

PAPER – 1 : ADVANCED ACCOUNTING

Answer all questions.

Working notes should form part of the answer.

Question 1

(a) Following is the information of two companies for the year ended 31st March, 2009:

	Aikya Ltd. (Rs.)	Bakya Ltd. (Rs.)
Equity shares of Rs.10 each	8,00,000	10,00,000
10 per cent Preference shares of Rs.10 each	6,00,000	4,00,000
Profit after tax	3,00,000	3,00,000
Assume that the market expectation is 18 percent and 80 percent of the profits are distributed as dividends.		

- (i) What is the rate you would pay to the equity shares -
 - (a) If you are buying a small lot?
 - (b) If you are buying a controlling interest in shares?
 - (ii) If you plan to invest only in Preference shares, which company's preference share would you choose?
- (b) From the following particulars of three companies, ascertain the value of goodwill. Terms and conditions are as follows:
- (i) Assets are to be revalued.
 - (ii) Goodwill is to be valued at four years' purchase of average super profits for three years. Such average is to be calculated after adjustment of depreciation at ten per cent on the amount of increase/decrease on revaluation of fixed assets. Income tax is to be ignored.
 - (iii) Normal profit on capital employed is to be taken at 10 per cent, capital employed being considered on the basis of net revalued amounts of tangible assets.

The summarized Balance Sheets and relevant information are given below:

				(Rs. in Lakhs)			
Liabilities	P Ltd.	Q Ltd.	R Ltd.	Assets	P Ltd.	Q Ltd.	R Ltd.
Equity shares of Rs.10 each	12.00	14.00	6.00	Goodwill	-	1.00	-
Reserves	2.00	1.00	2.00	Net tangible block	16.00	12.00	10.00
10 percent debentures	4.00	-	2.00	Current assets	6.00	5.00	2.00

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Trade and
expenses
creditors

4.00	3.00	2.00
22.00	18.00	12.00

22.00	18.00	12.00
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	P Ltd. Rs.	Q Ltd. Rs.	R Ltd. Rs.
Revaluation of tangible block	20,00,000	10,00,000	12,00,000
Revaluation of current assets	7,00,000	2,80,000	1,60,000
Average annual profit for three years before charging debenture interest	3,60,000	2,88,000	1,56,000
		(10+6 = 16 Marks)	

Answer

- (a) (i) (a) Buying a small lot of equity shares: If the purpose of valuation is to provide database to aid a decision of buying a small (non-controlling) portion of the equity of the companies, dividend capitalization method is most appropriate. Under this method, value of equity share is given by:

$$\frac{\text{Dividend Per Share}}{\text{Market Capitalisation Rate}} \times 100$$

$$\text{Aikya Ltd: } \frac{\text{Rs. 2.40}}{18} \times 100 = \text{Rs. 13.33 (approx.)}$$

$$\text{Bakya Ltd: } \frac{\text{Rs. 2.08}}{18} \times 100 = \text{Rs. 11.56 (approx.)}$$

[Refer Working Note for computation of dividend per share]

- (b) Buying controlling interest in equity shares: If the purpose of valuation is to provide database to aid a decision of buying controlling interest in the company, Earnings per share (EPS) capitalization method is the most appropriate. Under this method, value of equity share is given by:

$$\frac{\text{Earning Per Share (EPS)}}{\text{Market Capitalisation Rate}} \times 100$$

$$\text{Aikya Ltd: } \frac{\text{Rs. 3}}{18} \times 100 = \text{Rs. 16.67 (approx.)}$$

$$\text{Bakya Ltd: } \frac{\text{Rs. 2.60}}{\text{Rs. 18}} \times 100 = \text{Rs. 14.44 (approx.)}$$

[Refer Working Note for computation of earnings per share]

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- (ii) Preference Dividend coverage ratios of both companies are to be compared to make such decision. Dividend coverage ratio is given by:

$$\frac{\text{Profit after Tax}}{\text{Preference Dividend}}$$

$$\text{Aikya Ltd: } \frac{\text{Rs. 3,00,000}}{\text{Rs. 60,000}} = 5 \text{ times}$$

$$\text{Bakya Ltd: } \frac{\text{Rs. 3,00,000}}{\text{Rs. 40,000}} = 7.5 \text{ times}$$

If we are planning to invest only in Preference Shares, we would prefer shares of Bakya Ltd., as there is more coverage for preference dividend.

