PRACTICAL PROBLEMS ON ACCOUNTING STANDARDS AND GUIDANCE NOTES

Question 1

Events Occurring after the Balance Sheet Date and their disclosure requirements.

(5 marks) (Intermediate–Nov. 1994, May 97 and May 1998)

Answer

Events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and in the case of any other entity by the corresponding approving authority.

Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate. However, assets and liabilities should not be adjusted for but disclosure should be made in the report of the approving authority of events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise.

(ii) Disclosure regarding events occurring after the balance sheet date :

(a) The nature of the event;

(b) An estimate of the financial effect, or a statement that such an estimate cannot be made.

Question 2

Prior-Period items. *(2 marks) (Intermediate–Nov. 1994, May 1996 and May 1998)*

Answer

When income or expenses arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods, the said incomes or expenses have to be classified as prior period items. The errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts or oversight.

Question 3

Pre–incorporation expenses. *(5 marks) (Intermediate–May 1996)*

Answer

Pre–incorporation expenses denote expenses incurred by the promoters for the purposes of the company before its incorporation.

Broadly, these include expenses in connection with:

(a) preliminary analysis of the conceived idea,

(b) detailed investigation in terms of technical feasibility and commercial viability to establish the soundness of the proposition,

(c) preparation of 'project report' or 'feasibility report' and its verification through independent appraisal authority (before giving final approval to the proposition) and

(d) organisation of funds, property and managerial ability and assembling of other business elements.

These expenses should be properly capitalised and shown in the balance sheet under the heading "Miscellaneous Expenditure". There is no legal requirement to write–off these expenses to profit and loss account within any specified period of time nor is there any rigid accounting convention in regard to this matter. However, good corporate practice recognises the need to write off these expenses to profit and loss account whtin a period of 3 to 5 years.

Question 4

Provisions contained in the Accounting Standard in respect of Revaluation of fixed assets.

(10 marks) (Intermediate–Nov. 1996)

Answer

(i) Revaluation of fixed Assts

According to Accounting Standard 10 on "Accounting for Fixed Assets"

(a) When fixed assets are revalued in financial statements, the basis of selection should be an entire class of assets or the selection should be done on a systematic basis. The basis of selection should be disclosed.

(b) The revaluation of any class of assets should not result in the net book value of that class being greater than the recoverable amount of that class of assets.

(c) The accumulated depreciation should not be credited to profit and loss account.

(d) The net increase in book value should be credited to a revaluation reserve account.

(e) On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value should be charged or credited to the profit and loss account except that to the extent to which such a loss is related to an increase and which has not been subsequently reversed or utilised may be charged directly to that account.

Questiion 5

The difference between actual expense or income and the estimated expense or income as accounted for in earlier years' accounts, does not necessarily constitue the item to be a prior period item comment. *(2 marks) (Intermediate–May 1998)*

Answer

The statement given in the question is correct and is in accordance with the Accounting Standard (AS) 5 (Revised) "Net Profit or Loss for the Period. Prior Period Items and Changes in Accounting Policies''.

The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustments within the definition of an extraordinary item or a prior period item.

Question 6

When can revenue be recognised in the case of transaction of sale of goods?

(2 marks) (Intermediate–May 1998)

Answer

As per AS 9 Revenue Recognition, revenue from sales transactions should be recognised when the following requirements as to performance are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection :

(i) The seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of goods.

Question 7

Valuation of fixed assets in special cases. *(3 marks) (Intermediate–Nov. 1998)*

Answer

Para 15 of Accounting Standard 10 on "Accounting for Fixed Assets" states the following provisions regarding valuation of fixed assets in special cases :

1. In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate arration to indicate that the enterprise does not have full ownership thereof.

2. Where an enterprise owns fixed assets jointly with others (otherwise than as a partner in a firm), the extent of its share in such assets, and the proportion in the original cost, accumulated depreciaiton and written down value are stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.

3. Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers.

Question 8

What are the main features of the Cash Flow Statement? Explain with special reference to AS 3? *(5 marks) (Intermediate–Nov. 1999)*

Answer

According to AS 3 (Revised) on "Cash Flow Statements", cash flow statement deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise during the given period from operating, investing and financing activities. Cash flows from operating activities can be reported using either

(a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(b) the indirect method, whereby net profit or loss is adjusted for the effects of transactions of non–cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

As per para 42 of AS 3 (Revised), an enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

A cash flow statement when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency), and its ability to affect the amount and timing of cash flows in order to adapt to changing circumstances and opportunities. This statement also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

AS 3 (revised) is recommendatory at present but for companies listed on stock exchanges, its compliance is mandatory due to the listing agreement which provides for the listed companies to furnish cash flow statement in their Annual Reports.

Question 9

Extraordinary Items to be disclosed as per the Accounting Standard.

(3 marks) (Intermediate–Nov. 1994)

Answer

Extraordinary items are gains or losses which arise from events or transactions that are distinct from the ordinary activities of the business and which are both material and expected not to recur in future frequently. These would also include material adjustments necessitated by circumstances, which though related to previous periods are determined in the current period. Some examples of extraordinary items may be the sale of a signficant part of the business, the sale of an investment not acquired with the intention of resale etc. The nature and amount of each extraordinary item are separately disclosed so that users of financial statements can evaluate the relative significance of such items and their effect on the current operating results. It may be noted that income or expenses arising from the ordinary activities of the enterprise, though abnormal in amount or infrequent in occurrence, do not qualify as extraordinary.

