

PAPER – 1: FINANCIAL REPORTING

Question No. 1 is compulsory.

Attempt any five questions from the remaining six questions.

Working notes should form part of the answer.

Wherever necessary, suitable assumption(s) may be made by the candidates.

Question 1

- (a) The fair value of plan assets of Anupam Ltd. was ₹ 2,00,000 in respect of employee benefit pension plan as on 1st April, 2009. On 30th September, 2009 the plan paid out benefits of ₹ 25,000 and received inward contributions of ₹ 55,000. On 31st March, 2010 the fair value of plan assets was ₹ 3,00,000. On 1st April, 2009 the company made the following estimates, based on its market studies and prevailing prices.

	%
Interest and dividend income (after tax) payable by fund	10.25
Realized gains on plan assets (after tax)	3.00
Fund administrative costs	(3.00)
Expected rate of return	<u>10.25</u>

Calculate the expected and actual returns on plan assets as on 31st March, 2010, as per AS 15.

- (b) Certain callable convertible debentures are issued at ₹ 60. The value of similar debentures without call or equity conversion option is ₹ 57. The value of call as determined using Black and Scholes model for option pricing is ₹ 2. Determine values of liability and equity component.
- (c) HSL Ltd., is manufacturing goods for local sale and exports. As on 31st March, 2010, it has the following finished stock in the factory warehouse:
- (i) Goods meant for local sales ₹ 100 lakhs (cost ₹ 75 lakhs)
 - (ii) Goods meant for exports ₹ 50 lakhs (cost ₹ 20 lakhs)

Excise duty is payable at the rate of 12%. The company's Managing Director says that excise duty is payable only on clearance of goods and hence not a cost. Please advise HSL using guidance note, if any issued on this, including valuation of stock.

- (d) Rama Ltd, has provided the following information:

Depreciation as per accounting records	= ₹ 2,00,000
Depreciation as per income tax records	= ₹ 5,00,000
Unamortized preliminary expenses as per tax record	= ₹ 30,000

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There is adequate evidence of future profit sufficiency. How much deferred tax asset/liability should be recognized as transition adjustment ? Tax rate 50%.

(4 x 5 = 20 Marks)

Answer

(a) Computation of Expected Returns on Plan Assets as on 31st March, 2010, as per AS 15

	₹
Return on opening value of plan assets of ₹ 2,00,000 (held for the year) @ 10.25%	20,500
Add: Return on net gain of ₹ 30,000 (i.e. ₹ 55,000 – ₹ 25,000) during the year i.e. held for six months @ 5% (equivalent to 10.25% annually, compounded every six months)	1,500
Expected return on plan assets as on 31 st March, 2010	22,000

Computation of Actual Returns on Plan Assets as on 31st March, 2010, as per AS 15

	₹	₹
Fair value of Plan Assets as on 31 st March, 2010		3,00,000
Less: Fair value of Plan Assets as on 1 st April, 2009	2,00,000	
Add: Contribution received as on 30 th September, 2009	55,000	(2,55,000)
		45,000
Add: Benefits paid as on 30 th September, 2009		25,000
Actual returns on Plan Assets as on 31 st March, 2010		70,000

(b) A callable convertible debenture is one that gives the issuer a right to buy a convertible debenture from the debentureholder at a specified price. This feature in effect is a call option written by the debentureholder. The value of call (i.e. option premium) is payable by the issuer.

Liability component of non-convertible debentures (disregarding the call value) = ₹ 57

Less: Value of call payable by the issuer = ₹ 2

Net liability component of non-convertible debentures = ₹ 55

Equity component in callable convertible debentures = ₹ 60 – ₹ 55 = ₹ 5

(c) According to Central Excise Rules, 2002, excise duty is levied upon the manufacture or production of goods. However, it is collected only at the time of removal of goods from factory premises or factory warehouse.

Guidance Note on 'Accounting Treatment for Excise Duty' says that excise duty is a duty on manufacture or production of excisable goods in India.

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As explained in the Guidance Note, the liability for excise duty arises at the point of time at which the manufacture is completed. The excise duty paid or provided on finished goods should, therefore, be included in inventory valuation.

Further, the Guidance Note states that excise duty should be considered as a manufacturing expense and like other manufacturing expenses are considered as an element of cost for the purpose of inventory valuation, excise duty should also be considered as an element of cost while valuing the inventory.

Therefore, in the given case of HSL Ltd., the Managing Director's contention that "excise duty is payable only on clearance of goods and hence is not a cost" is incorrect. Excise duty on the goods meant for local sales should be provided for at the rate of 12% on the selling price, that is on ₹ 100 lakhs for valuation of stock.

Excise duty on goods meant for exports, should also be provided for, since the liability for excise duty arises when the manufacture of the goods is completed. However, if it is assumed that all the conditions specified in Rule 19 of the Central Excise Rules, 2002 regarding export of excisable goods without payment of duty are fulfilled by HSL Ltd. excise duty may not be provided for.

