

FRAMEWORK FOR PREPARATION & PRESENTATION OF FINANCIAL STATEMENTS

The Accounting Standards Board (ASB) of the ICAI issued framework in July, 2000 which provides the fundamental basis for development of new standards as also for review of existing standards.

PURPOSE OF FRAMEWORK

The framework sets out the concepts underlying the preparation and presentation of general purpose financial statements prepared by enterprises for external users. The main purpose of the framework is to assist:

- ❖ Enterprises in preparation of their financial statements in compliance with the accounting standards (AS) and in dealing with the topics not yet covered by any AS.
- ❖ Accounting Standard Board (ASB) in its task of development and review of AS.
- ❖ ASB in promoting harmonization of regulations, accounting standards & procedures relating to preparation & presentation of financial statements by providing basis for reducing the number of alternative accounting treatments permitted by accounting standards.
- ❖ Auditors in forming an opinion as to whether financial statements conform to the AS.
- ❖ Users in interpretation of financial statements.

STATUS & SCOPE OF THE FRAMEWORK

The framework applies to general-purpose financial statements (hereafter referred to as 'financial statements' usually prepared annually for external users, by all commercial, industrial and business enterprises, whether in public or private sector.

Nothing in the framework overrides any specific Accounting Standard. In case of conflict between an Accounting Standard and the framework, the requirements of the Accounting Standard will prevail over those of the framework.

The principal areas covered by the framework are as follows:

- ❖ Components of financial statements;
- ❖ Objectives of financial statements;
- ❖ Assumptions underlying financial statements;
- ❖ Qualitative characteristics of financial statements;
- ❖ Elements of financial statements;
- ❖ Criteria for recognition of elements in financial statements;
- ❖ Principles for measurement of financial elements;
- ❖ Concepts of Capital and Capital Maintenance.

COMPONENTS OF FINANCIAL STATEMENTS

Balance sheet	Portrays value of economics resources controlled by an enterprise.
Statement of P&L	Presents the results of operations of an enterprise.
Cash flow statement	Shows the way an enterprise generates cash and uses it.
Notes & other statements	Presents supplementary information explaining different items

OBJECTIVES & USERS 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.

<u>Investors</u>	Analysis of performance, profitability, financial position of Co.
<u>Employees</u>	Knowledge of stability, continuity, growth
<u>Suppliers, creditors</u>	Determination of credit worthiness
<u>Customers</u>	Analysis of <u>stability</u> , profitability.
<u>Government</u>	Evaluation of <u>entity's performance</u> & contribution to social objectives.
<u>Lenders</u>	Determine whether their loans and interest will be paid when due.
<u>Public</u>	Determine contribution to the local economy and public at large

FUNDAMENTAL ACCOUNTING ASSUMPTIONS

→ Same in AS 1
→ GCA

<u>Accrual</u>	Transactions are recognized as and when they occur, without considering receipt /payment of cash.
<u>Going concern</u>	Enterprise will continue in operation in foreseeable future and will not liquidate.
<u>Consistency</u>	Using same accounting policies for similar transactions in all accounting periods.

disclosure is required if not followed.

QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

Inter Nov 2020 (5 Marks)

<u>Understandability</u>	Information presented in financial statements should be readily understandable by the users with reasonable knowledge of business and economic activities.
<u>Relevance</u>	Financial statements should contain relevant information only. Information, which is likely to influence the economic decisions by the users, is called relevant.
<u>Reliability</u>	Information must be reliable; that is to say, they must be free from material error and bias.
<u>Comparability</u>	Financial statements should permit <u>both inter-firm and intra-firm</u> comparison.
<u>True and Fair view</u>	Financial statements should show a <u>true and fair</u> view of the performance, <u>financial position</u> and <u>cash flows</u> of an enterprise.

ELEMENTS OF FINANCIAL STATEMENTS

Inter May 2018 (5 Marks)

<u>Asset</u>	<u>Resource controlled by the enterprise</u> as a result of past events from which <u>future economic benefits</u> are expected to flow to the enterprise
<u>Liability*</u>	<u>Present obligation</u> of the enterprise arising from past events, the settlement of which is expected to result in an <u>outflow of a resource</u> embodying economic benefits.
<u>Equity</u>	Residual interest in assets of an enterprise after <u>deducting all its liabilities</u> .