Question 10

(i) *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.*

(ii) *There is a sales tax demand of Rs. 2.50 crores against a company relating to prior years against which the company has gone on appeal to the appellate authority in the department. The grounds of appeal deal with points covering Rs. 2 crores of the demand. State how the matter will have to be dealt with in the final accounts for the year.* *(8 marks) (Intermediate–May 1995)*

Answer

(i) The loss due to break out of fire is an example of event occurring after the balance sheet date that does not relate to conditiont existing at the balance sheet date. It has not affected the financial position as on the date of the balance sheet and therefore requires no specific adjustments in the financial statements. However, paragraph 8.6 of AS-4 states that disclosure is generally made of events in subsequent periods that represent unusual changes affecting the existence or substratum of the enterprise at the balance sheet date. In the given case, the loss of assets in a factory is considered to be an event affecting the substratum of the enterprise after the balance sheet date. Hence, as recommended in paragraph 15 of AS-4, disclosure of the event should be made in the report of the approving authority that represent material changes and commitments affecting the financial position of the enterprise.

(ii) The undisputed part of sales tax liability of Rs. 0.50 crore should be considered as actual liability and adequately provided for. The Institute of Chartered Accountants of India has issued Accounting standard 29 on “Provisions Contingent Liabilities and Contingent Assets’’ (comes into effect in respect of accounting periods commencing on or after 1.4.2004). According to the standard, an enterprise should not recognise a contingent liability but should disclose it, as required by paragraph 68, unless the possibility of an outflow of resources embodying economic benefits is remote. Accordingly the company should disclose the disputed part of sales tax liability of Rs. 2 crore as contingent liability in their financial statements of the year. However, the above disclosed contingent liability should be reviewed continuosly and if it becomes probable that an outflow of future economic benefit will be required , then recognise the contingent liability as a provision.

Question 11

Jagannath Ltd. had made a rights issue of shares in 1996. In the offer document to its members, it had projected a surplus of Rs. 40 crores during the accounting year to end on 31st March, 1998. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of Rs. 10 crores. The board in consultation with the managing director, decided on the following :

(i) Value year-end inventory at works cost (Rs. 50 crores) instead of the hitherto method of valuation of inventory at prime cost (Rs. 30 crores).

(ii) Provide depreciation for the year on straight line basis on account of substantial additions in gross block during the year, instead of on the reducing balance method, which was hitherto adopted. As a consequence, the charge for depreciation at Rs. 27 crores is lower than the amount of Rs. 45 crores which would have been provided had the old method been followed, by Rs. 18 cores.

(iii) Not to provide for "after sales expenses" during the warranty period. Till the last year, provision at 2% of sales used to be made under the concept of "matching of costs against revenue" and actual expenses used to be charged against the provision. The board now decided to account for expenses as and when actually incurred. Sales during the year total to Rs. 600 crores.

(iv) Provide for permanent fall in the value of investments - which fall had taken place over the past five years - the provision being Rs. 10 crores.

As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 1997-1998 (6 Marks) (Intermediate–May 1998)

Answer

As per AS 1 "Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. Accordingly, the notes on accounts should properly disclose the change and its effect.

Notes on Accounts :

(i) During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost as was the practice till last year. This has been done to take cognisance of the more capital intensive method of production on account of heavy capital expenditure during the year. As a result of this change, the year-end inventory has been valued at Rs. 50 crores and the profit for the year is increased by Rs. 20 crores.

(ii) In view of the heavy capital intensive method of production introduced during the year, the company has decided to change the method of providing depreciation from reducing balance method to straight line method. As a result of this change, depreciation has been provided at Rs. 27 crores which is lower than the charge which would have been made had the old method and the old rates been applied, by Rs. 18 crores. To that extent, the profit for the year is increased.

(iii) So far, the company has been providing 2% of sales for meeting "after sales expenses during the warranty period. With the improved method of production, the probability of defects occurring in the products has reduced considerably. Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for the year is increased by Rs. 12 crores than would have been the case if the old policy were to continue.

(iv) The company has decided to provide Rs. 10 crores for the permanent fall in the value of investments which has taken place over the period of past five years. the provision so made has reduced the profit disclosed in the accounts by Rs. 10 crores.

Question 12

Media Advertisers obtained advertisement rights for One Day World Cup Cricket Tournament to be held in May/June, 1999 for Rs. 250 lakhs.

By 31st March, 1999 they have paid Rs. 150 lakhs to secure these advertisement rights. The balance Rs. 100 lakhs was paid in April, 1999.

By 31st March, 1999 they procured advertisement for 70% of the available time for Rs. 350 lakhs. The advertisers paid 60% of the amount by that date. The balance 40% was received in April, 1999.

Advertisements for the balance 30% time were procured in April, 1999 for Rs. 150 lakhs. The advertisers paid the full amount while booking the advertisement.

25% of the advertisement time is expected to be available in May, 1999 and the balance 75% in June, 1999.

You are asked to :

(i) Pass journal entries in relation to the above.

(ii) Show in columnar form as to how the items will appear in the monthly financial statements for March, April, May and June 1999.

