Interpretation

On the whole, 2015 was a bad year but the recovery was made during 2016. In this year there is increase in sales as well as profit.

The figure of 2015 when compared with 2014 reveal that the sales have come down by 5%. However, the cost of goods sold and the expenses have decreased only by 1.8% and 3% respectively. This has resulted in decrease in Net profit by 12%.

The position was recovered in 2016 and not only is the decline but also there positive growth in both 2016 and 2017. Moreover, the increase in profit by 31.3% (2016) and 50.6% (2017) is much more than the increased in sales by 20% and 30% respectively. This shows major portion of cost of goods sold and expenses is of fixed nature.

D. Ratio Analysis

Introduction

Financial statements aim at providing financial information about a business enterprise to meet the information needs of the decision-makers. Financial statements prepared by a business enterprise in the corporate sector are published and are available to the decision-makers. These statements provide financial data which require analysis, comparison and interpretation for taking decision by the external as well as internal users of accounting information. This act is termed as financial statement analysis. It is regarded as an integral and important part of accounting. As indicated in the previous chapter, the most commonly used techniques of financial statements analysis are comparative statements, common size statements, trend analysis, accounting ratios and cash flow analysis. The first three have been discussed in detail in the previous chapter. This chapter covers the technique of accounting ratios for analyzing the information contained in financial statements for assessing the solvency, efficiency and profitability of the enterprises.

Meaning of Accounting Ratios

As stated earlier, accounting ratios are an important tool of financial statements analysis. A ratio is a mathematical number calculated as a reference to relationship of two or more numbers and can be expressed as a fraction, proportion, percentage and a number of times. When the number is calculated by referring to two accounting numbers derived from the financial statements, it is termed as accounting ratio.

For example, if the gross profit of the business is INR 10,000 and the ‗Revenue from Operations' are INR 1,00,000, it can be said that the gross profit is 10% ***[10, 000/1,00,000 X 100]*** of the ‗Revenue from Operations' . This ratio is termed as gross profit ratio. Similarly, inventory turnover ratio may be 6 which imply that inventory turns into ‗Revenue from Operations' six times in a year.

It needs to be observed that accounting ratios exhibit relationship, if any, between accounting numbers extracted from financial statements. Ratios are essentially derived numbers and their efficacy depends a great deal upon the basic numbers from which they are calculated. Hence, if the financial statements contain some errors, the derived numbers in terms of ratio analysis would also present an erroneous scenario. **Further, a ratio must be calculated using numbers which are meaningfully correlated.** A ratio calculated by using two unrelated numbers would hardly serve any purpose. For example, the furniture of the business is INR 1,00,000 and Purchases are INR 3,00,000. The ratio of purchases to furniture is 3 *[3,00,000/1,00,000]* but it hardly has any relevance.

The reason is that there is no relationship between these two aspects.

Objectives of Ratio Analysis

Ratio analysis is indispensable part of interpretation of results revealed by the financial statements. It provides users with crucial financial information and points out the areas which require investigation. Ratio analysis is a technique which involves regrouping of data by application of arithmetical relationships, though its interpretation is a complex matter. It requires a fine understanding of the way and the rules used for preparing financial statements. Once done effectively, it provides a lot of information which helps the analyst:

- To know the areas of the business which need more attention;
- To know about the potential areas which can be improved with the effort in the desired direction;
- To provide a deeper analysis of the profitability, liquidity, solvency
- and efficiency levels in the business;
- To provide information for making cross-sectional analysis by comparing the performance with the best industry standards; and
- To provide information derived from financial statements useful for making projections and estimates for the future.

Advantages of Ratio Analysis

The ratio analysis if properly done improves the user's understanding of the efficiency with which the business is being conducted. The numerical relationships throw light on many latent aspects of the business. If properly analysed, the ratios make us understand various problem areas as well as the bright spots of the business. The knowledge of problem areas help management takes care of them in future. The knowledge of areas which are working better helps you improve the situation further. It must be emphasized that ratios are means to an end rather than the end in them. Their role is essentially indicative and that of a whistle blower. There are many advantages derived from ratio analysis. These are summarised as follows:

A. **Helps to understand efficacy of decisions:** The ratio analysis helps you to understand whether the business firm has taken the right kind of operating, investing and financing decisions. It indicates how far they have helped in improving the performance.

B. **Simplify complex figures and establish relationships:** Ratios help in simplifying the complex accounting figures and bring out their relationships. They help summarise the financial information effectively and assess the managerial efficiency, firm‘s credit worthiness, earning capacity, etc.

C. **Helpful in comparative analysis:** The ratios are not being calculated for one year only. When many year figures are kept side by side, they help a great deal in exploring the trends visible in the business. The knowledge of trend helps in making projections about the business which is a very useful feature.

D. **Identification of problem areas:** Ratios help business in identifying the problem areas as well as the bright areas of the business. Problem areas would need more attention and bright areas will need polishing to have still better results.

E. **Enables SWOT analysis:** Ratios help a great deal in explaining the changes occurring in the business. The information of change helps the management a great deal in understanding the current threats and opportunities and allows business to do its own SWOT (Strength-Weakness-Opportunity-Threat) analysis.

F. **Various comparisons:** Ratios help comparisons with certain bench marks to assess as to whether firm‘s performance is better or otherwise. For this purpose, the profitability, liquidity, solvency, etc. of a business, may be compared: (i) over a number of accounting periods with itself (Intra-firm Comparison/Time Series Analysis), (ii) with other business enterprises (Inter-firm Comparison/Cross-sectional Analysis) and (iii) with standards set for that firm/industry (comparison with standard (or industry expectations).

Limitations of Ratio Analysis

Since the ratios are derived from the financial statements, any weakness in the original financial statements will also creep in the derived analysis in the form of ratio analysis. Thus, the limitations of financial statements also form the limitations of the ratio analysis. Hence, to interpret the ratios, the user should be aware of the rules followed in the preparation of financial statements and also their nature and limitations. The limitations of ratio analysis which arise primarily from the nature of financial statements are as under:

A. **Limitations of Accounting Data:** Accounting data give an unwarranted impression of precision and finality. In fact, accounting data –reflect a combination of recorded facts, accounting conventions and personal judgments which affect them materially. For example, profit of the business is not a precise and final figure. It is merely an opinion of the accountant based on application of accounting policies. The soundness of the judgment necessarily depends on the competence and integrity of those who make them and on their adherence to Generally Accepted Accounting Principles and Conventions‖. Thus, the financial statements may not reveal the true state of affairs of the enterprises and so the ratios will also not give the true picture.

B. **Ignores Price-level Changes:** The financial accounting is based on stable money measurement principle. It implicitly assumes that price level changes are either non-existent or minimal. But the truth is otherwise. We are normally living in inflationary economies where the power of money declines constantly. A change in the price-level makes analysis of financial statement of different accounting years meaningless because accounting records ignore changes in value of money.

C. **Ignore Qualitative or Non-monetary Aspects:** Accounting provides information about quantitative (or monetary) aspects of business. Hence, the ratios also reflect only the monetary aspects, ignoring completely the non-monetary (qualitative) factors.

D. **Variations in Accounting Practices:** There are differing accounting policies for valuation of inventory, calculation of depreciation, treatment of intangibles Assets definition of certain financial variables etc., available for various aspects of business transactions. These variations leave a big question mark on the cross-sectional analysis. As there are variations in accounting practices followed by different business enterprises, a valid comparison of their financial statements is not possible.

E. **Forecasting***:* Forecasting of future trends based only on historical analysis is not feasible. Proper forecasting requires consideration of non-financial factors as well.

Now let us talk about the limitations of the ratios. The various limitations are:

1. **Means and not the End:** Ratios are means to an end rather than the end by itself.
2. **Lack of ability to resolve problems:** Their role is essentially indicative and of whistle blowing and not providing a solution to the problem.
3. **Lack of standardised definitions:** There is a lack of standardized definitions of various concepts used in ratio analysis. For example, there is no standard definition of liquid liabilities. Normally, it includes all current liabilities, but sometimes it refers to current liabilities less bank overdraft.
4. **Lack of universally accepted standard levels:** There is no universal yardstick which specifies the level of ideal ratios. There is no standard list of the levels universally acceptable, and, in India, the industry averages are also not available.
5. **Ratios based on unrelated figures:** A ratio calculated for unrelated figures would essentially be a meaningless exercise. For example, creditors of Rs. 1,00,000 and furniture of Rs. 1,00,000 represent a ratio of 1:1. But it has no relevance to assess efficiency or solvency.

Hence, ratios should be used with due consciousness of their limitations while evaluating the performance of an organisation and planning the future strategies for its improvement.

Types of Ratios

There is a two way classification of ratios:

- traditional classification
- functional classification.

The traditional classification has been on the basis of financial statements to which the determinants of ratios belong. On this basis, the ratios are classified as follows:

1. **_Statement of Profit and Loss Ratios:** A ratio of two variables from the statement of profit and loss is known as statement of profit and loss ratio. For example, ratio of gross profit to revenue from operations is known as gross profit ratio. It is calculated using both figures from the statement of profit and loss.
2. **Balance Sheet Ratios:** In case both variables are from the balance sheet, it is classified as balance sheet ratios. For example, ratio of current assets to current liabilities known as current ratio. It is calculated using both figures from balance sheet.
3. **Composite Ratios:** If a ratio is computed with one variable from the statement of profit and loss and another variable from the balance sheet, it is called composite ratio. For example, ratio of credit revenue from operations to trade receivables (known as trade receivables turnover ratio) is calculated using one figure from the statement of profit and loss (credit revenue from operations) and another figure (trade receivables) from the balance sheet.

Although accounting ratios are calculated by taking data from financial statements but classification of ratios on the basis of financial statements is rarely used in practice. It must be recalled that basic purpose of accounting is to throw light on the financial performance (profitability) and financial position (its capacity to raise money and invest them wisely) as well as changes occurring in financial position (possible explanation of changes in the activity level). As such, the alternative classification (functional classification) based on the purpose for which a ratio is computed, is the most commonly used classification which is as follows:

1. **Liquidity Ratios:** To meet its commitments, business needs liquid funds. The ability of the business to pay the amount due to stakeholders as and when it is due is known as liquidity, and the ratios calculated to measure it are known as _Liquidity Ratios'. These are essentially short-term in nature.
2. **Solvency Ratios:** Solvency of business is determined by its ability to meet its contractual obligations towards stakeholders, particularly towards external stakeholders, and the ratios calculated to measure solvency position are known as _Solvency Ratios'. These are essentially long-term in nature.
3. **Activity (or Turnover) Ratios:** This refers to the ratios that are calculated for measuring the efficiency of operations of business based on effective utilisation of resources. Hence, these are also known as _Efficiency Ratios'.
4. **Profitability Ratios:** It refers to the analysis of profits in relation to revenue from operations or funds (or assets) employed in the business and the ratios calculated to meet this objective are known as _Profitability Ratios'.

Exhibit – 1 – Key Ratios of ABC LTD.

Particulars	FY 2017	FY 2018	FY 2019
Profitability Ratios			
PBDIT/total income (%)	14.09	15.6	17.78
Net profit/total income (%)	6.68	7.19	10.26
Cash flow/total income (%)	7.97	8.64	12.13
Return on Net Worth (PAT/Net Worth) (%)	16.61	10.39	14.68
Return on Capital Employed (PBDIT/Average capital employed) (%)	15.4	15.33	16.17
Activity Ratios			
Trade Receivables turnover (days)	104	87	80
Inventory turnover (days)	98	100	96
Working capital/total capital employed (%)	68.84	60.04	51.11
Interest/total income (%)	4.48	3.67	3.14
Leverage and Financial Ratios			
Debt-equity ratio	1.45	0.66	0.77
Current ratio	3.5	3.72	3.58
Quick ratio	2.45	2.4	2.39
Cash and Cash equivalents/total assets (%)	12.76	14.48	7.93
Interest cover/Age	3.15	4.25	4.69
Valuation Ratios			
Earnings per share	15	12.75	21.16
Cash earnings per share	18.78	15.58	24.85
Dividend per share	3.27	2.73	2.66
Book value per share	94.77	124.86	147.62
Price/Earning	8.64	15.03	13.4

1. Liquidity Ratios

Liquidity ratios are calculated to measure the short-term solvency of the business, i.e. the firm‘s ability to meet its current obligations. These are analysed by looking at the amounts of current assets and current liabilities in the balance sheet.

Liquidity reflects the ability of a company to meet its short-term obligations using assets that are most readily converted into cash. Assets that may be converted into cash in a short period of time are referred to as liquid assets; they are listed in financial statements as current assets. Current assets are often referred to as working capital because these assets represent the resources needed for the day-to-day operations of the company's long-term, capital investments. Current assets are used to satisfy short-term obligations, or current liabilities. The amount by which current assets exceed current liabilities is referred to as the net working capital.

The two ratios included in this category are **current ratio** and **quick ratio**.

Current Ratio

Current ratio is the proportion of current assets to current liabilities. It is expressed as follows:

Current Ratio = Current Assets : Current Liabilities (or) Current Assets/Current Liabilities

Current assets include current investments, inventories, trade receivables (debtors and bills receivables), cash and cash equivalents, short-term loans and advances and other current assets such as prepaid expenses, advance tax and accrued income, etc.

Current liabilities include short-term borrowings, trade payables (creditors and bills payables), other current liabilities and short-term provisions.

Illustration 1

Calculate Current Ratio from the following information:

Particulars	Amount
Inventories	50,000
Trade receivables	50,000
Advance tax	4,000
Cash and cash equivalents	30,000
Trade payables	100,000
Short-term borrowings (bank overdraft)	4,000

Solution:

Current Ratio =	Current Assets / Current Liabilities
Current Assets =	Inventories + Trade receivables + Advance tax + Cash and cash equivalents = Rs. 50,000 + Rs. 50,000 + Rs. 4,000 + Rs. 30,000 **Rs. 1,34,000**
Current Liabilities	`= Trade Payables + Short Term Borrowings = Rs. 1,00,000 + Rs. 4,000 **= Rs. 1,04,000**
Current Ratio =	**Rs.1,34,000 / Rs.1,04,000** **=1.29 :1**

Significance: It provides a measure of degree to which current assets cover current liabilities. The excess of current assets over current liabilities provides a measure of safety margin available against uncertainty in realisation of current assets and flow of funds. The ratio should be reasonable. It should neither be very high or very low. Both the situations have their inherent disadvantages. A very high current ratio implies heavy investment in current assets which is not a good sign as it reflects under utilisation or improper utilisation of resources. A low ratio endangers the business and puts it at risk of facing a situation where it will not be able to pay its short-term debt on time. If this problem persists, it may affect firm‘s credit worthiness adversely. Normally, it is safe to have this ratio within the range of 2:1.

Quick Ratio

It is the ratio of quick (or liquid) asset to current liabilities. It is expressed as

Quick Ratio = Quick Assets : Current Liabilities (or) Quick Assets/Current Liabilities

The quick assets are defined as those assets which are quickly convertible into cash. While calculating quick assets we exclude the inventories at the end and other current assets such as prepaid expenses, advance tax, etc., from the current assets. Because of exclusion of non-liquid current assets it is considered better than current ratio as a measure of liquidity position of the business. It is calculated to serve as a supplementary check on liquidity position of the business and is therefore, also **known as _Acid-Test Ratio‘.**

Illustration 2

Calculate quick ratio from the information given in **illustration 1**.

