CHAPTER 12 - Practical Problems relating to Accounting Standard

AS 2 (Revised) - Valuation of Inventories

OBJECTIVE

To prescribe, the manner of determination of value of inventories to be carried to the financial statements and the ascertainment of cost of inventories and any write-down thereof to net realisable value (NRV)

VALUE OF INVENTORY

(on item by item basis but in some cases may be done on Group basis)

Lower of Cost or NRV

Cost
means
All costs of (Purchase + Conversion)

Purchase Price
+ Freight duties & taxes
+ Other expenditures directly attributable to acquisition
Other costs incurred in bringing the inventories to their present condition & location.

Direct Labour + Allocated variable production overheads + Allocated Fixed production overheads (based on normal capacity)

NRV
means
Estimated selling price in the ordinary course of business- Estimated cost of completion- Estimated cost necessary to make sale.

COST FORMULAS

FIFO, Weighted Average, Standard Cost, Retail method, Specific Identification
LIFO not allowed

DISCLOSURE

- Accounting policies adopted for valuation (including change, impact)
- Cost Formula Used
- Carrying amount of inventories
- Appropriate classification of inventories

SPECIAL POINTS

♦ Joint costs to be allocated on a rational and consistent basis, e.g., relative sales value at split off point

♦ In case of by products, deduct the NRV of by products from the cost of main products

♦ NRV to be estimated by considering
- Most reliable evidence available
- Price fluctuations
- Relevant post balance sheet events
- Purpose for which inventory is held

♦ Material and other supplies for use in production of inventories
- Don't write down below cost if ultimate product expected to be sold at or above cost

AS 6 (Revised) – Depreciation Accounting

Depreciation to be charged for proper matching of revenue and related costs. It lays down the criteria in accordance with which various aspects relating to depreciation are to be dealt with so as to enhance the understandability of the F/S

Applies to Depreciable Assets

- used for more than one accounting period
- Limited useful life
- Held for production/supply of goods/service or for purposes other than sale in ordinary course

Depreciation Depends on

Historical Cost
Acquisitions Cost & other incidental expenses
Value could be substituted in certain cases, e.g., change in long-term liability due to exchange fluctuations, change in duties, etc.

Expected useful life
Shorter than physical life due to any of followings:
- Legal or contractual limits
- Extraction or consumption
- Extent of use

Can get reduced due to:
Technological changes
Improvement in production methods
Legal or other restrictions, etc.

Estimated residual value
Could be taken as equivalent to value of similar assets operated under similar conditions and have reached the end of their useful lives
If insignificant, considered NIL

Methods
Straight Line Methods (SLM) ← Methods → Written Down Value (WDV)

Special Issues

Addition/Extension to an existing asset
Has a separate identity and can be used after existing asset is disposed of
- Charge depreciation independently based on useful life of addition/ extensions

No separate identity
- Depreciate over remaining useful life or at the rate applied to existing asset

Charging Dep. at Rates diff. than as prescribed by Statute
- **Lower rate** Only if allowed by Statute
- **Higher rate** Permitted

Revaluation of assets
Revised Dep. = Revalued amount/ Remaining useful life

Change in useful life
Revised Dep. =Unamortised depreciable amount/Revised remaining useful life.

Disposal of assets
Credit profit/ charge loss on to P/L A/c in year of disposal

To be applied prospectively

Change in historical cost
Revised depn.= Revised unamortized depreciable amount/ Remaining useful life

Changing of method

When allowed
Required by statute or AS or results to more appropriate preparation/presentation of F/S

Effective date
Retrospective effect

Treatment
Charge deficiency/credit surplus to P&L A/c of year of change

DISCLOSURES

- Historical cost or other substituted amount
- Total depreciation for each class of assets
- Related accumulated depreciation
- Effect of revalution, if material
- Depreciation method used and any changes alongwith their impact, if material
- Depreciation rates or useful lives of assets, if different from principal rates specified in Statute
- Surplus or deficiency, if material, on disposal

AS 9 – Revenue Recognition

OBJECTIVE

To lays down the bases for recognition of revenue arising in the course of ordinary activities of an enterprise from sale of goods, rendering of services & use by others of enterprise resources yielding interest, royalties & dividends

