

Funda

on

Accounting Standards

[For PCC – Nov 2008 & May 2009 Examination]

- Including Problems & Hint Answers -

Preface

The rationale behind this work is already conveyed by the title "A Primer on Accounting Standards".

Not able to comprehend accounting Standards after spending many hours as the original text is not in a structured form, is worrisome for students in their attempts. In order to remove the difficulties experienced by the students, an attempt is made to bring all the important points at a glance. Now that the student can use this as **LMR** (Last Minute Reviser). This work primarily intends to cater the students requiring quick revision of accounting standards during the last few hours before exams.

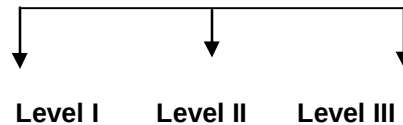
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ACCOUNTING STANDARD NOTES

Types of Enterprises**Level I Enterprises:**

Enterprises which fall in any one or more of the following categories, at any time during the accounting period, are classified as Level I enterprises:

- a. Enterprises whose equity or debt securities are listed in India or outside India.
- b. Enterprises, which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.
- c. Banks including co-operative banks.
- d. Financial institutions.
- e. Enterprises carrying on insurance business.
- f. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceed Rs.50 crore. Turnover does not include 'other income'.
- g. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs.10 crore at any time during the accounting period.
- h. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Level II Enterprises:

Enterprises which are not level I enterprises but fall in any one or more of the following categories are classified as level II enterprises:

- a. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceed Rs.40 lakhs but does not exceed Rs.50 crores. Turnover does not include 'other income'.
- b. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs.1 crore but not in excess of Rs. 10 crore at any time during the accounting period.
- c. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Level III Enterprises:

Enterprises, which are not covered under Level I and Level II, are considered as Level III enterprises.

AS - 1**DISCLOSURE OF ACCOUNTING POLICIES**

Applicable enterprise	All
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1. Only significant accounting policies adopted in the preparation and presentation of financial statements should normally be disclosed in one place.
2. The primary consideration in the selection of accounting policy is true and fair view and the secondary considerations are prudence, substance over form and materiality.
3. Changes in the accounting policy having material effect, affect current period and the future. To the extent determinable, the effect of change in Accounting Policy shall be disclosed. In case it is not ascertainable wholly or in part, the fact should be indicated. If it expected to affect the future, the fact should be disclosed.
4. Disclosure is not required if fundamental accounting assumptions viz. going concern, consistency and accrual are followed. Only when they are not followed, the fact should be disclosed.

AS - 2**VALUATION OF INVENTORIES**

Applicability of enterprises	All
ASI reference	ASI 2

1. Inventories would mean Raw material, Work in progress, finished good and consumable/spares.
2. Generally cost or NRV shall be scale of valuation for finished stock. But in case of raw materials, WIP and spares/consumables cost is the basis of evaluation.
3. Cost includes cost of purchase, conversion cost and other costs. It excludes abnormal cost, storage cost, administrative overheads and selling and distribution costs.
4. For the purpose of cost either FIFO method or weighted average method shall be used.
5. Many industries would have their unique way of identifying costs, as the items dealt are huge and having frequent fluctuations. Either standard cost shall be used taking normal capacity in computation or retail method of arriving at cost shall be used.
6. Standard cost formula method is often used in manufacturing industry and retail formula method is used in trading activity units.
7. NRV is the difference between the normal selling price and the cost of completing the sale/cost of completing the job/work.
8. NRV question will arise if the selling prices have declined or when the estimated cost to complete the sale is increased.
9. If the inventory is damaged partially or wholly, it may not fetch the normal selling price. Therefore it is often that damaged goods will be valued below cost i.e. at NRV.
10. Some of the items of inventory will be valued on item by item basis. Sometimes it will be valued on global basis or on a panel basis wherein inventories may not be practically segmented.
11. If inventory is stocked for a particular contract, then the price agreed in the contract is the selling price for the arrival of NRV. For the excess quantity stored if any, general selling price shall be considered as the base.
12. Normally cost is the basis of valuation for Raw material. There is no NRV concept in the valuation of raw material. In case the replacement cost of the raw material had fallen, with finished goods (in which such raw material is incorporated) are likely to be sold at a price below cost, then the raw material should be valued at replacement (as NRV) cost.
13. NRV should be computed at each balance sheet date.

AS – 2 Problems & Hint Answers**Question**

X Co. Ltd. purchased goods at the cost of Rs.40 lakhs in October, 2007. Till March, 2008, 75% of the stocks were sold. The company wants to disclose closing stock at Rs.10 lakhs. The expected sale value is Rs.11 lakhs and a commission at 10% on sale is payable to the agent. Advise, what is the correct closing stock to be disclosed as at 31.3.08.

Hint Answer:

Inventories should be valued at lower of cost or NRV. In the given case inventories should be valued at Rs.9.9 lacs [i.e. 11-1.1]

Question

Historical cost and net realisable value of five inventory items are given below:

	Historical cost	Net realisable value
	Rs.	Rs.
X	20,000	30,000
Y	12,000	10,000
Z	12,000	18,000
1	32,000	26,000
2	28,000	26,000
	<u>1,04,000</u>	<u>1,10,000</u>

Compute the amount to be recorded as inventory as per AS 2.

Hint Answer:

Inventories are usually written down to NRV on item by item basis. However in certain circumstances it may be appropriate to group similar items.

In the given case if the items are ordinary interchangeable, then the value of inventory will be Rs.1,04,000

If the items are not ordinarily interchangeable, the value of inventory will be [20000+10000+12000+26000+26000] = 94000

Question

Cost of production of product X (in Rs.) is given below:

Raw material per unit	120
Wages	80
Overheads	50
Total	<u>250</u>

The selling price of the product is Rs. 275. As on the balance sheet date net realisable value of the raw material has been estimated to be Rs. 110 as there was a reduction in market price. Should the raw material inventory be valued at Rs. 110 per unit? There is a decline in the market price of the product by Rs. 8 and it is expected to realise Rs. 267 per unit. Thoroughly discuss as per AS 2.