↳ Assets - Liabilities

Asset ↑, Liab ↓

Income/gain	Increase in <u>economic benefits</u> during accounting period in form of <u>inflows</u> or <u>enhancement of assets</u> or <u>decreases in liabilities</u> that result in <u>increase in equity</u> other than those relating to <u>contributions from equity participants</u>
Expense/loss	Decrease in <u>economic benefits</u> during accounting period in form of <u>outflows</u> or <u>depletions of assets</u> or <u>incurrence of liabilities</u> that result in <u>decrease in equity</u> other than those relating to <u>distributions to equity participants</u> .

Asset ↓
Liab ↑

* Example: (RTP May 2020) / (RTP May 2023) / (RTP Nov 2023)

A Ltd. has entered into a binding agreement with P Ltd. to buy a custom-made machine ₹ 40,000. At the end of 2021-22, 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.

Advise the accounting treatment & pass the necessary journal entry.

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:

Asset ↓

Loss on change in production method A/c Dr. To P Ltd.	40,000 40,000
(Loss due to change in production method) Profit & Loss A/c Dr. To Loss on change in production method A/c	40,000 40,000
(Loss transferred to P&L Account)	

MEASUREMENT BASIS OF ELEMENTS IN FINANCIAL STATEMENTS

Inter Dec 2021 (5 Marks)

Measurement is the process of determining money value at which an element can be recognised in the balance sheet or statement of profit & loss. Framework for Preparation and Presentation of Financial statements recognizes four alternative measurement bases for the purpose of determining the value at which an element can be recognized in the balance sheet or statement of profit & loss.

Historical cost	<u>Acquisition price</u>
Current Cost (Purchase Angle)	Assets are carried out at the amount of <u>cash or cash equivalent</u> that would have to be <u>paid</u> if the <u>same</u> or an <u>equivalent asset</u> was <u>acquired currently</u> . Liabilities are carried at the <u>undiscounted amount</u> of cash or cash equivalents that would be required to settle the obligation currently.
Realisable (Settlement) Value	For <u>assets</u> , amount <u>currently realisable</u> on <u>sale of the asset</u> in an <u>orderly disposal</u> . For <u>liabilities</u> , this is the <u>undiscounted amount</u> expected to be <u>paid on settlement of liability</u> in the normal course of business.
Present Value	Assets are carried at <u>present value of future net cash flows</u> generated by the <u>concerned assets</u> in the normal course of business. Liabilities are carried at <u>present value of future net cash flows</u> that are expected to be required to settle the <u>liability</u> in the normal course of business.

Sale Angle

(Discounted value of future cash flows)

Example 1 (Historical cost)

Mr. X purchased a machine on 1st January, 2016 at ₹ 7,00,000. As per historical cost basis, he has to record it at ₹ 7,00,000 i.e. the acquisition price. As on 1.1.2021, Mr. X found that it would cost ₹ 25,00,000 to purchase that machine. Mr. X also took loan from a bank as on 2016 ₹ 5,00,000 @ 18% p.a repayable at the end of 15th year together with interest. As per historical cost the liability is recorded at ₹ 5,00,000 at the amount or proceeds received in exchange for obligation and asset is recorded at ₹ 7,00,000.

Example 2 (Current cost)

Foreign currency Transactions: AS11

A machine was acquired for \$ 10,000 on deferred payment basis. The rate of exchange on date of acquisition was ₹ 49/\$. 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. (10000×49) To settle the deferred payment on current date one must buy dollars at ₹ 49/\$. The liability is therefore recognised at ₹ 4,90,000 $(\$ 10,000 \times ₹ 49)$.

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.

Example 3 (Present Value)

Net Realisable value

Carrying amount of a machine is ₹ 40,000 (Historical cost less depreciation). The machine is expected to generate ₹ 10,000 net cash inflow. The net realisable value (or net selling price) of machine on current date is ₹ 35,000. The enterprise's required earning rate is 10% per year. The enterprise can either use the machine to earn ₹ 10,000 for 5 years. This is equivalent of receiving present value of ₹ 10,000 for 5 years at discounting rate 10% on current date. The value realised by use of the asset is called value in use. The value in use is the value of asset by present value convention.

