

CHAPTER 2

FRAMEWORK FOR PREPARATION & PRESENTATION OF FINANCIAL STATEMENTS

CONCEPT 4: COMPONENTS OF FINANCIAL STATEMENTS

Problem.4.1

Opening Balance Sheet of Mr. A is showing the aggregate value of assets, liabilities and equity ₹ 8 lakh, ₹ 3 lakh and ₹ 5 lakh respectively.

During accounting period Mr. A has the following transactions:

- (1) Earned 10% dividend on 2,000 equity shares held of ₹ 100 each.
- (2) Paid ₹ 50,000 to creditors for settlement of ₹ 70,000.
- (3) Rent of the premises is outstanding ₹ 10,000.
- (4) Mr. A withdrew ₹ 9,000 for his personal use.

You are required to show the effect of above transactions on **Balance Sheet** in the form of Assets – Liabilities = Equity after each transaction. **[T.9]**

Solution

Effects of each transaction on Balance sheet of the trader is shown below:

Transactions	Assets ₹ lakh	–	Liabilities ₹ lakh	=	Equity ₹ lakh
Opening	8.00	–	3.00	=	5.00
(1) Dividend earned	8.20	–	3.00	=	5.20
(2) Settlement of Creditors	7.70	-	2.30	=	5.40
(3) Rent Outstanding	7.70	–	2.40	=	5.30
(4) Drawings	7.61	–	2.40	=	5.21

Problem.4.2

Mrs. A is showing the consolidated aggregate opening balance of equity, liabilities and assets of ₹ 6 lakh, 4 lakh and 10 lakh respectively. During the current year Mrs. A has the following transactions:

1. Received 20 % dividend on 10,000 equity shares of ₹ 10 each held as investment.
2. The amount of ₹ 70,000 is paid to creditors for settlement of ₹ 90,000.
3. Salary is pending by ₹ 20,000.
4. Mrs. A's drawing ₹ 20,000 for her personal use.

You are required to prepare the statement of the effect of aforesaid each transactions on closing balance sheet in the form of Assets - Liabilities = Equity after each transaction. **[Dec. 2021, 5 Marks]**

Solution

Effect of each transaction on Balance sheet of Mrs. A is shown below:

Transactions	Assets ₹ lakh	–	Liabilities ₹ lakh	=	Equity ₹ lakh
Opening	10.00	–	4.00	=	6.00
(1) Dividend earned	10.20 [10.00+0.20]	–	4.00	=	6.20 [6.00+0.20]
(2) Settlement of Creditors	9.50 [10.20-0.70]	-	3.10 [4.00-0.90]	=	6.40 [6.20+0.20]
(3) Salary Outstanding	9.50	–	3.30 [3.10+0.20]	=	6.20 [6.40-0.20]
(4) Drawings	9.30 [9.50-0.20]	–	3.30	=	6.00 [6.20-0.20]

Problem.4.3

As on 1st April, 2021 opening Balance Sheet of Mr. Mohanty is showing the aggregate value of Assets, Liabilities and Equity at ₹ 12 Lakhs, 3 Lakhs and 9 Lakhs respectively. During the accounting period 01/04/2021 to 31/03/2022, Mr. Mohanty has the following transactions:

- (1) A liability of ₹ 50,000 was finally settled at a discount of 2%.
- (2) Dividend earned @ 15% on 1000 (F.V ₹ 100 each) Equity shares held @ ₹ 12,000.
- (3) Rent of the premises paid ₹ 20,000.
- (4) Mr. Mohanty withdrew ₹ 10,000 for personal purposes and also withdrew goods worth ₹ 5,000 for personal purposes.
- (5) ₹ 15,000 were received against Bill Receivables.

You are required to show the effect of the above transactions on Balance Sheet in the form of Assets – Liabilities = Equity equation after each transaction.