Working Note:

Computation of earnings per share and dividend per share

	Aikya Ltd. Rs.	Bakya Ltd. Rs.
Profit after tax	3,00,000	3,00,000
Less: Preference Dividend	<u>60,000</u>	<u>40,000</u>
Earnings available to equity shareholders (A)	<u>2,40,000</u>	<u>2,60,000</u>
Number of equity shares (B)	80,000	1,00,000
Earning per share (A/B)	3.00	2.60
Retained earnings (20%)	48,000	52,000
Dividend declared (80%) (C)	1,92,000	2,08,000
Dividend per share (C/B)	2.40	2.08

- (b) Valuation of Goodwill

	P Ltd. Rs.	Q Ltd. Rs.	R Ltd. Rs.
Average annual profit after charging debenture interest	3,20,000	2,88,000	1,36,000
Less/Add : Depreciation on increased/decreased portion of revaluation	(-)40,000	+20,000	(-) 20,000
	<u>2,80,000</u>	<u>3,08,000</u>	<u>1,16,000</u>
Less: Normal profit at 10% on capital employed as calculated in working note	1,90,000	98,000	96,000
Super Profit	<u>90,000</u>	<u>2,10,000</u>	<u>20,000</u>
Goodwill valued at four years' purchase of super profits	<u>3,60,000</u>	<u>8,40,000</u>	<u>80,000</u>

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Working Note:

Calculation of Capital Employed

	P Ltd. Rs.	Q Ltd. Rs.	R Ltd. Rs.
Tangible fixed assets	20,00,000	10,00,000	12,00,000
Current assets	7,00,000	2,80,000	1,60,000
	27,00,000	12,80,000	13,60,000
Less: Debentures and Creditors	8,00,000	3,00,000	4,00,000
	19,00,000	9,80,000	9,60,000

Question 2

Agni Ltd. and Bayu Ltd. both engaged in similar merchandising activities since 2006, decide to amalgamate their businesses. A holding company, Chandrama Ltd. would be formed on 1st January, 2008 to acquire the entire shares in both the companies.

From the information given below you are required to prepare:

- (a) A statement of purchase consideration, supported by requisite working notes.
- (b) Balance Sheet of Chandrama Ltd. after the transactions have been completed.
 - (i) The terms of the offer were:
 - Rs.100, 15 per cent debentures for every Rs.100 of net assets owned by each company on 31st December, 2007.
 - Rs.100 equity shares based on two years purchase of profit before taxation. The profit is to be determined by taking weighted average profits of 2006 and 2007, weights being 1 and 2 respectively.
 - (ii) It was agreed that the accounts of Bayu Ltd. for the two years ended 31st December, 2007 be adjusted, where necessary, to conform to the accounting policies followed by Agni Ltd.
 - (iii) The Pre-tax profits, including investment income, of the two companies were as follows:

	2006 Rs.	2007 Rs.
Agni Ltd.	16,38,000	18,36,000
Bayu Ltd.	17,88,300	25,74,000

- (iv) Agni Ltd. values its stock on FIFO basis while Bayu Ltd. used a different basis. To bring Bayu Ltd.'s values in line with those of Agni Ltd, value of its stock will require to be reduced by Rs.36,000 at the end of 2006 and Rs.1,02,000 at the end of 2007.
 - (v) Both the companies use straight line method of depreciation.

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- (vi) Bayu Ltd. deducts 1 per cent from trade debtors as a general provision against doubtful debts.
- (vii) Prepaid expenses in Bayu Ltd. include advertisement expenditure carried forward of Rs.1,80,000 in 2006 and Rs.90,000 in 2007, being part of initial advertising in 2006, which is being written off over three years. Similar expenditure in Agni Ltd. has been fully written off in 2006.
- (viii) To bring Director's remuneration on to a comparative basis, the profits of Bayu Ltd. are to be reduced by Rs.1,20,000 in 2006 and Rs.1,80,000 in 2007 and the net assets are also to be adjusted accordingly.

Balance Sheets as at 31st December, 2006 and 2007 were as follows:

Agni Ltd.					
Liabilities	2006	2007	Assets	2006	2007
	Rs.	Rs.		Rs.	Rs.
Share capital issued and subscribed: 12,000 shares of Rs.100 each, fully paid	12,00,000	12,00,000	Fixed assets: Furniture and Fixtures: at cost	6,90,000	6,90,000
Reserves and Surplus:			Less: depreciation	(69,000)	(1,38,000)
Capital reserve	-	2,10,000	Investments:		
Revenue reserve	7,98,300	16,74,000	Quoted investments at market value	-	7,80,000
Current Liabilities and provisions:			Current assets:		
Sundry creditors	15,02,700	18,21,000	Stock at cost	18,30,000	21,75,000
Provision for taxation	8,40,000	9,60,000	Sundry debtors	18,00,000	22,20,000
			Prepaid expenses	30,000	42,000
			Cash at bank	60,000	96,000
	<u>43,41,000</u>	<u>58,65,000</u>		<u>43,41,000</u>	<u>58,65,000</u>
Bayu Ltd.					
Liabilities	2006	2007	Assets	2006	2007
	Rs.	Rs.		Rs.	Rs.
Share capital: Issued and subscribed 15,000 Equity shares of Rs.100 each, fully paid	15,00,000	15,00,000	Fixed assets: Furniture and fixture at cost	9,60,000	9,60,000
Reserves and surplus:			Less: Depreciation	(1,44,000)	(2,88,000)