Revenues

Gross inflow of cash, receivables or other consideration in the course of ordinary activities

CRITERION FOR REVENUE RECOGNITION

Sale of Goods
Transfer of property in Goods
Transfer of significant risk & rewards

Rendering of Services
Percentage completion method
Completed contract method

Use by others of enterprise's resources yielding interest royalties & dividend
Interest - Time proportion basis
Royalties- Accrual basis
Dividend- When owner's right to receive payment is established

EFFECT OF UNCERTAINTIES

As to collectability

If no reasonable certainty at the time of raising claim: postpone recognition to the extent of uncertainty
Recognise when ultimate **collection reasonably certain**

No uncertainty as to collection but payment received in instalments: Recognise revenue at the time of sale or rendering of services

Uncertainty as to collection arises subsequent to the time of sale or rendering service:
- Don't adjust revenue already recorded
- Make provision

As to Measurability

Amount not reasonably determinable: **Postpone recognition**
Amount reasonably determinable: **Recognise**

DISCLOSURES

- Revenue recognition policy
- Changes in accounting policies, if any, and the impact thereof
- Circumstances in which revenue recognition has been postponed
- Gross Turnover, Excise Duty & Net Turnover

AS 12 – Accounting for Government Grants

OBJECTIVE: To lay down the accounting treatment and disclosure norms of government grants such as subsidies, cash incentives, duty drawbacks, etc.

WHEN TO RECOGNISE: When there is reasonable assurance that the enterprise will comply with attached condition, if any and the grant will be received

ACCOUNTING TREATMENT IN DIFFERENT CASES OF GRANTS

In the nature of assets
promoter's Contribution
Credit to capital Reserve
Cannot be distributed as dividend or treated as deferred income

In the nature of revenue

- Deduct grant from related Expenses
- Credit P&L A/c (on systematic basis over periods necessary to match it with related costs).

If it relates to specific fixed

Depreciable F/A
- ♦ Deduct grant from Gross value of assets
  ♦ Depreciation on net value (gross value minus Grant)
- ♦ Treat it as deferred income & recognise as income in the proportion in which depn. is charged every year: Depreciate on Gross Value

♦ When grant= whole/virtually whole of the cost of assets: At Nominal Value

Non-depreciable F/A

Unconditional: Credit to Capital Reserve

Conditional: Credit to Income over the same period over which cost of meeting such obligation is charged to income

SPECIAL CASES

Contingency
If contingency arises after grant has been recognized, record at nominal value
AS 4 (Revised) applies

Non-monetary grant
Assets given at concessional rates
Record at acquisition cost
Assets given free of cost

Extraordinary item
AS 5 (Revised) applies when grant is awarded for giving immediate financial support & not as an incentive to undertake specific expenditure, or - as compensation for expenses or losses incurred in previous periods.

DISCLOSURE
Accounting policy including the methods of presentation.
Nature and extent of government grants recognised in the F/S.

AS 16 – Borrowing Costs

OBJECTIVE: To prescribe accounting treatment for borrowing costs.
The capitalization of the various costs in nature of borrowing of fund for assets that could be termed as qualifying asset is considered here.

QUALIFYING ASSET (QA) is the assets that needs substantial period of time to get ready for its intended use or sale (Substantial period of time - generally12 months, could be shorter or longer also).

BORROWING COSTS (BC) includes interest and other costs incurred in connection with borrowing of funds, e.g.:
- Interest & commitment charges
- Amortization of discounts/premium on loans
- Lease finance charges
- Exchange differences (due to foreign currency borrowings)

AMOUNT TO BE CAPITALISED

1. **When funds borrowed specifically:** Actual BC - Income on temporary investment of these borrowings.
2. **When funds borrowed generally:** Apply capitalization rate to expenditure on QA @ weighted average of BC that are outstanding during the period.