Hint Answer:

There is no NRV concept in the valuation of raw material. In case the replacement cost of the raw material had fallen, with finished goods are likely to be sold at a price below cost, then the raw material should be valued at replacement cost. Therefore, in the given case raw material will be valued at Rs.120 only.

Question

In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in a wastage of 300 MT. Cost per MT of input is Rs.1,000. The entire quantity of waste is on stock at the year end.

Hint Answer:

Abnormal amounts of waste material are excluded from cost of inventories. In the given situation, cost of normal waste is 250 MT [5000 x 5%] will be included in cost of finished goods. But, cost of abnormal waste i.e. Rs.50,000 [50MT x 1000] will be transferred to P & L a/c.

AS - 4**CONTINGENCIES AND EVENTS OCCURING AFTER BALANCE SHEET DATE**

Type of enterprises	All
Part of AS related to contingencies is withdrawn after the advent of AS29.	

1. Only events occurring after balance sheet date are taken up for discussion.
2. Such event may be favorable or unfavorable.
3. Events which take place after balance sheet date have bearing on the balance sheet date (condition/situation) but those occurring before the approval of accounts shall be referred to as Events occurring after balance sheet date.
4. They are classified as adjusting event and non-adjusting events.
5. Adjusting events are those events that would provide additional information materially affecting the conditions prevailed on the balance sheet date. E.g. loss of trade receivable account, which is confirmed by the insolvency of a customer, which occur after the balance sheet date.
6. Non-adjusting events are those events that do not relate to the conditions existing on the balance sheet date. Eg, decline in market value of investments between the balance sheet date and the date of approval having no bearing on the value of investments on the balance sheet date.
7. Disclosure is required for non-adjusting events.
8. Adjusting events are to be adjusted in the books of accounts whereas non-adjusting events are not to be adjusted in the books of account and are to be disclosed in financial statements. However there is an exception to non-adjusting event, i.e. proposed dividend though a non-adjusting event requires an adjustment in the books.
9. In case of events occurring after balance sheet date affecting the basic substratum of the enterprise, it may be appropriate to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of financial statement.

AS 4 – Problems & Hint Answers**Question**

As a statutory auditor, comment on following whether the treatment is correct

“The company has not made provision for proposed dividend in its accounts but has carried forward the balance on the profit and loss account and proposes to charge the dividend to the profit and loss account when payment is made”

Hint Answer:

The treatment is incorrect. Proposed dividend is statutorily required to be adjusted. It is an exception to non-adjusting event as per AS-4.

Question

In Ltd. theft of cash of Rs.5 lakhs by the cashier in January, 2008 was detected only in May 2008. 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 31.3.08. Decide.

Hint Answer:

It is an adjusting event

Question

A major fire has damaged the assets in a factory of a limited company on 2nd April-two days after the year end closure of account. The loss is estimated at Rs. 20 crores out of which Rs. 12 crores will be recoverable from the insurers. Explain briefly how the loss should be treated in the final accounts for the previous year.

Hint Answer:

It is an event occurring after balance sheet date. However it is a non-adjusting event since there is no condition existing on balance sheet date. If the amount is considered material, disclosure can be made in the financial statements.

Question

A company had taken a large sized civil construction contract, for a public sector undertaking, valued at Rs.2 crores. In the course of execution of the work on 29th May, 2008, the company found while raising the foundation work that it had met a rocky surface and cost of contract would go up by an extra Rs.50 lakhs, which would not be recoverable from the contractee.

Note: Accounting year ended on 31st March, 2008 and the books are approved on 15th May, 2008.

Hint Answer:

Since it is event occurring after balance date and also after approval of accounts, it is a non-adjusting event.

Question

A company had taken a large sized civil construction contract, for a public sector undertaking, valued at Rs.2 crores. In the course of execution of the work on 2th May, 2008, the company found while raising the foundation work that it had met a rocky surface and cost of contract would go up by an extra Rs.50 lakhs, which would not be recoverable from the contractee.

Note: Accounting year ended on 31st March, 2008 and the books are approved on 15th May, 2008.

Hint Answer:

The rocky surface was there on the balance sheet date. Therefore, the company should provide for extra cost of 50 lakhs.

AS - 5**NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES**

Number of Paragraphs	33
Applicable enterprise	All

1. There are five items dealt in this accounting standard. They are ordinary item, extraordinary item, prior period item, effect of changes in the accounting estimate and effect of changes in the accounting policy.
2. Ordinary items, which are related to the activities of the enterprise, include items which are incidental to the activities of the enterprise. Disclosure of ordinary items shall be taken up only to place a better understanding about the performance of the enterprise. Eg writing down of inventories as well as reversals, reversals of provisions.
3. Extraordinary items are distinctly different from ordinary activities, which are not expected to recur frequently or regularly. Eg Grant received from Government towards meeting revenue expenditure, loss of asset on account of earth quake.
4. Prior period items are matters related to one or more previous years arising on account of omission/commission in the preparation of financial statements affecting the current year's profit and loss account. Eg error in the stock sheet of the previous year, total omission of credit purchases/sales of the preceding year.
5. Certain items of expenditure may not be exactly known at the time of preparation of financial statements, requiring estimates. When they are met subsequently there will be difference between the estimates and the actuals. The difference will be referred to as changes in accounting estimates. Such differences shall not be considered as prior period items though it may relate to one or more previous years. They are purely judgment/estimate errors. They cannot be classified as prior period items. Eg Changes in the rate of depreciation (method followed shall be regarded as the same). The effect of changes in accounting estimate shall be applied prospectively.
6. Different methods are adopted in following principles of accounting. Such adoption of a method of accounting is referred to as accounting policy.
Eg. WDV method of accounting depreciation. Enterprise need not follow the method of depreciation throughout its lifetime what it had chosen at the initial stage. Circumstances, statutes and other factors will be considered in adoption and following of a policy. Therefore an enterprise might change the policy after some point of time. Such changes shall be taken up as changes in accounting policy. The change in accounting policy shall have retrospective effect.