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Revenue reserve	8,58,000	21,42,000	Investments:		
Current liabilities and provisions:			Quoted investments		
Sundry creditors	14,70,000	14,82,000	(Market value Rs.14,70,000)	-	12,00,000
Bank overdraft	-	5,10,000	Current assets:		
Provision for taxation	9,30,000	12,90,000	Stock at cost	17,91,000	22,26,000
			Sundry debtors		
			Less: provision	17,82,000	26,73,000
			Prepaid expenses	2,16,000	1,44,000
			Cash at bank	1,53,000	9,000
	<u>47,58,000</u>	<u>69,24,000</u>		<u>47,58,000</u>	<u>69,24,000</u>

(16 Marks)

Answer

(a) Statement of Purchase Consideration

Agni Ltd.				Bayu Ltd.		
Year	PBT (Rs.)	Weight	Rs.	PBT (Rs.)	Weight	Rs.
2006	16,38,000	1	16,38,000	15,18,300*	1	15,18,300
2007	18,36,000	2	36,72,000	27,63,000*	2	55,26,000
Total Profit			53,10,000	70,44,300		
Weighted average profit (Divided by 3)			17,70,000	23,48,100		
(i)	Two years' purchase of average profits		35,40,000	46,96,200		
(ii)	Net assets (Refer working notes 2 and 3)		30,84,000	35,43,000		
			66,24,000	82,39,200		

(iii) Discharge of purchase consideration

82,362 Shares will be issued for goodwill amounting Rs. 82,36,200
(Rs.35,40,000 + Rs. 46,96,200)

66,270 15% Debentures will be issued for net assets amounting Rs. 66,27,000
(30,84,000 + 35,43,000)

Total purchase consideration will amount to Rs.1,48,63,200.

* (Refer W.N. 1)

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(b) Balance Sheet of Chandrama Ltd. as on 1st January, 2008

Liabilities	Rs.	Assets	Rs.
Share Capital- issued and subscribed		Investments	
82,362 Equity shares of Rs.100 each, fully paid up	82,36,200	Shares in Agni Ltd.	66,24,000
(Issued for consideration other than cash)		Shares in Bayu Ltd.	82,39,200
Secured Loans			
66,270 15% Debentures of Rs.100 each, fully paid	66,27,000		
	<u>1,48,63,200</u>		<u>1,48,63,200</u>

Working Notes:

1. Statement of adjusted Net Profits of Bayu Ltd.

	Year 2006		Year 2007	
	Rs.	Rs.	Rs.	Rs.
Net Profit as given		17,88,300	-	25,74,000
Add: Provision for Bad Debts - Note (a)	18,000		27,000	
Advertising	-		90,000	
Depreciation- Note (b)	48,000		48,000	
Appreciation in Investment	-		2,70,000	
Value of Opening Stock	-	66,000	36,000	4,71,000
		<u>18,54,300</u>		<u>30,45,000</u>
Less: Value of Closing Stock	36,000		1,02,000	
Advertising	1,80,000		-	
Directors' Remuneration	1,20,000	3,36,000	1,80,000	2,82,000
		<u>15,18,300</u>		<u>27,63,000</u>

Note:

	Rs.	Rs.
	Year 2006	Year 2007
(a) Sundry Debtors as per Balance sheet	17,82,000	26,73,000
Provision created		
1% of (Rs. 17,82,000 / .99)	18,000	
1% of (Rs. 26,73,000 / .99)		27,000

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- (b) Rate of depreciation under straight line method for Agni Ltd. and Bayu Ltd. can be computed as follows:

Agni Ltd. = $\text{Rs.}(69,000 / 6,90,000) \times 100 = 10\%$.

Bayu Ltd. = $\text{Rs.}(1,44,000 / 9,60,000) \times 100 = 15\%$

Difference of 5% in depreciation amount i.e. (5% of Rs.9,60,000 = Rs. 48,000) has been added back to ensure uniform accounting policies.

2. Statement of Net Assets of Agni Ltd.

	Rs.	Rs.
Total Assets		58,65,000
Less: Sundry Creditors	18,21,000	
Provision for Taxation	<u>9,60,000</u>	27,81,000
		<u>30,84,000</u>

3. Statement of Adjusted Net Assets of Bayu Ltd.

	Rs.	Rs.
Furniture and Fixtures	9,60,000	
Less: Depreciation at 10% p.a. for two years	<u>1,92,000</u>	7,68,000
Quoted investments at market value		14,70,000
Stock (Rs.22,26,000 – Rs.1,02,000)		21,24,000
Sundry Debtors after Reversal of Provision (Rs.26,73,000 + Rs.27,000)		27,00,000
Prepaid Expenses (Rs.1,44,000 – 90,000)		54,000
Cash at Bank		<u>9,000</u>
		71,25,000
Less: Sundry Creditors	14,82,000	
Bank Overdraft	5,10,000	
Liability for Directors' Remuneration (1,20,000 + 1,80,000)	3,00,000	
Provision for Taxation	<u>12,90,000</u>	35,82,000
		<u>35,43,000</u>

Question 3

- (a) Parikshit Ltd. holds Rs.1,00,000 of loans yielding 18 per cent interest per annum for their estimated lives of 9 years. The fair value of these loans, after considering the interest yield, is estimated at Rs.1,10,000.

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The company securitises the principal component of the loan plus the right to receive interest at 14% to Susovana Corporation, a special purpose vehicle, for Rs.1,00,000.

