PAPER – 1 : ADVANCED ACCOUNTING

Answer all questions.

Working notes should form part of the answers.

Question 1

Laurel and Hardy are partners of the firm LH & Co., from 1.4.2003. Initially both of them contributed Rs.1,00,000 each as capital. They did not contribute any capital thereafter. They maintain accounts of the firm on mercantile basis. They were sharing profits and losses in the ratio of 5:4. After the accounts for the year ended 31.3.2007 were finalized, the partners decided to share profits and losses equally with effect from 1.4.2003.

It was also discovered that in ascertaining the results in the earlier years certain adjustments, details of which are given below, had not been noted.

Year ended 31st March	2004	2005	2006	2007
	Rs.	Rs.	Rs.	Rs.
Profit as per accounts prepared and finalized	1,40,000	2,60,000	3,20,000	3,60,000
Expenses not provided for (as at 31st March)	30,000	20,000	36,000	24,000
Incomes not taken into account (as at 31st March)	18,000	15,000	12,000	21,000

The partners decided to admit Chaplin as a partner with effect from 1.4.2007. It was decided that Chaplin would be allotted 20% share in the firm and he must bring 20% of the combined capital of Laurel and Hardy.

Following is the Balance sheet of the firm as on 31.3.2007 before admission of Chaplin and before adjustment of revised profits between Laurel and Hardy.

Balance Sheet of LH & Co. as at 31.3.2007

Liabilities	Rs.	Assets	Rs.
Capital Accounts:		Plant and machinery	60,000
Laurel	2,11,500	Cash on hand	10,000
Hardy	1,51,500	Cash at bank	5,000
Sundry creditors	2,27,000	Stock in trade	3,10,000
		Sundry debtors	2,05,000
	5,90,000		5,90,000

You are required to prepare:

(i) Profit and Loss Adjustment account;

(ii) Capital accounts of the partners; and

(iii) Balance Sheet of the firm after the admission of Chaplin. (20 Marks)

Answer

(i) Profit and Loss Adjustment Account*

		Rs.			Rs.
To	Expenses not provided for (years 2004-2007)	1,10,000	By	Income not considered (for years 2004-2007)	66,000
			By	Partners' capital accounts (loss)	
				Laurel	22,000
				Hardy	22,000
		1,10,000			1,10,000

(ii) Partners' Capital Accounts

		Laurel	Hardy	Chaplin			Laurel	Hardy	Chaplin
		Rs.	Rs.	Rs.			Rs.	Rs.	Rs.
To	P & L Adjustment A/c	22,000	22,000	-	By	Balance b/d	2,11,500	1,51,500	-
To	Hardy	60,000			By	Laurel	-	60,000	-
To	Balance c/d	1,29,500	1,89,500	63,800	By	Cash	-	-	63,800
		2,11,500	2,11,500	63,800			2,11,500	2,11,500	63,800
					By	Balance b/d	1,29,500	1,89,500	63,800

(iii) Balance Sheet of LH & Co.
as on 1.4.2007
(After admission of Chaplin)

Liabilities	Rs.	Assets	Rs.
Capital accounts:		Plant and machinery	60,000
Laurel	1,29,500	Sundry debtors	2,05,000
Hardy	1,89,500	Stock in trade	3,10,000
Chaplin	63,800	Accrued income	66,000
Sundry creditors	2,27,000	Cash on hand (10,000 + 63,800)	73,800
Outstanding expenses	1,10,000	Cash at bank	5,000
	7,19,800		7,19,800

* It is assumed that expenses and incomes not taken into account in earlier years were fully ignored.

Working Notes:

1. Computation of Profit and Loss distributed among partners

		Rs.
Profit for the year ended	31.3.2004	1,40,000
	31.3.2005	2,60,000
	31.3.2006	3,20,000
	31.3.2007	3,60,000
Total Profit		10,80,000

	Laurel	Hardy	Total
	Rs.	Rs.	Rs.
Profit shared in old ratio i.e 5:4	6,00,000	4,80,000	10,80,000
Profit to be shared as per new ratio i.e. 1:1	5,40,000	5,40,000	10,80,000
Excess share	60,000		
Deficit share		(60,000)	

Laurel to be debited by Rs.60,000 and Hardy to be credited by Rs.60,000.