AS 5 – Problems & Hint Answers**Question**

A Ltd. has a retained profit of Rs.32000 for the year ended 30.06.2008. The balance on the profit and loss account at 1.7.2007 stood at Rs.809500.

It was decided during the year to change the accounting policy regarding the valuation of stock from an average cost method to a FIFO method. This change in accounting policy would lead in increase in stock valuation by Rs.49000. Discuss the above situation as per applicable AS.

Hint Answer:

Due to requirement of statute or accounting standards or for better presentation of financial statements, accounting policy can be changed. In the given case, there was a shift from average cost method to FIFO method. It can be treated as change in accounting policy. Appropriate disclosure of change and amount by which any item in the financial statements is affected by such change is necessary.

Question

What will be the treatment of the following in the final statement of account for the year ended 31st March, 2008 of a limited company?

- (a) Revision in the salary, with effective from 1st April, 2006, would cost the company an additional liability of Rs. 3,00,000 per annum".

Hint Answer

It should be understood that additional expenditure of Rs.3 lacs due to revision in salary is an expense arising from ordinary activities of the enterprise. Despite, abnormal or infrequent in nature, it will not qualify for as extraordinary item.

- (b) It was found that an item of stock costing Rs. 50,000 had been included twice in the stock sheet as on 31st March, 2007.

Hint Answer

Rectification of error in stock valuation is treated as prior period item. Separate disclosure is required for prior period item and Rs.50,000 should be deducted from opening stock in Trading a/c [Profit & Loss] for the year ended 31.2.08

Question

Answer the following questions by quoting the relevant Accounting standard:

- (a) During the year 2007-08, a medium size manufacturing company wrote down its inventories to net realisable value by Rs. 5,00,000. Is a separate disclosure necessary?

Hint Answer:

Inventories should be valued at lower of cost or NRV. Writing down inventories to NRV is an ordinary item. However, if the income or expense is of such nature which will explain the performance of the enterprise, despite it is ordinary, disclosure should be made in financial statements.

- (b) A Ltd. company created a provision for bad and doubtful debts at 2.5% on debtors in preparing the financial statements for the year 2007-08.

Subsequently on a review of the credit period allowed and financial capacity of the customers, the company decided to increase the provision to 8% on Debtors as on 31.3.08. The accounts were not approved by the Board of Directors till the date of decision. While applying the relevant accounting standard can this revision be considered as an extraordinary item or prior period item?

Hint Answer:

Estimates are made where actuals are not known. In the given case, A Ltd. created 2.5% provision on debtors. Subsequently it has decided to increase it to 8%. This will be treated as changes in accounting estimate. Accordingly, accounting estimate having material effect in current period should be disclosed and quantified

AS - 6

DEPRECIATION ACCOUNTING

Number of Paragraphs	29
Applicable enterprise	All

1. Depreciation is a measure of diminution in the value of depreciable assets on account of wear and tear, efflux of time, obsolescence, etc., tried on an estimated basis.
2. For the computation of depreciation, the following factors are very important: cost, estimated residual value and life.
3. There can be reviews of depreciable age of the asset, estimated residual value, cost which would change the amount of depreciation.
4. When there is a change in the rate of depreciation, then it can be taken up as changes in accounting estimates. The effect of change should be accounted on a prospective basis
5. If changes are witnessed in the method of charging depreciation, then the same shall be taken up as changes in accounting policy. It should be accounted on a retrospective basis.
6. Addition/extension to the existing asset will qualify for depreciation either on the remaining useful life of the existing asset or based on the independent life of the added/extended asset.
7. In case the depreciation has material effect on the amount of depreciation because of revaluation made on the asset, then disclosure is to be made separately.

AS 6 – Problems & Hint Answers**Question**

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 AS-6.

Hint Answer:**Depreciable Amount = 10 lacs – 1 lacs = 9 lacs****Depreciation = 9 lacs / 5 years = 1.8 lacs**

Question

An asset was purchased for Rs.100000 on 1.1.06; straight-line depreciation of Rs.20000 per annum was charged (five-year life, no residual value). A general review of asset lives is undertaken and for this particular asset, the remaining useful life as at 31.12.08 is eight years.

The accounts for the year ended 31.12.08 are being prepared. What should the annual depreciation charge be for 2008 and subsequent years?

Hint Answer:**W.D.V as on 1.1.08 = 1,00,000 – [20,000x2] = Rs.60,000****Remaining useful life = 8 years****Depreciation = 60,000 / 8 = 7,500**

Question

X Co. Ltd. charged depreciation on its asset on SLM basis. For the year ended 31.3.08 it changed to WDV basis. The impact of the change when computed from the date of the asset coming to use amounts to Rs.20 lakhs being additional charge.

Decide, how it must be disclosed in Profit & Loss account. Also, discuss when such changes in method of depreciation can be adopted by an enterprise as per AS-6.

Hint Answer:**Additional charge being 20 lakhs due to change in method of depreciation should be charged to P & L a/c in the year of such change. It should be treated as changes in accounting policy as per AS-5.**

AS - 9**REVENUE RECOGNITION**

Applicable enterprise	All
Appendix	1
ASI	14

1. Revenue arising out of ordinary activities of the enterprise from (a) sale of goods, (b) rendering of services and (c) yielding interest, royalties and dividends are covered in revenue recognition.
2. Revenue should be recognised immediately after the rendering service or the delivery of products if it is not unreasonable to expect ultimate collection.
3. If there is no reasonability in the ultimate collection upon rendering services or delivery of products, then recognition should be postponed until the collectibility takes shape of certainty.
4. In the above points, it is assumed that the revenue can be measured at the time of delivery of products or rendering of services. If the measurability is not determinable, then recognition will be postponed until the measurability is spotted.
5. Three important factors are to be seen to recognise revenue. They are performance of act of sale/rendering of services, measurability of revenue and reasonability of ultimate collection.
6. After recognizing the revenue, if collectibility factor turns doubtful, then it is not appropriate to reverse the recognised revenue. It is more appropriate to create provision for doubtfulness in the collectibility factor.