Out of the balance interest of 4 percent, it is stipulated that half of such balance interest, namely 2 per cent, will be due to Parikshit Ltd. as fees for continuing to service the loans. The fair value of the servicing asset so created is estimated at Rs.3,500. The remaining half of the interest is due to Parikshit Ltd. as an interest strip receivable, the fair value of which is estimated at Rs.6,500.

Give the accounting treatment of the above transactions in the form of journal entries in the books of originator.

- (b) The Annuity fund of Patiala University accepts an annuity – based gift from an alumnus who specifies that he receives a monthly payment of Rs.25,000 for the remainder of his life. The gift consists of cash of Rs.20 lakh and securities having a market value of Rs.15 lakh at the time of the gift. The investment income of annuity fund for a particular month comes to Rs.38,500.

Draft journal entries in the University's books.

- (c) From the following information taken from the books of Sunagarik Ltd. relating to staff and community benefits, you are required to prepare a statement classifying the various items under the appropriate heads, required under corporate social reporting:

Particulars	Rs. in lakhs
Environmental improvements	36.18
Medical facilities	9.00
Training programmes	18.45
Generation of job opportunities	109.35
Municipal taxes	19.26
Increase in cost of living in the vicinity due to company's operations	29.79
Concessional transport, water-supply etc.	20.25
Generation of business	45.00
Leave encashment and leave travel benefits	93.60
Education facilities for children of staff members	38.88
Subsidised canteen facilities	25.92
Extra work put in by staff and officers for drought relief	33.30

(6+5+5= 16 Marks)

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Answer

(a)

Journal Entries in the Books of Originator

S.No.	Particulars		Debit Rs.	Credit Rs.
1.	Bank A/c	Dr.	1,00,000	
	To Loans (Cost of Securitised Component)			90,910
	To Profit on Securitisation			9,090
	(Being securitization of principal amount and right to receive interest at 14% interest rate)			
2.	Servicing Asset A/c	Dr.	3,180	
	Interest Strip A/c	Dr.	5,910	
	To Loans			9,090
	(Being creation of servicing asset and interest strip receivable)			

Working Notes:

1.	Fair value of securitized component of loan		Rs.
	Fair value of Loan		1,10,000
	Less: Fair value of servicing asset	3,500	
	Fair value of interest strip	<u>6,500</u>	<u>10,000</u>
			<u>1,00,000</u>

2. Apportionment of carrying amount based on relative Fair Values

Particulars	Fair Value Rs.	% based on Total Fair Value Rs.	Carrying Amount/Cost Rs.
Securitized component of the loan	1,00,000	90.91%	90,910
Servicing Asset	3,500	3.18%	3,180
Interest Strip Receivable	6,500	5.91%	5,910
	<u>1,10,000</u>	<u>100.00%</u>	<u>1,00,000</u>

3.	Profit on Securitisation		Rs.
	Net proceeds from securitisation		1,00,000
	Less: Cost (apportioned carrying amount) of securitized component of loan		<u>90,910</u>
			<u>9,090</u>

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(b)

Books of Patiala University
Journal Entries

S.No.	Particulars		Debit Rs.	Credit Rs.
1.	Bank A/c	Dr.	20,00,000	
	Investments A/c	Dr.	15,00,000	
	To Annuity Fund A/c			35,00,000
	(Being receipt of annuity based gift in the form of cash and marketable securities)			
2.	Bank A/c	Dr.	38,500	
	To Annuities Payable A/c			25,000
	To Annuity Fund A/c			13,500
	(Being monthly investment income received from the fund and surplus accruing after meeting the annuity payable, transferred to the fund)			
3.	Annuities Payable A/c	Dr.	25,000	
	To Bank A/c			25,000
	(Being monthly annuity payment made)			

(c)

Sunagarik Ltd.

Statement relating to Staff and Community Benefits

I.	Social Benefits and Cost to Staff	Rs. in lakhs
A.	Social Benefits to Staff	
1.	Medical Facilities	9.00
2.	Training Programmes	18.45
3.	Concessional Transport and Water Supply	20.25
4.	Leave Encashment and Leave Travel Benefits	93.60
5.	Educational Facilities for children of staff members	38.88
6.	Subsidized canteen facilities	25.92
	Total	206.10
B.	Social Costs to Staff	
	Extra work put in by staff and officers for drought relief	33.30
	Net Social Benefits to Staff (A-B)	172.80

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II. Social Benefits and Cost to Community

A. Social Benefits to Community

1. Environmental Improvements	36.18
2. Generation of Job Opportunities	109.35
3. Municipal Taxes	19.26
4. Generation of Business	45.00
Total	209.79

B. Social Costs to Community

Increase in cost of living in the vicinity due to company's operations	29.79
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Net Social Benefits to Community (A – B)	180.00
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Social Benefits to staff and community (I +II)	352.80
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Question 4

- (a) The borrowings profile of Santra Pharmaceuticals Ltd. set up for the manufacture of antibiotics at Navi Mumbai is as under:

Date	Nature of borrowings	Amount borrowed	Purpose of borrowings	Incidental expenses
		Rs.		
1 st January, 2008	15% demand loan	60 lakhs	Acquisition of Fixed assets	8.33%
1 st July, 2008	14.5% Term loan	40 lakhs	Acquisition of plant and machinery	5%
1 st October, 2008	14% bonds	50 lakhs	Acquisition of fixed assets	8%

The incidental expenses consist of commission and service charges for arranging the loans and are paid after rounding off to the nearest lakh.