2. Capital brought in by Chaplin

	Rs.
Capital to be brought in by Chaplin must be equal to 20% of the combined capital of Laurel and Hardy	
Capital of Laurel (2,11,500 – 22,000 – 60,000)	1,29,500
Capital of Hardy (1,51,500 – 22,000 + 60,000)	1,89,500
Combined Capital	3,19,000
20% of the combined capital brought in by Chaplin (20% of Rs. 3,19,000)	63,800

Question 2

P and Q have been carrying on same business independently. Due to competition in the market, they decided to amalgamate and form a new company called PQ Ltd.

Following is the Balance Sheet of P and Q as at 31.3.2007:

Liabilities	P	Q	Assets	P	Q
	Rs.	Rs.		Rs.	Rs.
Capital	7,75,000	8,55,000	Plant & machinery	4,85,000	6,14,000
Current liabilities	6,23,500	5,57,600	Building	7,50,000	6,40,000
			Current assets	1,63,500	1,58,600
	13,98,500	14,12,600		13,98,500	14,12,600

Following are the additional information:

(i) The authorised capital of the new company will be Rs.25,00,000 divided into 1,00,000 equity shares of Rs.25 each.

(ii) Liabilities of P includes Rs.50,000 due to Q for the purchases made. Q made a profit of 20% on sale to P.

(iii) P has goods purchased from Q, cost to him Rs.10,000. This is included in the Current asset of P as at 31st March, 2007.

(iv) The assets of P and Q are to be revalued as under:

	P	Q
	Rs.	Rs.
Plant and machinery	5,25,000	6,75,000
Building	7,75,000	6,48,000

(v) The purchase consideration is to be discharged as under:

(a) Issue 24,000 equity shares of Rs. 25 each fully paid up in the proportion of their profitability in the preceding 2 years.

(b) Profits for the preceding 2 years are given below:

	P	Q
	Rs.	Rs.
1st year	2,62,800	2,75,125
IInd year	2,12,200	2,49,875
Total	4,75,000	5,25,000

(c) Issue 12% preference shares of Rs.10 each fully paid up at par to provide income equivalent to 8% return on capital employed in the business as on 31.3.2007 after revaluation of assets of P and Q respectively.

You are required to:

(i) Compute the amount of equity and preference shares issued to P and Q.

(ii) Prepare the Balance Sheet of P & Q Ltd. immediately after amalgamation. (16 Marks)

Answer

(i) Calculation of amount of equity shares issued to P and Q

Profits of	P	Q
	Rs.	Rs.
Ist year	2,62,800	2,75,125
IInd year	2,12,200	2,49,875
Total	4,75,000	5,25,000

No. of shares to be issued = 24,000 equity shares in the proportion of the preceding 2 years' profitability

24000 x 475/1000	11,400 equity shares	
24000 x 525/1000		12,600 equity shares

Calculation of amount of 12% Preference shares issued to P and Q

	P	Q
	Rs.	Rs.
Capital employed (Refer working note 1)	8,40,000	9,24,000
8% return on capital employed	67,200	73,920
12% Preference shares to be issued $\left[67{,}200 \times \frac{100}{12}\right]$	Rs. 5,60,000	
$\left[73{,}920 \times \frac{100}{12}\right]$		Rs. 6,16,000

Total Purchase Consideration

	P	Q
	Rs.	Rs.
Equity Shares	2,85,000	3,15,000
12% Preference shares	5,60,000	6,16,000
Total	8,45,000	9,31,000

(ii) Balance Sheet of PQ Ltd. (after amalgamation)

Liabilities	Rs.	Assets	Rs.
Authorised share capital:		Fixed assets:	
1,00,000 Equity Share of Rs.25 each	25,00,000	Goodwill (W.N.1)	14,000
Issued and subscribed share capital:		Plant and Machinery	12,00,000
24,000 Equity Shares of Rs.25 each	6,00,000	Building	14,23,000
1,17,600 12% Preference shares of Rs.10 each	11,76,000	Current Assets (W.N.2)	2,70,100
(All of the equity and preference shares have been issued for consideration other than cash)			
Current Liabilities (W.N. 3)	11,31,100		
	29,07,100		29,07,100