AS - 9 Problems & Hint Answers**Question**

X Limited has recognised Rs.10 lakhs on accrual basis income from dividend on units of mutual funds of the face value of Rs.50 lakhs held by it as at the end of the financial year 31st March, 2008. The dividends on mutual funds were declared at the rate of 20% on 15th June, 2008. The dividend was proposed on 10th April, 2008 by the declaring company. Whether the treatment is as per the relevant AS?

Hint Answer:

Dividend was declared on 15th June, 2008. X Limited cannot recognise dividend on accrual basis. Dividend should be accounted only when owner's right to receive payment is established.

Question

A Ltd. sold farm equipments through its dealers. One of the conditions at the time of sale is, payment of consideration should be made in 14 days and in the event of delay, interest is chargeable @ 15% per annum. The company has not realised interest from the dealers in the past. However, for the year ended 31.3.08, it wants to recognise the interest due on the balances due from dealers. The amount is ascertained at Rs.9 lakhs. Decide whether the income by way of interest from dealers is eligible for recognition as per AS-9.

Hint Answer:

When there is an uncertainty with respect to ultimate collection, revenue recognition is postponed to the extent of uncertainty. In the given case, interest should not be recognised until is actually received.

AS - 10

ACCOUNTING FOR FIXED ASSETS

Applicable enterprise	All
ASI	2
Certain portions are withdrawn after the advent of AS 16,19 and AS 26	

1. Fixed assets shall be accounted either at cost or at revalued amount. Such revalued amount shall not exceed the recoverable amount of the asset
2. Fixed assets shall be accounted initially at cost if purchased by payment of money or money's worth. If money's worth is provided, fixed assets shall be accounted at its fair value of the asset or at the value of the securities issued or assets exchanged whichever is more clearly evident.
3. Downward revaluation of fixed assets shall be debited to profit and loss account or to revaluation reserve created if any on an earlier upward revaluation of the concerned fixed asset.
4. Upward revaluation of fixed assets shall be credited to revaluation reserve.
5. In case the present upward revaluation results as a reversal of previously recognised downward revaluation, then the present increase shall be credited only to profit and loss account because the previous downward revaluation would have been accounted through profit and loss account.
6. Self-constructed assets shall be accounted at cost, which are directly related to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.
7. Subsequent expenses on existing assets shall be capitalised only when there is an increase in the future benefits beyond their previously assessed performance.
8. When fixed assets are held for disposal after their usage, they shall be taken up at lower of the carrying amount or net realizable value.
9. Profit or loss on disposal of fixed assets shall be adjusted in profit and loss account and/or in revaluation reserve account if any.

AS -10 Problems & Hint Answers**Question**

Mr. Zee sold goods worth Rs. 5 lacs to Mr. Star on credit basis. Mr. Star gives a car in full settlement of due to Mr. Zee. It was estimated that worth of the car is Rs.5.25 lacs. What is value at which car will be recorded in Mr. Zee's books?

Hint Answer:

Car will be recorded only at Rs.5 lacs, since in case of fixed assets acquired in exchange for another asset; cost is usually determined by reference to fair market value of consideration given.

Question

ABC Ltd. gave 50000 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?

Hint Answer:

Machinery would be recorded for Rs.7,50,000 [50000x 15]; since in case of fixed assets acquired in exchange for securities, cost is usually determined by fair market value of asset acquired or fair market value of the securities issued whichever is more clearly evident.

AS - 12

ACCOUNTING FOR GOVERNMENT GRANTS

Applicable enterprise

All

1. This accounting standard deals with accounting of GOVERNMENT GRANT.
2. Government means local, state, central and international.
3. Government grant would be both in terms of cash contribution as well as contribution in kind.
4. There are two approaches in accounting for Government grants. They are capital approach and income approach
5. If the Government grant is in the nature of promoter's contribution then credit will be given to shareholders' funds. (Capital reserve)
6. For other types of grants, it is more appropriate to follow income approach.
7. Government grants will be taken up as extraordinary item both at the time of grant as well as when it is refunded for some reason.
8. When GOVERNMENT GRANT is in the form of non-monetary asset, then the asset shall be recorded at its nominal value. However when Asset is provided at concessional rate then the asset shall be recorded at acquisition cost (net of GOVERNMENT GRANT).
9. When GOVERNMENT GRANT is received with respect to specific fixed asset, there are two treatments recommended. They are (a) shown as reduction from Fixed Asset (FA) (b) Show the FA at gross value and take the GOVERNMENT GRANT on the liability side. In case of treatment
 - (a), depreciation will be calculated on the net amount whereas in case of treatment
 - (b), depreciation will be calculated on the gross amount and the grant will be taken as income in proportion of the depreciation charged. Both the treatment will result in same effect.
10. In case of GOVERNMENT GRANT value almost equivalent to the cost of the asset, then it is recommended to show the asset at gross value and the GOVERNMENT GRANT on the liability side.
11. In case GOVERNMENT GRANT is received on account of non-depreciable assets without any fulfillment of condition, then the receipt will be credited to capital reserve. In case with fulfillment of conditions, then amount will be transferred to P & L as and when the fulfillment is over.
12. In case of refund of GOVERNMENT GRANT results in increase in the value of FA, then the increased depreciation shall be effected for the remainder of the life of the FA under prospective basis.
13. In case of refund of GOVERNMENT GRANT results in a figure greater than the unamortised amount available in the balance sheet, then the difference shall be debited to profit and loss account.

AS 12 Problems & Hint Answers**Question**

Burger Limited belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31-3-2008. You are required to advise the company on the following item from the view point of finalization of accounts, taking note of the mandatory accounting standards.

"The company purchased on 1-4-2007, special purpose machinery for Rs. 25 lakhs. It received a Central Government Grant for 20% of the price. The machine has an effective life of 10 years."