Solution:

Significance: The ratio provides a measure of the capacity of the business to meet its short-term obligations without any flaw. Normally, it is advocated to be safe to have a ratio of 1:1 as unnecessarily low ratio will be very risky and a high ratio suggests unnecessarily deployment of resources in otherwise less profitable short-term investments.

Illustration 3

Calculate _Liquidity Ratio‘ from the following information:

Particulars	**Amount**
Inventories	20,000
Pre-Paid Expenses	5,000
Advance tax	5,000
Current Assets	80,000
Current Liabilities	50,000

Solution

Quick Ratio =	Quick Assets / Current Liabilities
Quick Assets =	Current Assets - (Inventories + Pre-paid Expenses + Advance tax) = Rs. 80,000 – (Rs. 20,000 + Rs. 5,000 + Rs. 5,000)

	Rs. 50,000
Current Liabilities	**= Rs. 50,000**
Current Ratio =	Rs.50,000 / Rs.50,000 **=1:1**

Illustration 4

Calculate the current ratio from the following information:

Particulars	**Amount**
Total Assets	3,00,000
Non-current liabilities	80,000
Shareholders Funds	2,00,000
Fixed (Non-Current) Assets	1,60,000
Non-Current Investments	1,00,000

Solution:

Total assets = Non-current assets + Current assets

Rs. 3,00,000 = Rs. 2,60,000 + Current assets

Current assets = Rs. 3,00,000 – Rs. 2,60,000 = Rs. 40,000

Total assets = Equity and Liabilities

= Shareholders' Funds + Non-current liabilities + Current liabilities

Rs. 3,00,000 = Rs. 2,00,000 + Rs. 80,000 + Current Liabilities

Current liabilities = Rs. 3,00,000 – Rs. 2,80,000 = Rs. 20,000

Current Ratio = Current Assets / Current Liabilities

= Rs. 40,000 / Rs. 20,000 = 2 :1

Illustration 5

The current ratio is 2 : 1. State giving reasons which of the following transactions would improve, reduce and not change the current ratio:

(a) Payment of current liability;

(b) Purchased goods on credit;

(c) Sale of a Computer (Book value: Rs. 4,000) for Rs. 3,000 only;

(d) Sale of merchandise (goods) costing Rs. 10,000 for Rs. 11,000;

(e) Payment of dividend.

Solution:

The given current ratio is 2 : 1. Let us assume that current assets are Rs. 50,000 and current liabilities are Rs. 25,000; Thus, the current ratio is 2 : 1. Now we will analyse the effect of given transactions on current ratio.

(a) Assume that Rs. 10,000 of creditors is paid by cheque. This will reduce the current assets to Rs. 40,000 and current liabilities to Rs. 15,000. The new ratio will be 2.67 : 1 (Rs. 40,000/Rs.15,000). Hence, it has ***improved***.

(b) Assume that goods of Rs. 10,000 are purchased on credit. This will increase the current assets to Rs. 60,000 and current liabilities to Rs. 35,000. The new ratio will be 1.7:1 (Rs. 60,000/Rs. 35,000). Hence, it has ***reduced.***

(c) Due to sale of a computer (a fixed asset) the current assets will increase to Rs. 53,000 without any change in the current liabilities. The new ratio will be 2.12 : 1 (Rs. 53,000/Rs. 25,000). Hence, it has ***improved.***

(d) This transaction will decrease the inventories by Rs. 10,000 and increase the cash by Rs. 11,000 thereby increasing the current assets by Rs. 1,000 without any change in the current liabilities. The new ratio will be 2.04 : 1 (Rs. 51,000/Rs. 25,000). Hence, it has ***improved.***

(e) Assume that Rs. 5,000 is given by way of dividend. It will reduce the current assets to Rs. 45,000 without any change in the current liabilities. The new ratio will be 1.8 : 1 (Rs. 45,000/Rs. 25,000). Hence, it has ***reduced***.

2. Solvency Ratios

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

- Debt-Equity Ratio;
- Debt to Capital Employed Ratio;
- Proprietary Ratio;
- Total Assets to Debt Ratio;
- Interest Coverage Ratio.

Debt-Equity Ratio

Debt-Equity Ratio measures the relationship between long-term debt and equity. If debt component of the total long-term funds employed is small, outsiders feel more secure. From security point of view, capital structure with less debt and more equity is considered favourable as it reduces the chances of bankruptcy. Normally, it is considered to be safe if debt equity ratio is 2 : 1. However, it may vary from industry to industry. It is computed as follows:

$$\text{Debt-Equity Ratio} = \text{Long term Debts} / \text{Shareholders' Funds}$$

where:

Shareholders‘ Funds (Equity) = Share capital + Reserves and Surplus + Money received against share warrants

Share Capital = Equity share capital + Preference share capital

or

Shareholders‘ Funds (Equity) = Non-current sssets + Working capital – Non-current liabilities

Working Capital = Current Assets – Current Liabilities

Significance: This ratio measures the degree of indebtedness of an enterprise and gives an idea to the long-term lender regarding extent of security of the debt. As indicated earlier, a low debt equity ratio reflects more security. A high ratio, on the other hand, is considered risky as it may put the firm into difficulty in meeting its obligations to outsiders. However, from the perspective of the owners, greater use of debt (trading on equity) may help in ensuring higher returns for them if the rate of earnings on capital employed is higher than the rate of interest payable.

Illustration 6

From the following balance sheet of ABC Co. Ltd. as on March 31, 2015. Calculate debt equity ratio:

ABC Co. Ltd.
Balance Sheet as at 31 March, 2019

Particulars	**Amount**
I. Equity and Liabilities	
1. Shareholders‘ funds	
a) Share capital	1,200,000
b) Reserves and surplus	200,000
c) Money received against share warrants	100,000
2. Non-current Liabilities	
a) Long-term borrowings	400,000
b) Other long-term liabilities	40,000
c) Long-term provisions	60,000
3. Current Liabilities	
a) Short-term borrowings	200,000
b) Trade payables	100,000
c) Other current liabilities	50,000
d) Short-term provisions	150,000
	2,500,000
II. Assets	
1. Non-Current Assets	
a) Fixed assets	1500000
b) Non-current investments	200000
c) Long-term loans and advances	100000
2. Current Assets	
a) Current investments	150000
b) Inventories	150000
c) Trade receivables	100000
d) Cash and cash equivalents	250000
e) Short-term loans and advances	50,000
	2500000

Solution:

Debt-Equity Ratio	= Debts/ Equity
Debt	= Long-term borrowings + Other long-term liabilities + Long-term provisions
	= Rs. 4,00,000 + Rs. 40,000 + Rs. 60,000
	= Rs. 5,00,000
Equity	= Share capital + Reserves and surplus + Money received against share warrants
	= Rs. 12,00,000 + Rs. 2,00,000 + Rs. 1,00,000
	= Rs. 15,00,000
Alternatively,	
Equity	= Non-current assets + Working capital – Non-current liabilities
	= Rs. 18,00,000 + Rs. 2,00,000 – Rs. 5,00,000
	= Rs. 15,00,000
Working Capital	= Current assets – Current liabilities
	= Rs. 7,00,000 –Rs. 5,00,000
	= Rs. 2,00,000
Debt Equity Ratio	= 5,00,000 / 15,00,000
	= 0.33 :1

Debt to Capital Employed Ratio

The Debt to capital employed ratio refers to the ratio of long-term debt to the total of external and internal funds (capital employed or net assets). It is computed as follows:

Debt to Capital Employed Ratio = Long-term Debt/Capital Employed (or Net Assets)

Capital employed is equal to the **long-term debt + shareholders‘ funds**. Alternatively, it may be taken as net assets which are equal to the total assets – current liabilities taking the data of Illustration 6, capital employed shall work out to Rs. 5,00,000 + Rs. 15,00,000 = Rs. 20,00,000. Similarly, Net Assets as Rs. 25,00,000 – Rs. 5,00,000 = Rs. 20,00,000 and the Debt to capital employed ratio as Rs. 5,00,000/Rs. 20,00,000 = 0.25:1.

Significance: Like debt-equity ratio, it shows proportion of long-term debts in capital employed. Low ratio provides security to lenders and high ratio helps management in trading on equity. In the above case, the debt to Capital Employed ratio is less than half which indicates reasonable funding by debt and adequate security of debt.

It may be noted that Debt to Capital Employed Ratio can also be computed in relation to total assets. In that case, it usually refers to the ratio of total debts (long-term debts + current liabilities) to total assets, i.e., total of non-current and current assets (or shareholders, funds + long-term debts + current liabilities), and is expressed as

Debt to Capital Employed Ratio = Total Debts/ Total Assets

Proprietary Ratio

Proprietary ratio expresses relationship of proprietor's (shareholders) funds to net assets and is calculated as follows:

Proprietary Ratio = Shareholders, Funds/Capital employed (or net assets)

Based on data of Illustration 7, it shall be worked out as follows: Rs. 15,00,000/Rs. 20,00,000 = 0.75 : 1

Significance: Higher proportion of shareholders funds in financing the assets is a positive feature as it provides security to creditors. This ratio can also be computed in relation to total assets instead of net assets (capital employed). It may be noted that the total of debt to capital employed ratio and proprietory ratio is equal to 1. Take these ratios worked out on the basis of data of Illustration - 7, the debt to Capital Employed ratio is 0.25 : 1 and the Proprietary Ratio 0.75 : 1 the total is 0.25 + 0.75 = 1. In terms of percentage it can be stated that the 25% of the capital employed is funded by debts and 75% by owners' funds.

Total Assets to Debt Ratio

This ratio measures the extent of the coverage of long-term debts by assets. It is calculated as

Total assets to Debt Ratio = Total assets/Long-term debts

The higher ratio indicates that assets have been mainly financed by owners funds and the long-term loans is adequately covered by assets. It is better to take the net assets (capital employed) instead of total assets for computing this ratio also. It is observed that in that case, the ratio is the reciprocal of the debt to capital employed ratio.

Significance: This ratio primarily indicates the rate of external funds in financing the assets and the extent of coverage of their debts are covered by assets.

Illustration 7

From the following information, calculate Debt Equity Ratio, Total Assets to Debt Ratio, Proprietory Ratio, and Debt to Capital Employed Ratio:

Balance Sheet as at March 31, 2019

Particulars	Amount
I. Equity and Liabilities:	
1. Shareholders' funds	
a) Share capital	400000
b) Reserves and surplus	100000
2. Non-current Liabilities	
Long-term borrowings	150000
3. Current Liabilities	50,000
	700000
II. Assets	
1. Non-current Assets	
a) Fixed assets	400000
b) Non-current investments	100000
2. Current Assets	200000
	700000

Solution:

i) Debt-Equity Ratio = Debts **/**Equity

Debt = Long-term borrowings = Rs. 1,50,000

Equity = Share capital + Reserves and surplus

= Rs. 4,00,000 + Rs. 1,00,000 = Rs. 5,00,000

Debt-Equity Ratio = Rs. 1,50,000 / Rs. 5,00,000

= 0.3 : 1

ii) Total Assets to Debt Ratio = Total assets / Long - term debts

Total Assets = Fixed assets + Non-current investments + Current assets

= Rs. 4,00,000 + Rs. 1,00,000 + Rs. 2,00,000 = Rs. 7,00,000

Long-term Debt = Rs. 1,50,000

Total Asset to Debt Ratio = Rs. 7,00,000/ Rs. 1,50,000

= **4.67 : 1**

iii) Proprietary Ratio = Shareholders' Funds / Total Assets

= Rs. 5,00,000 / Rs. 7,00,000

= **0.71 : 1**

iv) Debt to Capital Employed Ratio = Long - term debts/ Capital Employed

Capital Employed = Shareholders‘ Funds + Long-term borrowings

= Rs. 5,00,000 + Rs. 1,50,000

= Rs. 6,50,000

Debt to Capital Employed Ratio= Long - term debts / Capital Employed

= Rs. 1,50,000 / Rs. 6,50,000

= **0.23 : 1**

Illustration 8

The debt equity ratio of X Ltd. is 0.5 : 1. Which of the following would increase/ decrease or not change the debt equity ratio?

(i) Further issue of equity shares
(ii) Cash received from debtors
(iii) Sale of goods on cash basis
(iv) Redemption of debentures
(v) Purchase of goods on credit.

Solution:

The change in the ratio depends upon the original ratio. Let us assume that external funds are Rs. 5,00,000 and internal funds are Rs. 10,00,000. Now we will analyse the effect of given transactions on debt equity ratio.

(i) Assume that Rs. 1,00,000 worth of equity shares are issued. This will increase the internal funds to Rs. 11,00,000. The new ratio will be 0.45 : 1 (5,00,000/11,00,000). Thus, it is clear that further issue of equity shares decreases the debt-equity ratio.

(ii) Cash received from debtors will leave the internal and external funds unchanged as this will only affect the composition of current assets. Hence, the debt-equity ratio will remain unchanged.

(iii) This will also leave the ratio *unchanged* as sale of goods on cash basis neither affect Debt nor equity.

(iv) Assume that Rs. 1,00,000 debentures are redeemed. This will decrease the long-term debt to Rs. 4,00,000. The new ratio will be 0.4 : 1 (4,00,000/10,00,000). Redemption of debentures will decrease the debit-equity ratio.

(v) This will also leave the ratio *unchanged* as purchase of goods on credit neither affect Debt nor equity.

Interest Coverage Ratio

It is a ratio which deals with the servicing of interest on loan. It is a measure of security of interest payable on long-term debts. It expresses the relationship between profits available for payment of interest and the amount of interest payable. It is calculated as follows:

Interest Coverage Ratio = Net Profit before Interest and Tax / Interest on long-term debts

Significance: It reveals the number of times interest on long-term debts is covered by the profits available for interest. A higher ratio ensures safety of interest on debts.

Illustration 9

From the following details, calculate interest coverage ratio: Net Profit after tax Rs. 60,000; 15% Long-term debt 10,00,000; and Tax rate 40%.

Solution:

Net Profit after Tax = Rs. 60,000 and Tax Rate = 40%

Net Profit before tax = Net profit after tax × 100/(100 – Tax rate)

= Rs. 60,000 × 100/(100 – 40)

= Rs. 1,00,000

Interest on Long-term Debt = 15% of Rs. 10,00,000 = Rs. 1,50,000

Net profit before interest and tax = Net profit before tax + Interest

= Rs. 1,00,000 + Rs. 1,50,000 = Rs. 2,50,000

Interest Coverage Ratio = Net Profit before Interest and Tax/Interest on long-term debt

= Rs. 2,50,000/Rs. 1,50,000

= 1.67 times.

3. Activity (or Turnover) Ratio

These ratios indicate the speed at which, activities of the business are being performed. The activity ratios express the number of times assets employed, or, for that matter, any constituent of assets, is turned into sales during an accounting period. Higher turnover ratio means better utilisation of assets and signifies improved efficiency and profitability, and as such is known as efficiency ratios.

The important activity ratios calculated under this category are
1. Inventory Turnover;
2. Trade receivable Turnover;
3. Trade payable Turnover;
4. Investment (Net assets) Turnover
5. Fixed assets Turnover; and
6. Working capital Turnover.

Inventory Turnover Ratio

It determines the number of times inventory is converted into revenue from operations during the accounting period under consideration. It expresses the relationship between the cost of revenue from operations and average inventory.