[Nov. 2022, 5 Marks]

Solution

Effects of each transaction on Balance sheet of the trader is shown below:

Transactions	Assets	–	Liabilities	=	Equity
	₹ lakh		₹ lakh		₹ lakh
Opening	12	–	3	=	9
(1) Settlement of Creditors	12 – 0.49 11.51	–	3 – 0.50 2.5	=	9.0 + 0.01 9.01
(2) Dividend earned	11.51 + 0.15 11.66	–	2.5	=	9.01 + 0.15 9.16
(3) Rent paid	11.66 – 0.20 11.46	–	2.5	=	9.16 – 0.20 8.96
(4) Drawings	11.46 – 0.15 11.31	–	2.5	=	8.96 – 0.15 8.81
(5) *Money received against Bills receivables	11.31 + 0.15 – 0.15 11.31	–	2.5	=	8.81

*No change as cash received from bills receivable will have impact on individual asset only (will reduce bill receivables with corresponding increase in cash).

CONCEPT 6: QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

Problem.6.1

“One of the characteristic of the financial statement is neutrality.” Do you agree with this statement?

Explain in brief.

[Nov. 2018, 5 Marks]

Solution

Yes, one of the characteristics of financial statements is 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, the focus of analysis could shift from one area of business to another thereby arriving at a totally different conclusion based on the business results.

Problem.6.2

What are the qualitative characteristics of the Financial Statements which improve the usefulness of the information furnished therein?

[Nov. 2020, 5 Marks]

CONCEPT 7: FUNDAMENTAL ACCOUNTING ASSUMPTIONS

Problem.7.1

Balance sheet of a trader on 31st March, 20X1 is given below:

Liabilities	₹	Assets	₹
Capital	60,000	Property, Plant and Equipment	65,000
Profit and Loss Account	25,000	Stock	30,000
10% Loan	35,000	Trade receivables	20,000
Trade payables	10,000	Deferred costs	10,000
		Bank	5,000
	1,30,000		1,30,000

Additional information:

- a) The remaining life of Property, Plant and Equipment is 5 years. The pattern of use of the asset is even. The net realizable value of Property, Plant and Equipment on 31.03.X2 was ₹ 60,000.
- b) The trader’s purchases and sales in 20X1-X2 amounted to ₹ 4 lakh and ₹ 4.5 lakh respectively.
- c) The cost and net realizable value of stock on 31.03.X2 were ₹ 32,000 and ₹ 40,000 respectively.
- d) Expenses (including interest on 10% Loan of ₹ 3,500 for the year) amounted to ₹ 14,900.
- e) Deferred cost is amortised equally over 4 years.
- f) Trade receivables on 31.03.X2 is ₹ 25,000, of which ₹ 2,000 is doubtful. Collection of another ₹4,000 depends on successful re-installation of certain product supplied to the customer.
- g) Closing trade payable is ₹ 12,000, which is likely to be settled at 5% discount.
- h) Cash balance on 31.03.X2 is ₹ 37,100.
- i) There is an early repayment penalty for the loan ₹ 2,500.

You are required to prepare **Profit and Loss Accounts** and **Balance Sheets** of the trader in both cases (i) assuming going concern (ii) not assuming going concern.

[S.M.1]

Solution

Profit and Loss Account for the year ended 31st March, 20X2

	Case (i)	Case (ii)		Case (i)	Case (ii)
	₹	₹		₹	₹
To Opening Stock	30,000	30,000	By Sales	4,50,000	4,50,000
To Purchases	4,00,000	4,00,000	By Closing Stock	32,000	40,000
To Expenses	14,900	14,900	By Trade payables	-	600
To Depreciation	13,000	5,000			
To Provision for doubtful debts	2,000	6,000			
To Deferred cost	2,500	10,000			
To Loan penalty	-	2,500			
To Net Profit (b.f.)	19,600	22,200			
	4,82,000	4,90,600		4,82,000	4,90,600