(d) Table showing calculation of Deferred tax asset / liability

Particulars	Amount	Timing differences	Deferred tax	Amount @ 50%
	₹			₹
Excess depreciation as per tax records (5,00,000 – 2,00,000)	3,00,000	Timing	Deferred tax liability	1,50,000
Unamortised preliminary expenses as per tax records	30,000	Timing	Deferred tax asset	(15,000)
Net deferred tax liability				<u>1,35,000</u>

Question 2

The Balance Sheets of three companies Sun Ltd., Moon Ltd. and Light Ltd. as at 31st March, 2010 are given below:

Liabilities	Sun Ltd.	Moon Ltd.	Light Ltd.	Assets	Sun Ltd.	Moon Ltd.	Light Ltd.
	₹	₹	₹		₹	₹	₹
Share Capital (Shares of ₹ 10 each)	1,50,000	1,00,000	60,000	Fixed Assets	70,000	1,20,000	1,03,000
Reserves	50,000	40,000	30,000	Investments (at cost)			
Profit and Loss A/c	60,000	50,000	40,000	Shares in: Moon Ltd.	90,000	-	-

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Sundry creditors	30,000	35,000	25,000	Light Ltd.	40,000	-	-
				Light Ltd.	-	50,000	-
Sun Ltd.	-	10,000	8,000	Stock-in-trade	40,000	30,000	20,000
				Debtors	20,000	25,000	30,000
				Due from--			
				Moon Ltd.	12,000		
				Light Ltd.	8,000		
				Cash in hand	10,000	10,000	10,000
	2,90,000	2,35,000	1,63,000		2,90,000	2,35,000	1,63,000

- (a) Sun Ltd. held 8,000 shares of Moon Ltd. and 1,800 shares of Light Ltd.
(b) Moon Ltd. held 3,600 shares of Light Ltd.
(c) All investments were made on 1st July, 2009.
(d) The following balances were there on 1st July, 2009:

	Moon Ltd. ₹	Light Ltd. ₹
Reserves	25,000	15,000
Profits and Loss A/c	20,000	25,000

- (e) Moon Ltd. invoiced goods to Sun Ltd. for ₹ 4,000 at a cost plus 25% in December, 2009. The closing stock of Sun Ltd. includes such goods valued at ₹ 5,000.
(f) Light Ltd. sold to Moon Ltd. an equipment costing ₹ 24,000 at a profit of 25% on selling price on 1st January, 2010. Depreciation at 10% per annum was provided by Moon Ltd. on the equipment.
(g) Sun Ltd. proposes dividend at 10%.

Prepare the Consolidated Balance Sheet of the group as at 31st March, 2010. Working should form part of the answer. (16 Marks)

Answer 2

Consolidated Balance Sheet of Sun Ltd. and its subsidiaries Moon Ltd. and Light Ltd.
as at 31st March, 2010

Liabilities		₹	Assets			₹
Share Capital		1,50,000	Fixed Assets			
Minority Interest			Sun Ltd.		70,000	
Moon Ltd. (W.N.4)	41,400		Moon Ltd.	1,20,000		

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Light Ltd. (W.N.4)	<u>12,220</u>	53,620	Less: Unrealised			
Capital Reserve (W.N.3)		26,000	Profit (W.N.5)	<u>7,800</u>	1,12,200	
Other Reserves (W.N.7)		73,700	Light Ltd. Stock		<u>1,03,000</u>	2,85,200
Profit and Loss Account (W.N.6)		72,880	Sun Ltd.	40,000		
Creditors Sun Ltd.	30,000		Less: Unrealised Profit	<u>1,000</u>	39,000	
Moon Ltd.	35,000		Moon Ltd.		30,000	
Light Ltd.	<u>25,000</u>	90,000	Light Ltd.		<u>20,000</u>	89,000
Proposed Dividend		15,000	Debtors			
			Sun Ltd.		20,000	
			Moon Ltd.		25,000	
			Light Ltd.		<u>30,000</u>	75,000
			Cash in hand			
			Sun Ltd.		10,000	
			Moon Ltd.		10,000	
			Light Ltd.		<u>10,000</u>	30,000
			Cash in transit (W.N.8)			<u>2,000</u>
		<u>4,81,200</u>				<u>4,81,200</u>

Working Notes:

1. Analysis of Profits of Light Ltd.

	Pre-acquisition	Post acquisition	
	Capital Profit	Revenue Reserves	Revenue Profits
	₹	₹	₹
Reserves on 1.7.2009	15,000	-	-
Profit and Loss A/c on 1.7.2009	25,000	-	-
Increase in Reserves	-	15,000	-
Increase in Profit	-	-	15,000
	40,000	15,000	15,000
Less: Minority Interest (10%)	(4,000)	(1,500)	(1,500)

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	36,000	13,500	13,500
Share of Sun Ltd.	12,000	4,500	4,500
Share of Moon Ltd.	24,000	9,000	9,000