Give reasons for your treatment. *(12 marks) (Intermediate–May 1999)*

Answer

In the books of Media Advertisers

Journal Entries

			Dr.	*Cr.*
			Rs. in lakhs	*Rs. in lakhs*
1999				
March	Advance for advertisement rights (purchase) A/c	Dr.	150.00	
	To Bank A/c			150.00
	(Being advance paid for obtaining advertisement rights)			
	Bank A/c	Dr.	210.00	
	To Advance for advertisement time (sale) A/c			210.00
	(Being advance received from advertisers amounting to 60% of Rs. 350 lakhs for booking 70% advertisement time)			
April	Advance for advertisement rights (purchase) A/c	Dr.	100.00	
	To Bank A/c			100.00
	(Being balance advance i.e., Rs. 250 lakhs less Rs. 150 lakhs paid)			
	Bank A/c	Dr.	140.00	
	To Advance for advertisement time (sale) A/c			140.00
	(Being balance advance i.e., Rs. 350 lakhs less Rs. 210 lakhs received from advertisers)			
	Bank A/c	Dr.	150.00	
	To Advance for advertisement time (sale) A/c			150.00
	(Being advance received from advertisers in respect of booking of balance 30% time)			
May	Advertisement rights (purchase) A/c	Dr.	62.50	
	To Advance for advertisement rights (purchase) A/c			62.50
	(Being cost of advertisement rights used in May i.e., 25% of Rs. 250 lakhs, adjusted against advance paid)			

	Advance for advertisement time (sale) A/c	Dr.	125.00	
	To Advertisement time (sale) A/c			125.00
	(Being sale price of advertisement time in May i.e., 25% of Rs. 500 lakhs adjusted, against advance received from advertisers)			
	Profit and Loss A/c	Dr.	62.50	
	To Advertisement rights (purchase) A/c			62.50
	(Being cost of advertisement rights debited to Profit and Loss Account in May)			
	Advertisement time (sale) A/c	Dr.	125.00	
	To Profit and Loss A/c			125.00
	(Being revenue recognised in Profit and Loss Account in May)			
June	Advertisement rights (purchase) A/c	Dr.	187.50	
	To Advance for advertisement rights (purchase) A/c			187.50
	(Being cost of advertisement rights used in June, i.e., 75% of Rs. 250 lakhs, adjusted against advance paid)			
	Advance for advertisement time (sale) A/c	Dr.	375.00	
	To Advertisement time (sale) A/c			375.00
	(Being sale price of advertisement time availed in June i.e., 75% of Rs. 500 lakhs, adjusted against advance received from advertisers)			
June	Profit and Loss A/c	Dr.	187.50	
	To Advertisement rights (purchase) A/c			187.50
	(Being cost of advertisement rights used in June, debited to Profit and Loss Account in June)			
	Advertisement time (sale) A/c	Dr.	375.00	
	To Profit and Loss Account			375.00
	(Being revenue recognised in June)			

(ii) Monthly financial statements

(1) Revenue statement (Rs. in lakhs)

	March *Rs.*	*April* *Rs.*	*May* *Rs.*	*June* *Rs.*
Sale of advertisement time	–	–	125.00	375.00
Less: Purchase of advertisement rights	–	–	62.50	187.50
Netprofit	–	–	62.50	187.50

(2) Balance sheet as at	*31.3.99*	*30.4.99*	*31.5.99*	*30.6.99*
Sources of funds:				
Net profit	–	–	62.50	250.00
Application of funds:				
Current assets, loans and advances:				
Advance for advertisement rights	150.00	250.00	187.50	–
Bank Balance	60.00	250.00	250.00	250.00
	210.00	500.00	437.50	250.00
Less: Current liabilities				
Advance for advertisement time				
(received from advertisers)	210.00	500.00	375.00	–
Net current assets	–	–	62.50	250.00

As per para 7.1 of AS 9 on Revenue Recognition, under proportionate completion method, revenue from service transactions is recognised proportionately by reference to the performance of each act where performance consists of the execution of more than one act. Therefore, income from advertisement is recognised in May, 1999 (25%) and June, 1999 (75%) in the proportion of availability of the advertisement time.

Question 13

(a) Describe the factors for determination of "Reportable Segments" as per AS-17.

(b) Briefly describe the disclosure requirements for related party transactions as per Accounting Standard 18.

(c) State the different types of Leases contemplated in Accounting Standard 19 and discuss briefly. (12 marks) (Intermediate–May 2002)

Answer

(a) Paragraphs 27 to 29 of AS 17 on Segment Reporting deals with reportable segments.

Paragraph 27 requires that a business segment or geographical segment should be identified as a reportable segment if :

(i) its revenue from sales to external customers and from transactions with other segments is 10 percent or more of the total revenue, external and internal, of all segments; or

(ii) its segment result, whether profit or loss, is 10 percent or more of-

(a) the combined result of all segments in profit, or

(b) the combined result of all segments in loss, whichever is greater in absolute amount; or

(iii) its segment assets are 10 percent or more of the total assets of all segments.

A business segment or a geographical segment which is not a reportable segment as per paragraph 27, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

If total external revenue attributable to reportable segments constitutes less than 75% of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 percent thresholds specified in paragraph 27 of the standard, until at least 75 percent of the total enterprise revenue is included in reportable segments.

(b) Paragraph 23 of AS 18 on Related Party Disclosures requires that if there have been transactions between related parties, during the existence of the a related party relationship, the reporting enterprise should disclose the following :

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;

(vii) amounts written off or written back in the period in respect of debts due from or to related parties.

Point (v) requires disclosure of 'any other elements of the related party transactions necessary for an understanding of the financial statements. An example of such a disclosure would be an indication that the transfer of a major asset had taken place at an amount materially different from that obtainable on normal commercial terms.