Working Notes:

1. Goodwill

	P	Q
	Rs.	Rs.
Plant and machinery	5,25,000	6,75,000
Building	7,75,000	6,48,000
Current assets	1,63,500	1,58,600
	14,63,500	14,81,600
Less: Current liabilities	6,23,500	5,57,600
Net assets taken (capital employed)	8,40,000	9,24,000
Less: Purchase consideration	8,45,000	9,31,000
Goodwill	5,000	7,000
Total purchased goodwill		12,000
Add: Unrealised profit of Rs.10,000 @ 20% = Rs.2,000 is adjusted from current assets and from goodwill (since P & L A/c is not given)		2,000
Total Goodwill		14,000

2. Current Assets

	P	Q
	Rs.	Rs.
Balances before amalgamation	1,63,500	1,58,600
Less: Liabilities of P due to Q	-	50,000
Less: Unrealised Profit on stock i.e.Rs.10,000 x 20%	2,000	
Total	1,61,500	1,08,600
Grand Total		2,70,100

3. Current Liabilities

	P	Q
	Rs.	Rs.
Balances before amalgamation	6,23,500	5,57,600
Less: Liabilities of P due to Q	50,000	-
Total	5,73,500	5,57,600
Grand Total		11,31,100

Question 3

(a) S Ltd. has a Hire-purchase department. Goods are sold on hire-purchase at cost plus 60%.

From the following particulars draft Hire-purchase trading account and compute profit or loss for the year ended 31st March, 2007:

	Rs.
Goods with customers on 1.4.2006 (instalments are not due)	3,20,000
Instalments due on 1.4.2006 (customers are paying)	20,000
Goods sold on hire-purchase during the year (i.e., from 1.4.2006 to 31.3.2007)	16,00,000
Cash received from customers	11,20,000
Goods re-possessed from customers valued at 40%	16,000
Unpaid instalments in respect of re-possessed goods	40,000
Goods with customers as on 31.3.2007 (at hire-purchase price)	7,20,000

(b) On 2.6.2007 the stock of Mr. Black was destroyed by fire. However, following particulars were furnished from the records saved:

	Rs.
Stock at cost on 1.4.2006	1,35,000
Stock at 90% of cost on 31.3.2007	1,62,000
Purchases for the year ended 31.3.2007	6,45,000
Sales for the year ended 31.3.2007	9,00,000
Purchases from 1.4.2007 to 2.6.2007	2,25,000
Sales from 1.4.2007 to 2.6.2007	4,80,000

Sales upto 2.6.2007 includes Rs.75,000 being the goods not dispatched to the customers. The sales invoice price is Rs.75,000.

Purchases upto 2.6.2007 includes a machinery acquired for Rs.15,000.

Purchases upto 2.6.2007 does not include goods worth Rs.30,000 received from suppliers, as invoice not received upto the date of fire. These goods have remained in the godown at the time of fire.

Value of stock salvaged from fire Rs.22,500 and this has been handed over to the insurance company.

The insurance policy is for Rs.1,20,000 and it is subject to average clause. Ascertain the amount of claim for loss of stock. (8+8 = 16 Marks)

Answer

(a)

In the books of S Ltd.
Hire Purchase Trading Account
for the year ended on 31st March, 2007

		Rs.			Rs.
To	Hire Purchase Stock	3,20,000	By	Hire Purchase Stock Reserve (W.N.1)	1,20,000
To	Instalments due	20,000	By	Bank A/c (Cash received)	11,20,000
To	Goods sold on Hire Purchase	16,00,000	By	Goods Repossessed A/c	16,000
To	Hire Purchase Stock Reserve (W.N.3)	2,70,000	By	Goods sold on hire purchase (loading) (W.N.2)	6,00,000
To	Profit and Loss A/c (balancing figure)	4,26,000	By	Hire purchase stock	7,20,000
			By	Instalments due (W.N.4)	60,000
		26,36,000			26,36,000

Working Notes:

