

CHAPTER 1

CONCEPTUAL FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

BASIC CONCEPTS

The International Accounting Standards Committee (IASC) issued a Conceptual Framework to serve as a basis for the accounting standards. The Accounting Standards Board of the ICAI has issued a similar framework for the same purpose in July 2000. This framework provides the fundamental basis for development of new standards as also for review of existing standards. The framework sets out the concepts underlying the preparation and presentation of general-purpose financial statements prepared by enterprises for external users. This framework explains components, users, qualitative characteristics, elements & its measurement basis of financial statements.

➤ Capital Maintenance

- **Financial capital maintenance at historical cost** – opening and closing assets are stated at respective historical costs to ascertain opening and closing equity.
- **Financial capital maintenance at current purchasing power** – Opening and closing equity at historical costs are restated at closing prices using average price indices
- **Physical capital maintenance at current costs** – The historical costs of opening and closing assets are restated at closing prices using specific price indices

Question 1

What are the qualitative characteristics of the financial statements which improve the usefulness of the information furnished therein?
(May 2007 & 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

“One of the characteristics of financial statements is neutrality”- Do you agree with this statement?
(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.