(c) Accounting Standard 19 has divided the lease into two types viz. (i) Finance Lease and (ii) Operating Lease.

Finance Lease : A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. title may or may not eventually be transferred. At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and liability should be the present value of the minimum lease payments from the standpoint of the lessee.

Operating Lease : A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Question 14

(a) When Capitalisation of borrowing cost should cease as per Accounting Standard 16?

(b) Define a "Business Segment" and a "Geographical Segment" as per Accounting Standard 17.

(c) Briefly describe, how do you calculate "Diluted Earnings per Share" as per Accounting Standard 20.

(d) Briefly describe the disclosure requirements for "Deferred Tax Assets" and "Deferred Tax Liabilities" as per Accounting Standard 22.

(e) Write short note on Sale and Lease Back Transactions as per Accounting Standard 19.

(20 marks) (PE-II – Nov. 2002)

Answer

(a) Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

(b) **A Business Segment:** A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

(a) the nature of the products or services;

(b) the nature of the production processes;

(c) the type or class of customers for the products or services;

(d) the methods used to distribute the products or provide the services and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

A geographical segment: A geographical segment is a distinguishable component of an enterprise that is engaged in providing product or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

(a) similarity of economic and political conditions;

(b) relationships between operations in different geographical areas;

(c) proximity of operations;

(d) special risks associated with operations in a particular area;

(e) exchange control regulations; and

(f) the underlying currency risks.

(c) For the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

The amount of net profit or loss for the period attributable to equity shareholders should be adjusted, after taking into account any attributable change in tax expense for the period.

The number of equity shares should be the aggregate of the weighted average number of equity shares (as per paragraphs 15 and 22 of AS 20) and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares. Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

An enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no consideration.

(d) (i) An enterprise should offset deferred tax assets and deferred tax liabilities if:

(a) the enterprise has a legally enforceable right to set off assets against liabilities representing current tax, and

(b) the deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

(ii) Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.

(iii) The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts.

(iv) The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

(e) **Sale and leaseback transactions:** As per AS 19 on 'Leases', a sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the asset back to the vendor. The lease payments and the sale price are usually interdependent, as they are negotiated as a package. The accounting treatment of a sale and lease back transaction depends upon the type of lease involved.

If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sale proceeds over the carrying amount should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

If sale and leaseback transaction results in a operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

Question 15

(a) X Co. Ltd. charged depreciation on its asset on SLM basis. For the year ended 31.3.2003 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 and loss account. Also, discuss, when such changes in method of depreciation can be adopted by an enterprise as per AS–6.

(b) Decide when research and development cost of a project can be deferred to future periods as per AS 26.

(c) *You are an accountant preparing accounts of A Ltd. as on 31.3.2003. After year end the following events have taken place in April, 2003:*

(i) *A fire broke out in the premises damaging, uninsured stock worth Rs. 10 lakhs (Salvage value Rs. 2 lakhs).*

(ii) *A suit against the company's advertisement was filed by a party claiming damage of Rs. 20 lakhs.*

(iii) *Dividend proposed @ 20% on share capital of Rs. 100 lakhs.*

Describe, how above will be dealt with in the account of the company for the year ended on 31.3.2003.

(d) *How the government grants related to specific fixed assets should be presented in the Balance Sheet as per AS–12?*

(e) *Briefly describe the disclosure requirements for amalgamation including additional disclosure, if any, for different methods of amalgamation as per AS–14.*

(f) *Mention the prescribed accounting treatment in respect of gratuity benefits payable to employees as per AS–15.* *(24 marks) (PE-II – May 2003)*

Answer

(a) The company should disclose the change in method of depreciation adopted for the accounting year. The impact on depreciation charge due to change in method must be quantified and reported by the enterprise.

Following aspects may be noted in this regard as per AS 6 on Depreciation Accounting.

(a) The depreciation method selected should be applied consistently from period to period.

(b) A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.

(c) When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed.

(d) In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss.

(e) In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

(b) As per para 41 of AS 26 'Intangible Assets', no intangible asset arising from research should be recognized. The expenditure incurred on development phase can be deferred to the subsequent years if the company can demonstrate all of the following conditions (as specified in para 44 of AS 26 'Intangible Assets'):

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure the expenditure attributable to the intangible asset during its development reliably.

(c) Events occurring after the Balance Sheet date that represent material changes and commitments affecting the financial position of the enterprise must be disclosed according to para 15 of AS 4 on Contingencies and Events occurring after the Balance Sheet date. Hence, fire accident and loss thereof must be disclosed.

Suit filed against the company being a contingent liability must be disclosed with the nature of contingency, an estimate of the financial effect and uncertainties which may affect the future outcome must be disclosed as per para 16 of AS 4.

There are events which, although take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements. Thus, dividends which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted as per para 14 of AS 4.

(d) Paragraphs 8 and 14 of AS 12 on Accounting for Government Grants deal with presentation of government grants related to specific fixed assets.

Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the balance sheet at a nominal value. Alternatively, government grants related to depreciable fixed assets may be treated as deferred income which should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be allocated to income over the periods and in proportion in which depreciation on those assets is charged. Grants related to non-depreciable assets should be credited to capital reserve under this method. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income balance should be separately disclosed in the financial statements.

(e) The disclosure requirements for amalgamations have been prescribed in paragraphs 43 to 46 of AS 14 on Accounting for Amalgamation.