Fixed assets considered as qualifying assets are as under: Rs.

Sterile Manufacturing shed	10,00,000
Plant and machinery (total)	90,00,000
Other fixed assets	10,00,000

The Project is completed on 1st January, 2009 and is ready for commercial production. Show the capitalization of the borrowing costs.

- (b) A company is engaged in the business of ship building and ship repair. On completion of the repair work, a work completion certificate is prepared and countersigned by ship owner (customer). Subsequently, invoice is prepared based on the work completion certificate describing the nature of work done together with the rate and the amount.

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Customer scrutinizes the invoice and any variation is informed to the company. Negotiations take place between the company and the customer. Negotiations may result in a deduction being allowed from the invoiced amount either as a lumpsum or as a percentage of the invoiced amount. The accounting treatment followed by the company is as follows:

- (i) When the invoice is raised, the customer's account is debited and ship repair income account is credited with the invoiced amount.
- (ii) Deduction, if any, arrived after negotiation is treated as trade discount by debiting the ship repair income account.
- (iii) At the close of the year, negotiation in respect of certain invoices had not been completed. In such cases, based on past experience, a provision for anticipated loss is created by debiting the Profit and Loss account. The provision is disclosed in Balance Sheet.

Following two aspects are settled in the negotiations:

- (i) Errors in billing arising on account of variation between the quantities as per work completion certificate and invoice and other clerical errors in preparing the invoice.
- (ii) Disagreement between the company and customer about the rate/cost on which prior agreement has not been reached between them.

Comment:

- (i) Whether the accounting treatment of deduction as trade discount is correct? If not, state the correct accounting treatment.
- (ii) Whether the disclosure of the provision for anticipated loss in Balance Sheet is correct; if not, state the correct accounting treatment. (10+6 = 16 Marks)

Answer

(a) Specific Borrowings

14.5% Term Loan for acquisition of Plant & Machinery	Rs.
Interest from 1 st July, 2008 to 31 st December, 2008 = Rs. 40,00,000 $\times$ 14.5% $\times$ $\frac{6}{12}$	2,90,000
Incidental Expenses	<u>2,00,000</u>
Total	<u>4,90,000</u>
General Borrowings	
15% Demand Loan	
Interest from 1 st January, 2008 to 31 st December, 2008 = Rs. 60,00,000 $\times$ 15%	9,00,000
Incidental Expenses	<u>5,00,000</u>
Sub Total (A)	<u>14,00,000</u>

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14% Bonds

Interest from 1st October, 08 to 31st December, 08 = Rs.50,00,000 x 14% x $\frac{3}{12}$ 1,75,000

Incidental Expenses 4,00,000

Sub Total (B) 5,75,000

Total General Borrowing Cost (A+B) 19,75,000

Total Average Outstanding Borrowings will be as under:

$$\frac{(60,00,000 \times 12 + 50,00,000 \times 3)}{12}$$
 72,50,000

Weighted Average Borrowing Cost =
$$\frac{\text{Total Borrowing Cost} \times 100}{\text{Total Average Outstanding}}$$

$$\frac{19,75,000 \times 100}{72,50,000}$$
 27.24%

Allocation of General Borrowing Fund

Item	Cost	Specific Borrowing	Net of specific borrowing
Sterile Manufacturing Shed	10,00,000	Nil	10,00,000
Plant & Machinery	90,00,000	40,00,000	50,00,000
Other Fixed Assets	10,00,000	Nil	10,00,000

Item	Expenditure on qualifying asset out of general borrowing fund	Capitalization Rate	Cost eligible for capitalization
Sterile Manufacturing Shed	10,00,000	27.24	2,72,400
Plant & Machinery	50,00,000	27.24	13,62,000
Other Fixed Assets	10,00,000	27.24	2,72,400

Borrowing Costs to be Capitalized

Assets	Specific Borrowing Cost	General Borrowing Cost	Total
Sterile Manufacturing shed	Nil	2,72,400	2,72,400
Plant & Machinery	4,90,000	13,62,000	18,52,000
Other Fixed Assets	Nil	2,72,400	2,72,400
Total	4,90,000	19,06,800*	23,96,800

* Borrowing cost capitalized on general borrowings is Rs.19,06,800 which is less than the actual borrowing cost.