Value in use = ₹ 10,000 $(0.909 + 0.826 + 0.751 + 0.683 + 0.621)$ = ₹ 37,900

→ Present value of future cash flows

Net selling price = ₹ 35,000

Present value Factor

The present value of the asset is ₹ 37,900, which is called its recoverable value. It is obviously not appropriate to carry any asset at a value higher than its recoverable value. Thus the asset is currently overstated by ₹ 2,100 $(₹ 40,000 - ₹ 37,900)$.

$\frac{1}{1.10} = 0.909 \quad (\frac{1}{1.10})^2 = 0.826$

Logic of PVF & its computation: Questions in AS19 & AS26

CAPITAL MAINTENANCE

Financial capital maintenance	At <u>historical cost</u>	Opening & closing assets are stated at <u>historical costs</u> .
	At <u>current purchasing power</u>	Restatement at <u>closing prices</u> using <u>average price indices</u> .
Physical capital maintenance	Restatement at <u>closing prices</u> using <u>specific price indices</u> .	

Example 1 (Financial Capital Maintenance at historical cost) *Product price will not change*

A trader commenced business on 01/01/2021 with ₹ 12,000 represented by 6,000 units of a certain product at ₹ 2 per unit. During the year 2021 he sold these units at ₹ 3 per unit and had withdrawn ₹ 6,000. Thus:

Alt-1
 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 2022 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.

$$\text{Amount Required next year} = 6000 \times 2 = 12000$$

$$\text{Maximum Drawings} = 18000 - 12000 = 6000$$

$$\text{Retained Profit} = 6000 - 6000 = \text{Nil}$$

Example 2 (Financial Capital Maintenance at current purchasing power)

In the previous example (Example 1), suppose that the average price indices at the beginning and at the end of year are 100 and 120 respectively.

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

$$\text{Opening equity at closing price} = (\text{₹ } 12,000 / 100) \times 120 = \text{₹ } 14,400 \quad (6,000 \times \text{₹ } 2.40) \quad \text{Product Price} = 2 \times \frac{120}{100} = 2.40$$

Closing Equity at closing price = ₹ 12,000 (₹ 18,000 - ₹ 6,000) represented entirely by cash.

$$\text{Retained Profit} = \text{₹ } 12,000 - \text{₹ } 14,400 = (-) \text{₹ } 2,400$$

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund ₹ 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.

$$\text{Amount Required next year} = 6000 \times 2.40 = 14400$$

$$\text{Maximum Drawings} = 18000 - 14400 = 3600$$

$$\text{Retained Profit} = 3600 - 6000 = (2400)$$

Example 3 (Physical Capital Maintenance)

In the previous example (Example 1) suppose 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) × 125 = 6,000 × ₹ 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 ₹ 12,000 is not sufficient to buy 6,000 units again at increased price ₹ 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.

$$\text{Amount Required next year} = 6000 \times 2.50 = 15000$$

$$\text{Maximum Drawings} = 18000 - 15000 = 3000$$

$$\text{Retained Profit} = 3000 - 6000 = (3000)$$

$$\begin{aligned} \text{Amount Required} &= 60000 \times 20 = 1200000 \\ \text{Amount available} &= 60000 \times 30 = 1800000 \\ \text{Max. Drawings} &= 18L - 12L = 600000 \end{aligned}$$

ASSIGNMENT QUESTIONS

Question 1 (ICAI Study Material)

Mohan started a business on 1st April 2021 with ₹ 12,00,000 represented by 60,000 units of ₹ 20 each. During the financial year ending on 31st March, 2022, he sold the entire stock for ₹ 30 each. In order to maintain the capital intact, calculate maximum amount, which can be withdrawn by Mohan in the year 2021-22 if Financial Capital is maintained at historical cost.