Balance Sheet as at 31st March, 20X2

Liabilities	Case (i)	Case (ii)	Assets	Case (i)	Case (ii)
	₹	₹		₹	₹
Capital	60,000	60,000	Property, Plant and Equipment	52,000	60,000
Profit & Loss A/c	44,600	47,200	Stock	32,000	40,000
10% Loan	35,000	37,500	Trade receivables (less provision)	23,000	19,000
Trade payables	12,000	11,400	Deferred costs	7,500	Nil
			Bank	37,100	37,100
	1,51,600	1,56,100		1,51,600	1,56,100

Problem.7.2

Balance sheet of Anurag Trading Co. on 31st March, 20X1 is given below:

Liabilities	₹	Assets	₹
Capital	50,000	Property, Plant and Equipment	69,000
Profit and Loss Account	22,000	Stock in Trade	36,000
10% Loan	43,000	Trade receivables	10,000
Trade payables	18,000	Deferred Expenditure	15,000
		Bank	3,000
	1,33,000		1,33,000

Additional information:

- Remaining life of Property, Plant and Equipment is 5 years with even use. The net realizable value of Property, Plant and Equipment as on 31.03.X2 was ₹ 64,000.
- Firm's sales and purchases for the year 20X1-X2 amounted to ₹ 5 lakh and ₹ 4.50 lakh respectively.
- The cost and net realizable value of stock were ₹ 34,000 and ₹ 38,000 respectively.
- General Expenses for the year 20X1-X2 were ₹ 16,500.

- e) Deferred Expenditure is normally amortised equally over 4 years starting from FY 20X0-X1 i.e. ₹5,000 per year.
- f) Out of trade receivables worth ₹ 10,000, collection of ₹ 4,000 depends on successful re-design of certain product already supplied to the customer.
- g) Closing trade payable is ₹ 10,000, which is likely to be settled at 95%.
- h) There is pre-payment penalty of ₹ 2,000 for Bank loan outstanding.

Prepare **Profit and Loss Account** for the year ended 31st March, 20X2 by assuming it is not a Going Concern. **[T.10]**

Solution

Profit and Loss Account of Anurag Trading Co.
for the year ended 31st March, 20X2
(Assuming business is not a going concern)

Particulars	₹	Particulars	₹
To Opening Stock	36,000	By Sales	5,00,000
To Purchases	4,50,000	By Trade payables	500
To General Expenses	16,500	By Closing Stock	38,000
To Depreciation (69,000 – 64,000)	5,000		
To Provision for doubtful debts	4,000		
To Deferred Expenditure	15,000		
To Loan penalty	2,000		
To Net Profit (b.f.)	10,000		
	5,38,500		5,38,500

Problem.7.3

Summarised Balance Sheet of Cloth Trader as on 31.03.2017 is given below:

Liabilities	Amount (₹)	Assets	Amount (₹)
Proprietor's Capital	3,00,000	Fixed Assets	3,60,000
Profit & Loss Account	1,25,000	Closing Stock	1,50,000
10% Loan Account	2,10,000	Sundry Debtors	1,00,000
Sundry Creditors	50,000	Deferred Expenses	50,000
		Cash & Bank	25,000
	6,85,000		6,85,000

Additional Information is as follows:

- (i) The remaining life of fixed assets is 8 years. The pattern of use of the asset is even. The new realizable value of fixed assets on 31.3.2018 was ₹ 3,25,000.
- (ii) Purchase and Sales in 2017-18 amounted to ₹ 22,50,000 and ₹ 27,50,000 respectively.
- (iii) The cost and net realizable value of stock on 31.3.2018 were ₹ 2,00,000 and ₹ 2,50,000 respectively.
- (iv) Expenses for the year amounted to ₹ 78,000.