Capitalisation not to exceed BC incurred during the period

RULES RELATING TO CAPITALISATION OF BORROWING COSTS

When to capitalize BC
When likely to result In future economic benefits and can be respect reliably measured

Which BC to capitalize
Directly attributable costs to acquisition, contribution, or production of the QA

When capitalization should commence
3 conditions
- Activities necessary to prepare the asset for its' intended use/production or sale are in progress
- BC incurred; &
- Exp. for acquisition, construction use or production incurred

When to suspend capitalization
During extended periods when active development is interrupted

When should capitalization cease
- When substantially all activities necessary to prepare the asset for its intended use or sale or complete in all
- When construction of asset is completed in parts which is capable of being used, **stop capitalistion for that part only**

DISCLOSURES
- Accounting policy adopted for BC
- BC capitalised during the period

AS 26 – Intangible Asset

OBJECTIVE: Lays down criteria for recognition, accounting treatment & ascertaining amount of intangible assets.

APPLIES TO: Intangible asset that is identifiable, nonmonetary asset, held for use in the production/supply of goods/services, for rental to others, or for administrative purposes.

Identifiability
- Separable
- Can be distinguished from goodwill
- Future economic benefits

Non-monetary assets
- Value cannot be fixed by contract or otherwise

Without physical substance
- Also includes intangible asset with physical substance if cost of physical substance is not significant

RECOGNITION & INITIAL MEASUREMENT
- Recognise when probable that future economic benefits will flow & cost can be measured reliably
- Initial recognition at cost
- Asset acquired in exchange for securities, cost taken as fair value of assets or securities issued
- Asset acquired in amalgamation, apply AS 14 but if consideration allocated to individual identifiable assets on the basis of fair value then: If active market exists, take quoted market price, else arm's length price
- If Government grant received for acquisition, record at (nominal value or acquisition cost) + direct expenditure for putting asset into usable condition
- Do not recognise internally generated goodwill & asset generated at research phase.
- Recognise internally generated assets (through development phase) at expenditure

AMORTISATION
- Carry the asset at cost less accumulated amortisation & accumulated impairment loss
- Amortise over useful life (not more than 10 years unless higher period justified)
- Residual value to be taken as zero unless higher value justified
- Review amortisation method and period atleast once every year, change, if required

Impairment loss
- Follow AS28
- Impairment test is Required where:
  - Asset not available for use
  - Amortisation period exceeds 10 years

De-recognition of intangible asset
- On disposal, or
- When no future economic benefits expected

Gain or loss on retirement/disposal
- Recognise in P&L A/c

DISCLOSURES

(a) Separately for internally generated & other intangible assets
- Useful lives/amortisation rate, amortisation method
- Gross carrying amount, accumulated amortisation & impairment losses
- Additions, disposals, impairment losses recognised or reversed, amortisation, other changes in carrying amount during the period

(b) If amortisation period more than 10 years - reasons
(c) Existence & carrying amount of assets whose title is restricted & of assets pledged as security.
(d) Amount of commitments for acquisition of assets (e) R&D recognised as expense during the period

TRANSITIONAL PROVISIONS
- Eliminate an asset & adjust the opening balance of revenue reserves for those assets whose normal amortisation period already over.
- Restate the carrying amount if amortisation period adopted longer than that allowed by AS 26, compute as if AS 26 followed since acquisition
- No restatement required if amortisation period adopted is shorter than that allowed by

(1) The management tells you that WIP is not valued since it is difficult to know the same in the view of multiple processes involved and in any case opening and closing WIP would be more or less the same.

Ans.: AS 2, dealing with valuation of inventories includes the WIP in the definition of inventories. Unless the WIP is values in accordance with the requirements of AS 2, it leads to non-compliance with Accounting Standard.

The argument of management that the opening and closing WIP would be more or less the same is not justified because the cost incurred for raw materials and overheads would be different and would different value of opening and closing WIP. The auditor should qualify his report and should indicate the quantum of impact on P & L position, if determinable.

(2) The work-in-progress is valued by company consistently at direct material cost.

Ans.: Work-in-progress includes direct material cost as well as direct labour and proportion of factory overhead for attaining the appropriate stage of production. Valuation of work-in-progress at direct material cost only is not inconsistent with normally accepted accounting principle. In view of this, the auditor should qualify his report, if the impact is material, notwithstanding the fact that this method has been followed consistently.