Hint Answer:

If grant has been received towards specific assets, the following alternatives are available:

Alternative: 1

Reduce the grant from cost of assets. Provide depreciation for revised figure [i.e. reduced cost].

Alternative: 2

Defer the grant received to a separate account say "Deferred Government Grant". Deferred Government grant will be transferred to income [P & L] in the proportion in which depreciation is transferred to P & L.

Question

Explain the treatment of the following:

- a. Capital subsidy received from the central government for setting up a plant in the notified backward region. Cost of the plant Rs.300 lakhs, subsidy received Rs.100 lakhs.

Hint Answer:

Grant received in the nature of promoters contribution should be credited to Capital reserve account

- b. Rs.25 lakhs received from the local authority for providing medical facilities to the employees.

Hint Answer:

Grant received towards revenue can be deducted from relevant expenditure in P & L a/c or it can be shown as separate income in P & L a/c

Question

X Ltd. acquired a fixed asset for Rs.50,00,000. The estimated useful life of the asset is 5 years. The salvage value after useful life was estimated at Rs.5,00,000. The State Government gave a grant of Rs.10,00,000 to encourage the asset acquisition. At the end of the second year, the subsidy of the State Government became refundable. What is the fixed asset value after refund of grant/subsidy to the State Government but before amortisation the asset value at the end of second year?

Hint Answer:**Alternative: 1**

When the grant was received, if it was reduced from cost of asset, then:

- i) **Refundable amount should be added to book value of the asset in the year of refund**
- ii) **Depreciation should be provided for the revised value**

Alternative: 2

When the grant was received, if it was deferred, then:

- i) Refundable amount should be adjusted with unamortized deferred income and balance if any can be adjusted in P & L a/c**
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AS - 16

BORROWING COSTS

Applicable enterprise	All
ASI	1 & 10
Appendix	1

1. Not all assets can be bought. Some of the assets will be developed captively requiring substantial period of time to bring them into existence.
2. Such assets would require huge capital. Borrowed capital will constitute major source of funding such assets. This would result in borrowing cost for the enterprise.
3. It will be unfair to debit the profit and loss account for the borrowing cost incurred during the period of development of the assets.
4. Therefore it is considered appropriate to capitalise such borrowing cost during the course of development. This accounting standard prescribes the procedure of capitalization, suspension and cessation of borrowing cost.
5. Importantly borrowing cost shall be capitalised only for assets that require substantial period of development and not applicable for assets that can be put to use immediately upon purchases.
6. There are two types of borrowings. They are Specific borrowing and general borrowing
7. Borrowing costs incurred on specific borrowings shall be capitalised fully after considering the income from investments (investments made out of unutilized borrowings)
8. Borrowing costs incurred on general borrowings shall be capitalised using capitalization rate based on the actual expenses incurred. In no case capitalised sum shall exceed actual borrowing cost.
9. Process of capitalization shall be suspended if the development of assets is interrupted. However if the suspension of activity is part of developmental process then suspension of capitalization should not be recommended. In simple terms, if the interruption is part of development process, capitalization should continue.
10. Once the development process is completed substantially, capitalization process will be ceased.
11. What is substantial period of time for development is generally indicated as 12 months, which can differ from enterprise to enterprise. Therefore it is a matter of accounting policy to be disclosed along with the amount capitalised during the accounting period.

AS – 16 Problems & Hint Answers**Question**

S Ltd. started construction of a plant on 1.9.07, estimated to cost Rs.10 crores. The company did not raise any specific borrowings. It intends to use general borrowings which have a weighted average cost of 10%. Total borrowings cost incurred during 1-9-07 to 31.3.08 were Rs.0.60 crores.

The other relevant details are as under:

Month	Cost of construction accrued	Cash outflows [paid in advance at the start of each month]
September 2007	2.00	2.00
October 2007	0.50	1.50
November 2007	1.30	3.00
December 2007	0.50	-
January 2007	1.50	1.50
February 2007	0.30	-
March 2007	3.00	1.50

What is the amount of interest that should be capitalised as cost of plant in the financial statements during 2007-08?

Hint Answer:

Interest to be capitalised = $[2 \times 7 / 12 \times 10\%] + [1.5 \times 6 / 12 \times 10\%] + [3 \times 5 / 12 \times 10\%] + [1.5 \times 3 / 12 \times 10\%] + [1.5 \times 1 / 12 \times 10\%] = 0.37$ crores

Question

X Ltd. started constructing manufacturing plant on 1st April, 2007. During the year Rs.1200 crores were evenly incurred for construction of plant. At the beginning of the year, the company had the following borrowings:

	Amount [Rs. In crore]	Rate of interest
Term Loan from Financial Institution [specifically for the manufacturing plant]	300	10%
Bank Loans		
- Indian Bank	400	11%
- ICICI Bank	400	12%
- State Bank of India	200	12%

What is the amount of interest to be capitalised as on 31.12.08?

Hint Answer:

Specific Borrowings: $Rs.300 \times 10\% = Rs.30$ crores

Weighted Average Rate = $[(400 \times 11\%) + 400 \times 12\%] + [200 \times 12\%] / [400 + 400 + 200] = 11.6\%$

General Borrowings = $[1200 - 300] \times \frac{1}{2} \times 11.6\% = Rs.52.2$ crores

Total Interest to be capitalised = $Rs.30$ crores + $Rs.52.2$ crores = $Rs.82.2$ crores

Question

A building was constructed from 1.1.08 till 31.12.08 from borrowing of Rs.20 lacs taken from a financial institution on 1.1.08 @ 10%. Surplus funds were invested till 30.6.08 yielded

Rs.30,000 interest. Show how much borrowing cost will be capitalised for the year ended 30.6.08?