- (v) Deferred expenses are amortized equally over 5 Years.
- (vi) Sundry Debtors 31.03.2018 are ₹ 1,50,000 of which ₹ 5,000 is doubtful. Collection of another ₹25,000 depends on successful re-installation of certain product supplied to the customer.
- (vii) Closing Sundry Creditors are ₹ 75,000, likely to be settled at 10% discount.
- (viii) Cash balance as on 31.03.2018 is ₹ 4,22,000.
- (ix) There is a nearly repayment penalty for the loan of ₹ 25,000.

You are required to prepare: (Not assuming going concern)

- (1) Profit & Loss Account for the year 2017 -18.
- (2) Balance Sheet as on 31st March, 2018.

[May 2019, 5 Marks]

Solution

Profit and Loss Account for the year ended 2017-18

(not assuming going concern)

Particulars	₹	Particulars	₹
To Opening Stock	1,50,000	By Sales	27,50,000
To Purchases	22,50,000	By Closing Stock	2,50,000
To Expenses*	78,000	By Trade payables	7,500
To Depreciation	35,000		
To Provision for doubtful debts	30,000		
To Deferred cost	50,000		
To Loan penalty	25,000		
To Net Profit (b.f.)	3,89,500		
	30,07,500		30,07,500

Balance Sheet as at 31st March, 2018 (not assuming going concern)

Liabilities	₹	Assets	₹
Capital	3,00,000	Fixed Assets	3,25,000
Profit & Loss A/c	5,14,500	Stock	2,50,000
10% Loan	2,35,000	Trade receivables (less provision)	1,20,000
Trade payables	67,500	Deferred costs	Nil
		Bank	4,22,000
	11,17,000		11,17,000

*Assumed that ₹ 78,000 includes interest on 10% loan amount for the year.

Problem.7.4

Following is the Balance Sheet of M/s S Traders as on 31st March, 2019:

Liabilities	(₹)	Assets	(₹)
Capital	1,50,000	Fixed Assets	1,05,000
11% Bank Loan	80,000	Closing stock	76,000
Trade payables	52,000	Debtors	68,000
Profit & Loss A/c	56,000	Deferred Expenditure	24,000
		Cash & Bank	65,000
	3,38,000		3,38,000

Additional information:

- (i) Remaining life of Fixed Assets is 6 years with even use. The net realizable value of Fixed Assets as on 31st March, 2020 is ₹ 90,000.
- (ii) Firm's Sales & Purchases for the year ending 31st March, 2020 amounted to ₹ 7, 80,000 and ₹ 6, 25,000 respectively.
- (iii) The cost & net realizable value of the stock as on 31st March, 2020 was ₹ 60,000 and ₹ 66,000 respectively.
- (iv) General expenses (including interest on Loan) for the year 2019-20 were ₹ 53,800.
- (v) Deferred expenditure is normally amortised equally over 5 years starting from the Financial year 2018-19 i.e. ₹ 6,000 per year.
- (vi) Debtors on 31st March, 2020 is ₹ 65,000 of which ₹ 5,000 is doubtful. Collection of another ₹10,000 debtors depends on successful re-installation of certain products supplied to the customer.
- (vii) Closing Trading payable ₹ 48,000, which is likely to be settled at 5% discount.
- (viii) There is a prepayment penalty of ₹ 4,000 for Bank loan outstanding.
- (ix) Cash & Bank balances as on 31st March, 2020 is ₹ 1,65,200.

Prepare Profit & Loss Account and Balance sheet for the year ended 31st March, 2020 assuming the firm is not a going concern. [Nov. 2020, 5 Marks]

Solution Profit and Loss Account of M/s S Traders for the year ended 31st March, 2020

Particulars	(₹)	Particulars	(₹)
To Opening Stock	76,000	By Sales	7,80,000
To Purchases	6,25,000	By Disc. on Trade Payable	2,400
To Depreciation	15,000	By Closing stock	66,000
To General expenses	53,800		
To Deferred expenditure	24,000		
To Provision for doubtful debts	15,000		
To Pre-Payment Penalty	4,000		
To Net Profit (b.f.)	35,600		
	8,48,400		8,48,400