(3) A shortage of stock worth Rs. 1 lakh was noticed at the time of physical verification during the period under audit.

Ans.: The auditor should ascertain that the reasons for shortage have been properly investigated by the management and corrective measures have been taken on the report of the investigation. If the shortage valuing Rs.1 lakh is considered significant in comparison to the total value of stock, the auditor should ensure that the shortage is adjusted in the books of accounts in the year under audit. The auditor should also mention this and the action taken by the Management in his Report.

(4) The company has sent semi-finished goods to third parties for further processing, which is lying with them at the end of the year. Comment.

Ans.: Semi-finished goods being composite part of the inventories, normally, constitute significant item in case of any entity. It is the duty of the auditor to ensure that entire inventories which are owned by the enterprise on the date of balance sheet have been included for in valuation of inventories. The auditor should also obtain direct confirmation about the quantity of inventories lying with the processors at the end of the year. Also, the auditor should see that the valuation has been made properly with reference to the stage of completion in respect of work-in-process inclusive of expenses incurred in sending the goods for processing. In case, the amount happens to be material, such stock may be disclosed separately as stocks with processors.

(5) At the end of the financial year, inventory included goods already billed to customers but not dispatched. Comment.

Ans.: The Inventory value shown in the Balance Sheet should include only those goods/materials which are the property of the company valued at lower of cost and Net Realisable Value. In the problem the property held as custodian of the customer which are already billed and not dispatched. The same should be excluded from Inventory. Thus the auditor should qualify the audit report stating the impact of the same on the financial statements.

(6) The investment of ABC Limited includes 5,000 equity shares of Rs. 100 each in Amudham Bank Ltd (ABL). ABL declared 20% dividend for the year ended 31.3.2007. at its AGM held on 30.6.2007. ABC Limited finalised it accounts for the year ending 31/3/07 on 30/8/07, and it includes Rs. 1,00,000 being amount of dividend received by it from ABL in its other income subsequent to its Balance Sheet date, before approval by the BOD.

Ans.: Balance Sheet represent's the company's position as on the last date of the accounting year. Dividend has been declared only after the balance sheet date. As per AS-4, that event is not an event which gives additional evidence of situations existing on the balance sheet date. Therefore such dividend should not be recognized for the year ending 31/3/08

(28) There is no provision for Income Tax of 50 lakhs in respect of profits made in the financial year. Comment.

Ans.: Income-tax in respect of profits made in the financial year should be provided for in the accounts. Liability for income-tax arises with the earning of income, though the amount of liability is quantified subsequently after the close of financial year, in assessment proceedings. Though the exact amount of tax liability cannot be anticipated, liability for taxation having been incurred for the profit made, liability for tax should be provided for on a reasonable basis. Therefore the auditor can qualify the audit report.

(29) M Ltd. had filed suit against income tax liability on certain grounds which were not prima facie bonafide. What should be the manner of disclosure of these liabilities? Will your answer be different in case the liabilities have been contested on bonafide ground?

Ans.: Where the income tax liability has been contested not on bonafide grounds it does not fall within the word “contingent liabilities” but it is a real liability. The answer will be different if they have been contested on bonafide grounds because in such case they have to be disclosed as a foot note in the accounts as contingent liability.

(30) In a company Fixed Assets have been revalued and there has been resulting surplus of Rs. 200,000, which is transferred to revaluation reserve. The Company has a Debit balance in P&L account Rs. 120,000 as accumulated brought forward losses. The company has adjusted this loss balance against Revaluation reserve.

Ans.: The above accounting treatment is not correct because the debit balance of Rs. 120,000 in the P&L a/c is actual loss whereas Rs. 200,000 in -Revaluation Reserve is unrealized gain and as per accounting policies, standards, statutes, conventions etc. actual losses cannot be set off against anticipated profits or gains in the reserves.

The guidance Note on Treatment of Reserve created on Revaluation of 'Fixed Assets' advises that the accumulated losses must not be adjusted against revaluation reserve as it would amount to setting off actual losses against unrealized gains.