Hint Answer:

Interest for the period 1.1.08 to 31.12.08 = 20 lacs x 10 % = 2 lacs

Less: Interest on surplus funds received = Rs.30,000

Borrowing costs to be capitalised = Rs. 2,00,000 – Rs.30,000 = Rs.1,70,000

AS - 19
LEASES

Applicable enterprise	All
Appendix	1

1. There are two things in case of leases. One is the parties and the other is the asset taken up on lease
2. Parties are referred to as lessor and lessee. Owner of the asset is lessor and the user of the asset is lessee.
3. There are two types of leases. They are finance lease and operating lease.
4. In any lease, the lessor will give the right to use the asset to the lessee for a term for a payment or series of payments.
5. In case of finance lease, the lessor transfers substantially all the risks and the rewards incident to the ownership of the asset to the lessee.
6. Other than finance lease, all leases are operating leases.
7. The entire AS focuses only on non-cancellable lease.
8. There is no clear-cut definition for the term finance lease, however examples /situations which will indicate the presence of finance lease is given in Para 8. The situations envisaged there are like this way:
 - (a) The lessee should automatically get the asset at the end of the lease term.
 - (b) The lease term covers major portion of the useful life of the asset.
 - (c) The lessor could recover major cost of the asset through lease.
 - (d) The lessee is given the option to purchase at a substantially lower price at the end of the lease when compared to the fair value of the asset by then.
 - (e) The leased asset can never be used by any other person after the lease term.
9. These are indicative situations and not to be employed as cumulative conditions. In USA, finance lease is referred to as Capital lease. US GAAP specifies 75% of the useful life if covered, then it is taken as capital lease. Similarly if 90% of the cost is recovered, then the lease can be taken up as capital lease.
10. So one need to look for those example situations to take up the lease as finance lease. If those situations were absent then it will be handled as operating lease.
11. Finance lease in the books of lessee shall be recorded as asset as well as liability. The cost at which it shall be recorded shall not exceed the fair value of the asset. However if the Minimum Lease Payment (MLP) at PV terms were to be lower than the fair value, then MLP at PV terms will be recorded.
12. MLP has different meaning for lessee and lessor. The meaning for lessee is narrower than that for lessor.
13. MLP includes the regular lease rental payment *plus* guaranteed residual value
14. This guaranteed residual value is the bone of contention between the parties. For lessee it is the amount directly guaranteed or given guarantee on behalf by other party. Whereas from the lessor's point of view it includes besides the above, the choice of guarantee provided by third party independently having such financial capability to guarantee the leased asset at the end of the term.
15. Sometimes the lessee is given the option to take the asset at the end of the lease term for a substantially lower price than the fair value prevailing at the end of the term. This would definitely be an incentive for the lessee to take the asset at the end of the term. On such occasions the MLP will never have GRV but only this purchase option price. Consequently there will be no conflict in the meaning of MLP between the parties.
16. Finance lease shall appear on the asset side of the lessee and depreciation will be provided just like in any other owned asset. The lease rental payments will be split into principal and

interest components. The interest portion will be debited to profit and loss account and the principal amount will be shown as deduction from the liability.

17. The remaining amount of liability after the deduction of principal amount shall be reconciled each year as one, outstanding within one year and above, more one and but less than five year and above five years. The reconciliation shall be done with MLP at absolute terms as well as MLP at PV terms generated by using cost of capital implicit in the lease agreement with the outstanding figure shown in the balance sheet.
18. Mostly lessor will be financiers operating the business only for the interest content in the LR as income. Besides that Tax benefit they would be claiming on depreciation because they are the legal owner from the department's point of view. If the lessor is a manufacturer, then the source of income shall be two. They are interest income and the profit on account of outright sale.
19. There are occasions of manufacturer lessor charging artificially low rate of interest to lure/promote volume of business. If such were the case then there would be tendency of recognizing the majority of the margin as profit rather than allocating to interest income. AS conveys it very clearly that the interest income should be reckoned as if the normal commercial rate of interest is applied and the balance shall be taken up as profit.
20. Sale and lease back is a situation through which the owner of an asset can effect a sale and take money on account of that and use the asset by taking back on lease. This is what it is termed as sale and lease back. People might be asking as why the owner of the asset had chosen this way of financing and not the way people would mortgage a property and get money but still use the asset. In case of mortgage the owner would get only a maximum offer price as its sale price or fair value whereas in case of sale and lease back he would get unrealistic price for the deal. Basically it is intended to source a big requirement that is not possible through mortgage.
21. Since the price is artificially fixed to make a convenient deal between the parties, the selling price agreed upon may not reflect the true value/fair value; separate exercise is to be made to arrive at the profit or loss.

Treatment of initial Indirect Cost

	Finance Lease	Operating Lease
Lessee	Capitalise [Para 15]	Expense [No reference]
Lessor	Capitalise or Expense [Para 31]	Capitalise or Expense [Para 42]
Manufacturer Lessor	Expense [Para 36]	NA

AS - 20

EARNINGS PER SHARE

Applicable enterprise	All
Appendix	7
ASI	12

1. EPS information is so vital for the equity shareholders in the decision making process which is to be communicated not only every year-end but also for every interim period.
2. EPS is to be reported even though the reporting enterprises report loss.
3. EPS shall be computed after taking into account for cumulative preference dividend even though it is not declared. But declaration is so important for deducting in case of non-cumulative preference dividend.
4. Arrears of preference dividend should not be considered in the arrival of EPS.
5. Diluted EPS should be given the same status as that of basic EPS.
6. Only such capital, which is ranking for dividend, shall be considered for the purpose of arriving at weighted average no of equity shares.
7. Bonus issue effected shall be considered as if the bonus shares were in existence from the earliest reporting period.
8. Diluted EPS is basically a sort of writing on the wall to the equity shareholders that the EPS might fall down/go up in case of negative EPS, when the potential equity shares are issued on the assumption that the same results would be reported in the future also.
9. It is felt that only in case dilution it is to be reported. In case of anti dilution no reporting is required.
10. Effective dates are to be taken for the calculation of WANES and not the actual date of issue of shares.
11. Weight is to be assigned taking no of months and face value of the shares into consideration.
12. In case rights issue is made at a price lower than the fair value, then there is a concession offered to the shareholders. The concession offered is to be quantified in terms of free shares, i.e. Bonus Shares. Whatever treatment accorded to bonus shares the same treatment should be extended in this case also.
13. When shares are bought back, the price offered will be greater than the fair value of the shares. In this case also bonus element is seen. Similar treatment should be given for the bonus element as given in case of rights issue.
14. When shares are issued with differential rights, the EPS should also reflect the rights towards dividend.
15. When more than one instrument giving room for potential equity shares, then the company should prioritize the instrument in the order of most dilutive, next most dilutive and so on. In case any instrument that is likely to cause anti dilution, then that instrument shall be excluded in the computation of Diluted EPS.