Balance Sheet M/s S Traders as on 31st March, 2020

Liabilities	(₹)	(₹)	Assets	(₹)	(₹)
Proprietor Capital		1,50,000	PPE	1,05,000	
Profit & Loss A/c	56,000		(-) Depreciation	(15,000)	90,000
Profit earned during the year	<u>35,600</u>		Debtors	65,000	
11% Loan		91,600	(-) Provision	<u>(15,000)</u>	50,000
Trade payables	48,000	84,000	Cash & Bank		1,65,200
(-) 5% Discount	<u>(2,400)</u>	45,600	Closing Stock		66,000
		3,71,200			3,71,200

CONCEPT 8: ELEMENTS OF FINANCIAL STATEMENTS

Example 8.1

A Ltd. has entered into a binding agreement with P Ltd. to buy a custom-made machine for ₹ 40,000. At the end of 20X1-X2, before delivery of the machine, A Ltd. had to change its method of production. The new method will not require the machine ordered and it will be scrapped after delivery. The expected scrap value is nil. How it will be accounted?

Solution

A liability is recognised when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. In the given case, A Ltd. should recognise a liability of ₹ 40,000 to P Ltd.

When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognised as an expense rather than as an asset. In the present case, flow of future economic benefit from the machine to the enterprise is improbable. The entire amount of purchase price of the machine should be recognised as an expense. The accounting entry is suggested below:

		₹	₹
Loss on change in production Method To P Ltd. (Loss due to change in production method)	Dr.	40,000	40,000
Profit and loss A/c To Loss on change in production method (loss transferred to profit and loss account)	Dr.	40,000	40,000

CONCEPT 9: MEASUREMENT OF ELEMENTS OF FINANCIAL STATEMENTS

Example 9.1

A machine was acquired for \$ 10,000 on deferred payment basis. The rate of exchange on the date of acquisition was ₹ 49 per \$. The payments are to be made in 5 equal annual instalments together with 10% interest per year. The current market value of similar machine in India is ₹ 5 lakhs.

Current cost of the machine = Current market price = ₹ 5,00,000.

By historical cost convention, the machine would have been recorded at ₹ 4,90,000.

To settle the deferred payment on current date one must buy dollars at ₹ 49/\$. The liability is therefore recognised at ₹ 4,90,000 (\$ 10,000 × ₹ 49).

Note that the amount of liability recognised is not the present value of future payments. This is because, in current cost convention, liabilities are recognised at undiscounted amount.

CONCEPT 10: CAPITAL MAINTENANCE

Example 10.1

A trader commenced business on 01/01/20X1 with ₹ 12,000 represented by 6,000 units of a certain product at ₹ 2 per unit. During the year 20X1 he sold these units at ₹ 3 per unit and had withdrawn ₹6,000.

Solution:

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

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

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

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

Example 10.2

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

Solution

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

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

Closing Equity at closing price

= ₹ 12,000 (₹ 18,000 – ₹ 6,000) represented entirely by cash. Retained Profit = ₹ 12,000 – ₹ 14,400 = (-) ₹ 2,400

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

₹ 3,600 (₹ 6,000 – ₹ 2,400).

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

Problem.10.1

A trader commenced business on 01/01/20X1 with ₹ 12,000 represented by 6,000 units of a certain product at ₹ 2 per unit. During the year 20X1 he sold these units at ₹ 3 per unit and had withdrawn ₹ 6,000. Let us assume that the price of the product at the end of year is ₹ 2.50 per unit. In other words, the specific price index applicable to the product is 125.

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

Current cost of closing cash = ₹ 12,000 (₹ 18,000 – ₹ 6,000)

Opening equity at closing current costs = ₹ 15,000

Closing equity at closing current costs = ₹ 12,000

Retained Profit = ₹ 12,000 – ₹ 15,000 = (-) ₹ 3,000

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund of ₹ 12,000 is not sufficient to buy 6,000 units again at increased price of ₹ 2.50 per unit. The drawings should have been restricted to ₹ 3,000 (₹ 6,000 – ₹ 3,000). Had the trader withdrawn ₹ 3,000 instead of ₹ 6,000, he would have left with ₹ 15,000, the fund required to buy 6,000 units at ₹ 2.50 per unit.