2. Analysis of Profits of Moon Ltd.*

	Pre-acquisition	Post acquisition	
	Capital Profit	Revenue Reserves	Revenue Profits
	₹	₹	₹
Reserves on 1.7.2009	25,000	-	-
Profit and Loss A/c on 1.7.2009	20,000	-	-
Increase in Reserves	-	15,000	-
Increase in Profit	-	-	30,000
	45,000	15,000	30,000
Share in Light Ltd. (post acquisition)	-	9,000	9,000
	45,000	24,000	39,000
Less: Minority Interest (20%)	(9,000)	(4,800)	(7,800)
Share of Sun Ltd.	36,000	19,200	31,200

3. Cost of Control

		₹
Investment in Moon Ltd.		90,000
Investment in Light Ltd.		
by Moon Ltd.	50,000	
by Sun Ltd.	<u>40,000</u>	90,000
		1,80,000
Less: Paid up value of shares		
in Moon Ltd.	80,000	
in Light Ltd.	<u>54,000</u>	1,34,000

* Treatment of capital profit of sub-subsidiary company i.e. Light Ltd. has been done by applying direct approach.

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Capital Profit of Sun Ltd.		
in Moon Ltd.	36,000	
in Light Ltd.	<u>12,000</u>	48,000
Capital profit of Moon Ltd. in Light Ltd.	24,000	(2,06,000)
Capital Reserve		26,000

4. Minority Interest

	Moon Ltd.	Light Ltd.
	₹	₹
Share Capital	20,000	6,000
Capital Profit	9,000	4,000
Revenue Reserves	4,800	1,500
Revenue Profits	7,800	1,500
	41,600	13,000
Less: Unrealised Profit on Stock (20% of ₹ 5,000 x 25/125)	(200)	
Unrealised Profit on Equipment (10% of ₹ 7,800)		(780)
	41,400	12,220

5. Unrealised Profit on Equipment Sale

	₹
Selling price of the equipment $\frac{24,000 \times 100}{75} = 32,000$	32,000
Less: Cost price of the equipment	(24,000)
Profit on sale	8,000
Unrealised profit = $[8,000 - (8,000 \times \frac{10}{100} \times \frac{3}{12})] = ₹ 7,800$	

6. Profit and Loss Account – Sun Ltd.

	₹
Balance as per separate Balance Sheet	60,000
Less: Proposed dividend	(15,000)
	45,000
Add: Share in Moon Ltd.	31,200

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Share in Light Ltd.	4,500
	80,700
Less: Unrealised profit on Equipment (90% of 7,800)	(7,020)
	73,680
Less: Unrealised profit on Stock ($5,000 \times \frac{25}{125} \times 80\%$)	(800)
	72,880

7. Other Reserves – Sun Ltd.

	₹
Balance as per separate Balance Sheet	50,000
Share in Moon Ltd.	19,200
Share in Light Ltd.	<u>4,500</u>
	<u>73,700</u>

8. Cash in Transit

	₹
Due to Sun Ltd. from Moon Ltd.	12,000
Less: Due by Moon Ltd.	10,000
	<u>2,000</u>

Question 3

A Ltd. and B Ltd. were amalgamated on and from 1st April, 2010. A new company C Ltd. was formed to take over the business of the existing companies. The Balance Sheets of A Ltd., and B Ltd., as on 31st March, 2010 are given below:

				(₹ in lakhs)	
Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Share capital:			Fixed Assets:		
Equity shares of ₹100 each	800	750	Land and Building	550	400
12% Preference shares of ₹ 100 each	300	200	Plant and Machinery	350	250
Reserves and surplus:			Investments:	150	50
Revaluation Reserve	150	100	Current Assets,		
General Reserve	170	150	Loans and Advances:		

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Investment Allowance Reserve	50	50	Stock	350	250
Profit & Loss account	50	30	Sundry Debtors	250	300
Secured Loans:			Bills Receivable	50	50
10% Debentures (₹ 100 each)	60	30	Cash and Bank	300	200
Current Liabilities and Provisions:					
Sundry Creditors	270	120			
Bills Payable	<u>150</u>	<u>70</u>			
	<u>2,000</u>	<u>1,500</u>		<u>2,000</u>	<u>1,500</u>

Additional Information:

- (1) 10% Debentureholders of A Ltd., and B Ltd., are discharged by C Ltd., issuing such number of its 15% Debentures of ₹ 100 each, so as to maintain the same amount of interest.
- (2) Preference shareholders of the two companies are issued equivalent number of 15% Preference shares of C Ltd., at a price of ₹ 150 per share (face value of ₹ 100).
- (3) C Ltd., will issue 5 equity shares for each equity share of A Ltd. and 4 equity shares for each share of B Ltd. The shares are to be issued @ ₹ 30 each, having a face value of ₹ 10 per share.
- (4) Investment allowance reserve to be maintained for 4 more years.