The formula for its calculation is as follows:

Inventory Turnover Ratio = Cost of Revenue from Operations / Average Inventory

Where average inventory refers to arithmetic average of opening and closing inventory, and the cost of revenue from operations means revenue from operations less gross profit.

Significance : It studies the frequency of conversion of inventory of finished goods into revenue from operations. It is also a measure of liquidity. It determines how many times inventory is purchased or replaced during a year. Low turnover of inventory may be due to bad buying, obsolete inventory, etc., and is a danger signal. High turnover is good but it must be carefully interpreted as it may be due to buying in small lots or selling quickly at low margin to realise cash.

Thus, it throws light on utilisation of inventory of goods.

Illustration 10

From the following information, calculate inventory turnover ratio:

Inventory in the beginning	= 18,000
Inventory at the end	= 22,000
Net purchases	= 46,000
Wages	= 14,000
Revenue from operations	= 80,000
Carriage inwards	= 4,000

Solution:

Inventory Turnover Ratio = Cost of Revenue from Operations / Average Inventory

Cost of Revenue from Operations = Inventory in the beginning + Net Purchases + Wages + Carriage inwards – Inventory at the end
= Rs. 18,000 + Rs. 46,000 + Rs. 14,000 + Rs. 4,000 – Rs. 22,000
= Rs. 60,000

Average Inventory = (Inventory in the beginning + Inventory at the end) / 2
= Rs. 18,000 + Rs. 22,000
= Rs. 20,000

Inventory Turnover Ratio = Rs. 60,000 / Rs. 20,000
= **3 Times**

Illustration 11
From the following information, calculate inventory turnover ratio:
.
Revenue from operations = 4,00,000
Average Inventory = 55,000
Gross Profit Ratio = 10%

Solution:
Revenue from operations = Rs. 4,00,000
Gross Profit = 10% of Rs. 4,00,000 = Rs. 40,000

Cost of Revenue from operations = Revenue from operations – Gross Profit
= Rs. 4,00,000 – Rs. 40,000 = Rs. 3,60,000

Inventory Turnover Ratio = Cost of Revenue from Operations/ Average Inventory
= Rs. 3,60,000 / Rs. 55,000
= 6.55 times

Trade Receivables Turnover Ratio

It expresses the relationship between credit revenue from operations and trade receivable. It is calculated as follows:

Trade Receivable Turnover ratio = Net Credit Revenue from Operations/Average Trade

Where, Average Trade Receivable = (Opening Debtors and Bills Receivable + Closing Debtors and Bills Receivable)/2

It is to be noted that debtors should be taken before making provision for doubtful debts.

Significance: The liquidity position of the firm depends upon the speed with which trade receivables are realised. This ratio indicates the number of times the receivables are turned over and converted into cash in an accounting period Higher turnover means speedy collection from trade receivable.

This ratio also helps in working out the average collection period. The ratio is calculated by dividing the days or months in a year by trade receivables turnover ratio.

Average collection period = Number of days or Months / Trade receivables turnover ratio

Illustration 12

Calculate the Trade receivables turnover ratio from the following information:

Total Revenue from operations 4,00,000
Cash Revenue from operations 20% of Total Revenue from operations
Trade receivables as at 1.4.2014 40,000
Trade receivables as at 31.3.2015 1,20,000

Solution:

Trade Receivables Turnover Ratio = Net Credit Revenue from Operations / Average Trade Receivables

Credit Revenue from operations = Total revenue from operations – Cash revenue from operations
Cash Revenue from operations = 20% of Rs. 4,00,000
= Rs. 4,00,000 × (20/100)
= Rs. 80,000

Credit Revenue from operations = Rs. 4,00,000 – Rs. 80,000 = Rs. 3,20,000

Average Trade Receivables = (Opening Trade Receivables + Closing Trade Receivables)/2
= (Rs. 40,000 + Rs. 1,20,000) /2
= Rs. 80,000

Trade Receivables Turnover Rations = Net Credit Revenue Form Operations / Average Inventory
Trade Receivables Turnover Ratio = Rs. 3,20,000/ Rs. 80,000
= 4 times.

Trade Payable Turnover Ratio

Trade payables turnover ratio indicates the pattern of payment of trade payable. As trade payable arise on account of credit purchases, it expresses relationship between credit purchases and trade payable. It is calculated as follows:

Trade Payables Turnover ratio = Net Credit purchases/ Average trade payable

Where Average Trade Payable = (Opening Creditors and Bills Payable + Closing Creditors and Bills Payable)/2

Average Payment Period Ratio = No. of days/month in a year / Trade Payables Turnover Ratio

Significance: It reveals average payment period. Lower ratio means credit allowed by the supplier is for a long period or it may reflect delayed payment to suppliers which is not a very good policy as it may affect the reputation of the business. The average period of payment can be worked out by days/months in a year by the Trade Payable Turnover Ratio.

Illustration 13

Calculate the Trade payables turnover ratio from the following figures:

Credit purchases during 2014-15 = 12,00,000
Creditors on 1.4.2014 = 3,00,000
Bills Payables on 1.4.2014 = 1,00,000
Creditors on 31.3.2015 = 1,30,000
Bills Payables on 31.3.2015 = 70,000

Solution:

Trade Payables Turnover Ratio = Net Credit Purchases / Average Trade Payables

Average Trade Payables = (Creditors in the beginning + Bills payables in the beginning + Creditors at the end + Bills payables at the end) / 2
= (Rs. 3,00,000 + Rs. 1,00,000 + Rs. 1,30,000 + Rs. 70,000) / 2
= Rs. 3,00,000

Trade Payables Turnover Ratio = Rs. 12,00,000 / Rs. 3,00,000
= **4 times**

Net Assets or Capital Employed Turnover Ratio

It reflects relationship between revenue from operations and net assets (capital employed) in the business. Higher turnover means better activity and profitability.

It is calculated as follows:

Net Assets or Capital Employed Turnover ratio = Revenue from Operation / Capital

Capital employed turnover ratio which studies turnover of capital employed (or Net Assets) is analysed further by following two turnover ratios:

(a) Fixed Assets Turnover Ratio = Net Revenue from Operation/ Net Fixed Assets

(b) Working Capital Turnover Ratio: Net Revenue from Operation/Working Capital

Significance: High turnover of capital employed, working capital and fixed assets is a good sign and implies efficient utilisation of resources. Utilisation of capital employed or, for that matter, any of its components is revealed by the turnover ratios. Higher turnover reflects efficient utilisation resulting in higher liquidity and profitability in the business.

Illustration 14

From the following information, calculate (i) Net assets turnover, (ii) Fixed assets turnover, and (iii) Working capital turnover ratios: Given that the Revenue from operations for the year 2019 were Rs. 30,00,000

Particulars	**Amount**
I. Equity and Liabilities:	
1. Shareholders‘ funds	
Preference shares capital	400,000
Equity share capital	600,000
General reserve	100,000
Balance in Statement of Profit and Loss	300,000

2. Non-current Liabilities	
15% debentures	200,000
14% Loan	200,000
3. Current Liabilities	
Creditors	140,000
Bills payable	50,000
Outstanding expenses	10,000
	2,000,000
II. Assets	
1. Non-current Assets	
Plant and Machinery	800,000
Land and Building	500,000
Motor Car	200,000
Furniture	100,000
2. Current Assets	
Inventory	180,000
Debtors	110,000
Bank	80,000
Cash	30,000
	2,000,000

Solution:

Revenue from Operations = Rs. 30,00,000

Capital Employed = Share Capital + Reserves and Surplus + Long-term Debts (or Net Assets)
= (Rs.4,00,000 + Rs.6,00,000) + (Rs.1,00,000 + Rs.3,00,000) + (Rs.2,00,000 + Rs.2,00,000)
= Rs. 18,00,000

Fixed Assets = Rs.8,00,000 + Rs.5,00,000 + Rs.2,00,000 + Rs.1,00,000
= Rs. 16,00,000

Working Capital = Current Assets – Current Liabilities
= Rs.4,00,000 – Rs.2,00,000 = Rs. 2,00,000

Net Assets Turnover Ratio = Rs.30,00,000/Rs.18,00,000 = 1.67 times

Fixed Assets Turnover Ratio = Rs.30,00,000/Rs.16,00,000 = 1.88 times

Working Capital Turnover Ratio = Rs.30,00,000/Rs.2,00,000 = 15 times.

4. Profitability Ratios

The profitability or financial performance is mainly summarised in the statement of profit and loss. Profitability ratios are calculated to analyse the earning capacity of the business which is the outcome of utilisation of resources employed in the business. There is a close relationship between the profit and the efficiency with which the resources employed in the business are utilized.

The various ratios which are commonly used to analyse the profitability of the business are:

1. Gross profit ratio
2. Operating ratio
3. Operating profit ratio
4. Net profit ratio
5. Return on Investment (ROI) or Return on Capital Employed (ROCE)
6. Return on NetWorth (RONW)
7. Earnings per share
8. Book value per share
9. Dividend payout ratio
10. Price earning ratio.

Gross Profit Ratio

Gross profit ratio as a percentage of revenue from operations is computed to have an idea about gross margin. It is computed as follows:

Gross Profit Ratio = Gross Profit/Net Revenue of Operations × 100

Significance: It indicates gross margin on products sold. It also indicates the margin available to cover operating expenses, non-operating expenses, etc.

Change in gross profit ratio may be due to change in selling price or cost of revenue from operations or a combination of both. A low ratio may indicate unfavorable purchase and sales policy. Higher gross profit ratio is always a good sign.

Operating Ratio

It is computed to analyse cost of operation in relation to revenue from operations. It is calculated as follows:

Operating Ratio = (Cost of Revenue from Operations + Operating Expenses)/ Net Revenue from Operations × 100

Operating expenses include office expenses, administrative expenses, selling expenses, distribution expenses, depreciation and employee benefit expenses etc.

Cost of operation is determined by excluding non-operating incomes and expenses such as loss on sale of assets, interest paid, dividend received, loss by fire, speculation gain and so on.

Operating Profit Ratio

It is calculated to reveal operating margin. It may be computed directly or as a residual of operating ratio.

Operating Profit Ratio = 100 – Operating Ratio

Alternatively, it is calculated as under:

Operating Profit Ratio = Operating Profit/ Revenue from Operations × 100

Where Operating Profit = Revenue from Operations – Operating Cost

Significance: Operating ratio is computed to express cost of operations excluding financial charges in relation to revenue from operations. A corollary of it is _Operating Profit Ratio'. It helps to analyse the performance of business and throws light on the operational efficiency of the business. It is very useful for inter-firm as well as intra-firm comparisons. Lower operating ratio is a very healthy sign.

Illustration 15

Given the following information:

Revenue from Operations =3,40,000
Cost of Revenue from Operations =1,20,000
Selling expenses =80,000

Administrative Expenses =40,000
Calculate Gross profit ratio and Operating ratio.

Solution:

Gross Profit = Revenue from Operations – Cost of Revenue from Operations
= Rs. 3,40,000 – Rs. 1,20,000
= Rs. 2,20,000

Gross Profit Ratio = (Gross Profit/Revenue from operation) X 100
= (Rs. 2,20,000/ Rs. 3,40,000) X 100
= 64.71%

Operating Cost = Cost of Revenue from Operations + Selling Expenses + Administrative Expenses
= Rs. 1,20,000 + 80,000 + 40,000
= Rs. 2,40,000

Operating Ratio = (Operating Cost / Net Revenue from Operations) × 100
= (Rs. 2,40,000/Rs. 3,40,000) X 100
= 70.59%

Net Profit Ratio

Net profit ratio is based on all inclusive concept of profit. It relates revenue from operations to net profit after operational as well as non-operational expenses and incomes. It is calculated as under:

Net Profit Ratio = Net profit/Revenue from Operations × 100

Generally, net profit refers to profit after tax (PAT).

Significance: It is a measure of net profit margin in relation to revenue from operations. Besides revealing profitability, it is the main variable in computation of Return on Investment. It reflects the overall efficiency of the business, assumes great significance from the point of view of investors.

Return on Capital Employed or Investment

It explains the overall utilisation of funds by a business enterprise. Capital employed means the long-term funds employed in the business and includes shareholders‘ funds, debentures and long-term loans. Alternatively, capital employed may be taken as the total of non-current assets and working capital.

Profit refers to the Profit Before Interest and Tax (PBIT) for computation of thisratio. Thus, it is computed as follows:

Return on Investment (or Capital Employed) = Profit before Interest and Tax/ Capital Employed × 100

Significance: It measures return on capital employed in the business. It reveals the efficiency of the business in utilisation of funds entrusted to it by shareholders, debenture-holders and long-term loans. For inter-firm comparison, return on capital employed funds is considered a good measure of profitability. It also helps in assessing whether the firm is earning a higher return on capital employed as compared to the interest rate paid.

Return on Shareholders‘ Funds

This ratio is very important from shareholders‘ point of view in assessing whether their investment in the firm generates a reasonable return or not. It should be higher than the return on investment otherwise it would imply that company‘s funds have not been employed profitably. A better measure of profitability from shareholders point of view is obtained by determining return on total shareholders‘ funds, it is also termed as Return on Net Worth (RONW) and is calculated as under :

Return on Shareholders‘ Fund = (Profit after Tax / Shareholders' Funds) × 100

Earnings per Share

The ratio is computed as:

EPS = Profit available for equity shareholders/Number of Equity Shares

In this context, earnings refer to profit available for equity shareholders which is worked out as Profit after Tax – Dividend on Preference Shares.

This ratio is very important from equity shareholders point of view and also for the share price in the stock market. This also helps comparison with other to ascertain its reasonableness and capacity to pay dividend.

Book Value per Share

This ratio is calculated as:

Book Value per share = Equity shareholders‘ funds/Number of Equity Shares

Equity shareholder fund refers to Shareholders‘ Funds – Preference Share Capital. This ratio is again very important from equity shareholders point of view as it gives an idea about the value of their holding and affects market price of the shares.

Dividend Payout Ratio

This refers to the proportion of earning that are distributed to the shareholders.

It is calculated as –

<u>Dividend Payout Ratio = Dividend per share / Earnings per share</u>

This reflects company's dividend policy and growth in owner's equity.

Price / Earnings Ratio

The ratio is computed as –

<u>P/E Ratio = Market Price of Share/Earnings per Share</u>

For example, if the EPS of X Ltd. is Rs. 10 and market price is Rs. 100, the price earnings ratio will be 10 (100/10). It reflects investors' expectation about the growth in the firm's earnings and reasonableness of the market price of its shares. P/E Ratio vary from industry to industry and company to company in the same industry depending upon investors perception of their future.

Illustration 16

From the following details, calculate Return on Investment:

Share Capital : Equity (Rs.10) Rs. 4,00,000 Current Liabilities Rs. 1,00,000

12% Preference Rs. 1,00,000 Fixed Assets Rs. 9,50,000

General Reserve Rs. 1,84,000 Current Assets Rs. 2,34,000

10% Debentures Rs. 4,00,000

Also calculate Return on Shareholders' Funds, EPS, Book value per share and P/E ratio if the market price of the share is Rs. 34 and the net profit after tax was Rs. 1,50,000, and the tax had amounted to Rs. 50,000.

