

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

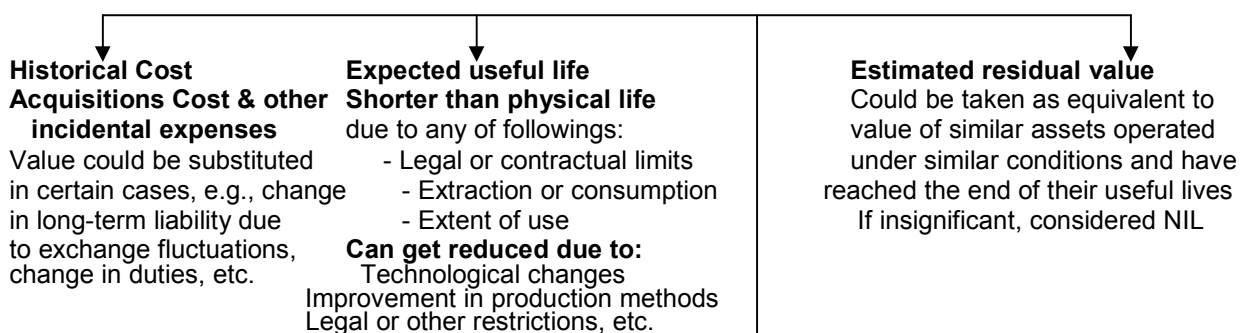
AS 6 (Revised) – Depreciation Accounting

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

- ♦ used for more than one accounting period
 - ♦ Limited useful life
- Applies to Depreciable Assets**

↓ Held for production/supply of goods/service or for purposes other than sale in ordinary course

Depreciation Depends on

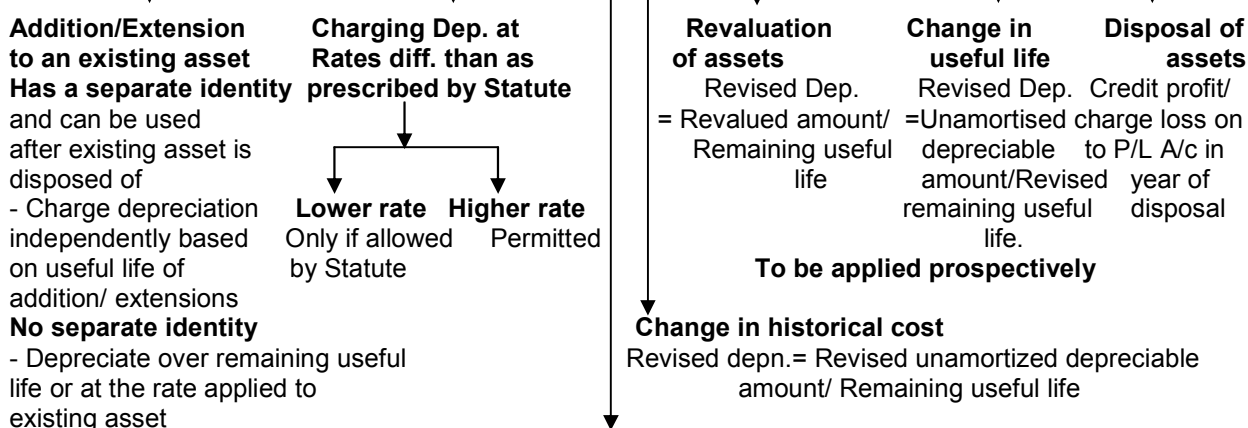


Straight Line Methods (SLM)

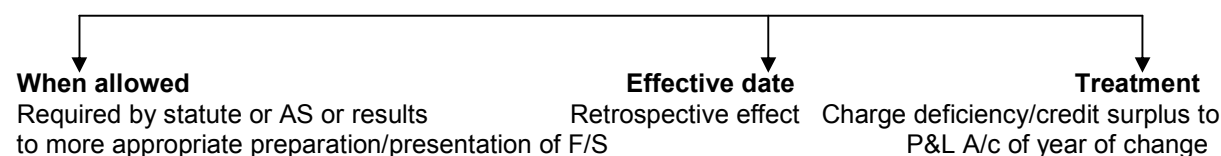
Methods

Written Down Value (WDV)