For all amalgamations, the following disclosures should be made in the first financial statements following the amalgamation:

(a) names and general nature of business of the amalgamating companies;

(b) the effective date of amalgamation for accounting purpose;

(c) the method of accounting used to reflect the amalgamation; and

(d) particulars of the scheme sanctioned under a statute.

For amalgamations accounted under the pooling of interests method, the following additional disclosures should be made in the first financial statements following the amalgamation:

(a) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation; and

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

For amalgamations, accounted under the purchase method, the following additional disclosures should be made in the first financial statements following the amalgamation;

(a) consideration for the amalgamation and a description of the consideration paid or contingently payable; and

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

(f) Accounting treatment in respect of gratuity benefits payable to employees has been prescribed under paragraph 28 of AS 15 on Accounting for Retirement Benefits in the Financial Statements of Employers.

Accounting treatment in respect of gratuity benefit and other defined benefit schemes will depend on the type of arrangement, which the employer has chosen to make.

(i) If the employer has chosen to make payment for retirement benefits out of his own funds, an appropriate charge to the statement of profit and loss for the year should be made through a provision for the accruing liability. The accruing liability should be calculated according to actuarial valuation. However, those enterprises which employ only a few persons may calculate the accrued liability by reference to any other rational method e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

(ii) In case the liability for retirement benefits is funded through creation of a trust, the cost incurred for the year should be determined actuarially. Such actuarial valuation should normally be conducted at least once in every three years. However, where actuarial valuation are not conducted annually, the actuary's report should specify the contributions to be made by the employer on annual basis during the inter-valuation period. This annual contribution (which is in addition to the contribution that may be required to finance unfunded past service cost) reflects proper accrual of retirement benefit cost for each of the years during the inter-valuation period and should be charged to the statement of profit or loss each year. Where the contribution paid during a year is lower than the amount required to be contributed during the year to meet the accrued liability as certified by the actuary, the shortfall should be charged to the statement of profit or loss for the year. Where the contribution paid during a year is in excess of the amount required to be contributed during the year to meet the accrued liability as certified by the actuary, the excess should be treated as a pre-payment.

(ii) In case the liability for retirement benefits is funded through a scheme administered by an insurer, an actuarial certificate or a confirmation from the insurer should be obtained that the contribution payable to the insurer is the appropriate accrual of the liability for the year. Where the contribution paid during a year is lower than the amount required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the shortfall should be charged to the statement of profit or loss for the year. Where the contribution paid during a year is in excess of the amount required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the excess should be treated as a pre-payment.

Question 16

(a) How is software acquired for internal use accounted for under AS-26?

(b) What are the principles for recognition of deferred taxes under AS-22?

(c) Define related party transaction under AS-18.

(d) A Limited company charged depreciation on its assets on the basis of W.D.V. method from the date of assets coming to use till date amounts to Rs. 32.23 lakhs. Now the company decides to switch over to Straight Line method of providing for depreciation. The amount of depreciation computed on the basis of S.L.M. from the date of assets coming to use till the date of change of method amounts to Rs. 20 lakhs.

Discuss as per AS-6, when such changes in method of can be adopted by the company and what would be the accounting treatment and disclosure requirement.

(e) X Limited has recognized 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, 2003. The dividends on mutual funds were declared at the rate of 20% on 15th June, 2003. The dividend was proposed on 10th April, 2003 by the declaring company. Whether the treatment is as per the relevant Accounting Standard? You are asked to answer with reference to provisions of Accounting Standard.

(20 marks) (PE-II – Nov. 2003)

Answer

(a) Paragraphs 10 and 11 of Appendix A to the Accounting Standard 26 on Intangible Assets, lays down the following procedure for accounting of software acquired for internal use:-

- The cost of a software acquired for internal use should be recognised as an asset if it meets the recognition criteria prescribed in paragraphs 20 and 21 of this statement.
- The cost of a software purchased for internal use comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities) and any directly attributable expenditure on making the software ready for its use.

Any trade discounts and rebates are deducted in arriving at the cost. In the determination of cost, matters stated in paragraphs 24 to 34 of the Statement which deal with the method of accounting for 'Separate Acquisitions', 'Acquisitions as a part of Amalgamations', Acquisitions by way of Government Grant', and 'Exchanges of Assets', need to be considered, as appropriate.

Recognition criteria as per paragraphs 20 and 21 of the standard are stated below:-

- An intangible asset should be recognised if, and only if:
  - (a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
  - (b) the cost of the asset can be measured reliably.
- An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

(b) Taxable income is calculated in accordance with tax laws. In some circumstances the requirements of these laws to compute taxable income differ from the accounting policies applied to determine accounting income. This results in a difference between the taxable and the accounting income. Such differences are classified into Permanent and Timing differences. The tax effect of the timing differences is known as Deferred Tax and is included as tax expense in the statement of profit and loss and as deferred tax assets or as deferred tax liabilities, in the balance sheet.

Prudence would dictate that deferred tax liabilities are provided for without exception, even in situations where an enterprise is incurring losses. Deferred tax assets should be recognized and carried forward only to the extent that there is reasonable certainty that sufficient future taxable income will be available against which such deferred tax asset can be realized. Reasonable certainty can be demonstrated by providing robust and realistic estimates of profits for the future. A company with a track record of losses with no immediate visibility of a turnaround should not recognise a deferred tax asset as a matter of prudence. In the case of an unabsorbed depreciation and carry forward losses under the tax laws, the recognition principles are more stricter, i.e. deferred tax asset should be recognized only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax asset can be realized. The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not be available.