Solution

Particulars	₹
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)

Question 2 (ICAI Study Material)

Balance sheet of a trader on 31st March, 2021 is given below

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

Additional information:

- a) The remaining life of Property, Plant & Equipment is 5 years. The pattern of use of the asset is even. The net realisable value of Property, Plant & Equipment on 31.03.22 was ₹ 60,000.
- b) The trader's purchases & sales in 2021-22 amounted to ₹ 4 lakh and ₹ 4.5 lakh respectively.
- c) The cost and net realisable value of stock on 31.03.22 were ₹ 32,000 & ₹ 40,000 respectively.
- d) Expenses (including interest on 10% loan of 3,500) for the year amounted to ₹ 14,900.
- e) Deferred expenditure is amortised equally over 4 years.
- f) Trade Receivables on 31.03.22 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 31.03.22 is ₹ 37,100.
- i) There is an early repayment penalty for the loan ₹ 2,500.

Prepare the Profit and Loss Accounts and Balance Sheets of the trader in two cases

- (i) assuming going concern (ii) not assuming going concern

Solution

Profit and Loss Account for the year ended 31st March, 2022

	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 expenditure	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, 2022

Liabilities	Case (i)	Case (ii)	Assets	Case (i)	Case (ii)
Capital	60,000	60,000	Property, Plant & Equipment	52,000	60,000
Profit and 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 expenditure	7,500	-
			Bank	37,100	37,100
	1,51,600	1,56,100		1,51,600	1,56,100

Question 3 (Inter Jan 2025) (4 Marks)

Given below is the Balance Sheet of Sky and Associates as on 31st March, 2023:

Liabilities	₹	Assets	₹
Capital	1,60,000	Machinery	1,80,000
Profit and Loss Account	93,000	Stock	1,15,000
8% Loan	40,000	Trade Receivables	75,000
Trade Payables	66,000	Deferred Expenditure	9,000
Bank Overdraft	20,000		
	3,79,000		3,79,000

Additional Information:

- The firm is planning to shutdown its business with immediate effect from 1st April, 2024.
- The sale and purchase of the firm for the year 2023-24 amounts to ₹ 8,20,000 and ₹ 6,50,000 respectively
- The value of Closing Stock as on 31-3-2024 was ₹ 65,000. The net realizable value is estimated at 120% of cost.
- Other expenses for the period amount to ₹ 25,000
- Deferred expenditure is getting amortized over 5 years starting from 31-3-2022.
- The remaining life of Machinery is expected to be 3 years. The realizable value of Machine is expected at ₹ 1,65,000, an expense of ₹ 5,000 is to be incurred to realize the same.
- Out of trade receivables, ₹ 5,000 is expected to be unrealizable due to an ongoing dispute.
- Bank has charged a penalty of ₹ 2,500 for crossing the overdraft limit.
- The lender has agreed to forgo 50% of interest charge for the year.
- The firm is expecting a discount of ₹ 4,000 from creditors at the time of full and final settlement.

You are required to prepare a Profit and Loss A/c. for the year ended 31st March, 2024 to ascertain its Profit/Loss for the period.

Question 4 (ICAI Study Material)

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.

Bank 20000
 To Dividend 20000
 Creditors 70000
 To Bank 50000
 To Dis. Res. 20000

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

Solution

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

	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

Question 5 *Accrual & cash Basis*

Mr. Roy is engaged in Trading of Item I and II. Following Data are available from his Accounting records for Accounting period (1st April, 2021 to 31st March, 2022)

- (i) Purchased item I on cash for ₹ 60,000 in F.Y. 2021-22.
- (ii) Purchased item II on credit for ₹ 4,500 in F.Y. 2021-22.
- (iii) Sold item II for ₹ 5,000 in cash in F.Y. 2021-22.
- (iv) He also sold item I for ₹ 60,000 in cash and ₹ 15,000 on credit in F.Y. 2021-22.
- (v) Payment for Item II purchase was done on 20th April 2022 for ₹ 4,300 as full and final payment
- (vi) Paid Insurance ₹ 2,400 for one year as on 1st July, 2021
- (vii) Wages to worker is payable for the month of March, 2022 ₹ 200.