			Rs.
1.	Opening H.P. Stock reserve	$3,20,000 \times \frac{60}{160}$	1,20,000
2.	Loading on goods sold on H.P.	$16,00,000 \times \frac{60}{160}$	6,00,000
3.	Closing H.P. Stock reserve	$7,20,000 \times \frac{60}{160}$	2,70,000

4. Calculation of Instalments due at the end of the year

Opening H.P. Stock + Opening Instalments due + H.P. Sales during the year (i.e., 3,20,000 + 20,000 + 16,00,000)			19,40,000
Less:	Cash received from customers	11,20,000	
	Instalments unpaid for repossessed goods	40,000	
	Closing balance of H.P. Stock	7,20,000	18,80,000
Closing Instalments Due			60,000

(b)

In the books of Mr. Black
Trading Account for the year ended 31.3.2007

		Rs.			Rs.
To	Opening Stock	1,35,000	By	Sales	9,00,000
To	Purchases	6,45,000	By	Closing Stock at cost $\left(1,62,000 \times \frac{100}{90}\right)$	1,80,000
To	Gross Profit	3,00,000			
		10,80,000			10,80,000

Memorandum Trading A/c
for the period from 1.4.2007 to 02.06.2007

To	Opening Stock at cost		1,80,000	By	Sales	4,80,000	
To	Purchases	2,25,000			Less: Goods not dispatched	75,000	4,05,000
	Add: Goods received but invoice not received	30,000		By	Closing stock (Balancing figure)		1,50,000
		2,55,000					
	Less: Machinery	15,000	2,40,000				
To	Gross Profit (Refer working note)		1,35,000				
			5,55,000				5,55,000

Calculation of Insurance Claim

Claim subject to average clause = Actual loss of stock x Amount of Policy / Value of stock on the date of fire

$$= 1,50,000^{*} \times \left(\frac{1,20,000}{1,50,000}\right) = \text{Rs.}1,20,000$$

Working Note:

$$\text{G.P. ratio} = \frac{3,00,000}{9,00,000} \times 100 = 33\frac{1}{3}\%$$

$$\text{Amount of Gross Profit} = \text{Rs. } 4,05,000 \times 33\frac{1}{3}\% = \text{Rs.}1,35,000$$

* Salvaged stock amounting Rs.22,500 handed over to the insurance company is also a loss to Mr. Black.

Question 4

Mr. Y keeps his books under single entry system. On 31st March, 2006 his Balance Sheet was as follows:

Liabilities	Rs.	Assets	Rs.
Capital of Mr. Y	4,50,000	Fixed assets	2,25,000
Creditors	8,70,000	Stock	9,15,000
Bills payable	1,87,500	Debtors	2,22,000
Expenses outstanding	67,500	Bills receivable	90,000
		Prepaid insurance	3,000
		Cash / Bank balance	1,20,000
	15,75,000		15,75,000

(i) Following are the summary of cash and bank transactions for the year ended 31st March, 2007:

	Rs.
Cash sales	1,10,70,000
Collection from debtors	22,65,000
Payments to creditors	1,12,60,500
Paid for bills payable	12,22,500
Sundry expenses paid	9,31,050
Drawings for domestic expenses by Mr. Y	3,60,000
Cash and bank balance as on 31.3.2007	1,90,950

(ii) Following further details are furnished:

Gross profit on sales @ 10%	
Bills receivable from debtors during the year	6,52,500
Discount allowed to debtors	54,000
Discount received from creditors	42,000
Bills receivable endorsed to creditors	22,500
Annual fire insurance premium paid (This is paid on 1st August every year)	9,000
Depreciate fixed assets @ 10%	

(iii) Balances as on 31.3.2007 are given below:

	Rs.
Stock in hand	9,75,000
Debtors	2,28,000
Bills receivable	2,10,000

Bills payable	2,10,000
Outstanding expenses	7,500

Prepare Trading, Profit and Loss Account for the year ended 31st March, 2007 and Balance Sheet on that date. (16 Marks)