Prepare the Balance Sheet of C Ltd., as on 1st April, 2010 after the amalgamation has been carried out on the basis of amalgamation in the nature of purchase. (16 Marks)

Answer

Balance Sheet of C Ltd. as on 1st April, 2010

(₹ in lakhs)			
Liabilities	Amount	Assets	Amount
Share Capital:		Fixed Assets:	
70,00,000, Equity Shares of ₹ 10 each (W.N. 4)	700	Goodwill (W.N. 2)	20
5,00,000, 15% Preference Shares of ₹ 100 each (all the above shares are allotted for consideration other than cash)	500	Land and Building (550+400)	950
		Plant and Machinery (350+250)	600
		Investments (150+50)	200
		Current Assets, Loans and	

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Reserves and Surplus:		Advances:	
Securities Premium Account (W.N.4)	1,650	Stock (350+250)	600
Investment Allowance Reserve (50+50)	100	Sundry Debtors (250+300)	550
Secured Loans:		Cash and Bank (300+200)	500
15% Debentures (40+20) (W.N.5)	60	Bills Receivable (50+50)	100
Unsecured Loans	-	Miscellaneous Expenditure:	
Current liabilities and provisions:		Amalgamation Adjustment Account	100
Sundry Creditors (270+120)	390		
Bills Payable (150+70)	220		
	3,620		3,620

Working Notes:

1. Computation of Purchase Consideration

	(₹ in lakhs)	
	A Ltd.	B Ltd.
(a) Preference Shareholders (3,00,00,000 ÷ 100) ie. 3,00,000 Shares x ₹ 150 each (2,00,00,000 ÷ 100) ie 2,00,000 Shares x ₹ 150 each	450	300
(b) Equity Shareholders: [(8,00,00,000 ÷ 100) x 5] ie 40,00,000 Shares x ₹ 30 each [(7,50,00,000 ÷ 100) x 4] ie. 30,00,000 Shares x ₹ 30 each	1,200	<u>900</u>
Amount of purchase consideration	<u>1,650</u>	<u>1,200</u>

2. Net Assets taken over

	₹ in lakhs	
	A Ltd.	B Ltd.
Assets taken over:		
Land and Building	550	400
Plant and Machinery	350	250
Investments	150	50
Stock	350	250
Sundry Debtors	250	300

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Bills Receivable		50		50
Cash and Bank		<u>300</u>		<u>200</u>
		2,000		1,500
Less: Liabilities taken over				
Debentures	40		20	
Sundry Creditors	270		120	
Bills Payable	<u>150</u>	<u>(460)</u>	<u>70</u>	<u>(210)</u>
Net Assets taken over		<u>1,540</u>		<u>1,290</u>

3. Goodwill / Capital Reserve

	₹ in lakhs	
	A Ltd.	B Ltd.
Purchase Consideration	1,650	1,200
Less: Net Assets taken over	<u>(1,540)</u>	<u>(1,290)</u>
Goodwill	<u>110</u>	-
Capital Reserve	-	<u>(90)</u>
Net Goodwill	110 – 90 = 20	

4. Share Capital / Securities Premium

Particulars	Share Capital		Securities
	Equity	Preference	Premium
	₹ in lakhs	₹ in lakhs	₹ in lakhs
A Ltd.			
Equity shares (8,00,000 shares x 5 x ₹ 10)	400		
Securities premium (8,00,000 shares x 5 x ₹ 20)			800
Preference shares (3,00,000 shares x ₹ 100)		300	
Securities premium (3,00,000 shares x ₹ 50)			150
B Ltd.			
Equity shares (7,50,000 shares x 4 x ₹ 10)	300		
Securities premium (7,50,000 shares x 4 x ₹ 20)			600
Preference shares (2,00,000 shares x ₹ 100)		200	
Securities premium (2,00,000 shares x ₹ 50)			<u>100</u>
	<u>700</u>	<u>500</u>	<u>1,650</u>

5. Debentures

	₹ in lakhs	
	A Ltd.	B Ltd.
Interest on debentures @ 10% = 60 x 10% = 6 Number of 15% debentures to maintain same amount of interest $\frac{6}{15} \times 100 = 40$	40	
Interest on debentures @ 10% = 30 x 10% = 3 Number of 15% debentures to maintain same amount of interest $\frac{3}{15} \times 100 = 20$		20

Question 4

- (a) A Ltd., agreed to absorb B Ltd., on 31st March 2010, whose Balance Sheet stood as follows:

Liabilities	₹	Assets	₹
Share Capital: 80,000 Equity shares of ₹ 10 each fully paid up	8,00,000	Fixed Assets	7,00,000
Reserves & Surplus:		Investments	-
General Reserve	1,00,000	Current Assets, Loans and Advances:	
Current Liabilities and Provisions :		Stock-in-trade	1,00,000
Sundry Creditors	1,00,000	Sundry Debtors	2,00,000
	10,00,000		10,00,000

The consideration was agreed to be paid as follows:

- (a) A payment in cash of ₹ 5 per share in B Ltd., and
(b) The issue of shares of ₹ 10 each in A Ltd. on the basis of 2 equity shares (valued at ₹ 15) and one 10% Cumulative Preference shares (valued at ₹ 10) for every five shares held in B Ltd.