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- (b) (i) As per AS 9 “Revenue Recognition”, revenue is recognized at the time when the invoice is raised to the customers; however the treatment of deduction as trade discount is not in accordance with AS 9. Considering the treatment prescribed by AS 4 “Contingencies and Events occurring after the Balance Sheet Date”, adjustment of the difference between the invoice amount and the amount finally settled against ‘Ship Repair Income’ account is in order. Events occurring up to the date of approval of the accounts by the Board of Directors should be taken into consideration in determining the amount of adjustment to be made in this regard. The description of the difference as ‘trade discount’ is not appropriate.
- (ii) In respect of ship repair jobs for which negotiations between the ship owners and the company are not over, the accounting treatment is not appropriate. Instead, the amount of difference between the invoiced amount and the amount likely to be finally settled (as estimated on the basis of past experience) should be adjusted in the “Ship Repair Income” by a corresponding credit to the accounts of the respective ship owners. Consequently, the figure of sundry debtors included in the balance sheet would be net of adjustment for such difference. In other words, the amount of the difference would be neither shown under the head provisions nor shown as a deduction from the sundry debtors in the balance sheet.

Question 5

- (a) Santhosh Ltd. granted 500 options to each of its 2,500 employees in 2003 at an exercise price of Rs.50 when the market price was the same. The contractual life (vesting and exercise period) of the options granted is 6 years with the vesting period and exercise period being 3 years each. The expected life is 5 years and the expected annual forfeitures are estimated at 3 per cent. The fair value per option is arrived at Rs.15. Actual forfeitures in 2003 were 5 per cent. However at the end of 2003 the management of Santhosh Ltd. still expects that the actual forfeitures would average only 3 per cent over the entire vesting period. During 2004 the management revises its estimated forfeiture rate to 10 per cent per annum. Of the 2,500 employees, 1,900 employees have completed the 3 year vesting period. 1,000 employees exercise their right to obtain shares vested in them in pursuance of ESOP at the end of 2007 and 500 employees exercise their right at the end of 2008. The rights of the remaining employees expire unexercised at the end of 2008. The face value per share is Rs.10. Show the necessary journal entries with suitable narrations. Workings should form part of the answer.
- (b) On 1st February, 2008, an Indian Company sold goods to an American Company at an invoice price of US \$20,000 when the spot market rate was Rs.48.10 to a U.S. dollar. Payment was to be made in three months time, namely, by 1st May, 2008.
- To avoid the risk of foreign exchange fluctuations the Indian exporter acquired a forward contract to sell U.S. \$20,000 at Rs.47.90 per U.S. dollar on 1st May, 2008.
- The Indian company's accounting year ended on 31st March, 2008 and the spot rate on this date was Rs.47.20 per U.S. dollar. The spot rate on 1st May, 2008, the date by which the money was due from the American buyer, was Rs.50 per dollar.
- Show what accounting entries will have to be made in the books of the Indian exporter at the relevant period of time.
- (10+10 = 20 Marks)

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Answer

(a)

Journal Entries

Year 2003		Rs.	Rs.
Employee Compensation Expense A/c	Dr.	57,04,205	
To Employee Stock Options Outstanding A/c			57,04,205
(Being the compensation expenses recognized in respect of the ESOP)			
Profit and Loss A/c	Dr.	57,04,205	
To Employee Compensation Expense A/c			57,04,205
(Being expenses of the year transferred to P & L A/c)			
Year 2004			
Employee Compensation Expense A/c	Dr.	34,08,295	
To Employee Stock Options Outstanding A/c			34,08,295
(Being the compensation expenses recognized in respect of the ESOP)			
Profit and Loss A/c	Dr.	34,08,295	
To Employee Compensation Expense A/c			34,08,295
(Being expenses of the year transferred to P & L A/c)			
Year 2005			
Employee Compensation Expense A/c	Dr.	51,37,500	
To Employee Stock Options Outstanding A/c			51,37,500
(Being the compensation expenses recognized in respect of the ESOP)			
Profit and Loss A/c	Dr.	51,37,500	
To Employee Compensation Expense A/c			51,37,500
(Being expenses of the year transferred to P & L A/c)			
Year 2007			
Bank A/c	Dr.	2,50,00,000	
Employee Stock Options Outstanding A/c	Dr.	75,00,000	
To Share Capital A/c			50,00,000
To Securities Premium			2,75,00,000

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(Being shares issued to employees against options vested in them in pursuance of the ESOP)

Year 2008

Bank A/c	Dr.	1,25,00,000	
Employee Stock Options Outstanding A/c	Dr.	37,50,000	
To Share Capital A/c			25,00,000
To Securities Premium A/c			1,37,50,000

(Being shares issued to employees against options vested in them in pursuance of the ESOP)

Employee Stock Options Outstanding A/c	Dr.	30,00,000	
To General Reserve A/c			30,00,000

(Being the balance standing to the credit of stock options outstanding account, in respect of vested options expired unexercised, transferred to general reserve account)

Working Notes:

1. Fair value of options recognized as expense

Year 2003

Number of options expected to vest = $500 \times 2,500 \times .97 \times .97 \times .97 = 11,40,841$ options

Fair value of options expected to vest = $11,40,841 \times \text{Rs.}15 = \text{Rs.}1,71,12,615$

One third of fair value recognized as expense = $\text{Rs.}1,71,12,615 / 3 = \text{Rs.}57,04,205$