Solution:

Profit before interest and tax = Rs. 1,50,000 + Debenture interest + Tax
= Rs. 1,50,000 + Rs. 40,000 + Rs. 50,000
= Rs.2,40,000

Capital Employed = Equity Share Capital + Preference Share Capital + Reserves + Debentures
= Rs. 4,00,000 + Rs. 1,00,000 + Rs. 1,84,000 + Rs. 4,00,000 = Rs. 10,84,000

Return on Investment = Profit before Interest and Tax/ Capital Employed × 100
= Rs. 2,40,000/Rs. 10,84,000 × 100
= 22.14%

Shareholders' Fund = Equity Share Capital + Preference Share Capital + General Reserve
= Rs. 4,00,000 + Rs. 1,00,000 + Rs. 1,84,000
= Rs. 6,84,000

Return on Shareholders' Funds = Profit after tax/shareholders' Funds × 100
= Rs. 1,50,000/Rs. 6,84,000 × 100
= 21.93%

EPS = Profit available for Equity Shareholders/Number of Equity
Shares
= Rs. 1,38,000/ 40,000 = Rs. 3.45

Preference Share Dividend = Rate of Dividend × Prefence Share Capital
= 12% of Rs. 1,00,000
= Rs. 12,000

Profit available to equity = Profit after Tax – Preference dividend on Shareholders
preference shares
where, Dividend on Prefrence = Rate of Dividend × Preference Share Capital shares
= 12% of Rs. 1,00,000
= Rs.12,000
= Rs. 1,50,000 – Rs. 12,000 = Rs. 1,38,000

P/E Ratio = Market price of a share/ Earnings per share
= 34/3.45
= 9.86 Times

No. od Shares Outstanding = Rs. 4,00,000 /Rs.10
= 40,000 Shares

Book Value per share = Equity Shareholders' fund/No. of equity shares
Where,
Number of Equity Shares = Equity share capital / Face value per share

Hence, Book value per share = Rs. 5,84,000/40,000 shares = Rs. 14.60

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ANALYSIS OF —FLOW OF FUNDS‖ AND —FLOW OF CASH‖

INTRODUCTION

One of the most fundamental objectives of business is to make a profit. Long run survival requires that the business must be able to deal with any liquidity problems which arise in the short term. Basically any business must be concerned with making a profit and marinating a solvent financial position. The financial statement of the business indicates assets, liabilities and capital on a particular date and also the profit or loss during a period. But it is possible that there is enough profit in the business and the financial position is also good and still there may be deficiency of cash or of working capital in business. If the management wants to find out as to where the cash is being utilized, financial statement cannot help.

In the other words, the profit and loss account and balance sheet statements are the common important accounting statements of a business organization. The profit and loss account provides the financial information relating to only a limited range of financial transactions entered into during an accounting period and which have impact on the profits to be reported. The balance sheet contains information relating to capital debt raised or assets purchased. Along with the information about the assets and liabilities as well as the profit and loss, it is equally important to know what funds became available during the accounting year and how such funds were applied. This information may be obtained by preparing a statement of source and application of funds. This statement demonstrates the movement of funds into and out of the business during the course during the accounting period.

CONCEPT OF —FUND‟:

The term ‗fund' has been defined and interpreted differently by different experts. Broadly the term ‗fund' refers to all the financial resources of the company. On the other extreme, fund has been understood as ‗cash' only. According to the *AS 3 /IAS 7 / IND AS – 7*, the term generally refers to cash, to working capital and to cash and cash equivalents (long term financial sources).

A. **Fund means cash:** Under this concept, the term –funds‖ is used only in the sense of cash and bank balance. Here, only the changes in cash and bank are considered. Hence, the statement is called –Cash Flow statement. This statement aims at listing the various items which bring about changes in the cash balance between two balance sheet dates. Cash planning becomes useful for control purposes. Since cash is considered as short term assets, they are subjected to short term fluctuations. A delay in making payment to suppliers and a provision of one month's credit for making a payment of land purchases may show sufficient cash flow. They may reflect a satisfactory position, but it is not a reality. Therefore, cash equivalent concept of fund is useful only for short term financial planning and not for long term. Thus cash and bank is one part of fund.

B. **Fund means Working Capital:** Working capital is the excess of current assets over current liabilities. It means working capital = Current asserts - current liabilities. It is an alternative measure of the changes in the financial position. All those transactions which increase or decrease working capital are included in this statement. It excludes all such items which do not affect the working capital. The working capital concept of funds is in conformity with normal accounting procedures. Hence, a funds flow statement based on this concept fits well with the other statements. Moreover, working capital is also a measure of short term liquidity of the firm. Therefore, an analysis of factors bringing about a change in the amount of net working capital is useful for decision making by shareholders, creditors and management. Due to these reasons, the working capital approach to funds is more useful than the cash approach.

The Operating Cycle of the Working Capital is depicted below:

Fund means total financial resources: The term ―funds‖ is very often used in the sense of useful financial resources also. Cash approach and working capital approach both are incomplete and inadequate to the extent that they omit a few major financial and investment transactions. Such items do not affect net working capital. But, if they are included, they would certainly provide qualitative information for the decision making, For example issuing equity shares and debentures for purchase of buildings or assets shall not have any effect on the working capital. But it is a significant financial transaction that should be disclosed. Therefore, this concept seems to be the best approach to disclose the changes in the financial position as compared to other concepts. It is in conformity with the statutory regulations and legal requirements.

CONCEPT OF ―FUND FLOW‘‘:

The term "Flow of Funds" refers to changes or movement of funds or changes in working capital in the normal course of business transactions. The changes in working capital may be in the form of inflow of working capital or outflow of working capital. In other words, any increase or decrease in working capital when the transactions take place is called as "Flow of Funds."

If the components of working capital results in increase of the fund, it is known as Inflow of Fund or Sources of Fund. Similarly, if the components of working capital effects in decreasing the financial position it is treated as Outflow of Fund. For example, if the fund raised by way of issue of shares will be taken as a source of fund or inflow of fund. This transaction results in increase of the financial position. Like this, the fund used for the purchase of machinery will be taken as application or use of fund or outflow of fund, because it stands to reduce the fund position.

Some transactions increase the funds while others decrease the funds. Some may not make any change in the funds position. In case a transaction results in increase of funds, it will be termed as a **―sources of funds‖**. In case a transaction results in decrease of funds it will be taken as an –**application or use of funds‖**. In case a transaction does not make any change in the funds position, it is said that it is a **non-fund transaction**.

> **According to R.N. Anthony**, –Fund Flow is a statement prepared to indicate the increase in cash resources and the utilization of such resources of a business during the accounting period.‖

> **According to Smith Brown**, –Fund Flow is prepared in summary form to indicate changes occurring in items of financial condition between two different balance sheet dates.‖

No Flow of Funds:
Some transactions may not make any movement or changes in the fund position. Such transactions are involved within the business concern. Like the transaction which involves both between current assets and current liabilities and between non-current assets and non-current liabilities and hence do not result in the flow of funds. For example, conversion of shares in to debentures. Such transaction involves between non-current accounts only and this activity does not effect in increase or decrease of the working capital position.

CONCEPT OF ―FUND FLOW STATEMENT‶:

It is a statement showing the movement of funds into and out of business. In other words it is a statement showing sources and application of fund. A fund flow statement deals with the financial resources required for running the business activities. It explains how the funds were obtained and how they were used.

A fund flow statement matches the funds raised and funds applied during a particular period. The sources and applications of fund may be of capital as well as of revenue nature. A fund flow statements provide a meaningful link between the balance sheets at the beginning and at the end of the period and profit and loss account of the period. In view of recognized importance of capital inflows and outflows which often involve large amount of money should be reported to stake holders, the fund flow statement is devised.

> In the words of **Dr. Shailesh Ransariya,** *"Funds flow statement is a modern technique of analyzing financial statement. Fund flow statement shows as to where have the funds come from and where have they been used during the accounting period. It helps in analyzing the movement of funds of a firm between the two balance sheet dates."*

> As per ***Foulk*** point of view –A statement of sources and applications of fund is a technical device deigned to analyze the changes in the financial condition of a business enterprise between two dates.‖

The ***I.C.W.A***. in glossary of management accounting terms defines fund flow statement as ―a statement prospective or retrospective, setting out the sources and applications of the funds of an enterprise. The purpose of this statement is to indicate clearly the requirement of funds and how they are proposed to be raised and the efficient utilization and application of the same.‖

OBJECTIVES OF FUNDS FLOW STATEMENT:

The main objectives of the fund flow statement are:

1. **Helpful in finding the answer to some important financial question**:-

A fund flow statement is prepared to give satisfactory answer to the following question:-

a) What have been the main source and application of funds during the period?
b) How much funds have been generated from business operations?
c) Where did the profits go?
d) Why where dividends not larger?
e) How was it possible to distribute dividends in excess of current earning or in the presence of net loss for the period?
f) Why the net current assets are up even though there is a net loss for the period?
g) How was the expansion in plant and equipment financed?
h) How was the repayment of long term debt accomplished?
i) How was the increase in working capital financed?

2. **Helpful in financial analysis:** A fund flow statement provides a complete analysis of the financial position of a firm.

3. **It provides more reliable figures of profit and loss of the business:** It gives much more reliable figure of the profits of the business than the figures shown by P/L account because the figure of profit shown by P/L account is affected by the personal decision of management in deciding the amount of depreciation and other adjustments regarding the writing off preliminary expanses etc.

4. **It enables to know whether the funds have been properly used:** The funds flow statement enables the management to know whether the funds have been properly used in purchasing various assets or repaying loans etc.

5. **Helpful in proper management of working capital:** While managing working capital in a business, it becomes essential to ensure that it should neither be excessive nor inadequate. A fund flow statement indicates the excessiveness or inadequacy in working capital.

6. **Helps in preparation of budget for the next period:** A fund flow statement is prepared for next year, it will enable the management to plan its financial resources properly. The firm will know how much funds it requires, how much the firm can manage internally and how much it should arrange from outside source. This is helpful in preparing the budgets for the future period.

7. **It helps a firm in borrowing operations:** A fund flow statement prepared for the future period indicates whether the company will have sufficient funds to repay the interest & loans in time.

8. **Helpful in determining dividend policy:** Sometimes, there may be sufficient profit but the distribution of dividend may not be possible due to its adverse effect on the liquidity and working capital of the business. in such cases a funds flow statement help in leading whether to distribute the dividend or not because a funds flow statement will reveal from where and how much funds can be managed for distributing the dividends.

9. **Useful to shareholders:** Shareholders also get information about the financial policies of the enterprise with the help of fund flow statement.

SOURCES AND USES (APPLICATIONS) OF FUNDS:

Since a fund flow statement describes the varies sources and uses of funds, it is imperative that one should know the varies sources and uses of funds:

Sources of funds:

Generally funds are derived from:

1. Operating of business i.e. operating income
2. Income from investment
3. Sale of assets
4. Sale of long term investments
5. Contribution of share holders
6. Increase in long term liabilities, e.g., issue of debentures
7. Gifts, damages awarded in legal action etc.

Uses (Applications) of funds:

Generally funds are utilized to:

1. Operating loses
2. Repayment of long term loan and debentures
3. Redemption of preference share capital
4. Payment of cash dividends
5. Purchase of fixed assets
6. Purchase of long term investments
7. Loss of cash by embezzlement costs in legal action etc.

IMPORTANCE/SIGNIFICANCE OF FUND FLOW STATEMENT:

Fund flow statement is a useful tool in the financial managers‘ analytical kit. The basic propose of this statement is to indicate where funds came from and where it was used during certain period. Following are the uses of this which show its importance:

1. Fund flow statement determines the financial consequences of business operations. It shows how the funds were obtained and used in the past. Financial manager can take corrective actions.

2. The management can formulate its financial policies – dividend, reserve etc. on the basis of the statement.
3. It serves as a control device, when comparing with budgeted figures. The financial manager can take remedial steps, if there is any deviation.
4. Other points:
    a. It points out the sound and weak financial position of the enterprise.
    b. It points out the causes for changes in working capital.
    c. It enables the Bankers, creditors or financial institutions in assessing the degree of risk involved in granting credit to the business.
    d. The management can rearrange the firm‘s financing more effectively on the basis of the statement.
    e. Various uses of funds can be known and after comparing them with the uses of previous years, improvement or downfall in the firm can be assessed
    f. It provides a basis for preparation budgets for the future.
    g. The statement compared with the budget concerned will show to what extent the resources of the firm were used according to plan and what extent the utilization was unplanned.
    h. It tells whether sources of funds are increasing or decreasing or constant.
    i. It points out the financial strengths and weaknesses of the business.
    j. It helps in working capital management of the company.
    k. It appraises the shareholders regarding the uses of funds in the business.

LIMITATION OF FUND FLOW STATEMENT:

The main limitations of fund flow statement are as under:

1. The statement lacks originality because it is only rearrangement of data appearing in account books
2. It indicates only the past position and not future.
3. It indicates Fund flow a summary form and it does not show various changes which take place continuously.
4. When both the aspects of a transaction are current, they are not considered.
5. When both the aspects of a transaction are non- current, even then they are not included in this statement.
6. It is not an ideal tool for financial analysis.
7. It is not an original statement but simply a rearrangement of two statements or financial data.
8. It is not a substitute of income statement or a balance sheet. It is only a supplement to them.

COMPONENTS OF FLOW OF FUNDS:

In order to analyze the sources and application of funds, it is essential to know the meaning and components of flow of funds given below:

1. Current Assets
2. Non-Current Assets (Fixed or Permanent Assets)
3. Current Liabilities
4. Non-Current Liabilities (Capital & Long-Term Liabilities)
5. Provision for Tax
6. Proposed Dividend

1. **Current Assets:** The term "Current Assets" refer to the assets of a business of a transitory nature which are intended for resale or conversion into different form during the course of business operations. For example, raw materials are purchased and the amount unused at the end of the trading period forms part of the current as stock on hand. Materials· in process at the end of the trading period and the labour incurred in processing them also form part of current assets.

2. **Non-Current Assets (Permanent Assets):** Non-Current Assets also refer to as Permanent Assets or Fixed Assets. These classes of asset include those of tangible and intangible nature having a specific value and which are not consumed during the course of business and trade but provide the means for producing saleable goods or providing services. Land and Building, Plant and Machinery, Goodwill and Patents etc. are the few examples of Non-Current assets.

3. **Current Liabilities:** The term Current Liabilities refer to amount owing by the business which are currently due for payment. They consist of amount owing to creditors, bank loans due for repayment, proposed dividend and proposed tax for payment and expenses accrued due.

4. **Non-Current Liabilities:** The term Non-Current Liabilities refer to Capital and Long-Term Debts. It is also called as Permanent Liabilities. Any amount owing by the business which are payable over a longer period time, i.e., after a year are referred as Non-Current Liabilities. Debenture, long-term loans and loans on mortgage etc., are the few examples of non-current liabilities.

5. **Provision for Taxation:** Provision for taxation may be treated as a current liability or an appropriation of profit. When it is made during the year it is not used for adjusting the net profit, it is advisable to treat the same as current liability. Any amount of tax paid during the year is to be treated as application of funds or non-current liability. Because it is used for adjusting the net profit made during the year.

6. **Proposed Dividend:** Like provision for taxation, it is also treated as a current liability and noncurrent liability, when dividend may be considered as being declared. And thus, it will not be used for adjusting the net profit made during the year. If it is treated as an appropriation, i.e., an non-current liability when the dividend paid during the year.

7. **Provisions Against Current Assets and Current Liabilities:** Provision for bad and doubtful debts, provision for loss on inventories, provision for discount on creditors and provision made against investment etc. are made during the year, they may be treated separately as current assets or current liabilities or reduce the same from the respective gross value of the assets or liabilities.