AS – 20 Problems & Hint Answers**Question**

Find out weighted average number of equity shares from the following information for the year ended 31.3.08:

Date	Transaction	Numbers of shares
1 st April, 2007	Opening Balance	1800
31 st August, 2007	Additional Shares issued for cash	600
1 st Feb, 2008	Buyback of shares	300

All the shares have equal rights and are fully paid.

Hint Answer:

$$\text{Weighted Average Number of Equity shares} = [1800 \times 12 / 12] + [600 \times 7 / 12] - [300 \times 2 / 12] = 2100$$

Question

Find out weighted average number of equity shares from the following information:

Date	Transaction	Number of shares
1 st Apr 2007	Opening Balance	14400
1 st Jun 2007	Amalgamation merger (Rs.6 paid up)	9000
1 st Oct 2007	Issue shares – Assets purchase on 1/7	7200
1 st Feb 2008	Buyback of ¼ of opening balance	

Hint Answer:

$$\text{Weighted Average Number of Equity Shares} = [14400 \times 12 / 12] + [9000 \times 6 / 10 \times 12 / 12] \times [7200 \times 9 / 12] - [14400 \times 1 / 14 \times 2 / 12] = 24600$$

Question

In April, 2007 a Ltd Co. issued 1,20,000 equity shares of Rs.100 each, Rs.50 per share was called up on that date which was paid by all shareholders. The remaining Rs.50 was called up on 1.9.2007. All shareholders paid the sum in September, 2007, except one shareholder having 24,000 shares. The net profit for the year ended 31.3.05 is Rs.3,28,000 before dividend on preference shares and dividend distribution tax of Rs.64,000.

Hint Answer:

$$\text{Amount attributable to Equity Share Holders} = \text{Rs.3,28,000} - \text{Rs.64,000} = \text{Rs.2,64,000}$$

$$\text{Weighted Average number of equity shares} = [120000 \times 50 / 100 \times 12 / 12] + [(120000 - 24000) \times 50 / 100 \times 7 / 12] = \text{Rs.88,000}$$

$$\text{Basic EPS} = \text{Rs.2,64,000} / 88,000 = \text{Rs.3 / share}$$

Question

Net Profit for Current Year = Rs.1 Crore,
 No of Equity shares Outstanding throughout the year = 50 lacs
 12% convertible debentures of Rs. 100 Lacs of Rs.100 each
 Each debenture is convertible to 10 equity shares.
 Income tax rate = 30%.

Find out

- a. Basic EPS
- b. Diluted EPS
- c. Find out the impact of dilutive earning per share on basic EPS.

Hint Answer:

- **Basic Earnings = 100L (Assumed as after tax earnings)**
 - **Diluted Earnings = 108.4L {Basic Earnings = 100L (+) Deb. Interest = 8.4L (12% on 100L x 70%)}**
 - **WANES (Basic) = 50L x 12/12 = 50L**
 - **Debenture converted in to equity = (100L / 100) x (10 / 1) = 10 lacs**
 - **WANES Diluted = (50L x 12/12) + (10L x 12/12) = 60L**
 - **EPS basic = 100L / 50L = Rs.2**
 - **EPS Diluted = 108.4L / 60 L = Rs.1.81**
 - **Impact on Dilution is 0.19 (2 - 1.81)**
-

AS - 26

INTANGIBLE ASSETS

Applicable enterprise	All
Appendix	2

1. Intangible assets are identifiable assets having no physical substance, which are non-monetary in nature and expected to generate future economic benefits.
2. It should be under the fullest control of the enterprise.
3. Intangible assets can be acquired independently, through acquisition of business, exchange of another intangible asset or security.
4. It can also be given as part of government grant.
5. Internally generated intangible assets are not capitalised unless such expenditure is identified as part of development phase.
6. Expenditure under Research phase is expensed
7. Once an item is expensed it can never be taken back for capitalization process.
8. However if additional expenses are incurred resulting in enhanced future economic benefits than originally assessed benefits, then such expenses can be capitalised or else it will be expensed
9. Residual value will normally be taken up as nil, unless there is a commitment by a third party for an amount.
10. Intangible assets are normally amortised during its best estimate of useful life not exceeding ten year. In case the life is contractually decided as greater than ten years then, such number of years can be used for amortisation.
11. Amortisation method shall reflect the pattern in which the asset's economic benefits are consumed by the enterprise.
12. Development expenditure is not capitalised immediately. It is deferred before it is capitalised. Until the capitalization stage is over, it shall appear under the head Miscellaneous expenditure. Once the capitalization process is over, it is taken under Fixed assets.
13. Normally recoverable amount is determined for assets that are tested for impairment at every balance sheet date. In the cases of intangible asset that are in the stage of development and intangible assets whose costs are amortised for a period exceeding ten years, an enterprise should estimate the recoverable amount even though there is no indication of the asset is impaired

AS – 26 Problems & Hint Answers**Question**

Rajesh Ltd. develops and manufactures exotic cutlery and has the following projects in hand.

Particulars	1	2	3	4
Deferred development Expenditure b/f 1.1.04	-	450	-	-
Development expenditure incurred during the year				
Salaries, Wages so on	29	-	60	20
Overhead costs	5	-	-	3
Materials and services	13	-	11	4
Patents and licenses	2	-	-	-

Project 1: Rs.3,70,000 development expenditure on this project has been written off in previous years. Directors now believe, on the best advice that the project will in future earn revenue considerably in excess of all development costs and they therefore wish to reinstate the expenditure of the previous years.

