

Chapter 1

Conceptual Framework for Preparation and Presentation of Financial Statements

Question 1

What are the qualitative characteristics of the financial statements which improve the usefulness of the information furnished therein?

(4 Marks) (May, 2007 and November, 2008)

Answer

The qualitative characteristics are attributes that improve the usefulness of information provided in financial statements. The framework suggests that the financial statements should observe and maintain the following four qualitative characteristics as far as possible within limits of reasonable cost/benefit.

1. *Understandability*: The financial statements should present information in a manner as to be readily understandable by the users with reasonable knowledge of business and economic activities. It is not right to think that more disclosures are always better. A mass of irrelevant information creates confusion and can be even more harmful than non-disclosure. No relevant information can be however withheld on the grounds of complexity.
2. *Relevance*: The financial statements should contain relevant information only. Information, which is likely to influence the economic decisions by the users, is said to be relevant. Such information may help the users to evaluate past, present or future events or may help in confirming or correcting past evaluations. The relevance of a piece of information should be judged by its materiality. A piece of information is said to be material if its omission or misstatement can influence economic decisions of a user.
3. *Reliability*: To be useful, the information must be reliable; that is to say, they must be free from material error and bias. The information provided are not likely to be reliable unless:
 - (a) Transactions and events reported are faithfully represented.
 - (b) Transactions and events are reported in terms of their substance and economic reality not merely on the basis of their legal form. This principle is called the principle of 'substance over form'.
 - (c) The reporting of transactions and events are neutral, i.e. free from bias.
 - (d) Prudence is exercised in reporting uncertain outcome of transactions or events.
4. *Comparability*: Comparison of financial statements is one of the most frequently used and most effective tools of financial analysis. The financial statements should permit both inter-firm and intra-firm comparison. One essential requirement of comparability is disclosure of financial effect of change in accounting policies.
5. *True and Fair View*: Financial statements are required to show a true and fair view of the performance, financial position and cash flows of an enterprise. The conceptual framework does not deal directly with this concept of true and fair view, yet the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements portraying true and fair view of information about an enterprise.

Question 2

When can a company change its accounting policy?

(4 Marks) (May 2007)

Answer

A change in accounting policy should be made in the following conditions:

- (i) If the change is required by some statute or for compliance with an Accounting Standard.
- (ii) Change would result in more appropriate presentation of the financial statement.

Change in accounting policy may have a material effect on the items of financial statements. For example, if depreciation method is changed from straight-line method to written-down value method, or if cost formula used for inventory valuation is changed from weighted average to FIFO, or if interest is capitalized which was earlier not in practice, or if proportionate amount of interest is changed to inventory which was earlier not the practice, all these may increase or decrease the net profit. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts. Therefore, it is necessary to quantify the effect of change on financial statement items like assets, liabilities, profit / loss.

Question 3

What is meant by accounting estimate? Give two examples for accounting estimate.

(2 Marks) (November, 2007)

Answer

As a result of the uncertainties in business activities, many financial statement items cannot be measured with precision but can only be estimated. These are called accounting estimates. Therefore, the management makes various estimates and assumptions of assets, liabilities, incomes and expenses as on the date of preparation of financial statements. This process of estimation involves judgements based on the latest information available.

Examples of estimation in some fields are:

- (i) Estimation of useful life of depreciable assets.
- (ii) Estimation of provision to be made for bad and doubtful debts.

Question 4

Mention six areas in which different accounting policies are followed by companies.

(4 Marks) (November, 2007)

Answer

Following are the examples of the areas in which different accounting policies may be adopted by different enterprises:

- (i) Methods of depreciation, depletion and amortisation.
- (ii) Treatment of expenditure during construction.
- (iii) Valuation of inventories.
- (iv) Treatment of goodwill.
- (v) Valuation of investments.

- (vi) Valuation of fixed assets.

Question 5

List the criteria to be applied for rating an enterprise as Level-I enterprise for the purpose of compliance of Accounting Standards in India.

(4 Marks) (November, 2007)

Answer

Following are the criteria for classifying an enterprise as Level -I enterprise:

- (i) Enterprises, whose equity or debt securities are listed or is in the process of being listed in India.
- (ii) Banks (including co-operative banks), Insurance companies and Financial Institutions.
- (iii) All commercial, industrial and other business reporting enterprises whose turnover during the previous year is in excess of Rs.50 crores. Here turnover does not include 'other income'.
- (iv) All commercial, industrial and other business reporting enterprises whose total borrowings including public deposits during the accounting year exceeds Rs.10 crores.
- (v) Holding and subsidiary companies of any of the above enterprises at any time during the accounting year.

Question 6

"One of the characteristics of financial statements is neutrality"- Do you agree with this statement?

(2 Marks) (May 2008)

Answer

Yes, one of the characteristics of financial statements is neutrality. To be reliable, the information contained in financial statement 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 pre-determined result or outcome. Financial statements are said to depict the true and fair view of the business of the organization by virtue of neutrality.