In that situation there has to be convincing evidence that sufficient future taxable income will be available against which such deferred tax asset can be realized. This is a matter of judgement and the conclusion would depend on facts and circumstances of each case.

(c) Accounting Standard 18 on Related Party Disclosures defines a related party transaction as transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Related parties have been defined by the standard in the following words. “Parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.”

Further, paragraph 24 of the Standard gives certain examples of related party transactions in respect of which disclosures may be made by a reporting enterprise. Those examples are listed below:-

(a) purchases or sales of goods (finished or unfinished);

(b) purchases or sales of fixed assets;

(c) rendering or receiving of services;

(d) agency arrangements;

(e) leasing or hire purchase arrangements;

(f) transfer of research and development;

(g) license agreements;

(h) finance (including loans and equity contributions in cash or in kind);

(i) guarantees and collaterals; and

(j) management contracts including for deputation of employees.

(d) Paragraph 21 of Accounting Standard 6 on Depreciation Accounting says, "The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise."

The paragraph also mentions the procedure to be followed when such a change in the method of depreciation is made by an enterprise. As per the said paragraph, depreciation should be recalculated in accordance with the new method from the date of the asset coming to use. The difference in the amount, being deficiency or surplus from retrospective recomputation should be adjusted in the profit and loss account in the year such change is effected. Since such a change amounts to a change in the accounting policy, it should be properly quantified and disclosed. In the question given, the surplus arising out of retrospective recomputation of depreciation as per the straight line method is Rs. 12.23 lakhs (Rs. 32.23 lakhs – Rs. 20 lakhs). This should be written back to Profit and Loss Account and should be disclosed accordingly.

(e) Paragraph 8.4 and 13 of Accounting Standard 9 on Revenue Recognition states that dividends from investments in shares are not recognised in the statement of profit and loss until a right to receive payment is established.

In the given case, the dividend is proposed on 10th April, 2003, while it is declared on 15th June, 2003. Hence, the right to receive payment is established on 15th June, 2003. As per the above mentioned paragraphs, income from dividend on units of mutual funds should be recognised by X Ltd. in the financial year ended 31st March, 2004.

The recognition of Rs. 10 lakhs on accrual basis in the financial year 2002-2003 is not as per AS 9 'Revenue Recognition'.

(i) Acting as a banker in respect of funds of local bodies, Zilla Parishads, Panchayat Institutions etc. who keep their funds with the treasuries.

(ii) Custody of opium and other valuables because of the strong room facility provided at the treasury.

(iii) Custody of cash balances of the State Government and conducting cash business of Government at non-banking treasuries.

Question 17

(a) X Ltd. received a grant of Rs. 2 crores from the Central Government for the purpose of a special Machinery during 1998-99. The cost of Machinery was Rs. 20 crores and had a useful life of 9 years. During 2002-03, the grant has become refundable due to non-fulfillment of certain conditions attached to it. Assuming the entire grant was deducted from the cost of Machinery in the year of acquisition. State with reasons, the accounting treatment to be followed in the year 2002-03.

(b) The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2002-03. The Historical Cost and Net Realizable Value of the items of closing stock are determined as follows:

Items	Historical Cost (Rs. in lakhs)	Net Realisable Value (Rs. in lakhs)
A	40	28
B	32	32
C	16	24

What will be the value of Closing Stock?

(c) During the current year 2002–2003, X Limited made the following expenditure relating to its plant building:

	Rs. in lakhs
Routine Repairs	4
Repairing	1
Partial replacement of roof tiles	0.5
Substantial improvements to the electrical wiring system which will increase efficiency	10

What amount should be capitalized?

(d) A plant was depreciated under two different methods as under:

Year	SLM (Rs. in lakhs)	W.D.V. (Rs. in lakhs)
1	7.80	21.38
2	7.80	15.80
3	7.80	11.68
4	7.80	8.64
	31.20	57.50
5	7.80	6.38

What should be the amount of resultant surplus/deficiency, if the company decides to switch over from W.D.V. method to SLM method for first four years? Also state, how will you treat the same in Accounts.

(e) Briefly explain the methods of accounting for amalgamation as per Accounting Standard-14. *(20 marks) (PE-II – May 2004)*

Answer

(a) As per para 11.3 of AS 12 on Accounting for Government Grants, the amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset. Depreciation on the revised book value is provided prospectively over the residual useful life of the asset. In the given case, book value of machinery will be increased by Rs. 2 crores in the year 2002-2003. The computations for the depreciation on machinery can be given as:

Cost of machinery	Rs. 20 crores
Less: Grant received	Rs. 2 crores
Cost of machinery	Rs. 18 crores
Useful life of machinery	9 years
Depreciation per year as per straight line method	Rs. 18 crores/9
(assuming residual value to be zero)	= Rs. 2 crores
Total depreciation for 4 years (1998-99 to 2001-2002)	Rs. 8 crores
Book value (in year 2002-2003)	Rs. 10 crores
Add: Grant refunded	Rs. 2 crores
Revised book value	Rs. 12 crores
Remaining useful life	5 years
Revised annual depreciation	Rs. 12 crores/5
	= 2.4 crores

Thus, book value of machinery will be Rs. 12 crores in the year 2002-2003 and the depreciation amounting Rs. 2.4 crores will be charged on machinery. Annual depreciation of Rs. 2.4 crores will be charged in the next four years.