Answer

Trading and Profit and Loss Account of Mr. Y for the year 31.3.2007

		Rs.				Rs.
To	Opening stock	9,15,000	By	Sales: Cash	1,10,70,000	
To	Purchases (W.N.5)	1,27,02,750		Credit (W.N.2)	29,77,500	1,40,47,500
To	Gross profit	14,04,750	By	Closing stock		9,75,000
		1,50,22,500				1,50,22,500
To	Expenses (W.N.6)	8,71,050	By	Gross profit		14,04,750
To	Discount allowed	54,000	By	Discount received		42,000
To	Depreciation	22,500				
To	Net profit	4,99,200				
		14,46,750				14,46,750

Balance Sheet of Mr. Y
as on 31st March, 2007

Liabilities		Rs.	Assets		Rs.
Capital	4,50,000		Fixed assets	2,25,000	
Add: Net profit	4,99,200		Less: Depreciation	22,500	2,02,500
	9,49,200		Stock		9,75,000
Less: Drawings	3,60,000	5,89,200	Debtors		2,28,000
Bills payable		2,10,000	Bills receivable		2,10,000
Creditors		10,02,750	Prepaid insurance		3,000
Outstanding expenses		7,500	Cash on hand/bank		1,90,950
		18,09,450			18,09,450

Working Notes:

1. Bills Receivable Account

To	Balance b/f	90,000	By	Cash (Balancing figure)	5,10,000
To	Debtors	6,52,500	By	Creditors (Bills endorsed)	22,500
			By	Balance c/f	2,10,000
		7,42,500			7,42,500

2. Debtors Account

		Rs.			Rs.
To	Balance b/f	2,22,000	By	Cash/Bank	22,65,000
To	Credit Sales (Balancing figure)	29,77,500	By	Discount allowed	54,000
			By	Bills receivable	6,52,500
			By	Balance c/f	2,28,000
		31,99,500			31,99,500

3. Bills Payable Account

To	Bank	12,22,500	By	Balance b/f	1,87,500
To	Balance c/f	2,10,000	By	Creditor (Balancing figure)	12,45,000
		14,32,500			14,32,500

4. Creditors Account

To	Cash/Bank	1,12,60,500	By	Balance b/f	8,70,000
To	Discount	42,000	By	Purchases	1,27,02,750
To	B/R endorsed	22,500			
To	B/P	12,45,000			
To	Balance c/f (Balancing figure)	10,02,750			
		1,35,72,750			1,35,72,750

5. Stock Account

To	Balance b/f	9,15,000	By	Cost of goods sold (Rs.1,40,47,500 x 90%)	1,26,42,750
To	Purchases (Balancing figure)	1,27,02,750	By	Balance c/d	9,75,000
		1,36,17,750			1,36,17,750

6. Expenses for the year ended 31st March, 2007

	Rs.
Expenses paid during the year	9,31,050
Add: Outstanding expenses as on 31.3.2007	7,500
	9,38,550
Less: Outstanding expenses as on 1.4.2006	67,500

	8,71,050
Add: Prepaid Insurance as on 1.4.2006	3,000
	8,74,050
Less: Prepaid Insurance as on 31.3.2007 (9,000 x 4/12)	3,000
Expenses shown in the profit and loss account for the year ended 31.3.2007	8,71,050

Question 5

Answer any eight out of the following:

(i) In X Co. Ltd., theft of cash of Rs.5 lakhs by the cashier in January, 2007 was detected only in May, 2007. The accounts of the company were not yet approved by the Board of Directors of the company.

Whether the theft of cash has to be adjusted in the accounts of the company for the year ended 31.3.2007. Decide.

(ii) A machinery costing Rs.10 lakhs has useful life of 5 years. After the end of 5 years, its scrap value would be Rs.1 lakh. How much depreciation is to be charged in the books of the company as per Accounting Standard-6?

(iii) In X Bank Ltd., the doubtful assets (more than 3 years) as on 31.3.2007 is Rs.1,000 lakhs. The value of security (including DICGC 100% cover of Rs.100 lakhs) is ascertained at Rs.500 lakhs. How much provision must be made in the books of the Bank towards doubtful assets?

(iv) A and B are equal partners. They admit C and D as partners with 1/5 and 1/6 share respectively. What is the profit sharing ratio of all the partners?

(v) A promissory note executed by Mr. X is due on 12.8.2007. What is the maturity date of the promissory note including grace days?