General Rules in Preparation of Funds Flow Statement:

1. We know, working capital (WC) = Current Assets (CA) – Current Liabilities (CL) or, WC = CA – CL

   From the above equation, we may deduce

   (i) An increase in CA or a decrease in CL = Causes an increase in WC

   (ii) A decrease in CA or an increase in CL = Causes a decrease in WC

   (iii) A simultaneous increase in CA and CL or a simultaneous decrease in CA and CL = will have no effect on WC.

2. A flow of funds takes place only if a transaction involves one current account (CA or CL) and one Non-current account (NCA or NCL). From above the following general rules can be formed:

   (i) Transactions which involve only current accounts (CA or CL) do not result in a flow of funds.

   (ii) Transactions which involve only Non-current accounts (NCA or NCL) do not result in a flow of funds.

   (iii) Transactions which involve one current account (CA or CL) and one Non-current account (NCA or NCL) results in a flow of funds.

Generally, two comparative balance sheets—one at the beginning and the other at the end of the period—are used for preparing a fund flow statement. In addition, a summarised income statement comprising non-fund or _non-operating‘ items and a statement of retained earnings or at least material information from these statements are required in order to find out fund from operations.

Additional information regarding change in non-current accounts like plant and machinery, building, share capital, debentures etc., if available, will sharpen the firms‘ financial profile as revealed by the fund flow statement.

The fund flow analysis involves the preparation of two statements:

(a) Statement or Schedule of Changes in Working Capital and
(b) Statement of Sources and Application of funds.

(a) Statement or Schedule of Changes in Working Capital:

The primary purpose of a fund flow statement is to explain the net change in working capital, it will be better to prepare first the schedule of changes in working capital before preparing a fund flow statement.

The Schedule or Statement of changes in working capital is a statement that compares the change in the amount of current assets and current liabilities on two balance sheet dates and highlights its impact on working capital.

Schedule of Changes in Working Capital

Particulars	Previous Year Rs.	Current Year Rs.	Effect on Working Capital: Increase (+) Rs.	Effect on Working Capital: Decrease (–) Rs.
Current Assets				
Cash in hand	...	...		
Cash at Bank	...	...		
Bills Receivable	...	...		
Sundry Debtors	...	...		
Closing Stock	...	...		
Short-term Investments	...	...		
Prepaid Expenses	...	...		
Other Current Assets	...	...		
Total [A]	...	...		
Current Liabilities				
Bills Payable	...	...		
Sundry Creditors	...	...		
Outstanding Expenses	...	...		
Bank Overdraft	...	...		
Short-term Loan taken	...	...		
Proposed Dividend(1)	...	...		
Provision for Taxation (1)	...	...		
Other Current Liabilities	...	...		
Total [B]	...	...		
Working Capital [A – B]	...	...		
Net Increase/Decrease in working capital	...	...		
	...	...	...	...

Note (1) : May or may not be treated as current liability. This matter has been discussed subsequently.

To analyse the effect of working capital as a result of change in current assets and current liabilities, the following general rules should be considered :

Nature of Transactions	Effect on Working Capital
1. Increase in Current Assets	Increase in Working Capital (+)
2. Decrease in Current Assets	Decrease in Working Capital (–)
3. Increase in Current Liabilities	Decrease in Working Capital (–)
4. Decrease in Current Liabilities	Increase in Working Capital (+)

(b) Statement of Sources and Application of funds.

After preparing the schedule of changes in working capital, the next step is to prepare the Fund Flow Statement to find out the different sources and applications of funds. While preparing this statement the emphasis is given on the changes in the fixed assets and fixed liabilities.

Notes:

(1) Either of the two will appear in the Fund Flow Statement.

(2) Either of the two will appear in the Fund Flow Statement.

(3) Payment of dividend and tax will appear as an application of funds only when these items are appropriation of profits and not current liabilities.

Illustration: For Analysis of Funds Flow Statement

FUND FLOW STATEMENTS OF ABC Limited

DESCRIPTION	**2013-14**	**2012-13**	**2011-12**	**2010-11**
Sources of Funds:				
Cash Profit from operations	195.9	146.1	179.1	154.7
Decrease in Investments	1.9	61.1	-	-
Increase in Share Capital	1.7	-	-	-
Increase in Share warrants/outstanding	-	10.9	-	-
Increase in Sec. Loans	-	52.9	-	-
Increase In Unsecured Loans	165.1	51.2	825.0	-
Decrease in Working Capital	186.5	45.7	-	115.6
Others	211.9	164.8	233.1	149.8
Total	**763.0**	**532.5**	**1,237.2**	**420.1**
Application of Funds:				
Increase in Gross Block	625.4	532.5	285.6	204.5
Decrease in Share Capital	-	-	-	-
Decrease in Sec. Loans	126.6	-	97.8	124.4
Decrease in Un. Sec Loans	-	-	-	91.2
Decrease in Share warrants/outstanding	10.9	-	-	-
Increase in Investments	-	-	85.8	-
Interim Dividend Paid	-	-	-	-
Equity Dividend Paid	-	-	-	-
Corporate dividend tax paid	-	-	-	-
Increase in Working Capital	-	-	768.0	-
Others	-	-	-	-
Total	**763.0**	**532.5**	**1,237.2**	**420.1**

Analysis

The above table no.6.1 presents the fund flow statement of ABC Limited during the study period of 2010-11 to 2013-14. It would provide the valuable information about the changes in the long-term sources of funds and in the quantum of working capital. First part of the statement shows the sources of funds. Profit from operations shows the mixed trend during the study period. It is ranged between 146.05 in 2012-13 and 195.87 in 2013-14. The company has sold the investments during last two years of the study period. Company has issued additional share capital 1.66 crore in 2013-14. Again it shows that company has taken a secured loan of 52.86 in the year 2012-13. Company has borrowed huge amount in form unsecured loan in the year 2011-12, 2012-13 and 2013-14. 824.97% increase in unsecured loan in 2011-12 as compare to 2010-11. Amount in working capital was also decreased in the year 2010-11, 2012-13 and 2013- 14.

Second part of the statement shows the application of funds. Company has purchased the fixed assets of Rs.204.48 crore, Rs.285.61 crore, Rs.532.55 crore and Rs.625.42 crore in the year 2010-11, 2011-12, 2012-13 and 2013-14 respectively. It shows the progressive trends during the study period. 86.46% increase in fixed assets in 2012-13 as compare to the year

2011-12. Company has repaid the secured loans in the year 2010-11, 2011-12 and 2013-14. Company‘s working capital was increased of Rs.768.02 crore in the year 2011- 12. Company has invested Rs.85.78 crore in investments in the year 2011-12.

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Cash Flow Statement

Introduction

Cash flow analysis is highly useful for financial planning in the firm. This analysis is used to determine the ―Quality of Cash Earnings‖ of the firm and what transactions caused the cash balance to change during a particular period. **Cash flow** is the changes in firm‘s cash during a particular period by indicating the firm‘s sources and uses of cash during that period. It is the actual movement of money in and out of a business. Money flowing into a business is termed as positive cash flow and is credited as cash received. Monies paid out are termed as negative cash flow and are debited to the business. The difference between the positive and negative cash flows is termed as net cash flow

Success of every business depends on its cash management. The supply of cash is frequently a limitation on the successful execution of many policies and programs. So it is necessary to study the composition of cash of a firm to know the impact of its cash flow decision on its liquidity, profitability and solvency. A firm would enter into trouble when it spends more cash than it‘s able to generate. To know the firm is generating adequate cash we can look into the cash flow statement as the balance sheet or the profit and loss accounts (prepared on accrual basis) do not provide sufficient detail.

CONCEPT OF CASH FLOW:

A cash flow statement is a financial report that describes the sources of a company's cash and how that cash was spent over a specified time period. It does not include non-cash items. The cash flow statement is a cash basis report on three types of financial activities: operating activities, investing activities, and financing activities. Non-cash activities are usually reported in footnotes. This makes it useful for determining the short-term viability of a company, particularly its ability to pay bills. Because the management of cash flow is so crucial for businesses and small businesses in particular, most analysts recommend that an entrepreneur should study a cash flow statement at least every quarter.

The cash flow statement is similar to the income statement in that it records a company's performance over a specified period of time. The difference between the two is that the income statement also takes into account some non-cash accounting items such as depreciation. The cash flow statement strips away all of this and shows exactly how much actual money the company has generated. Cash flow statements show how companies have performed in managing inflows and outflows of cash. It provides a sharper picture of a company's ability to pay creditors, and finance growth.

The Cash Flow Statement (CFS) provides relevant financial information about the cash receipts and cash disbursements of a firm during a fiscal year. This information is especially important to shareholders and creditors. As part of their investment return, shareholders often expect to receive dividends, and the ability to pay cash dividends depends on the availability of cash flows. Creditors are concerned about a firm‘s ability to make interest and principal payments on loans they have made to the firm. Other stakeholders such as employees and suppliers are also concerned about a firm‘s ability to meet its financial obligations.

It is perfectly possible for a company that is shown to be profitable according to accounting standards to go under if there isn't enough cash on hand to pay bills. Comparing amount of cash generated to outstanding debt, known as the "operating cash flow ratio," illustrates the company's ability to service its loans and interest payments. If a slight drop in a company's quarterly cash flow would jeopardize its ability to make loan payments that company is in a riskier position than one with less net income but a stronger cash flow level.

Unlike the many ways in which reported earnings can be presented, there is little a company can do to manipulate its cash situation. Barring any outright fraud, the cash flow statement tells the whole story. The company either has cash or it does not. Analysts will look closely at the cash flow statement of any company in order to understand its overall health.

Statement of cash flows provides the answer to the following simple but important question about an enterprise. (Keiso and Weygand, 1998: 1275-76)

i. Where did cash come from during the period?

ii. What was the cash used for during the period?

iii. What was the change in the cash balance during the period?

The use of cash flow information is gaining value in the analysis of financial statements. Cash flow information is measured less open to manipulation than information on earnings, because it is based on the actual receipt and payment of cash only and not on the accrual and other accounting principles.

Need and Utility of Cash Flow Statement

The cash flow statement enables effective planning and coordination of financial operations. This also enables the proper allocation of cash among the various activities of the firm. The liquidity picture of the firm is shown by the cash flow statement of the firm and can also support informed investment decision making for the management

A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

Format for Preparation of Cash Flow Statement (Applicability of AS – 3)

Section 129 of the CA, 2013 requires that the financial statements shall comply with the accounting standards notified under Section 133 and Section 133 provides that the Central

Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

Rule 7 of the Companies (Accounts) Rules, 2014 provided that as a transition provision, the standards of accounting as specified under the Companies Act, 1956 (i.e. the Companies (Accounting Standards) Rules, 2006) shall be deemed to be the accounting standards until accounting standards are specified by the Central Government under Section 133.

The inclusion of cash flow along with balance sheet and P&L for all companies is a new requirement. Earlier only listed companies under listing agreement clause no. 32 are required to prepare cash flow statement as per AS 3 of Accounting standards issued by the ICAI.

Simply put, we can state that the cash flow statement is applicable for all companies (including Private Company) however the certain exemption is provided to *OPC, Dormant Companies and Small Companies* in respect of Applicability of Cash Flow Statement.

Since the Companies Act, 2013 does not lay down any format for preparation of cash flow statement; companies will need to follow AS 3 /IAS 7 / IND AS – 7 in this regard. In respect of listed companies, the listing agreement requires the indirect method for preparing cash flow statements. Thus, under the Companies Act, 2013, non-listed companies will have a choice of either applying the direct or indirect method under AS 3 to prepare the cash flow statement. Due to the listing agreement requirement, that choice will not be available to listed companies.

This means a private limited company with paid up share capital of less than 50 lakh rupees or such higher amount as may be prescribed or with a turnover of less than 2 crore rupees or such higher amount as may be prescribed is **not required** to prepare cash flow statements while preparing financial statements at the end of the financial year or say Cash Flow Statement is not applicable to such companies.

Preparation of cash flow statement is not mandatory for Small and Medium Sized Companies and non-corporate entities. Such entities are however encouraged to comply in view of better financial management.

Excerpts from Accounting Standard (AS) 3 (as revised 1997) on Cash Flow Statement

Stated Objective of AS-3

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

The Standard deals with the provision of information about the *historical changes in cash and cash equivalents* of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.

Users of an enterprise‘s financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise‘s activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial enterprise. Enterprises need cash for essentially the same reasons, however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors.

Definitions

The following terms are used in this Standard with the meanings specified:

- **Cash** comprises cash on hand and demand deposits with banks.
- Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. *[Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition.*

  Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).
- **Cash flows** are inflows and outflows of cash and cash equivalents. *[Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.]*
- **Operating activities** are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.
- **Investing activities** are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
- **Financing activities** are activities that result in changes in the size and composition of the owners‘ capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Presentation of a Cash Flow Statement

The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

An enterprise presents its cash flows from **operating, investing and financing** activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

A. Operating Activities

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss.

Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

(b) cash receipts from royalties, fees, commissions and other revenue;

(c) cash payments to suppliers for goods and services;

(d) cash payments to and on behalf of employees;

(e) cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

(h) Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

(i) An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

B. Investing Activities

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

(a) cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;

(b) cash receipts from disposal of fixed assets (including intangibles);

(c) cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(d) cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);

(f) cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

(i) When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

C. Financing Activities

The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are:

(a) cash proceeds from issuing shares or other similar instruments;

(b) cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and

(c) cash repayments of amounts borrowed.

<u>Reporting Cash Flows from Operating Activities</u>

An enterprise should report cash flows from operating activities using either:

*(a) **the direct method**, whereby major classes of gross cash receipts and gross cash payments are disclosed; or*

*(b) **the indirect method**, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.*

<u>The direct method</u> provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

a) from the accounting records of the enterprise; or
b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statement of profit and loss for:
   i. changes during the period in inventories and operating receivables and payables;
   ii. other non-cash items; and

iii. other items for which the cash effects are investing or financing cash flows.

Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:

a) changes during the period in inventories and operating receivables and payables;

b) non-cash items such as depreciation, provisions, deferred taxes, and unrealised foreign exchange gains and losses; and

c) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

Reporting Cash Flows from Investing and Financing Activities

An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described below are reported on a net basis.

Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

1. Cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise. Examples of cash receipts and payments referred are:

   a. the acceptance and repayment of demand deposits by a bank;
   b. funds held for customers by an investment enterprise; and
   c. rents collected on behalf of, and paid over to, the owners of properties.

2. Cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short. Examples of cash receipts and payments referred are advances made for, and the repayments of:

   a. principal amounts relating to credit card customers;
   b. the purchase and sale of investments; and
   c. other short-term borrowings, for example, those which have a maturity period of three months or less.

3. Cash flows arising from each of the following activities of a financial enterprise may be reported on a net basis:

   a. cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;
   b. the placement of deposits with and withdrawal of deposits from other financial enterprises; and
   c. cash advances and loans made to customers and the repayment of those advances and loans.

Reporting Special Cases

1. Foreign Currency Cash Flows

Cash flows arising from transactions in a foreign currency should be recorded in an enterprise‘s reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow. A rate that approximates the actual rate may be used if the result is substantially the same as would arise if the rates at the dates of the cash flows were used. The effect of changes in exchange rates on cash and cash equivalents held in a foreign currency should be reported as a separate part of the reconciliation of the changes in cash and cash equivalents during the period.