Year 2004

Fair Value of options revised in the year = $500 \times 2500 \times 0.90 \times 0.90 \times 0.90 \times \text{Rs.}15 = \text{Rs.}1,36,68,750$

Revised cumulative expenses in year 2004 = $1,36,68,750 \times \frac{2}{3}$ 91,12,500

Less: Already recognized in year 2003 57,04,205

Expenses to be recognized in year 2004 34,08,295

Year 2005

Number of options actually vested = $1900 \times 500 = 9,50,000$

Fair Value of options actually vested = $9,50,000 \times 15$ 1,42,50,000

Less: Expense recognized till year 2005 91,12,500

Balance amount to be recognized 51,37,500

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2. Amount recorded in share capital account and securities premium account upon issue of shares

Particulars	Year 2007	Year 2008
Number of employees exercising option	1,000	500
Number of shares issued upon exercise of option @ 500 per employee	<u>5,00,000</u>	<u>2,50,000</u>
Exercise price received @ Rs.50 per share	2,50,00,000	1,25,00,000
Corresponding amount recognized in the 'Employee stock options outstanding A/c' @ Rs.15 per option	<u>75,00,000</u>	<u>37,50,000</u>
Total consideration	<u>3,25,00,000</u>	<u>1,62,50,000</u>
Amount to be recorded in 'Share capital A/c' @ Rs.10 per share	50,00,000	25,00,000
Amount to be recorded in 'Securities premium A/c' @ Rs.55 (i.e.65 –10) per share	<u>2,75,00,000</u>	<u>1,37,50,000</u>
	<u>3,25,00,000</u>	<u>1,62,50,000</u>

- (b) Journal Entries in the books of Indian Exporter

	Dr.	Cr.
	Rs.	Rs.
1 st February, 2008		
Sundry Debtors (American Company)A/c	Dr. 9,62,000	
To Sales A/c		9,62,000
(Being sales recorded at Rs. 9,62,000 [US\$ 20,000 x Rs.48.10])		
Forward (Rs.) Contract Receivables A/c (20,000 US \$ x Rs.47.9)	Dr. 9,58,000	
Deferred Discount A/c (20,000 US \$ x Rs. .20)	Dr. 4,000	
To Forward (\$) Contract Payable A/c (20,000 US \$ x Rs.48.10)		9,62,000
(Being forward exchange cover purchased and deferred discount amounting Rs.4,000 recorded)		
31 st March, 2008		
Profit and Loss A/c	Dr. 18,000	
To Sundry Debtors (American Company) A/c		18,000
(Being transaction loss recorded {20,000 US \$ x [Rs.48.10 less Rs. 47.2]} that occurred between the date of transaction and the date of closing of accounts)		

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Forward (\$) Contract Payable A/c	Dr.	18,000	
To Profit and Loss A/c			18,000
(Being exchange gain recorded {20,000 US \$ x [Rs.48.10 less Rs. 47.2]} as less rupees becoming payable to the exchange dealer on the basis of the spot rate at the end of the year)			
Discount A/c	Dr.	2,666	
To Deferred Discount A/c			2,666
(Being proportionate discount [two-third of Rs.4,000] charged as discount expenses)			
1 st May, 2008			
Bank A/c (20,000 US\$ x Rs. 50)	Dr.	10,00,000	
To Sundry Debtors A/c (20,000 US \$ x Rs. 47.2)			9,44,000
To Profit and Loss A/c (20,000 US \$ x Rs. 2.8)			56,000
(Being actual receipt of money from the buyer recorded)			
Forward (\$) Contract Payable (20,000 US \$ x Rs. 47.2)	Dr.	9,44,000	
Profit and Loss A/c (20,000 US \$ x Rs. 2.8)	Dr.	56,000	
To Bank A/c (20,000 US \$ x Rs. 50)			10,00,000
(Being delivery of 20,000 Dollars against forward contract at spot rate on 1 st May)			
Bank A/c	Dr.	9,58,000	
To Forward (Rs.) Contract Receivable A/c			9,58,000
(Being forward contract settled)			
Discount A/c (4,000- 2,666)	Dr.	1,334	
To Deferred Discount A/c			1,334
(Being balance amount of discount recognized)			

Question 6

- (a) Pilot Ltd. supplies the following information using which you are required to calculate the economic value added.
- Financial Leverage 1.4 times
 - Capital (equity and debt)

Equity shares of Rs.1,000 each	34,000 (number)
Accumulated profit	Rs. 260 lakhs
10 percent Debentures of Rs.10 each	80 lakhs (number)