You are required to compute the Capital maintenance under all three bases i.e.

- (i) Historical costs,
- (ii) Current purchasing power and
- (iii) Physical capital maintenance.

Solution

Financial Capital Maintenance at historical costs

	₹	₹
Closing capital (At historical cost)		12,000
Less: Capital to be maintained		
Opening capital (At historical cost)	12,000	
Introduction (At historical cost)	Nil	(12,000)
Retained profit		Nil

Financial Capital Maintenance at current purchasing power

	₹	₹
Closing capital (At closing price)		12,000
Less: Capital to be maintained		
Opening capital (At closing price)	14,400	
Introduction (At closing price)	<u>Nil</u>	<u>(14,400)</u>
Retained profit/(loss)		(2,400)

Physical Capital Maintenance

	₹	₹
Closing capital (At current cost) (4,800 units)		12,000
Less: Capital to be maintained		
Opening capital (At current cost) (6,000 units)	15,000	
Introduction (At current cost)	<u>Nil</u>	<u>(15,000)</u>
Loss resulting in non-maintenance of capital		(3,000)

Problem.10.2

Mohan started a business on 1st April 20X1 with ₹ 12,00,000 represented by 60,000 units of ₹ 20 each. During the financial year ending on 31st March, 20X2, he sold the entire stock for ₹ 30 each. In order to maintain the capital intact.

Calculate the maximum amount, which can be withdrawn by Mohan in the year 20X1-X2 if Financial Capital is maintained at historical cost. [T.8]

Solution

Particulars	Financial Capital Maintenance at Historical Cost (₹)
Closing equity (₹ 30 x 60,000 units)	18,00,000 represented by cash
Opening equity	60,000 units x ₹ 20 = 12,00,000
Permissible drawings to keep Capital intact	6,00,000 (18,00,000 – 12,00,000)

Problem.10.3

Explain how financial capital is maintained at historical cost?

Kishore started a business on 1st April, 2019 with ₹ 15, 00,000 represented by 75,000 units of ₹ 20 each. During the financial year ending on 31st March, 2020, he sold the entire stock for ₹ 30 each. In order to maintain the capital intact, calculate the maximum amount, which can be withdrawn by Kishore in the year 2019-20 if Financial Capital is maintained at historical cost. **[Jan. 2021, 5 Marks]**

Solution

Financial capital maintenance at historical Cost: Under this convention, opening and closing assets are stated at respective historical costs to ascertain opening and closing equity. If retained profit is greater than or equals to zero, the capital is said to be maintained at historical costs. This means the business will have enough funds to replace its assets at historical costs.

This is quite right as long as prices do not rise. Maximum amount withdrawn by Kishore in year 2019-20 if Financial capital is maintained at historical cost:

Particulars	Financial Capital Maintenance at Historical Cost (₹)
Closing equity (₹ 30 × 75,000 units)	22,50,000 represented by cash
Opening equity	75,000 units × ₹ 20 = 15,00,000
Permissible drawings to keep Capital intact	7,50,000 (22,50,000 – 15,00,000)

Thus ₹ 7,50,000 is the maximum amount that can be withdrawn by Kishore in year 2019-20 if financial capital is maintained at historical cost.

Problem.10.4

What is meant by 'Measurement'? What are the bases of measurement of Elements of Financial Statements? Explain in brief. **[Dec. 2021, 5 Marks]**

CONCEPT 11 – MCQs

1. The 'going concern' concept assumes that
 - (a) The business can continue in operational existence for the foreseeable future.
 - (b) The business cannot continue in operational existence for the foreseeable future.
 - (c) The business is continuing to be profitable.
 - (d) The business cannot continue if it is not able to earn profits.
2. Two principal qualitative characteristics of financial statements are
 - (a) Understandability and materiality
 - (b) Relevance and reliability
 - (c) Relevance and materiality
 - (d) Comparability and materiality
3. All of the following are components of financial statements except

(a) Balance sheet	(b) Statement of Profit and loss
(c) Human responsibility report	(d) Social responsibility report.