Cash flows denominated in foreign currency are reported in a manner consistent with Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates. This permits the use of an exchange rate that approximates the actual rate. For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions.

Unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end-of-period exchange rates.

2. Extraordinary Items

The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed.

The cash flows associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the cash flow statement, to enable users to understand their nature and effect on the present and future cash flows of the enterprise. These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items required by Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

3. Interest and Dividends

Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

The total amount of interest paid during the period is disclosed in the cash flow statement whether it has been recognized as an expense in the statement of profit and loss or capitalised in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets. Interest paid and interest and dividends received are usually classified as operating cash flows for a financial enterprise. However, there is no consensus on the classification of these cash flows for other enterprises.

Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of net profit or loss. However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash flows and investing cash flows respectively, because they are cost of obtaining financial resources or returns on investments.

Some argue that dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows. However, it is considered more appropriate that dividends paid should be classified as cash flows from financing activities because they are cost of obtaining financial resources.

4. Taxes on Income

Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a cash flow statement. While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transactions. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flow are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

5. Investments in Subsidiaries, Associates and Joint Ventures

When accounting for an investment in an associate or a subsidiary or a joint venture, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee/joint venture, for example, cash flows relating to dividends and advances.

6. Acquisitions and Disposals of Subsidiaries and Other Business Units

The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented separately and classified as investing activities.

An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:

(a) the total purchase or disposal consideration; and

(b) the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

The separate presentation of the cash flow effects of acquisitions and disposals of subsidiaries and other business units as single line items helps to distinguish those cash flows from other cash flows. The cash flow effects of disposals are not deducted from those of acquisitions.

7. <u>Non-cash Transactions</u>

Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an enterprise. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period. Examples of non-cash transactions are:

(a) the acquisition of assets by assuming directly related liabilities;

(b) the acquisition of an enterprise by means of issue of shares; and

(c) the conversion of debt to equity.

<u>Components of Cash and Cash Equivalents</u>

An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

In view of the variety of cash management practices, an enterprise discloses the policy which it adopts in determining the composition of cash and cash equivalents.

The effect of any change in the policy for determining components of cash and cash equivalents is reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

COMPARISION OF FUND FLOW STATEMENT & CASH FLOW STATEMENT

FUND FLOW STATEMENT	**CASH FLOW STATEMENT**
This analysis shows the changes in working capital fixed assets etc. between two periods	This analysis shows the changes in cash position between two periods.
Increase in funds does not always means increase in cash.	Increase in cash does always mean increase in fund.
Fund flow analysis notes the overall changes in funds of the company and we can decide overall stability of business unit.	Cash flow analysis notes the changes in cash position only and one can‘t know the stability of Co. by this analysis.
It reveals the long term stability of business	It reveals the short term cash position of the business
This analysis includes a high level cash flow analysis because cash is a part of working capital.	This analysis does not include fund flow analysis because this covers only cash transactions

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Module V

Understanding Residual Sections of Annual Reports

Components of an Annual Report

An annual report is a comprehensive report on a company's activities throughout the preceding year. Annual reports are intended to give shareholders and other interested people information about the company's activities and financial performance.

It contains repository of information for a comprehensive analysis on the company‘s historical performance and also a vision onto its future plans. The primary components of the annual report are –

1. **Chairman‘s message**
2. **Director‘s Report** to include Director‘s responsibility statement; Management Discussion and Analysis report; Corporate governance report and Other reports to comply with various statutory & legal requirements.
3. **Auditor‘s Report** to include an opinion on the true and fair view of the accounts
4. **Financial Statements** including Balance Sheet; Profit & Loss Statement; Cash Flow Statement; Notes to accounts

In this Chapter, discusses in detail about the statutory obligations to be reported under major sections of **Director‘s Report** and **Auditor‘s Report**

Director‘s Report

Introduction

The Board‘s Report is the most important means of communication by the Board of Directors of a company with its shareholders. It is a comprehensive document which serves to inform the shareholders about the performance and various other aspects of the company, its major policies, relevant changes in management, future programmes of expansion, modernization and diversification, capitalization or reserves, etc.

It is mandatory for the Board of Directors of every company to present financial statement to the shareholders along with its report, known as the –Board‘s Report‖ at every annual general meeting. Apart from giving a complete review of the performance of the company for the year under report, material changes till the date of the report, the report highlights the significance of various national and international developments which can have an impact on the business and indicates the future strategy of the company. The Board‘s Report, thus, is a comprehensive document circumscribing both financial and non-financial information, serving to inform the stakeholders about the performance and prospects of the company, relevant changes in management, capital structure, major policies, recommendations as to the distribution of profits, future programmes of expansion, modernization and diversification, capitalization of reserves, further issue of capital, etc. The Board‘s Report enables shareholders, lenders, bankers, government, prospective investors, all the stakeholders and the public to make an appraisal of the company's performance and reflects the level of corporate governance in the company.

The Board's Report enables not only the shareholders but also the lenders, bankers, government and the public to make an appraisal of the company's performance and provides an insight into the future growth and profitability of the company. The Companies Act, 2013 is based on enhanced disclosures and transparency.

The matters to be included in the Board's Report have been specified in Section 134 of the Companies Act, 2013 and Rule 8 of the Companies (Accounts) Rules, 2014. Apart from this, under Sections 67, 921, 129, 131, 135, 149, 160, 168, 177, 178, 188, 197, 204 of the Companies Act, 2013, relevant information has to be disclosed in the Board's Report. The Board's Report of companies whose shares are listed on a stock exchange must include additional information as specified in the Listing Agreement*. Further, the Reserve Bank of India Act, 1934, the Securities and Exchange Board of India Act, 1992 and the regulations, rules, directions, guidelines, circulars, etc. issued thereunder, Disclosure under the Sexual Harassment of Women at Workplace (Prevention, Prohibition and Redressal) Act, 2013, necessitate certain additional disclosures to be made in the Board's Report.

The following are the major components of Director's Report

Disclosures Pursuant to the Companies Act, 2013	➢ Disclosures under Section 134 (3) ➢ Disclosures related to Employees ➢ Re-Appointment of Independent Directors; Disqualifications of Directors and Change in the composition of the Board ➢ Audit Committee ➢ Companies (Auditor's Report) Order, 2015 ➢ Issue of Equity Shares with differential rights; Sweat Equity; Redemption of shares/debentures ➢ Investor Education and Protection Fund ➢ Disclosures pertaining to Consolidated Financial Statements ➢ Additional disclosures
Disclosure pursuant to the Listing Agreement of Stock Exchanges	➢ Additional information as required by the listing agreement ➢ Management Discussion and Analysis Report (MDAR) ➢ Report on Corporate Governance
Disclosure pursuant to Employee Stock Option and Employee Stock Purchase	➢ Under Companies Act, 2013

Schemes	➢ Under SEBI Regulations ➢ Provision of money for purchase of own shares by company
Disclosures Pursuant to Directions of Reserve Bank of India	➢ Non-Banking Financial Companies ➢ Miscellaneous Non-Banking Companies ➢ Residuary Companies
Other Disclosures	➢ Disclosures pursuant to National Housing Bank Directions ➢ Secretarial Audit Report ➢ Cost Audit Report ➢ Explanations in the Board‘s report in response to Auditors‘ qualification ➢ Information on accounts ➢ Approval of the Board‘s Report ➢ Signing and Dating of the Board‘s Report ➢ Collective Responsibility of the Board ➢ Filing of the Board‘s Report ➢ Right of Members to Receive Copies of Financial Statement, Board‘s Report, etc. ➢ Consistency ➢ Liability for Mis-Statement

➢ **<u>Disclosures Pursuant to Sec 134 (3) of the Companies Act, 2013</u>**

a) **An extract of the Annual Return for the financial year** ended shall form part of Board‘s Report, in case of every company *The Extract of such Annual Return shall be in Form MGT-9.*

b) Para 9 of the Secretarial Standard-1 : Meetings of the Board of Directors requires the annual report and annual return of a company to **disclose the number and dates of meetings of the Board and Committees held during the financial year**, indicating the number of meetings attended by each director.

c) **Directors‘ Responsibility Statement** shall set out the following affirmations:

i) In the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

ii) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;

iii) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

iv) the directors had prepared the annual accounts on a going concern basis; and

v) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively;

NOTE: In view of the very wide meaning ascribed to the expression Internal Financial Controls in the Explanation to Section 134[e], it would be necessary for a company to lay down policies and procedures for ensuring efficient and effective conduct of business, safeguarding of its assets and prevention & detection of frauds and errors. It would also be necessary to put in place essential and complete Accounting policies and systems for ensuring timely and reliable MIS. Adoption of Accounting Manual, Internal Control Manual focussing on the Finance function, Internal Audit Manual and having a proper Fraud Prevention Policy would go a long way in helping the Board to make this assertion. It may be noted that Internal Financial Control is one of the elements in the overall Internal Control System and that adequacy of Internal Control System constitutes one of the reporting points of the Auditors under the Companies [Auditor's Report] Order, 2015.

vi) The directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

NOTE: In view of the wide coverage intended here, it is recommended that the Board considers Secretarial Audit as a potent mechanism for ensuring legal compliance and draws up the terms of reference of the audit accordingly.

d) **A statement on declaration given by independent directors** under sub-section (6) of section 149; Declaration that the Independent Director meets the criteria of independence laid down in sub-section (6) of section 149, which is to be given by him at the first meeting of the Board in which he participates as a director and thereafter at the first meeting of the Board in every financial year or whenever there is any change in the circumstances which may affect his status as an independent director. The Board's Report should contain a statement to the effect that the independent directors have given such a declaration.

e) **Company's policy on directors' appointment and remuneration** including criteria for determining qualifications, positive attributes, independence of a director and other matters provided under sub-section (3) of section 178

a. The Board of directors of every listed company and the following classes of companies shall constitute Nomination and Remuneration Committee of the Board and such committees are required to formulate the criteria for determining qualifications, positive attributes and independence of a director and recommendation of directors, Key Managerial Personnel and other employees.

i. all public companies with a paid up capital of ten crore rupees or more;

ii. all public companies having turnover of one hundred crore rupees or more;

iii. all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

f) **Explanations or comments by the Board** on every qualification, reservation or adverse remark or disclaimer made—

a. by the auditor in his report; and

b. by the Secretarial Auditors in his secretarial audit report

g) The **particulars of loans given, guarantees provided, investments in securities and acquisition** made during the year under review should be attached to the Board's Report

h) The Report of the Board shall contain the **particulars of contracts or arrangements with Related Parties** referred to in Section 188. The key consideration here is that every transaction entered into under Section 188 of the Act shall be recorded in the Directors' Report along with justifications

i) Information and data which are usually considered pertinent and necessary for the purpose of a proper appreciation of the state of affairs of a company. The state of affairs of the company should relate to the period for which the financial statements have been prepared along with Relevant changes which have occurred, as compared to the position as stated in the previous year's Board's Report which have a material bearing on the performance of the company should be indicated in the Board's Report to facilitate comparison some of the important points to include are the following –

i. Consolidated and standalone financial results, including dividend declared;

ii. further issue of capital or debentures, if any;

iii. change in status of the company, if any;

iv. change in accounting year, if any; (v) production and sales targets and achievement thereof;

v. major capital expenditure programmes;

vi. business prospects including programmes of acquisition, mergers, expansion, modernization and diversification;

vii. development, acquisition and assignment of Intellectual Property Rights (IPRs);

viii. marketing policies;

ix. availability of raw materials, water and power supply; and

x. manpower training and executive development programmes.

j) The Board's Report should disclose the amount which has been transferred to reserves in the financial statements, for instance, general reserve, debenture redemption reserve, capital redemption reserve, etc. If no amount is proposed to be transferred to reserves, a statement to that effect should be incorporated in the Board's Report. It is pertinent to note that in terms of Companies Act, 2013, there is no requirement for mandatory transfer to general reserve If no amount is proposed to be transferred to reserves, a statement to that effect should be incorporated in the Board's Report as a good practice.

k) The Board's Report shall disclose the amount per share and the percentage which the Board recommends to be paid as dividend. The total amount to be utilized for payment of dividend should be disclosed, stating separately the total outgo on account of dividend and on account of dividend distribution tax thereon for the year under report, along with the corresponding figures of the previous year. If no dividend has been recommended or declared during the year, a statement to that effect along with the reasons therefor should be incorporated in the Board's Report as a good corporate practice

l) In terms of Section 134 (3) (1), material changes and commitments, if any, affecting the financial position of the company and occurring between the balance sheet date and the date of the report should be disclosed in the Board's Report. The Directors' Report should, therefore, contain material changes pertaining to post-financial statement events. In this context, materiality has to be carefully weighed. *(The term „material" includes items, the knowledge of which might influence the decisions of the users of the financial statements.)* The Board's Report should also include any material event or material change occurring during the period till Board's approval of the Report.

m) Board Report should include the conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed

Conservation of energy	the steps taken or impact on conservation of energy; utilising alternate sources of energy; and the capital investment on energy conservation equipment;
Technology absorption	i. The efforts made towards technology absorption and the benefits derived like product improvement, cost reduction, product development or import substitution and in case of imported technology (imported during the last three years reckoned from the beginning of the financial year). ii. the expenditure incurred on Research and Development
Foreign exchange earnings and Outgo	The Foreign Exchange earned in terms of actual inflows during the year and the Foreign Exchange outgo during the year in terms of actual outflows.

n) A statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the company

o) The Board after taking into consideration the recommendations of the CSR Committee shall approve the CSR Policy, disclose the contents of the CSR Policy and also its implementation in its Report. The Companies (Corporate Social Responsibility Policy)

Rules, 2014 requires that the Board's Report shall include an annual report on CSR containing particulars specified in Annexure to the rules.

- **<u>Disclosures related to Key Managerial Personnel and Employees</u>**

a) The disclosures related to employees is mandatory in the Board's report for a listed company as per Rule 5 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 -

i. the ratio of the remuneration of each director to the median remuneration of the employees of the company for the financial year;

ii. the percentage increase in remuneration of each director, Chief Financial Officer, Chief Executive Officer, Company Secretary or Manager, if any, in the financial year;

iii. the number of permanent employees on the rolls of company; the percentage increase in the median remuneration of employees in the financial year;

iv. the remuneration details, average increase YoY, explanation on the relationship between average increase in remuneration and company performance of the Key Managerial Personnel against the performance of the company;

v. Variations in the market capitalisation of the company, price earnings ratio as at the closing date of the current financial year and previous financial year and percentage increase over decrease in the market quotations of the shares of the company in comparison to the rate at which the company came out with the last public offer in case of listed companies, and in case of unlisted companies, the variations in the net worth of the company as at the close of the current financial year and previous financial year;

vi. average percentile increase already made in the salaries of employees other than the managerial personnel in the last financial year and its comparison with the percentile increase in the managerial remuneration and justification thereof and point out if there are any exceptional circumstances for increase in the managerial remuneration;

vii. comparison of the remuneration of each Key Managerial Personnel against the performance of the company;

viii. the key parameters for any variable component of remuneration availed by the directors;

ix. the ratio of the remuneration of the highest paid director to that of the employees who are not directors but receive remuneration in excess of the highest paid director during the year; and

x. Affirmation that the remuneration is as per the remuneration policy of the company.

xi. the percentage increase in the median remuneration of employees in the financial year

- **<u>Appointment, re-appointment, resignation and disqualification details of directors and also the changes in the composition of the Board.</u>**

Any appointment, reappointment or change in the office of a director (including whole-time director, additional director, alternate director or a director filling a casual vacancy) whether by virtue of rotation, resignation, death or otherwise should be indicated in the Board's Report. *Section 168(1) requires to place the fact of resignation of a director in report of directors laid in the immediately following general meeting of the Company.*

The Board Report shall disclose the appointment and/or re-appointment of Independent Director. *In terms of section 149 (10), an independent director shall hold office for a term up to five consecutive years on the Board of a company, but shall be eligible for reappointment on passing of a special resolution by the company.*

The Board's Report should also disclose if any director has incurred any disqualification on account of non-compliance with any of the provisions of the Act. Acts of omission/commission by the company itself, as a result of which the directors may be liable for disqualification, should be disclosed.