Special Issues



Changing of method



DISCLOSURES

- ♦ Historical cost or other substituted amount
- ♦ Related accumulated depreciation
- ♦ Depreciation method used and any changes along with 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
- ♦ Total depreciation for each class of assets
- ♦ Effect of revaluation, if material

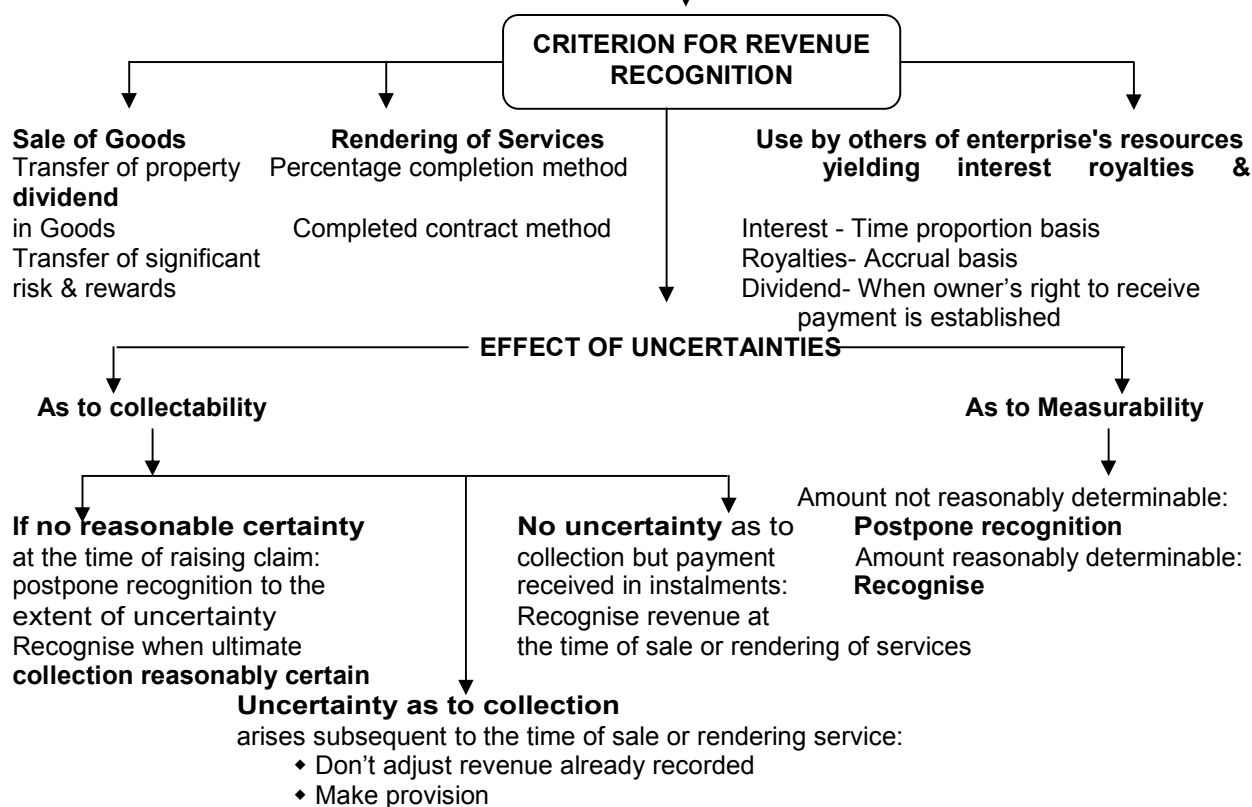
AS 9 – Revenue Recognition

OBJECTIVE