The whole of the share capital consists of shareholdings in exact multiple of five except the followings holdings:

A	116
B	76
C	72

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D	28
Other individual	<u>8</u> (each member holding one share each)
	<u>300</u>

It was agreed that A Ltd. will pay in cash for fractional shares equivalent at agreed value of shares in B Ltd., i.e. ₹ 65 for five shares of ₹ 50 paid.

Prepare a statement showing the purchase consideration receivable in shares and cash.

- (b) The following are the summarized Balance Sheets of two companies, A Ltd., and B Ltd. as on 31-03-2010:

Liabilities	A Ltd. ₹	B Ltd. ₹	Assets	A Ltd. ₹	B Ltd. ₹
Equity shares of ₹ 10 each	15,00,000	10,00,000	Goodwill	2,00,000	1,00,000
Reserves	3,00,000	2,00,000	Net tangible block	17,00,000	14,00,000
10% Debentures	6,00,000	4,00,000	Current Assets	8,00,000	6,00,000
Creditors	<u>3,00,000</u>	<u>5,00,000</u>			
	<u>27,00,000</u>	<u>21,00,000</u>		<u>27,00,000</u>	<u>21,00,000</u>

Additional information:

- (i) Assets are to be revalued as follows:

	A Ltd. ₹	B Ltd. ₹
Revaluation of Tangible Block	21,00,000	12,00,000
Revaluation of Current Assets	10,00,000	4,00,000

- (ii)

Average annual profit for three years before charging debenture interest	4,50,000	3,10,000
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- (iii) Goodwill is to be valued at four year's purchase of average super profits for three years. Average is to be calculated after adjustment of depreciation at 10% on the amount of increase/decrease on revaluation of fixed assets. In the case of B Ltd. a claim of ₹10,000, which was omitted, is to be adjusted against its average profit. Income tax is to be ignored.
- (iv) Normal profit on capital employed is to be taken at 15%, capital employed being considered on the basis of revalued amount of tangible assets.

Ascertain the value of goodwill of A Ltd. and B Ltd.

(8 Marks)

Answer

(a) Purchase Consideration

₹

31,994 Equity shares @ ₹ 15 each	4,79,910
15,997 Preference shares @ ₹ 10 each	1,59,970
Cash on 79,985 shares (i.e 80,000 – 15) of B Ltd.@ ₹ 5 each	<u>3,99,925</u>
	10,39,805
Add: Cash for fractional shares (W.N. 3)	<u>195</u>
	<u>10,40,000</u>

Working Notes:

1. Schedule showing fractional shares

Holding of Shares		Exchangeable in multiple of five	Exchange in Equity shares	Exchange in preference shares	Non exchangeable shares
A	116	115	46	23	1
B	76	75	30	15	1
C	72	70	28	14	2
D	28	25	10	5	3
Others	8	-	-	-	8
	300	285	114	57	15

2. Shares Exchangeable: Equity Shares in A Ltd.

	No. of shares		No. of shares
(i) 80,000 – 300	79,700	2/5 thereof	31,880
(ii) 300 – 15	<u>285</u>	2/5 thereof	<u>114</u>
	<u>79,985</u>		<u>31,994</u>

Shares Exchangeable: Preference Shares in A Ltd.

	No. of shares		No. of shares
(i) 80,000 – 300	79,700	1/5 thereof	15,940
(ii) 300 – 15	<u>285</u>	1/5 thereof	<u>57</u>
	<u>79,985</u>		<u>15,997</u>

3. There are 15 shares (W.N.1) in B Ltd. which are not capable of exchange into equity and preference shares of A Ltd. They will be paid cash = $15 \times 10 \times \frac{65}{50} = 195$

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(b) Valuation of Goodwill

	₹	₹
Average annual profit	4,50,000	3,10,000
Less: Debenture Interest	(60,000)	(40,000)
	3,90,000	2,70,000
Less: Depreciation on amount increased on revaluation (W.N.2)	(40,000)	-
Add: Depreciation on amount reduced on revaluation (W.N.2)	-	20,000
Less: Omission of claim	-	(10,000)
Average profit	3,50,000	2,80,000
Less: Normal profit @ 15% on closing capital employed (W.N.1)	(3,30,000)	(1,03,500)
Super profit	20,000	1,76,500
Goodwill valued at four years' purchase of super profits	80,000	7,06,000

Working Notes:

1. Calculation of Closing Capital Employed

	A Ltd.	B Ltd.
	₹	₹
Tangible Fixed Assets (Revalued)	21,00,000	12,00,000
Current Assets (Revalued)	10,00,000	4,00,000
	31,00,000	16,00,000
Less: Debentures	(6,00,000)	(4,00,000)
Creditors	(3,00,000)	(5,00,000)
Claim	-	(10,000)
Closing Capital Employed	22,00,000	6,90,000

2. Excess / short depreciation

	A Ltd.	B Ltd.
	₹	₹
Revalued Assets	21,00,000	10,00,000
Tangible Assets as per the Balance Sheet	17,00,000	12,00,000