- **<u>Constitution of the Audit Committee</u>**

Every listed company and the following companies as prescribed under rule 6 of Companies (Meetings of Board and its powers) Rules, 2014, shall constitute an Audit Committee.

(i) all public companies with a paid up capital of Rs.10 Crores or more;

(ii) all public companies having turnover of Rs.100 Crores or more;

(iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding Rs.50 Crores or more.

The Board's report under section 134(3) of the Companies act, 2013 shall disclose the composition of an Audit committee and where the Board had not accepted any recommendation of the Audit Committee, the same shall be disclosed in such report along with the reasons therefor.

- **<u>Compliance with CARO 2015</u>**

The Board Report is to provide explanation on every qualification or adverse reporting in such Audit Report given under CARO 2015.

The Central Government has on 10th April, 2015 issued a fresh Order called the Companies (Auditor's Report) Order, 2015, [–CARO 2015‖]. The Order has immediate effect and is applicable for the financial year commencing on or after 1st April, 2014.

It applies to every company including a foreign company as defined under Section 2[42][3] of the Companies Act, 2013 except (i) a banking company (ii) an insurance company (iii) a company licensed to operate under section 8 of the Companies Act;
(iv) a One Person Company; (v) small company as defined under clause (85) of section 2 of the Companies Act; and (vi) a private limited company with a paid up capital and reserves not more than rupees fifty lakh and which does not have loan outstanding exceeding rupees twenty five lakh from any bank or financial institution and does not have a turnover exceeding rupees five crore at any point of time during the financial year

The auditor's report on the account of a company to which this Order applies shall include a statement on proper maintenance of accounts, records in general and more specifically on items specified in the CARO 2015.

- **Issue of Equity Shares with differential rights; Sweat Equity; Redemption of shares/debentures**

The Board's Report for the financial year in which the issue of equity shares with differential rights as to dividend, voting or otherwise was completed, the details being –

(a) the total number of shares allotted with differential rights;

(b) the details of the differential rights relating to voting rights and dividends;

(c) the percentage of the shares with differential rights to the total post issue equity share capital with differential rights issued at any point of time and percentage of voting rights which the equity share capital with differential voting right shall carry to the total voting right of the aggregate equity share capital;

(d) the price at which such shares have been issued;

(e) the particulars of promoters, directors or key managerial personnel to whom such shares are issued;

(f) the change in control, if any, in the company consequent to the issue of equity shares with differential voting rights;

(g) the diluted Earning Per Share pursuant to the issue of each class of shares, calculated in accordance with the applicable accounting standards;

(h) the pre and post issue shareholding pattern along with voting rights in the format specified under sub-rule (2) of rule 4.

In terms of Rule 8 of Companies (Share Capital and Debentures) Rules, 2014, the Board of Directors shall, inter alia, disclose in the Directors' Report for the year in which such shares are issued, the following details of issue of sweat equity shares namely:

(a) the class of director or employee to whom sweat equity shares were issued;

(b) the class of shares issued as Sweat Equity Shares;

(c) the number of sweat equity shares issued to the directors, key managerial personnel or other employees showing separately the number of such shares issued to them , if any, for consideration other than cash and the individual names of allottees holding one percent or more of the issued share capital;

(d) the reasons or justification for the issue;

(e) the principal terms and conditions for issue of sweat equity shares, including pricing formula;

(f) the total number of shares arising as a result of issue of sweat equity shares;

(g) the percentage of the sweat equity shares of the total post issued and paid up share capital;

(h) the consideration (including consideration other than cash) received or benefit accrued to the company from the issue of sweat equity shares;

(i) the diluted Earnings Per Share (EPS) pursuant to issuance of sweat equity shares.

It is necessary in view of Section 164(2), Section 167(1) and Schedule V Part II of Companies Act, 2013 that where the redemption of debentures or preference shares was due during the year but has not taken place, the Board‘s Report should explain the reasons therefor. Further, as a good corporate practice, disclosure regarding the redemption of debentures or preference shares, if any, during the relevant period should be given in the director‘s report.

- **<u>Disclosures pertaining to consolidated financial statements</u>**

If a company has one or more subsidiaries, it shall, in addition to financial statements, prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company. The term –subsidiaries‖ shall include both Associate companies and Joint Venture companies.

Separate Statement containing salient features of Subsidiaries are to be attached to the Holding Company‘s Financial Statements in the Form AOC-2 and authenticated and signed in the same manner as the financial statements.

The Board‘s Report shall be prepared on the basis of standalone financial statements of the company. Where consolidated accounts are presented, the Board‘s Report should, as a good corporate practice, make the relevant disclosures necessary.

- **<u>Additional Disclosures</u>**

The Board‘s Report should also contain disclosures with regard to:

(i) name of the candidate nominated by small shareholders in terms of Section 151 of the Act which states that a listed company may upon notice of not less than one thousand small shareholders or one-tenth of the total number of such shareholders, whichever is lower, have a small shareholder‘s director elected by the them.

(ii) name of retiring Auditors and/or the Secretarial Auditors and whether or not they are eligible and willing for reappointment;

(iii) name of Auditors and/or Secretarial Auditors, if any, who resigned during the year;

(iv) reasons for delay, if any, in holding Annual General Meeting together with references to the approval obtained from the Registrar of Companies for extension of time for holding Annual General Meeting pursuant to the 3rd Proviso to Section 96[1] of the Act;

(v) change in auditor and/or Secretarial Auditors during the year along with the reasons if any;

(vi) appointment of relatives of directors to an office or place of profit;

(vii) special resolutions which were passed by the shareholders in the previous meeting(s) but which have not been acted upon and the reasons therefor

(viii) The existence of the mechanism may be appropriately communicated within the organization. The details of establishment of Vigil mechanism shall be disclosed by the company on the website, if any, and in the Board‘s Report.

Disclosure pursuant to the Listing Agreement of Stock Exchanges

In case of a listed company, the compliance and disclosure requirements for the Board of Directors is higher. The Board should give additional information as required by the listing agreement

- **Clause 32 of NSE Listing Agreement**

  The following disclosures are also to be made by the Board in its report:

  (i) in case the shares are delisted, the fact of delisting, together with reasons therefor;

  (ii) in case the securities are suspended from trading, the reasons thereof;

  (iii) the name and address of each stock exchange at which the company‘s securities are listed and also confirmation that annual listing fee has been paid to each such exchange.

- **Clause 43 of the NSE/BSE Listing Agreement**

  A listed company should furnish particulars of material variations between projected utilization of funds and/or projected profitability statement made by it in its prospectus or letter of offer or object/s stated in the explanatory statement to the notice for the general meeting for considering preferential issue of securities and the actual utilisation of funds and/ or actual profitability.

  Reasons for material variations between the projections and the actual utilization/ profitability should also be stated in the Board‘s Report.

Clause 49 Revised Clause 49 of the standard Listing Agreement

The stock exchange requires listed companies to give the following additional information in their annual reports:

A. Management Discussion and Analysis Report (MDAR)
B. Report on Corporate Governance

A. Management Discussion and Analysis Report (MDAR)

The MDAR should be a part of the report or annexed to it. It should be considered The MDAR should include a brief analysis of the company‘s opportunities and threats. The MDAR should either form a part of the Board‘s Report or be given as an addition thereto in the annual report to the shareholders. The MDAR should include a discussion on the following matters within the limits set by the company‘s competitive position:

- Industry structure and developments
- Opportunities and threats
- Segment –wise or product –wise performance

- Outlook
- Risks and areas of concern
- Internal control systems and their adequacy
- Discussion on financial performance with respect to operational performance
- Material developments in Human Resources/ Industrial Relations front, including number of people employed

MDAR should be considered in the meeting of the Board and not through resolution passed by circulation. It is desirable that MDAR is signed in the same manner as in the case of the Board's Report.

Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

B. <u>Report on Corporate Governance</u>

A compliance report on corporate governance should be included as a separate section in the annual report confirming compliance/non-compliance of the requirements of Clause 49 of the Listing Agreement* with reasons for non- compliance. The extent to which the non-mandatory requirements have been adopted should be specifically highlighted.

The report should include a detailed compliance report on corporate governance covering the following:

- The composition of all committees constituted by the Board
- The reasons of the board for not accepting the recommendations of the Audit Committee
- The reasons for the failure to act upon the resolutions which were passed by the shareholders in the previous meeting(s)

The reference of inclusion of report on corporate governance in the annual report should be made in the Board's Report and, as a good corporate practice, information relating to any non-compliance of the requirements of Clause 49 of the Listing Agreement* should be incorporated in the Board's Report.

<u>Disclosure pursuant to Employee Stock Option and Employee Stock Purchase Schemes</u>

Under Companies Act, 2013 Rule 11(9) of Companies (Share Capital and Debentures) Rules, 2014 provides that the Board of directors, shall, inter alia, disclose in the Directors' Report for the year, the following details of the Employees Stock Option Scheme:

i. Options granted
ii. Options vested
iii. Options exercised
iv. the total number of shares arising as a result of exercise of Options
v. Options lapsed

vi. the exercise price

vii. variation of terms of Options

viii. money realised by exercise of Options

ix. total number of Options in force

x. Employee wise details of Options granted to – (i) key managerial personnel; (ii) any other employee who receives a grant of options in any one year of option amounting to five percent or more of options granted during that year. (iii) identified employees who were granted option, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant.

Under SEBI Regulations* The newly introduced SEBI (Share Based Employee Benefits) Regulations, 2014 replacing the erstwhile SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 states that in addition to the information that a listed company is required to disclose, in relation to employee benefits under the Companies Act, 2013, the board of directors of such a company shall also disclose the details of the scheme(s) being implemented, as specified by SEBI in this regard (Regulation 14).

Regulation 16 provides that No ESOS shall be offered unless the disclosures, as specified by SEBI in this regard, are made by the company to the prospective option grantees.

No such disclosures under Regulation 14 to be made in the Board‘s Report have been specified by SEBI till date (though these were prescribed in the earlier ESOP Guidelines). The same is expected to be prescribed by SEBI in due course.

Provision of money by company for purchase of its own shares by employees or by trustees for the benefit of employees

As per Rule 16 of Companies (Share Capital and Debentures) Rules, 2014, where the voting rights are not exercised directly by the employees in respect of shares to which the scheme relates, the Board of Directors shall, inter alia, disclose in the Board‘s report for the relevant financial year the following details, namely:

i. the names of the employees who have not exercised the voting rights directly;

ii. the reasons for not voting directly;

iii. the name of the person who is exercising such voting rights;

iv. the number of shares held by or in favour of, such employees and the percentage of such shares to the total paid up share capital of the company;

v. the date of the general meeting in which such voting power was exercised;

vi. the resolutions on which votes have been cast by persons holding such voting power;

vii. the percentage of such voting power to the total voting power on each resolution;

viii. whether the votes were cast in favour of or against the resolution.

Disclosures Pursuant to Directions of Reserve Bank of India

Non-Banking Financial Companies (NBFCs) are governed by the directions issued by the Reserve Bank of India (RBI) pursuant to the power vested in it by the RBI Act, 1934. NBFCs have to furnish certain additional information in the Board‘s Report. Separate provisions in this regard have been made for the three categories of NBFCs namely, non-banking financial companies, miscellaneous nonbanking companies and residuary nonbanking companies. These are explained hereunder:

Non-Banking Financial Companies: The Board's Report, in the case of a non-banking financial company, should also contain the following information regarding overdue public deposits / unclaimed public deposits as on the last day of the financial year:

i. total number of accounts of public deposits of the company which have not been claimed by the depositors or not paid by the company after the date on which the deposit became due for repayment; and

ii. the total amounts due under such accounts remaining unclaimed or unpaid beyond the dates referred to in clause (a) as aforesaid.

This information should be furnished with reference to the position as on the last day of the financial year to which the report relates and if the amounts remaining unclaimed or undisbursed as referred to in clause (b) above exceed in the aggregate a sum of Rs. 500,000, there shall be included in the report a statement on the steps taken or proposed to be taken by the Board for repayment of the amounts due to the depositors and remaining unclaimed or undisbursed.

Miscellaneous Non-Banking Companies: In the case of a miscellaneous non-banking company, the Board's Report should contain the following information:

i. the total number of depositors of the company whose deposits have not been claimed by the depositors or paid by the company after the date on which the deposit became due for repayment or renewal, as the case may be, according to the contract with the depositor or the provisions of the RBI directions, whichever may be applicable; and

ii. the total amounts due to the depositors and remaining unclaimed or unpaid beyond the dates referred to in clause (a) aforesaid.

This information should be furnished with reference to the position as on the last day of the financial year to which the report relates and if the amounts remaining unclaimed or undisbursed as referred to in clause (b) above exceed in the aggregate a sum of Rs. 500,000, there shall also be included in the report a statement on the steps taken or proposed to be taken by the Board for the repayment of the amounts due to the depositors and remaining unclaimed or undisbursed.

Residuary Companies: In the case of residuary companies, the Board's Report should contain the following information:

i. compliance with the provisions of the RBI directions;

ii. the total number of depositors of the company whose deposits have not been claimed by the depositors or paid by the company after the date on which the deposit became due for repayment or renewal, as the case may be, according to the contract with the depositor or the provisions of the RBI directions, whichever may be applicable; and

iii. the total amounts due to the depositors and remaining unclaimed or unpaid beyond the dates referred to in clause (b) as aforesaid.

This information should be furnished with reference to the position as on the last day of the financial year to which the report relates and if the amounts remaining unclaimed or unpaid as referred to in clause (c) above exceed in the aggregate a sum of Rs. 500,000, there shall also be included in the report a statement on the steps taken or proposed to be taken by the Board for the repayment of the amounts due to the depositors and remaining unclaimed or unpaid.

Other Disclosures

The Report should state that the consolidated financial statements are also presented in addition to the individual financial statement of the company.

SWOT Analysis: The Board's Report should include a brief analysis of the company's strengths, weaknesses, opportunities and threats as envisaged by the Board. Such a SWOT analysis should be made at micro level.

Projections and Estimates: If any estimate or future projection related to the company's performance is included in the Board's Report, it should be ensured that it is realistic and unambiguous. In case the company is unable to meet the projections made in the previous year's Board's Report, it is desirable that the Board's Report for the current year incorporates a statement mentioning the fact as well as the reasons for such failure.

Disclosures as per Secretarial Standards: As per the Secretarial Standards on Meeting of Board of Directors (SS-1) issued by ICSI, the Board Report shall disclose the number and dates of Meetings of the Board and Committees held during the financial year indicating the number of Meetings attended by each Director.

Likewise, as per the Secretarial Standards on General Meeting (SS-2), the Board Report shall disclose the date of Annual General Meeting held during the financial year.