To lay 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



DISCLOSURES

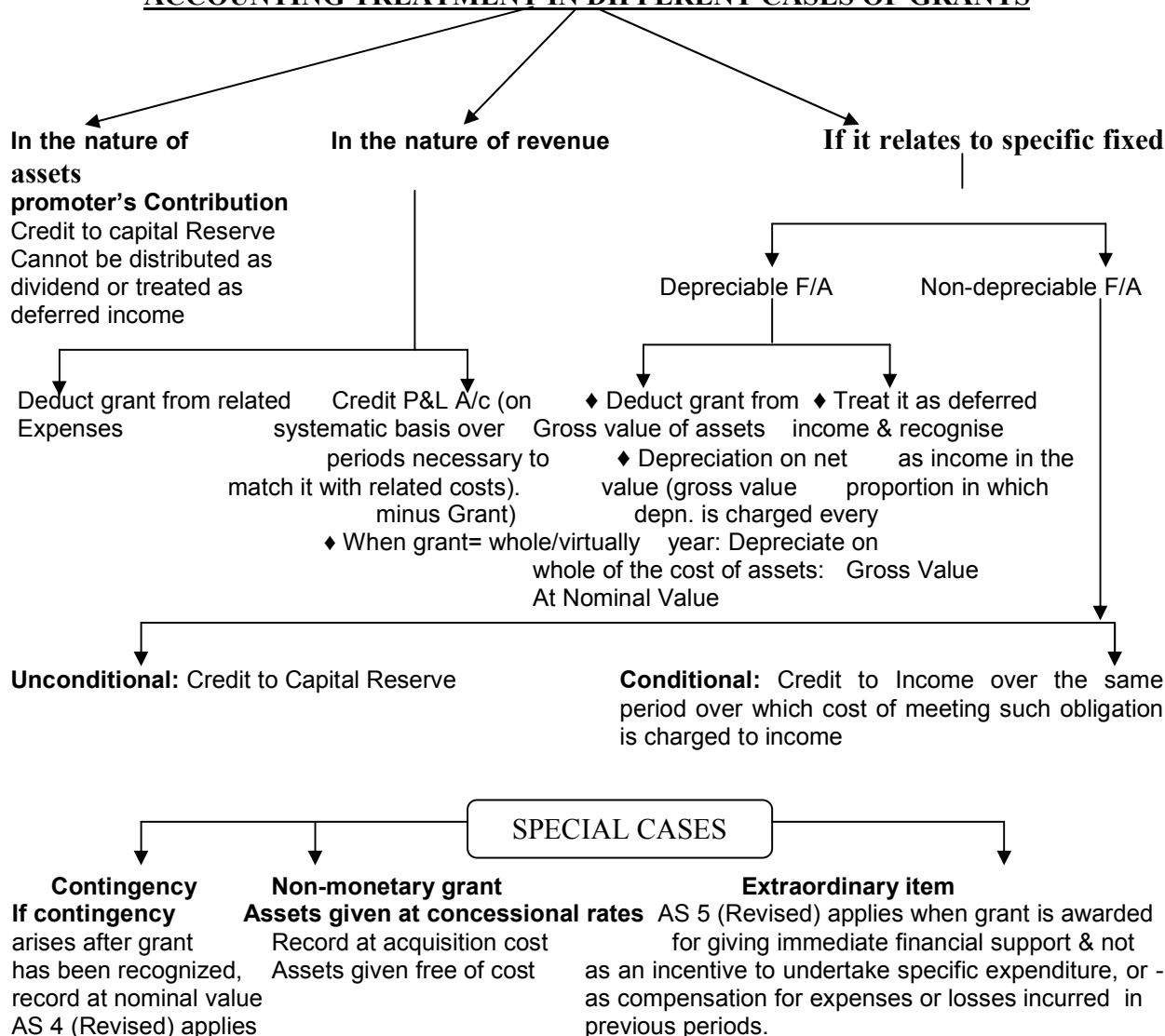
- Revenue recognition policy
- Changes in accounting policies, if any, and the impact thereof
- Circumstances in which revenue recognition has been postponed
- Gross Turnover, Excise Duty & Net Turnover

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



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.