Project 2: commercial production started during the year. Sales were 20000 units in 2004 and future sales are expected to be 2005 – 30000 units; 2006- 60000 units; 2007 – 40000 units; 2008 – 10000 units. There are no sales expected after 2008.

Project 3: these costs relate to a new project, which meets the criteria for deferral of expenditure and which is expected to last for three years.

Project 4 is another new project, involving the development cost and not expected to raise the level of future sales.

The Company follows AS 26. Show how the above projects should be treated in the Accounting statements of Rajesh Ltd. for the year ended 31st December 2008.

Hint Answer:

Project 1: Past expensed item can never be capitalised in future

Project 2: Amount to be amortized = $450 \times 20000 / 160000 = 56.25$

Project 3: Since the project meets the recognition criteria, the entire amount shall be capitalised

Project 4: Since there is no future economic benefits, entire amount should be charged to P & L a/c. One of the conditions for recognizing intangible asset is future economic benefits.

Question

Comment on how the following should be treated –

1. A company spent Rs.200,000 on acquiring new plant and machinery for its R&D unit.
2. In previous years the company had spent Rs.2 million on developing a cure for influenza. This had previously been capitalized in accordance with the criteria laid down in AS 26. However, circumstances have changed and the product is viewed as no longer viable. Rs.100,000 had already been spent in the current year.

Hint Answer:

1. Rs.2,00,000 should be capitalised as Plant & Machinery. Even though Plant and Machinery is used for R&D unit, its identity as “Tangible Fixed Asset” will not change.

2. Since the product is no longer viable, intangible asset should be derecognised in the statement of P & L.

Question

You are the management accountant of XYZ Ltd. The financial statements for the year ended 31st March 2008 are currently being finalized and are due to be published and filed in 30th June 2008. Your assistant has highlighted the following transaction.

For a number of years XYZ Ltd has been selling a product called "Timid" which is a superior brand of washing powder. This product was developed by the company and has now become a household name and has captured a substantial share of the market. Your assistant has heard members of the board express the view that the value of the Timid brand name 'must be worth at least Rs.400 Lakhs' and proposes to bring an intangible asset of Rs.400 Lakhs into the financial statements by debiting intangible fixed assets and crediting reserves.

Comment on whether the treatment suggested by your assistant is correct.

Hint Answer:

Internally generated intangible asset like goodwill, brand, mastheads, etc. should not be capitalised. Suggestion made by assistant is incorrect.

AS - 29

PROVISIONS, CONTINGENT LIABILITIES & ASSETS

Applicable enterprise	All
Appendix	5
ASI	30

1. All events are not qualifying for a place of recording in the books of accounts either in the form of adjustment in the books or disclosure
2. Only obligating event will be taken up for consideration. Non-obligating event will be ignored.
3. Obligating event is the one that has no other realistic way of settlement except to honor the obligation that includes onerous contracts
4. Obligation events will be classified as (a) Present obligation and (b) possible obligation
5. Liability is a present obligation on the reporting date that arose on account of past events, which would result in outflow of resources embodying economic benefits.
6. Provision is also a liability that is computed with a fair degree of estimation.
7. If estimation of outflow of resources becoming difficult then the event shall be taken up as contingent liability.
8. Similarly when the obligating event is classified as possible and that event is not likely to result in outflow of resources at all or the chances of outflow is remote, then, contingent liability need not be disclosed. If this is not the case, then disclose as contingent liability. But at the same time if the possible obligation is identified as persisting but the outflow is not determinable, continue to disclose as contingent liability with all the facts of the case.
9. In case a company had undertaken joint and several liability, contingent liability shall be disclosed only to the extent of other parties share in the joint and several liability.
10. Contingent asset shall be recognized only when it is virtually certain of recovery
11. In the event of contingent asset arising out of counter party commitment, it shall be recorded only when it is virtually certain, only to the extent of provision created for our obligation to another third party.
12. No provision should be created for future operating losses.
13. Provision for loss shall be made on account of restructuring only when there is a binding agreement made on restructuring.

AS – 29 Problems & Hint Answers**Question No:**

A company follows a policy of refunding money to the dissatisfied customers if they claim within thirty days from the date of purchase and return the goods. It appears from the past experience that in a month only 0.25% of the customers claim refunds. The company sold goods amounting to Rs.10 lakhs during the last month of the financial year. Whether provision should be created?

Hint Answer:

Since there is a present obligation as a result of past event [sales] and outflow of resources embodying economic benefits are probable, provision should be created for Rs.2,500 [10 lakhsx0.25%]. Also there is no realistic alternative to settle the obligation.

Question No:

An enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31.3.08 it is virtually certain that a law requiring a clean up of land already contaminated will be enacted shortly after the year end

Hint Answer:

Contamination of land is the obligating event. Outflow of resources embodying economic benefits is probable. Because of virtual certainty of legislation requiring cleaning up, a provision is required for the best estimate of the costs of cleanup.

Question No:

An airline is required by law to overhaul its aircraft once in every three years. Is there any provision required?

Hint Answer:

Since there is no present obligation, no provision is recognised. There is a realistic alternative that enterprise could avoid the future expenditure by its future actions. Example: Sell the aircraft.

Question No:

During the year under review, the company was visited by the tax authorities for the verification of the tax expense of the two preceding years. Shortly before reporting date, the company received a notification reassessing its tax expense for those two years and calling for an additional payment of Rs.48,00,000. The company has replied to the tax authorities indicating that it accepts part of the assessment but rejects certain points and is ready to defend its position, if necessary, in the court. The amount accepted is Rs.24,00,000.

Hint Answer:

The existence of liability is proved by the notice given by the department which the company admits only for Rs.24 Lacs. The remaining 24 Lacs for which it prepares to take up in the court of law for defence. Rs.24 lacs for the admitted amount, it shall create provision and for the remaining amount contingent liability shall be shown.