Prepare Profit & Loss A/c of trader by applying cash basis and accrual basis of accounting

Solution

Cash basis of accounting

Profit and Loss Account for the period 2021-22

Particulars	₹	Particulars	₹
To Purchase	60,000	By Sale (5000 + 60000)	65,000
To Insurance (vi)	2,400		
To Net Profit	2,600		
	65,000		65,000

Accrual basis of accounting

Profit and Loss Account for the period 2021-22

Particulars	₹	Particulars	₹
To Purchase (60000 + 4500)	64,500	By Sale (65000 + 15000)	80,000
To Wages* (prepaid)	200	By Discount Received**	200
To Insurance (2,400 - 600)*	1,800		
To Net Profit	13,700		
	80,200		80,200

*Considered that there was no payment of wages during the year. This worker was hired only in month of March.

** This discount was known and determined in the year 2021-22 (till 31st March, 2022).

Wages: Alternative
 Cash Basis : Wages = 200 x 11 = 2200
 Accrual Basis : Wages 200 x 12 = 2400

PRACTICE QUESTIONS

Question 1 *(RTP Nov 2019) / (RTP May 2021) / (RTP May 2024) (Similar)*

Aman started a business on 1st April 2021 with ₹ 24,00,000 represented by 1,20,000 units of ₹ 20 each. During the financial year ending on 31st March, 2022, he sold the entire stock for ₹ 30 each. In order to maintain the capital intact, calculate the maximum amount, which can be withdrawn by Aman in the year 2021-22 if Financial Capital is maintained at historical cost.

Solution

Particulars	₹
Closing equity (₹ 30 x 1,20,000 units)	36,00,000 represented by cash
Opening equity	1,20,000 units x ₹ 20 = 24,00,000
Permissible drawings to keep Capital intact	12,00,000 (36,00,000 - 24,00,000)

Question 2 *(Inter Jan 2021) (5 Marks)*

Explain how financial capital is maintained at historical cost?

Kishore started a business on 1st April, 2021 with ₹ 15,00,000 represented by 75,000 units of ₹ 20 each. During the financial year ending on 31st March, 2022, 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 2021-22 if Financial Capital is maintained at historical cost.

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 which can be withdrawn by Kishore in year 2021-22 if Financial capital is maintained at historical cost

Particulars	₹
Closing equity (₹ 30 x 75,000 units)	22,50,000 represented by cash
Opening equity	75,000 units x ₹ 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 2021-22 if Financial capital is maintained at historical cost.

Question 3 *(Inter July 2021) (5 Marks)*

A trader commenced business on April 1, 2020 with ₹ 120,000, represented by 6000 units of a certain product at ₹ 20 per unit. During the year 2020-21 he sold these units at ₹ 30/- per unit and had withdrawn ₹ 60,000. The price of the product at the end of financial year was ₹ 25/- per unit. Compute retained profit of the trader under the concept of physical capital maintenance at current cost. Also state, whether answer would be different if the trader had not withdrawn any amount.

Solution

Physical Capital Maintenance at Current Cost

In the given case, the specific price index applicable to the product is 125 (25/20X100).

Current cost of opening stock = (₹ 1,20,000/100) x 125 Or 6,000 units x ₹ 25	₹ 1,50,000
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Current cost of closing cash (₹ 1,80,000 – ₹ 60,000)	₹ 1,20,000
Opening equity at closing current costs	₹ 1,50,000
Closing equity at closing current costs	₹ 1,20,000
Retained Profit = ₹ 1,20,000 – ₹ 1,50,000	(-) ₹ 30,000

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund of ₹ 1,20,000 is not sufficient to buy 6,000 units again at increased price of ₹ 25 per unit. The drawings should have been restricted to ₹ 30,000 (₹ 60,000 – ₹ 30,000).

If the trader had not withdrawn any amount, then the answer would have been as below:

Current cost of opening stock	₹ 1,80,000
Opening equity at closing current costs	₹ 1,50,000
Retained Profit (₹ 1,80,000 – ₹ 1,50,000)	₹ 30,000

If the trader had not withdrawn any amount, then the retained profit would have been ₹ 30,000.