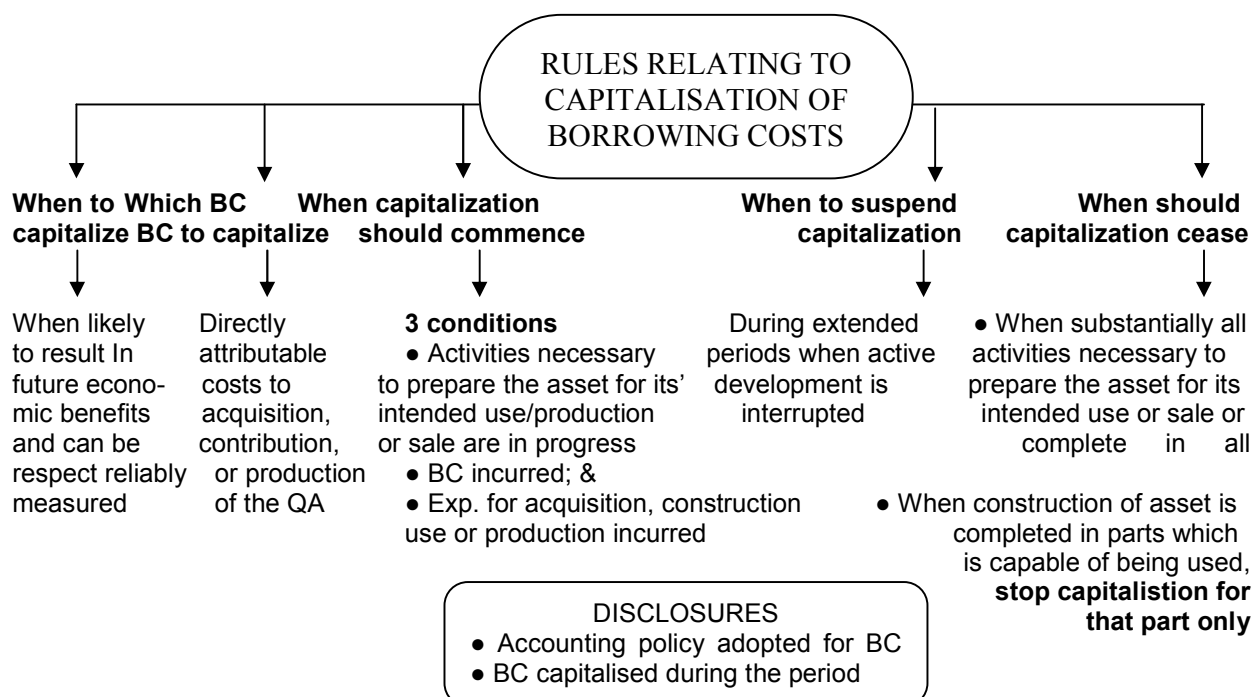
QUALIFYING ASSET (QA) is the assets that needs substantial period of time to get ready for its intended use or sale (Substantial period of time - generally 12 months, could be shorter or longer also).

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

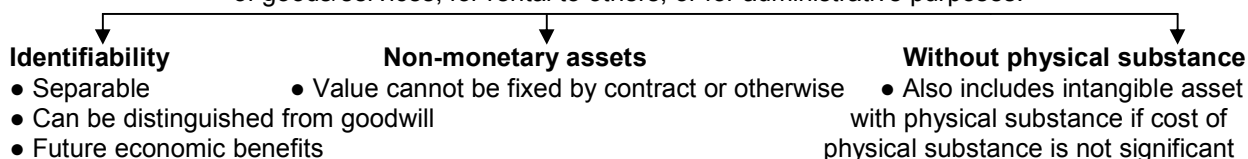
1. **When funds borrowed specifically:** Actual BC - Income on temporary investment of these borrowings.
2. **When funds borrowed generally:** Apply capitalization rate to expenditure on QA @ weighted average of BC that are outstanding during the period.
Capitalisation not to exceed BC incurred during the period



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.



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 De-recognition of intangible asset

- Follow AS28
- Impairment test is
- On disposal, or
- When no future economic benefits expected

Required where:

- Asset not available for use
- Amortisation period exceeds 10 years

Gain or loss on retirement/disposal

- Recognise in P&L A/c

DISCLOSURES

- 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
- If amortisation period more than 10 years - reasons
- Existence & carrying amount of assets whose title is restricted & of assets pledged as security.
- 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 valued 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 have 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 its 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 represents 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.