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Upward/(Downward) revaluation	4,00,000	(2,00,000)
(Increase)/decrease in depreciation @ 10%	(40,000)	20,000

Question 5

The Balance Sheet of PNR Limited as on 31-12-2010 is as follows:

(₹ in lakhs)			
Liabilities		Assets	
1,00,000 Equity shares of ₹10 each fully paid up	10	Goodwill	5
1,00,000 Equity shares of ₹6 each fully paid-up	6	Fixed Assets	15
Reserves & Surplus	4	Others Tangible Assets	5
Liabilities	10	Intangible Assets (Market Value)	3
	—	Miscellaneous expenditure to the extent not written off	<u>2</u>
	<u>30</u>		<u>30</u>

Fixed assets are worth ₹ 24 lakhs. Other tangible assets are valued at ₹ 3 lakhs. The company is expected to settle the disputed bonus claim of ₹ 1 lakh, not provided for in the accounts. Goodwill appearing in the Balance Sheet is purchased goodwill. It is considered reasonable to increase the value of goodwill by an amount equal to average of the book value and a valuation made at 3 years' purchase of average super profit for the last 4 years.

After tax profits and dividend rates were as follows:

Year	PAT (₹ in lakhs)	Dividend %
2007	3.00	11
2008	3.50	12
2009	4.00	13
2010	4.10	14

Normal expectation in the industry to which the company belongs to is 10%.

Kamalesh holds 20,000 equity shares of ₹ 10 each fully paid up and 10,000 equity shares of ₹ 6 each fully paid up. He wants to sell away his holdings.

- Determine the break-up value and market value of both kinds of shares.
- What should be the fair value of shares, if controlling interest is being sold?

Note: Make necessary assumptions, wherever required.

(16 Marks)

Answer

- (i) Break up value of ₹1 of share capital = $\frac{\text{Net assets available for shareholder}}{\text{Total share capital}}$

$$= \frac{\text{Rs.28.98 lakhs}}{\text{Rs.16.00 lakhs}} = ₹ 1.81$$

$$\text{Break up value of ₹ 10 paid up share} = 1.81 \times 10 = ₹18.10$$

$$\text{Break up value of ₹ 6 paid up share} = 1.81 \times 6 = ₹10.86$$

Market value of shares

$$\text{Average dividend} = \frac{11\% + 12\% + 13\% + 14\%}{4} = 12.5\%$$

$$\text{Market value of ₹ 10 paid up share} = \frac{12.5\%}{10\%} \times 10 = ₹12.50$$

$$\text{Market value of ₹ 6 paid up share} = \frac{12.5\%}{10\%} \times 6 = ₹ 7.50$$

- (ii) Break up value of share will remain as before even if the controlling interest is being sold. But the market value of share will be different as the controlling interest would enable the declaration of dividend upto the limit of disposable profit.

$$\frac{\text{Average Profit}}{\text{Paid up value of shares}} \times 100 = \frac{\text{Rs.3.4 lakhs}}{\text{Rs.16 lakhs}} \times 100 = 21.25\%$$

Market value of shares:

$$\text{For ₹ 10 paid up share} = \frac{21.25\%}{10\%} \times 10 = ₹ 21.25$$

$$\text{For ₹ 6 paid up share} = \frac{21.25\%}{10\%} \times 6 = ₹ 12.75$$

$$\text{Fair value of shares} = \frac{\text{Break up value} + \text{Market value}}{2}$$

$$\text{Fair value of ₹ 10 paid up share} = \frac{18.10 + 21.25}{2} = ₹ 19.68$$

$$\text{Fair value of ₹ 6 paid up share} = \frac{10.86 + 12.75}{2} = ₹ 11.81$$

* Transfer to reserves has been ignored.

Working Notes:

			₹ in lakhs
(1)	Calculation of average capital employed		
	Fixed assets		24.00
	Other tangible assets		3.00
	Intangible assets		<u>3.00</u>
			30.00
	Less: Liabilities	10	
	Bonus	<u>1</u>	<u>(11.00)</u>
	Net assets (excluding goodwill/Closing capital employed)		19.00
	Less: ½ of profits [1/2 (4.10 – 1.0 (ie. Disputed Bonus))]		<u>(1.55)</u>
	Average Capital Employed		<u>17.45</u>
(2)	Calculation of average super profit for 4 years		
	Average profit = $\frac{1}{4}$ [3+3.5+4+4.1 – 1.0 (ie. Bonus)] = $\frac{1}{4}$ x 13.60		3.400
	Less: Normal Profit = 10% of ₹ 17.45 lakhs		<u>(1.745)</u>
	Super Profit		<u>1.655</u>
(3)	Calculation of goodwill*		
	3 years' purchase of average super profit		
	= 3 x 1.655 = ₹ 4.965 lakhs		
	Increase in value of goodwill = $\frac{1}{2}$ (Book value + 3 years' super profit)		
	= $\frac{1}{2}$ (5+4.965) = ₹ 4.9825 lakhs		
	Net assets as valued in W.N.1 including book value of goodwill		19.00
	Add: Goodwill as per the balance sheet	5.00	
	Add: Increase in goodwill (rounded off)	<u>4.98</u>	<u>9.98</u>
	Net Assets available for shareholders		<u>28.98</u>

Note: Tax effect on disputed bonus and corporate dividend tax has been ignored.