Question 4 (ICAI Study Material)

Balance Sheet of Anurag Trading Co. on 31st March, 2021 is given below:

Liabilities	Amount	Assets	Amount
Capital	50,000	Property, Plant & Equipment	69,000
Profit and Loss Account	22,000	Stock	36,000
10% Loan	43,000	Trade Receivables	10,000
Trade Payables	18,000	Deferred Expenses	15,000
		Bank	3,000
	1,33,000		1,33,000

Additional Information:

- Remaining life of Property, Plant & Equipment is 5 years with even use. The net realizable value of Property, Plant & Equipment as on 31st March, 2022 was ₹ 64,000.
 - Sales and purchases for the year 2021-22 amounted to ₹ 5 lacs and ₹ 4.50 lacs respectively.
 - The cost and net realizable value of the stock were ₹ 34,000 and ₹ 38,000 respectively.
 - General Expenses for the year 2021-22 were ₹ 16,500.
 - Deferred Expenditure is normally amortised equally over 4 years starting from F.Y. 2020-21 i.e. ₹ 5,000 per year.
 - Out of trade receivables worth ₹ 10,000, collection of ₹ 4,000 depends on successful redesign of certain product already supplied to the customer.
 - Closing trade payable is ₹ 10,000, which is likely to be settled at 95%.
 - There is pre-payment penalty of ₹ 2,000 for Bank loan outstanding.
- Prepare Profit & Loss Account for year ended 31st Mar, 2022 by assuming not a Going Concern.

Solution

Profit and Loss Account for the year ended 31st March, 2022 (not assuming going concern)

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

*Assumed that General Expenses includes interest on 10% loan amount for the year.

Question 5 *(Inter Nov 2020) (5 Marks)*

Following is the Balance Sheet of M/s. S Traders as on 31st March, 2021:

Liabilities	Amount	Assets	Amount
Capital	1,50,000	Fixed Assets	1,05,000
Profit and Loss Account	56,000	Stock	76,000
11% Bank Loan	80,000	Debtors	68,000
Trade Payables	52,000	Deferred Expenses	24,000
		Cash & Bank	65,000
	3,38,000		3,38,000

Additional Information:

- Remaining life of Fixed Assets is 6 years with even use. The net realizable value of Fixed Assets as on 31st March, 2022 is ₹ 90,000.
- Sales & Purchases for year 2021-2022 amounted to ₹ 7,80,000 & ₹ 6,25,000 respectively.
- The cost & net realizable value of the stock as on 31st March, 2022 was, ₹ 60,000 and ₹ 66,000 respectively.
- General expenses (including interest on Loan) for the year 2021-22 were ₹ 53,800.
- Deferred expenditure is normally amortised equally over 5 years starting from the Financial year 2020-21 i.e. ₹ 6,000 per year.
- Debtors on 31st March, 2022 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.
- Closing Trade payable ₹ 48,000, which is likely to be settled at 5% discount.
- There is a prepayment penalty of ₹ 4,000 for Bank loan outstanding.
- Cash & Bank balances as on 31st March, 2022 is ₹ 1,65,200.

Prepare Profit & Loss Account for the year ended 31st March, 2022 and Balance Sheet as on 31st March, 2022 assuming the firm is not a going concern

Solution**Profit and Loss Account for the year ended 31st March, 2022 (not assuming going concern)**

	Amount		Amount
To Opening Stock	76,000	By Sales	7,80,000
To Purchases	6,25,000	By Closing Stock	66,000
To General Expenses	53,800	By Trade payables	2,400
To Depreciation	15,000		
To Provision for doubtful debts	15,000		
To Deferred expenses	24,000		
To Loan penalty	4,000		
To Net Profit (b.f.)	35,600		
	8,48,400		8,48,400

Balance Sheet as at 31st March, 2022 (not assuming going concern)

Liabilities	Amount	Assets	Amount
Capital	1,50,000	Fixed Assets	90,000
Profit and Loss Account 56,000+35,600	91,600	Stock	66,000
11% Loan	84,000	Trade receivables (less provision)	50,000
Trade payables	45,600	Deferred costs	Nil
		Cash & Bank	1,65,200
	3,71,200		3,71,200

Question 6 (*Inter May 2019*) (5 Marks) / (*RTP May 2022*) / (*RTP Nov 2022*)