(b) As per para 5 of AS 2 on Valuation of Inventories, inventories should be valued at the lower of cost and net realizable value. Inventories should be written down to net realizable value on an item-by-item basis in the given case.

Items	*Historical Cost (Rs. in lakhs)*	*Net Realisable Value (Rs. in lakhs)*	*Valuation of closing stock (Rs. in lakhs)*
A	40	28	28
B	32	32	32
C	16	24	16
	88	84	76

Hence, closing stock will be valued at Rs. 76 lakhs.

(c) As per para 12.1 of AS 10 on Accounting for Fixed Assets, expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity. Hence, in the given case, Repairs amounting Rs. 5 lakhs and Partial replacement of roof tiles should be charged to profit and loss statement. Rs. 10 lakhs incurred for substantial improvement to the electrical writing system which will increase efficiency should be capitalized.

(d) As per para 21 of AS 6 on Depreciation Accounting, when a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In the given case, there is a surplus of Rs. 26.30 lakhs on account of change in method of depreciation, which will be credited to Profit and Loss Account. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

(e) As per AS 14 on 'Accounting for Amalgamations', there are two main methods of accounting for amalgamations:

(i) The Pooling of Interest Method

Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (after making the necessary adjustments).

If at the time of amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

(ii) The Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

Where assets and liabilities are restated on the basis of their fair values, the determination of fair values may be influenced by the intentions of the transferee company.

Question 18

(a) On 20.4.2003 JLC Ltd. obtained a loan from the Bank for Rs. 50 lakhs to be utilised as under:

	Rs.
Construction of a shed	*20 lakhs*
Purchase of machinery	*15 lakhs*
Working capital	*10 lakhs*
Advance for purchase of truck	*5 lakhs*

In March, 2004 construction of shed was completed and machinery installed. Delivery of truck was not received. Total interest charged by the bank for the year ending 31.3.2004 was Rs. 9 lakhs. Show the treatment of interest under AS 16.

(b) A limited company created a provision for bad and doubtful debts at 2.5% on debtors in preparing the financial statements for the year 2003-2004.

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 31.3.2004. 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?

(c) Explain the treatment of cost arising from alteration in retirement benefit cost as per AS 15. (12 marks) (PE-II – Nov. 2004)

Answer

(a) As per AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized. A qualifying asset is an asset that necessarily takes a substantial period of time (usually 12 months or more) to get ready for its intended use or sale. If an asset is ready for its intended use or sale at the time of its acquisition then it is not treated as a qualifying asst for the purposes of AS 16.

Treatment of interest as per AS 16

	Particulars	Nature	Interest to be capitalized	Interest to be charged to profit and loss account
(1)	Construction of a shed	Qualifying asset	$\left(\text{Rs. 9 lakhs} \times \frac{\text{Rs. 20 lakhs}}{\text{Rs. 50 lakhs}}\right)$ = Rs. 3.60 lakhs	
(2)	Purchase of machinery	Not a qualifying asset*		$\left(\text{Rs. 9 lakhs} \times \frac{\text{Rs. 15 lakhs}}{\text{Rs. 50 lakhs}}\right)$ = Rs. 2.70 lakhs.
(3)	Working capital	Not qualifying asset		$\left(\text{Rs. 9 lakhs} \times \frac{\text{Rs. 10 lakhs}}{\text{Rs. 50 lakhs}}\right)$ = Rs. 1.80 lakhs
(4)	Advance for purchase of truck	Not a qualifying asset		$\left(\text{Rs. 9 lakhs} \times \frac{\text{Rs. 5 lakhs}}{\text{Rs. 50 lakhs}}\right)$ = Rs. 0.90 lakhs
	Total		Rs.3.60 lakhs	Rs.5.40 lakhs

* On the basis that machinery is ready for its intended use at the time of its acquisition/purchase.

(b) The preparation of financial statements involve making estimates which are based on the circumstances existing at the time when the financial statements are prepared. It may be necessary to revise an estimate in a subsequent period if there is a change in the circumstances on which the estimate was based. Revision of an estimate, by its nature, does not bring the adjustment within the definitions of a prior period item or an extraordinary item [para 21 of AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies].

In the given case, a limited company created 2.5% provision for doubtful debts for the year 2003-2004. Subsequently in 2004 they revised the estimates based on the changed circumstances and wants to create 8% provision. As per AS-5 (Revised), this change in estimate is neither a prior period item nor an extraordinary item.

However, as per para 27 of AS 5 (Revised), a change in accounting estimate which has material effect in the current period, should be disclosed and quantified. Any change in the accounting estimate which is expected to have a material effect in later periods should also be disclosed.

(c) Alteration in the retirement benefit cost may arise from introduction of a retirement benefit scheme for existing employees or because of making of improvements to an existing scheme. As per AS 15 any alternation in retirement benefit cost arising from changes in the actuarial method used or assumptions adopted should be charged or credited to the statement of profit or loss as they arise in accordance with AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies". Additionally, a change in the actuarial method should be treated as a change in accounting policy and disclosed in accordance with AS 5. The cost of additional benefits provided to retired employees due to amendments in the retirement benefit scheme should also be treated in the same manner (i.e. charged to profit and loss statement of the year).