* Goodwill has been calculated on the basis of average capital employed. Alternatively, it may be calculated on the basis of closing capital employed. Accordingly, the closing capital employed will be ₹ 19 lakhs, super profit will be ₹ 1.5 lakhs, increase in the value of goodwill will be ₹ 4.75 lakhs and net assets available for shareholders will be ₹ 28.75 lakhs. In such a case, the break-up value of ₹ 1 of share capital will be ₹ 1.80 (instead of ₹ 1.81).

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Question 6

- (a) Prosperous Bank has a criterion that it will give loans to companies that have an "Economic Value Added" greater than zero for the past three years on an average. The bank is considering lending money to a small company that has the economic value characteristics shown below. The data relating to the company is as follows:

- (i) Average operating income after tax equals ₹25,00,000 per year for the last three years.
- (ii) Average total assets over the last three years equals ₹75,00,000.
- (iii) Weighted average cost of capital appropriate for the company is 10% which is applicable for all three years.
- (iv) The company's average current liabilities over the last three years are ₹15,00,000.

Does the company meet the bank's criterion for a positive economic value added? (5 Marks)

- (b) Calculate the NAV of a mutual fund from the following information:

On 1-4-2009

Outstanding units 1 crore of ₹10 each = ₹10 crores (Market Value ₹16 crores)

Outstanding liabilities ₹5 crores.

Other information:

- (i) 20 lakhs units were sold during the year at ₹24 per unit.
- (ii) No additional investments were made during the year and as at the year end 50% of the investments held at the beginning of the year were quoted at 80% of book value.
- (iii) 10% of the investments have declined permanently 10% below cost.
- (iv) At the year end 31-3-10 outstanding liabilities were ₹1 crore.
- (v) Remaining investments were quoted at ₹13 crores. (6 Marks)

- (c) A Company has a capital base of ₹3 crores and has earned profits of ₹33 lakhs. Return on investment of the particular industry to which the company belongs is 12.5%. If the services of a particular executive are acquired by the company, it is expected that the profits will increase by ₹7.5 lakhs over and above the target profit. Determine the amount of maximum bid price for that particular executive and the maximum salary that could be offered to him.

	₹
Capital base	3,00,00,000
Actual profit	33,00,000
Target profit	37,50,000

(5 Marks)

Answer

(a) Calculation of Economic Value Added

	₹
Net Operating Profit After Tax	25,00,000
Less: Cost of capital employed (Refer W.N.)	<u>(6,00,000)</u>
Economic Value Added	<u>19,00,000</u>

Economic value added is greater than zero. Therefore, the company qualifies for the loan.

Working Note:

Calculation of Cost of Capital employed	₹
Average total assets	75,00,000
Less: Average current liabilities	<u>(15,00,000)</u>
Capital employed	<u>60,00,000</u>
Cost of capital = Capital employed x Weighted average cost of capital	
$= ₹ 60,00,000 \times \frac{10}{100} = ₹ 6,00,000$	

(b)

Units at the end of the year 2009-2010	Units in crores
Units as on 1/4/2009	1.00
Add: Units issued during the year	<u>0.20</u>
	<u>1.20</u>

Net Asset Value of a mutual fund	₹ in crores
Market value of investments -	
₹ 10 x 50% x 80%	4.00
₹ 10 crores x 10% x 90%	0.90
Remaining investment at market value	<u>13.00</u>
	17.90
Less: Liabilities	<u>(1.00)</u>
Net asset value	<u>16.90</u>
NAV per unit (₹ 16.90 crores ÷ 1.2 crores) = ₹ 14.08	

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(c)

Target Profit = ₹ 3,00,00,000 x 12.5% = ₹ 37,50,000
Expected profit on employing the particular executive=Target profit + Increase in profit = ₹ 37,50,000 + ₹ 7,50,000 = ₹ 45,00,000
Additional profit = Expected profit – Actual profit = ₹ 45,00,000 – ₹ 33,00,000 = ₹ 12,00,000
Maximum bid price = $\frac{\text{Additional profit}}{\text{Rate of return on investment}}$ $= \frac{12,00,000}{12.5} \times 100 = ₹ 96,00,000$
Maximum salary that can be offered = 12.5% of ₹ 96,00,000 = ₹ 12,00,000

Question 7

Answer any **four** of the following:

- (a) Anil Pharma Ltd. ordered 16,000 kg of certain material at ₹160 per unit. The purchase price includes excise duty ₹10 per kg in respect of which full CENVAT credit is admissible. Freight incurred amounted to ₹1,40,160. Normal transit loss is 2%. The company actually received 15,500 kg and consumed 13,600 kg of material. Compute cost of inventory under AS 2 and amount of abnormal loss.