Note: The Secretarial Standards I and II applicable from 1st July, 2015, therefore for the Board's Report of the year 201415, these are not applicable.

Disclosure of commission to managing or whole-time director: Any director who is in receipt of any commission from the company and who is a managing or whole-time director of the company shall not be disqualified from receiving any remuneration or commission from any holding company or subsidiary company of such company subject to its disclosure by the company in the Board's report

As a good corporate governance practice, the Director's report should disclose such other additional matters viz. implementation plans under The Sexual Harassment of Women At Workplace (Prevention, Prohibition And Redressal) Act, 2013, JVs, collaborations, Investments, foreign exchange transactions, social welfare activities undertaken, CSR activities etc.

Secretarial Audit Report

As per provisions of Section 204(1) of Companies Act, 2013, every listed company or every public company having a paidup share capital of fifty crore rupees or more or every public company having a turnover of two hundred fifty crore rupees or more shall annex with its Board's report, a Secretarial audit report, given by a company secretary in practice.

Cost Audit Report

As per Rule 4 of the Companies (Cost Records and Audit) Rules, 2014, every company engaged in a strategic industry and covered under sub-clause (b) of clause (A) of rule 3 of the Companies (Cost Records and Audit) Rules, 2014, shall be required to get its cost records audited.

The cost auditor shall forward his report to the Board of Directors of the company and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.

The Board of Directors should explain in full any qualifications or observations or any other remarks made by the cost auditor in his report

Explanations in the Board‘s report in response to Auditors‘ qualification

The Board should be bound to give full information, explanation or comments, if any, in its report on every qualifications, reservation, adverse remark or disclaimer contained in Auditor‘s report on the annual financial statement

The Board should state detailed explanation for all the observations and qualifications given by the auditor in his main report and in the notes attached to the financial statement sheet including the reasons for such material deviations for not complying with the statutory requirements under the law and the circumstances that led to such deviations.

The Board‘s Report should also contain a confirmation of the follow-up action taken by the directors on qualifications made in accounts for previous years.

Information on Accounts

The Report may disclose any information which is required by the Act to be given in the accounts. Such information may be given in the Report or in the accounts, or in a statement annexed to the accounts.

The Board‘s Report should be prepared based on the stand alone financial statements of the company and the report should contain a separate section wherein a report on the performance and financial position of each of the subsidiaries, associates and joint venture companies included in the consolidated financial statement is presented.

The report of the Board should contain the details in respect of adequacy of internal financial controls with reference to the Financial Statements. The revised financial statement or a revised report may be prepared in respect of any of the three preceding financial years and the detailed reasons for revision of such financial statement or report should be disclosed in the Board‘s report in the relevant financial year in which such revision is being made.

Additional disclosures mandated for producer companies, nonbanking financial companies, miscellaneous nonbanking companies, residuary companies and housing finance companies regulators of the respective companies to which it pertains needs to be complied with.

Approval of the Board‘s Report

The Board‘s Report should be considered, approved and signed at a meeting of the Board, convened in accordance with the provisions of the Act and shall not be dealt with: — by means of a resolution passed by circulation — in any meeting held through video conferencing or other audio visual means (Rule 4 of the Companies (Meetings of Board and its Powers) Rules, 2014).A specimen of the Board resolution for approval of the Board‘s Report is placed at AppendixIXA and a specimen of the Board resolution for approval of the Board‘s Report containing response to Auditors‘ comments and qualifications is placed at AppendixIXB. Further, as per secretarial standard on the meeting of the Board of directors (SS-1), any director participating through electronic mode in respect of restricted items with the express permission of chairman shall however, neither be entitled to vote nor be counted for the purpose of quorum in respect of approval of Director‘s Report.

Signing and Dating of the Board‘s Report

Section 134(6) of the Act provides that the Board‘s report and any annexures thereto should be signed by its chairperson of the company if he is authorised by the Board and where he is not so authorised, shall be signed by at least two directors, one of whom shall be a managing director, or by the director where there is one director. If the Auditor‘s Report is available for consideration at the time of approving the Board‘s Report, the Board‘s Report may bear the same date as that of the Auditor‘s Report. However, if the Auditor‘s Report is dated subsequent to the date of Board‘s Report, then the Addendum to the Board‘s Report may bear the same date or a date after the date of the Auditor‘s Report.

Collective Responsibility of the Board

The Board‘s Report should be the collective responsibility of all the directors though the report may have been approved only by a majority of the directors. The dissent, if any, of any director(s) on any item in the Board‘s Report may be reflected in the minutes of the meeting but not in the report. The Board should be collectively responsible for any statement in its Report, which is false in any material particular or for any omission of a material fact, knowing it to be material

Filing of the Board‘s Report

Section 137(1) of the Act provides that copies of financial statement along with all documents required to be annexed should be filed with the Registrar of Companies within 30 days along with the prescribed fees, after the financial statement, including consolidated financial statement have been adopted at the annual general meeting. The Board‘s Report has to be attached to the financial statements.

In the case of listed companies, the full version of the annual report, including the Board‘s Report, should be forwarded to stock exchange as soon as they are issued through CDFS (Corporate Filing and dissemination System)

Right of Members to receive copies of financial statement, board‘s report, etc.

A copy of the financial statements, including consolidated financial statements, if any, auditor‘s report and every other document required by law to be annexed or attached to the financial statements, which are to be laid before a company in its general meeting, shall be sent to every member of the company, to every trustee for the debenture holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled, not less than twenty-one days before the date of the meeting. Provided that in the case of a listed company, the provisions of this sub-section shall be deemed to be complied with, if the copies of the documents are made available for inspection at its registered office during working hours for a period of 21 days before the date of the meeting and a statement containing the salient features of such documents in the prescribed form or copies of the documents, as the company may deem fit, is sent to every member of the company and to every trustee for the holders of any debentures issued by the company not less than 21 days before the date of the unless the shareholders ask for full financial statements.

Provided also that a listed company shall also place its financial statements including consolidated financial statements, if any, and all other documents required to be attached thereto, on its website, which is maintained by or on behalf of the company. In terms of Clause 32 of the listing agreement, a copy of the Board's Report along with a copy of the complete and full Balance Sheet and Profit and Loss Account should be sent by the company to each shareholder. Soft copies of full Balance Sheet, Profit and Loss Account and Board's Report should be sent to those shareholders who have registered for the purpose at their registered e-mail address (es); other shareholders should be sent hard copy of statement containing the salient features of Board's report. Hard copies of full annual report should also be sent to those shareholders who request for the same.

Consistency

The Board should ensure consistency of information given in the Board's Report, the Management Discussion & Analysis Report, Report on Corporate Governance and the explanatory statements to Resolutions. Repetitions in the various sections of the annual report should be avoided so that the information about a particular item is clearly and completely available at one place only.

The Board's Report should clearly explain any material deviations from the disclosures made in the previous report and the reasons thereof. Further, the Board should make a balanced assessment in the report in order to provide an unambiguous and unbiased insight into the affairs of the company.

LIABILITY FOR MIS-STATEMENT

The Board shall be collectively responsible for any statement in its Report which is false in any material particular, or for any omission of a material fact, knowing it to be material. Section 448 of the Act provides that if in any return, report, certificate, financial statement, prospectus, statement or other document required by the Act or the rules made thereunder, any person makes a statement,— (a) which is false in any material particulars, knowing it to be false; or

(b) which omits any material fact, knowing it to be material, then he shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and should also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

AUDIT REPORT

Management is responsible for the preparation of the financial statements. Management also accepts responsibility for necessary internal controls to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements. The aforesaid purpose is achieved by the expression of an independent reporting by the auditor as to whether the financial statements exhibit a true and fair view of the affairs of the entity.

Thus, an Audit report is an opinion drawn on the entity‘s financial statements to make sure that the records are true and fair representation of the transactions they claim to represent. This involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements. The main users of audit report are shareholders, members and all other stakeholders of the company

Objective of the Auditor - Forming an Opinion on the Financial Statement

The objectives of the auditor as per SA 700 (Revised), –Forming an Opinion and Reporting on Financial Statements‖ are:

- To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
- To express clearly that opinion through a written report.

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

The two major opinions framed by the auditor are-

1. **Unmodified Opinion:** The Auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
2. **Modified Opinion:** The Auditor shall express a modified opinion if, he concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement (or) if, he fails to obtain sufficient and appropriate audit evidence.

What are the Pre-requisites to Form an Opinion?

3. Auditor to Obtain Reasonable Assurance

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

That conclusion shall take into account:

- Whether sufficient appropriate audit evidence has been obtained;
- Whether uncorrected misstatements are material, individually or in aggregate;
- Evaluations by the Auditor on –
    - o whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.
    - o consideration of the qualitative aspects of the entity‘s accounting practices, including indicators of possible bias in management‘s judgments.

4. Auditor to evaluate qualitative aspects of the entity‘s accounting practices

Management makes a number of judgments about the amounts and disclosures in the financial statements. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices. In considering the qualitative aspects of the entity‘s accounting practices, the auditor may become aware of possible bias in management‘s judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:

- The selective correction of misstatements brought to management‘s attention during the audit. Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
- Possible management bias in the making of accounting estimates. Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor‘s evaluation of whether the financial statements as a whole are free from material misstatement.

5. **Specific Evaluations by the Auditor**

In particular, the auditor shall evaluate whether:

- The financial statements adequately disclose the significant accounting policies selected and applied;
- The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- The accounting estimates made by management are reasonable;
- The information presented in the financial statements is relevant, reliable, comparable, and understandable;
- The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
- The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Components (Headings) of Audit Report

The auditor‘s report shall be in writing. A written report encompasses reports issued in hard copy and those using an electronic medium. The use of specific headings, which are intended to assist in making auditor‘s reports that refer to audits that have been conducted in accordance with SAs more recognizable.

1 **Title:** The auditor‘s report shall have a title that clearly indicates that it is the report of an independent auditor. For example, –Independent Auditor‘s Report,‖ distinguishes the independent auditor‘s report from reports issued by others

2 **Addressee:** The auditor‘s report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor‘s report is to be addressed. The auditor‘s report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

3 **Auditor‘s Opinion:** The first section of the auditor‘s report shall include the auditor‘s opinion, and shall have the heading –Opinion.‖ The Opinion section of the auditor‘s report shall also:

- Identify the entity whose financial statements have been audited;
- State that the financial statements have been audited;
- Identify the title of each statement comprising the financial statements;
- Refer to the notes, including the summary of significant accounting policies; and
- Specify the date of, or period covered by, each financial statement comprising the financial statements.

When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as –with the foregoing explanation‖ or –subject to‖ in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

4 **Basis for Opinion:** The auditor‘s report shall include a section, directly following the Opinion section, with the heading –Basis for Opinion‖, that:

- States that the audit was conducted in accordance with Standards on Auditing;
- Refers to the section of the auditor‘s report that describes the auditor‘s responsibilities under the SAs;
- Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor‘s other ethical responsibilities in accordance with these requirements.
- States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor‘s opinion.

5 **Going Concern:** Where applicable, the auditor shall report on the entity‘s going concern status in accordance with SA 570 (Revised).

6 **Key Audit Matters:** For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor‘s report in accordance with SA 701.

7 **Responsibilities for the Financial Statements:** The auditor‘s report shall include a section with a heading –Responsibilities of Management for the Financial Statements.‖ SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. *Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements.* Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management‘s responsibilities in the auditor‘s report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

The auditor should obtain representations for all financial statements and periods referred to in our auditor‘s report. Auditor should obtain a specific representation if a restatement is made to correct a material misstatement in the prior period financial statements that affects the comparative information in the financial statements. If current management was not present during all periods covered by auditor‘s report, he still would obtain written representations from current management on all such periods.

8 **Auditor‘s Responsibilities for the Audit of the Financial Statements:** This section of the auditor‘s report shall:

i. State that the objectives of the auditor are to:

a. **Obtain reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and

b. **Issue an auditor‘s report** that includes the auditor‘s opinion.

ii. State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and

iii. State that misstatements can arise from fraud or error, and either:

a. Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or

b. Provide a definition or description of materiality in accordance with the applicable financial reporting framework.

iv. State that, as part of an audit in accordance with SAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and

a. The Auditor‘s Responsibilities for the Audit of the Financial Statements section of the auditor‘s report also shall:

b. State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;

c. For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor‘s independence, and where applicable, related safeguards; and

d. For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in accordance with SA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. The auditor describes these matters in the auditor‘s report unless law or regulation precludes public disclosure.

9 **Location of the description of the auditor‘s responsibilities for the audit of the financial statements:** The description of the auditor‘s responsibilities for the audit of the financial statements shall be included:

a. Within the body of the auditor‘s report;

b. Within an appendix to the auditor‘s report, in which case the auditor‘s report shall include a reference to the location of the appendix; or

c. By a specific reference within the auditor‘s report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

10. **Other Reporting Responsibilities:** If the auditor addresses other reporting responsibilities in the auditor‘s report on the financial statements that are in addition to the auditor‘s responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor‘s report with a heading titled- –Report on Other Legal and Regulatory Requirements‖ or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs.
    If other reporting responsibilities are presented in the same section as the related report elements required by the SAs, the auditor‘s report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the SAs.
    If the auditor‘s report contains a separate section that addresses other reporting responsibilities, the requirements stated above shall be included under a section with a heading –Report on the Audit of the Financial Statements.‖ The –Report on Other Legal and Regulatory Requirements‖ shall follow the –Report on the Audit of the Financial Statements.‖

11. **Signature of the Auditor:** The auditor‘s report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm.
    The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

12. **Auditor‘s Address:** The auditor‘s report shall name specific location, which is ordinarily the city where the audit report is signed.

13. **Date of the Auditor‘s Report:** The auditor‘s report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor‘s opinion on the financial statements, including evidence that:

    a. All the statements that comprise the financial statements, including the related notes, have been prepared; and

    b. Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

    The date of the auditor‘s report informs the user of the auditor‘s report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor‘s responsibility for events and transactions after the date of the auditor‘s report is addressed in SA 560.

Various Types of Audit Opinions in the INDEPENDENT AUDITOR'S REPORT

Standard on Auditing (SA) 705 –Modifications to the Opinion in the Independent Auditor's Report‖ deals with the auditor's responsibility to issue an appropriate report. in circumstances when, in forming an opinion in accordance with SA 700 (Revised) –Forming An Opinion And Reporting On Financial Statements‖, the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

Circumstances when a modification to the auditor‘s opinion is required:

a. The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

b. The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a Whole are free from material misstatement.

Types of Audit Opinion

There are three types of modified opinions, namely-

a. A qualified opinion

b. An adverse opinion

c. A disclaimer of opinion

Qualified Opinion

The auditor shall express a qualified opinion when:

a. The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

b. The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Adverse Opinion

The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Disclaimer of Opinion

a. The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

b. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements

Which type of opinion is appropriate?

The decision regarding which type of modified opinion is appropriate depends upon:

The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

The auditor‘s judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

The table below illustrates how the auditor‘s judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	**Auditor‘s Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements**	
	Material But Not Pervasive	**Material and Pervasive**
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Communicating Key Audit Matters in The Independent Auditor‘s Report‖

The objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor‘s report. There are two different broad approaches to the auditor‘s reporting responsibilities in respect of comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement. The essential audit reporting differences between the approaches are: for corresponding figures, the auditor‘s opinion on the financial statements refers to the current period only; whereas for comparative financial statements, the auditor‘s opinion refers to each period for which financial statements are presented.