4. An accounting policy can be changed if the change is required
 - (a) By statute or accounting standard
 - (b) For more appropriate presentation of financial statements
 - (c) Both (a) and (b)
 - (d) By statute as well as accounting standards.
5. Value of equity may change due to
 - (a) Contribution from or Distribution to equity participants
 - (b) Income earned
 - (c) Expenses incurred
 - (d) All the three.
6. What are the three fundamental accounting assumptions mentioned in the framework?
 - (a) Consistency, Relevance, Understandability
 - (b) Going Concern, Accrual, Consistency
 - (c) Historical Cost, Present Value, Realisable Value
 - (d) Asset, Liability, Equity
7. The main purpose of the framework is to assist in:
 - (a) Preparing tax computations
 - (b) Developing and reviewing Accounting Standards
 - (c) Maximizing company profits
 - (d) Regulating the stock market
8. Who are considered primary users of financial statements according to the framework?
 - (a) Competitors and government agencies
 - (b) Investors and employees
 - (c) Auditors and accountants only
 - (d) General public and local communities
9. What is the importance of 'understandability' as a qualitative characteristic of financial statements?
 - (a) It ensures financial statements are complex
 - (b) It makes sure only accountants can interpret the data
 - (c) It helps in presenting information clearly to users with reasonable knowledge
 - (d) It guarantees financial statements are free from errors
10. If a company's financial statements show a consistent application. of accounting policies over years, which fundamental assumption is being adhered to?
 - (a) Accrual
 - (b) Going Concern
 - (c) Consistency
 - (d) Relevance
11. In assessing a company's ability to continue as a going concern, which element of the financial statements would be most relevant?
 - (a) Balance Sheet
 - (b) Cash Flow Statement
 - (c) Statement of Profit and Loss
 - (d) Notes to the Financial Statements
12. Analyze how the change from historical cost to current cost as a measurement basis would affect the financial statements.
 - (a) Decrease in asset values
 - (b) No impact on financial statements
 - (c) Potential increase in reported profits
 - (d) Reduction in shareholders' equity

13. Evaluate the impact of not adhering to the accrual assumption in preparing financial statements.
- (a) Financial statements would be more accurate
 - (b) It could lead to misleading financial positions
 - (c) No impact on the financial outcomes
 - (d) Improve cash flow analysis
14. Propose a method to enhance the relevance of financial statements for a company in a rapidly changing industry.
- (a) Use of more historical data
 - (b) Incorporating forward-looking information
 - (c) Reducing the number of financial statements
 - (d) Increasing the complexity of notes
15. What is the primary objective of financial statements as outlined in the framework?
- (a) To provide tax computation data
 - (b) To detail internal management strategies
 - (c) To offer information useful in making economic decisions
 - (d) To report only financial data without non-financial information
16. Which measurement basis is largely used in the preparation of financial statements, as per the framework?
- (a) Historical Cost
 - (b) Present Value
 - (c) Current Cost
 - (d) Realisable Value
17. How does the framework describe the relevance of information in financial statements?
- (a) Information that creates confusion by being too detailed
 - (b) Information likely to influence economic decisions of users
 - (c) Information that focuses solely on non-financial data
 - (d) Information only relevant to auditors and accountants
18. What role does the 'true and fair view' concept play in the framework's approach to financial statements?
- (a) It is an alternative to the qualitative characteristics
 - (b) It is directly dealt with in the framework
 - (c) It is implied by adhering to qualitative characteristics and standards
 - (d) It is unrelated to the preparation of financial statements
19. In the framework, who is considered an important user group of financial statements for their role in resource allocation?
- (a) Competitors
 - (b) Government and its agencies
 - (c) Internal management
 - (d) Media and press
20. When a company needs to determine if it has maintained its financial capital at historical cost, what should be compared?
- (a) Opening and closing liabilities
 - (b) Opening and closing assets at historical costs
 - (c) Current year profits to previous year losses
 - (d) Share capital at the beginning and end of the period
21. Applying the accrual assumption, how should a company record expenses incurred in a period but not paid until the next period?
- (a) Exclude from current period financial statements
 - (b) Record as a liability in the current period
 - (c) Add to the next period's expenses
 - (d) Record as an asset in the current period