- (b) Jain Construction Co. Ltd. undertook a contract on 1st January, 2010 to construct a building for ₹80 lakhs. The company found on 31st March, 2010 that it had already spent ₹ 58,50,000 on the construction. Prudent estimate of additional cost for completion was ₹ 31,50,000.

What amount should be charged to revenue and what amount of contract value to be recognized as turnover in the final accounts for the year ended 31st March 2010 as per provisions of AS 7 (revised)?

- (c) Kumar Ltd., is in engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employee is estimated to be 6 years.

You are required to advise the company.

- (d) An enterprise reports quarterly, estimates an annual income of ₹ 10 lakhs. Assume tax rates on 1st ₹ 5,00,000 at 30% and on the balance income at 40%. The estimated quarterly income are ₹ 75,000, ₹ 2,50,000, ₹ 3,75,000 and ₹ 3,00,000.

Calculate the tax expense to be recognized in each quarter.

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- (e) From the following information determine the possible value of brand under the potential earning model:

	(₹ in lakhs)
(a) Profit before tax	13.00
(b) Income tax	3.00
(c) Tangible Fixed Asset	20.00
(d) Identifiable Intangible other than brand model	10.00
(e) Expected return on tangible fixed assets	6.00

Appropriate capitalization factor for intangibles is 25%.

(4 x 4=16 Marks)

Answer

- (a) Calculation of total cost of material

	₹
Purchase price (16,000 kg. x Rs 160)	25,60,000
Less : CENVAT credit (16,000 kg. x Rs 10)	<u>(1,60,000)</u>
	24,00,000
Add : Freight	<u>1,40,160</u>
Total material cost	<u>25,40,160</u>
Number of units after normal loss = 16,000 kg. x (100-2)% = 15,680 kg	
Revised cost per kg. = $\frac{25,40,160}{15,680 \text{ kg}}$ = ₹ 162	
Closing inventory = Material actually received – Material consumed	
= 15,500 kg – 13,600 kg = 1,900 kg	
Value of closing stock	
= 1,900 kg x ₹ 162 = ₹ 3,07,800	
Abnormal loss in kg = 15,680 kg. – 15,500 kg = 180 kg.	
Abnormal loss in value = 180 kg x ₹ 162 = ₹ 29,160	

- (b)

	₹
Cost incurred till 31 st March, 2010	58,50,000
Prudent estimate of additional cost for completion	<u>31,50,000</u>
Total cost of construction	90,00,000
Less: Contract price	<u>(80,00,000)</u>
Total foreseeable loss	<u>10,00,000</u>

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As per para 35 of AS 7 (Revised) 'Construction Contracts' when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

Accordingly, the loss of ₹10,00,000 is required to be recognized as an expense in the year 2009-10.

Also as per para 21 of the said standard when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. Accordingly,

$$\text{Contract work in progress} = \frac{58,50,000 \times 100}{90,00,000} = 65\%$$

$$\begin{aligned} \text{Proportion of total contract value to be recognized as turnover} \\ = 65\% \text{ of ₹ } 80,00,000 = ₹ 52,00,000 \end{aligned}$$

- (c) According to para 92 of AS 15 (Revised) "Employee Benefits", actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus of ₹ 6 lakhs in the pension scheme on its actuarial valuation is required to be credited to the profit and loss statement of the current year. Hence, Kumar Ltd. cannot spread the actuarial gain of ₹ 6 lakhs over the next 2 years by reducing the annual contributions to ₹ 2 lakhs instead of ₹ 5 lakhs. It has to contribute ₹ 5 lakhs annually for its pension schemes.
- (d) As per para 29 of AS 25 'Interim Financial Reporting', income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

Estimated Annual Income	₹10,00,000
Tax expense:	
30% on ₹ 5,00,000	₹ 1,50,000
40% on remaining ₹ 5,00,000	<u>₹2,00,000</u>
	<u>₹3,50,000</u>

$$\text{Weighted average annual income tax rate} = \frac{3,50,000}{10,00,000} = 35\%$$

Tax expense to be recognised in each of the quarterly reports	
Quarter I - ₹ 75,000 x 35%	₹ 26,250
Quarter II - ₹ 2,50,000 x 35%	₹ 87,500
Quarter III - ₹ 3,75,000 x 35%	₹ 1,31,250

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Quarter IV - ₹ <u>3,00,000</u> x 35%	₹ <u>1,05,000</u>
₹ <u>10,00,000</u>	₹ <u>3,50,000</u>

(e) Calculation of possible value of brand under potential earning model

	₹ in lakhs
Profit after tax (13 – 3)	10.00
Less: Profit allocated to tangible fixed assets	<u>(6.00)</u>
Profit relating to intangible assets including brand	<u>4.00</u>
Capitalisation factor 25%	
Capitalised value of intangibles including brand ($\frac{4.00}{25} \times 100$)	16.00
Less: Identifiable intangibles other than brand	<u>(10.00)</u>
Brand value	<u>6.00</u>