Summarised Balance Sheet of Cloth Trader as on 31.03.2021 is given below

Liabilities	Amount	Assets	Amount
Capital	3,00,000	Property, Plant & Equipment	360,000
Profit and Loss Account	1,25,000	Stock	1,50,000
10% Loan	2,10,000	Debtors	1,00,000
Creditors	50,000	Deferred Expenses	50,000
		Cash & Bank	25,000
	6,85,000		6,85,000

Additional Information is as follows:

- The remaining life of Property, Plant & Equipment is 8 years. The pattern of use of asset is even. The net realisable value of Property, Plant & Equipment on 31.03.2022 was 3,25,000
- Purchases and Sales in 2021-22 amounted to ₹ 22,50,000 and ₹ 27,50,000 respectively.
- Cost & net realizable value of stock on 31.03.2022 were ₹2,00,000 & ₹2,50,000 respectively.
- Expenses for the year amounted to ₹ 78,000.
- Deferred Expenses are amortized equally over 5 years.
- Sundry Debtors on 31.03.22 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;
- Closing Sundry Creditors are ₹ 75,000, likely to be settled at 10% discount.
- Cash balance as on 31.03.2022 is ₹ 4,22,000.
- There is an early repayment penalty for the loan of ₹ 25,000.

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

- Profit & Loss Account for the year 2021-22.
- Balance Sheet as on 31st March, 2022.

Solution**Profit and Loss Account for the year ended 31st March, 2022 (not assuming going concern)**

	Amount		Amount
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, 2022 (not assuming going concern)

Liabilities	Amount	Assets	Amount
Capital	3,00,000	Property, Plant & Equipment	3,25,000
Profit and Loss Account	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.

Question 7 *(Inter Dec 2021) (5 Marks)*

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:

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

You are required to prepare the statement of the effect of aforesaid each transaction on closing balance sheet in the form of Assets - Liabilities = Equity after each transaction.

Solution

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

Transactions	Assets	-	Liabilities	=	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]

Question 8 *(Inter Nov 2022) (5 Marks)*

As on 1st April, 2021 opening Balance Sheet of Mr. Mohanty is showing the aggregate value of Assets, Liabilities and Equity ₹ 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:

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

Solution

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

Transactions	Assets ₹ lakh	-	Liabilities ₹ lakh	=	Equity ₹ 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 B/R	$11.31 + 0.15 - 0.15 = 11.31$	-	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)

Question 9 (ICAI Study Material)

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

Solution

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, the focus of analysis could shift from one area of business to another thereby arriving at a totally different conclusion on the business results.

Question 10 (Inter May 2023) (5 Marks)

Pg no. _____

Mille started a business on 01.04.2022 with a capital of ₹ 15,00,000. She purchased 1,500 units of stock at ₹ 1,000 each. She sold the entire stock for ₹ 1,500 each unit till 31.03.2023.

You are required to calculate the maximum amount which can be withdrawn by Mille in order to keep her capital intact, if Financial Capital is maintained at:

- Historical Cost
- Current Purchasing Power (opening index at 100 and closing index at 125)
- Physical Capital Maintenance (Price per unit at the end of year is ₹ 1,350)

Solution

Financial Capital Maintenance at historical Costs

Sr. No.	Particulars	Computation	₹
(i)	Opening Equity <i>Amt. Required</i>	$1,500 \times 1,000$	15,00,000
(ii)	Closing Equity <i>Amt. Available</i>	$1,500 \times 1,500$	22,50,000
(iii)	Maximum Drawing	(ii)-(i)	7,50,000

Financial Capital Maintenance at current purchasing power

Sr. No.	Particulars	Computation	₹
(i)	Opening Equity <i>Amt. Required</i>	$1,500 \times 1,000 \times 125/100$	18,75,000
(ii)	Closing Equity <i>Amt. Available</i>	$1,500 \times 1,500$	22,50,000
(iii)	Maximum Drawing	(ii)-(i)	3,75,000

Financial Capital Maintenance at Physical Capital Maintenance

Sr. No.	Particulars	Computation	₹
(i)	Opening Equity <i>Amt. Required</i>	$1,500 \times 1,350$	20,25,000
(ii)	Closing Equity <i>Amt. Available</i>	$1,500 \times 1,500$	22,50,000
(iii)	Maximum Drawing	(ii)-(i)	2,25,000