(vi) X, Y and Z are partners. X became insolvent on 15.4.2007. The Capital account balance of partner Y is on the debit side. Partner Y is solvent. Should partner Y bear the loss arising on account of the insolvency of partner X?

(vii) Alphs & Co., having head office in Mumbai has a branch in Nagpur. The branch at Nagpur is an independent branch maintaining separate books of account. On 31.3.2007, it was found that the goods dispatched by head office for Rs.2,00,000 was received by the branch only to the extent of Rs.1,50,000. The balance goods are in transit. What is the accounting entry to be passed by the branch for recording the goods in transit, in its books?

(viii) Garden Ltd. acquired fixed assets viz. plant and machinery for Rs.20 lakhs. During the same year it sold its furniture and fixtures for Rs.5 lakhs. Can the company disclose, net cash outflow towards purchase of fixed assets in the cash flow statement as per AS-3?

(ix) ABC Ltd. gave 50,000 equity shares of Rs.10 each (fully paid up) in consideration for supply of certain machinery by X & Co. The shares exchanged for machinery are quoted on Bombay Stock Exchange (BSE) at Rs.15 per share, at the time of transaction. In the

absence of fair market value of the machinery acquired, how the value of machinery would be recorded in the books of the company?

(x) A company took a construction contract for Rs.100 lakhs in January, 2006. It was found that 80% of the contract was completed at a cost of Rs.92 lakhs on the closing date i.e. on 31.3.2007. The company estimates further expenditure of Rs.23 lakhs for completing the contract. The expected loss would be Rs.15 lakhs. Can the company recognise the loss in the financial statements prepared for the year ended 31.3.2007?

(8x2 = 16 Marks)

Answer

(i) As per paragraph 13 of AS 4 (revised) 'Contingencies and Events occurring after the Balance Sheet Date', an event occurring after the balance sheet date may require adjustment to the reported values of assets, liabilities, expenses or incomes.

If a fraud of the accounting period is detected after the balance sheet date but before approval of the financial statements, it is necessary to recognize the loss amounting Rs. 5,00,000 and adjust the accounts of the company for the year ended 31st March, 2007.

(ii) As per paragraph 20 of AS 6 'Depreciation Accounting', the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset. In the given case, the depreciation amount can be calculated as follows:

	Rs.
Cost of machinery	10,00,000
Less: Scrap value at the end of useful life	1,00,000
Amount to be written off during useful life of machinery	9,00,000
Useful life of the asset	5 years
Depreciation to be provided each year (Rs.9,00,000 / 5 years)	Rs.1,80,000

(iii)

	(Rs. in lakhs)
Doubtful Assets (more than 3 years)	1,000
Less: Value of security (excluding DICGC cover)	400
	600
Less: DICGC cover	100
Unsecured portion	500
Provision:	
for unsecured portion @100%	500 lakhs
for secured portion @ 100% w.e.f 31.3.2007	400 lakhs
Total provision to be made	900 lakhs

(iv) Let total profits or losses of the firm be 1

Shares of C and D is $\frac{1}{5}$ and $\frac{1}{6}$ respectively.

Balance remaining: $1 - (\frac{1}{5} + \frac{1}{6}) = 1 - \frac{11}{30} = \frac{19}{30}$

$\frac{19}{30}$ to be shared equally by A and B as $\frac{9.5}{30} : \frac{9.5}{30}$

New profit sharing ratio will be A: B: C: D

$$\left[\frac{9.5}{30} \times \frac{2}{2}\right] : \left[\frac{9.5}{30} \times \frac{2}{2}\right] : \left[\frac{1}{5} \times \frac{12}{12}\right] : \left[\frac{1}{6} \times \frac{10}{10}\right]$$

Thus new profit sharing ratio of all the partners will be 19:19:12:10.

(v) Where the promissory note is due (including grace days) on public holiday, the preceding day shall be the due date. Hence, the due date is 14.8.2007.

(vi) If some partner is having debit balance in his capital account and is not insolvent, then he cannot be called upon to bear the loss on account of the insolvency of the other partner.

Hence, Y need not bear the loss due to insolvency of partner X.

(vii) Nagpur branch must include the inventory in its books as goods in transit.