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- Dividend expectations of equity shareholders 17.50%
 - Prevailing Corporate Tax rate 30%
- (b) Amigo Mutual Fund Ltd. is a SEBI Registered mutual fund. The Company follows the practice of valuing its investments on “mark to market basis”. For the financial year ended March, 2009 the investments which were acquired at a cost of Rs.109 crores were reflected in the Balance Sheet at Rs.89 crore. The company insists that the depreciation in value of the investments need not be disclosed separately in its financial statements since its investment valuation policy is disclosed as part of its accounting policies. Discuss the validity of this argument.
- (c) Good Drugs and Pharmaceuticals Ltd. acquired a sachet filling machine on 1st April, 2007 for Rs.60 lakhs. The machine was expected to have a productive life of 6 years. At the end of financial year 2007-08 the carrying amount was Rs.41 lakhs. A short circuit occurred in this financial year but luckily the machine did not get badly damaged and was still in working order at the close of the financial year. The machine was expected to fetch Rs.36 lakhs, if sold in the market. The machine by itself is not capable of generating cash flows. However, the smallest group of assets comprising of this machine also, is capable of generating cash flows of Rs.54 crore per annum and has a carrying amount of Rs.3.46 crore. All such machines put together could fetch a sum of Rs.4.44 crore if disposed. Discuss the applicability of Impairment loss.
- (d) EXOX Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2008. The company seeks your advice on the following:
- (i) The Company's sales tax assessment for assessment year 2005-06 has been completed on 14th February, 2008 with a demand of Rs.2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.
 - (ii) The Company has entered into a wage agreement in May, 2008 whereby the labour union has accepted a revision in wage from June, 2007. The agreement provided that the hike till May, 2008 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 2008. (6+4+3+3= 16 Marks)

Answer

(a) Computation of EVA	Rs. in lakhs
Net Profit after Tax (Refer Working Note 1)	140
Add: Interest [adjusted for tax effect ($800 \times 10\% \times 0.70$)]	<u>56</u>
	196
Less: Cost of Capital (Refer Working Note 2)	<u>161</u>
Economic Value Added (EVA)	<u>35</u>

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Working Notes:

1. Interest and Net Profit

$$\text{Financial Leverage} = \frac{\text{Profit before Interest \& Taxes (PBIT)}}{\text{Profit before Tax (PBT)}}$$

Interest on Borrowings = Rs. 800 lakhs × 10% = Rs.80 lakhs

Therefore,	1.40	=	PBIT
			PBIT – Interest
	1.40	=	PBIT
			PBIT – 80
	1.40 (PBIT- 80)	=	PBIT
	1.40 PBIT- 112	=	PBIT
	1.40 (PBIT- PBIT)	=	112
	0.40 PBIT	=	112
	PBIT	=	112/0.40
	PBIT	=	Rs. 280 lakhs
	PBT = PBIT- I =280-80	=	Rs. 200 lakhs
	Tax (30%)	=	Rs. 60 lakhs
	Net profit after tax	=	Rs. 140 lakhs

2. Cost of Capital

	Rs.(in lakhs)
Equity Shareholders' funds	600
10% Debenture holders' funds	<u>800</u>
Total	<u>1400</u>

$$\text{Weights assigned to Equity shareholders fund} = \frac{600}{1400} = 0.4286$$

$$\text{Weights assigned to Debenture holders fund} = \frac{800}{1400} = 0.5714$$

Source of Funds	Amount (Rs.in lakhs)	Weight	Cost %	WACC %
(1)	(2)	(3)	(4)	(5)=(3 × 4)%
Equity share holders' funds	600	0.4286	17.50	7.50
Debenture holders' funds	<u>800</u>	<u>0.5714</u>	<u>7.00*</u>	<u>4.00</u>
Total	<u>1400</u>	<u>1.0000</u>	<u>----</u>	<u>11.50</u>

* Rate of interest net of corporate tax of 30%.

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Cost of Capital = Average Capital Employed × Weighted Average cost of Capital (WACC)
= Rs.1400 lakhs × 11.50% = Rs.161 lakhs

- (b) The Guidance note on “Accounting for Investments in Financial Statements of Mutual Funds” provides that Investments should be marked to market on balance sheet date with provision for depreciation, if any, in the value of investments debited to revenue account. The provision so created should be shown as a deduction from the value of investments in the Balance Sheet. The Guidance notes further states that the depreciation or appreciation should be worked out on individual basis or by category of investment basis but not on an overall basis. Keeping in view ‘prudence’ as a factor for preparation of financial statements and correct disclosure of the amount of depreciation on investments, the Guidance Note states that the gross value of depreciation on investments should be reflected in the revenue account rather than the same being netted off with the appreciation in the value of other investments. Thus the claim of Amigo Mutual Fund Ltd. is not correct.
- (c) As per provisions of Para 91(b) of AS 28 “Impairment of Assets”, impairment loss is not to be recognized for a given asset if the related cash generating unit (CGU) is not impaired. In the given question, the related cash generating unit, which is group of asset to which the damaged machine belongs, is not impaired; as the recoverable amount is more than the carrying amount of group of assets. Hence there is no need to provide for impairment loss on the damaged sachet filling machine.
- (d) (i) Since the company is not appealing against the addition of Rs. 0.66 crore, the same should be provided for, in its accounts for the year ended on 31st March, 2008. The amount paid under protest can be kept under the heading ‘Loans & Advances’ and disclosed along with the contingent liability of Rs.2.10 crore.
- (ii) The arrears for the period from June, 2007 to March, 2008 are required to be provided for in the accounts of the company for the year ended on 31st March, 2008.