22. Considering the framework, how would the absence of comparability in financial statements affect users' economic decisions?
- (a) Enhance the decision-making process
 - (b) No significant impact on decisions
 - (c) Make it difficult to assess financial trends and performances
 - (d) Simplify the interpretation of financial data
23. Evaluate the implications of a company not following the going concern assumption in its financial reporting.
- (a) Increased reliability of financial statements
 - (b) Misleading information about the company's future operations
 - (c) Enhanced transparency in reporting
 - (d) Improved assessment of short-term solvency
24. Create a strategy for a company to enhance the understandability of its financial statements for users without a strong background in accounting.
- (a) Use more technical accounting terms
 - (b) Provide detailed explanations of complex transactions
 - (c) Limit the financial statements to basic components
 - (d) Exclude notes and supplementary information
25. What distinguishes the 'realisable value' measurement base from the 'current cost' base in financial statement preparation?
- (a) Realisable value focuses on the future earnings potential, whereas current cost considers the current market value of assets.
 - (b) Realisable value is based on the sale price of assets, while current cost is based on the replacement cost of assets.
 - (c) Realisable value calculates the historical cost, whereas current cost calculates the discounted future value.
 - (d) Realisable value and current cost are essentially the same in terms of financial valuation.
26. Understanding the concept of 'capital maintenance', how does inflation affect the measurement of profit in financial statements?
- (a) Inflation has no impact on the measurement of profit.
 - (b) Inflation may lead to overstated profits due to increased nominal values of assets.
 - (c) Inflation results in understated profits as costs rise:
 - (d) Inflation affects profit measurement only if the historical cost basis is used.
27. Apply the framework's qualitative characteristics to a scenario where a company has switched from historical cost to fair value measurement for its assets. What are the implications for the reliability of its financial statements?
- (a) Reliability increases due to the reflection of current market conditions.
 - (b) Reliability decreases due to the subjective nature of fair value estimates.
 - (c) There is no change in reliability as both are accepted measurement bases.
 - (d) Reliability is only affected if the change is not disclosed in the financial statements.

28. Analyze the potential effects of a company's failure to disclose significant related party transactions in its financial statements.
- (a) Enhanced clarity due to reduced complexity.
 - (b) Potential misinterpretation of the financial position and performance.
 - (c) Improved comparability with other companies.
 - (d) No effect as related party transactions are not crucial for financial analysis.
29. Evaluate the impact of adhering strictly to the accrual basis of accounting in industries where cash flow is highly unpredictable.
- (a) It ensures more accurate representation of financial performance.
 - (b) It could lead to a misleading portrayal of financial health due to timing differences in revenue and cash receipts.
 - (c) It has minimal impact as long as proper disclosures are made.
 - (d) It improves the management of working capital.

ANSWERS

1 (a)	2 (b)	3 (c)	4 (c)	5 (d)	6 (b)	7 (b)	8 (b)	9 (c)	10 (c)
11 (b)	12 (c)	13 (b)	14 (b)	15 (c)	16 (a)	17 (b)	18 (c)	19 (b)	20 (b)
21 (b)	22 (c)	23 (b)	24 (b)	25 (b)	26 (b)	27 (b)	28 (b)	29 (b)	