The following journal entry must be made by the branch:

Goods in transit A/c	Dr.	50,000	
To Head office A/c			50,000

[Being Goods sent by Head office is still in transit on the closing date].

(viii) According to Para 21 of AS 3 (Revised) 'Cash Flow Statements', 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 in paragraphs 22 and 24 are reported on a net basis. Acquisition and disposal of fixed assets is not prescribed in para 22 and 24 of the standard.

Hence, the company cannot disclose net cash flow in respect of acquisition of plant and machinery and disposal of furnitures and fixtures.

(ix) As per paragraph 22 of AS 10 'Accounting for Fixed Assets' , fixed asset acquired in exchange for shares or other securities in the enterprise should be recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident. Since, the market value of the shares exchanged for the asset is more clearly evident, the company should record the value of machinery at Rs.7,50,000. (i.e., 50,000 shares × Rs.15 per share being the market price)

(x) As per paragraphs 31 and 35 of AS 7 on Construction Contracts, an expected loss on the construction contract should be recognized as an expense immediately irrespective of (i) whether or not the work has commenced on the contract; or (ii) the stage of completion of the contract; or (iii) the amount of profits expected to arise in other contracts.

Hence, the company must recognize the loss immediately.

Question 6

Answer any four out of the following:

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

(b) What are the advantages and disadvantages of ERP package?

(c) How Government grant relating to specific fixed asset is treated in the books as per AS-12?

(d) Explain the accounting treatment of donation received for specific purpose in the case of charitable society.

(e) What is meant by 'Cash' and 'Cash equivalents' as per AS-3?

(f) When can a company change its accounting policy? (4x4 = 16 Marks)

Answer

(a) 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.

(b) Larger organisations often go for an ERP package where finance comes as a module. An ERP is an integrated software package that manages the business process across the entire enterprise.

Advantages of using an ERP

The advantages of using an ERP for maintaining accounts are as follows:

1. Standardised processes and procedures : An ERP is a generalised package which covers most of the common functionalities of any specific module.

2. Standardised reporting : Majority of the desired reports are available in an ERP package. These reports are standardised across industry and are generally acceptable to the users.

3. Duplication of data entry is avoided as it is an integrated package.

4. Greater information is available through the package.

Disadvantages of an ERP

The disadvantages of an ERP are the following:

1. Lesser flexibility : The user may have to modify their business procedure at times to be able to effectively use the ERP.

2. Implementation hurdles : Many of the consultants doing the implementation of the ERP may not be able to fully appreciate the business procedure to be able to do a good implementation of an ERP.

3. Very expensive : ERP are normally priced at an amount which is often beyond the reach of small and medium sized organisation. However, there are some ERP

coming into the market which are moderately priced and may be useful to the small businesses.

4. Complexity of the software : Generally an ERP package has large number of options to choose from. Further the parameter settings and configuration makes it a little complex for the common users.

(c) In accordance with AS 12, government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the balance sheet at a nominal value. Alternatively, government grants related to depreciable fixed assets may be treated as deferred income which should be recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to profit and loss account.

(d) Donations may have been raised either for meeting some revenue or capital expenditure; those intended for the first mentioned purpose are credited directly to the Income and Expenditure Account but others, if the donors have declared their specific intention, are credited to special fund account and in the absence thereof, to the Capital Fund Account. If any investments are purchased out of a special fund or an asset is acquired therefrom, these are disclosed separately. Any income received from such investments or any donations collected for a special purpose are credited to an account indicating the purpose and correspondingly the expenditure incurred in carrying out the purpose of the fund is debited to this account. On no account any such expense is charged to the Income and Expenditure Account. The term "Fund" is strictly applicable to the amounts collected for a special purpose when these are invested, e.g. Scholarship Fund, Prize Fund etc. In other cases, when the amounts collected are not invested in securities or assets distinguishable from those belonging to the institution, the word "Account" is more appropriate e.g. Building Account, Tournament Account etc.

(e) As per AS 3 'Cash Flow Statements', the term 'Cash' and 'Cash equivalents' mean the following:

Cash: It includes cash on hand and demand deposits with banks.

Cash Equivalents: It means short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to 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.

(f) 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.