Question 19

(a) *A major fire has damaged assets in a factory of X Co. Ltd. on 8.4.2004, 8 days after the year end closing of accounts. The loss is estimated to be Rs. 16 crores (after estimating the recoverable amount of Rs. 24 crores from the Insurance Company).*

If the company had no insurance cover, the loss due to fire would be Rs. 40 crores.

Explain, how the loss should be treated in the Final accounts of the year ended 31.3.2004.

(b) *A Company had deferred research and development cost of Rs. 150 lakhs. Sales expected in the subsequent years are as under:*

Years	*Sales (Rs. in lakhs)*
I	*400*
II	*300*

III	*200*
IV	*100*

You are asked to suggest how should Research and Development cost be charged to Profit and Loss account.

If at the end of the III year, it is felt that no further benefit will accrue in the IV year, how the unamortised expenditure would be dealt with in the accounts of the Company?

(c) In April, 2004 a Limited Company 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 1.9.2004. All shareholders paid the sum in September, 2004, except one shareholder having 24,000 shares. The net profit for the year ended 31.3.2005 is Rs. 2,64,000 after dividend on preference shares and dividend distribution tax of Rs. 64,000.

Compute basic EPS for the year ended 31.3.2005 as per Accounting Standard 20.

(d) (i) Mr. Raj a relative of key Management personnel received remuneration of Rs. 2,50,000 for his services in the company for the period from 1.4.2004 to 30.6.2004. On 1.7.2004 he left the service.

Should the relative be identified as at the closing date i.e. on 31.3.2005 for the purposes of AS 18?

(ii) X Ltd. sold goods to its associate Company for the 1st quarter ending 30.6.2004. After that, the related party relationship ceased to exist. However, goods were supplied as was supplied to any other ordinary customer. Decide whether transactions of the entire year has to be disclosed as related party transaction.

(e) On 1.4.2001 ABC Ltd. received Government grant of Rs. 300 lakhs for acquisition of a machinery costing Rs. 1,500 lakhs. The grant was credited to the cost of the asset. The life of the machinery is 5 years. The machinery is depreciated at 20% on WDV basis. The Company had to refund the grant in May 2004 due to non-fulfillment of certain conditions.

How you would deal with the refund of grant in the books of ABC Ltd.?

(4 marks each) (PE-II – May 2005

Answer

(a) The present event does not relate to conditions existing at the balance sheet date. Hence, no specific adjustment is required in the financial statements for the year ending on 31.3.2004. But if the event occurring after balance sheet date gives an indication that the enterprise may cease to be a going concern, then the assets and liabilities are required to be adjusted for the financial year ended 31st March, 2004. AS 4 (Revised) requires disclosure in respect of events occurring after the balance sheet date representing unusual changes affecting the existence or substratum of the enterprise after the date of the Balance Sheet. In the present event, the loss of assets in a factory can be considered to be an event affecting the substratum of the enterprise. Hence, an appropriate disclosure should be made in the report of the approving authority.

(b) (i) Based on sales, research and development cost to be allocated as follows:

Year	*Research and Development cost allocation (Rs. in lakhs)*
I	$\frac{400}{1,000} \times 150 = 60$
II	$\frac{300}{1,000} \times 150 = 45$
III	$\frac{200}{1,000} \times 150 = 30$
IV	$\frac{100}{1,000} \times 150 = 15$

(ii) If at the end of the III year, the circumstances do not justify that further benefit will accrue in IV year, then the company has to charge the unamortised amount i.e. remaining Rs. 45 lakhs [150 – (60 + 45)] as an expense immediately.

Note: As per para 41 of AS 26 on Intangible Assets, expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred. It has been assumed in the above solution that the entire cost of Rs. 150 lakhs is development cost. Therefore, the expenditure has been deferred to the subsequent years on the basis of presumption that the company can demonstrate all the conditions specified in para 44 of AS 26. An intangible asset should be derecognised when no future economic benefits are expected from its use according to para 87 of the standard. Hence the remaining unamortised amount of Rs. 45,00,000 has been written off as an expense at the end of third year.

(c) Basic earnings per share (EPS) = $\frac{\text{Net profit attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$

$$= \frac{\text{Rs. 2,64,000}}{\text{88,000 shares (as calculated in working note)}} = \text{Rs. 3}$$

Working Note:

Calculation of weighted average number of equity shares

	Number of shares	*Nominal value of shares*	*Amount paid*
1st April, 2004	1,20,000	100	50
1st September, 2004	96,000	100	100
	24,000	100	50

As per para 19 of AS 20 on Earnings per share, Partly paid equity shares are treated as a fraction of equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period. Assuming that the partly paid shares are entitled to participate in the dividends to the extent of amount paid, weighted average number of shares will be calculated as:

		Shares
$1{,}20{,}000 \times \frac{1}{2} \times \frac{5}{12}$	=	25,000
$96{,}000 \times \frac{7}{12}$	=	56,000
$24{,}000 \times \frac{1}{2} \times \frac{7}{12}$	=	7,000
		88,000 shares

(d) (i) According to para 10 of AS 18 on Related Party Disclosures, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Hence, Mr. Raj, a relative of key management personnel should be identified as relative as at the closing date i.e. on 31.3.2005.

(ii) As per para 23 of AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.2004 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did not exist need not be reported.

(e) According to para 21 of AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. The accounting treatment in both the alternatives can be given as follows:

Alternative 1:

		Rs. (in lakhs)
1st April, 2001	Acquisition cost of machinery (Rs. 1,500 – 300)	1,200.00
31st March, 2002	*Less*: Depreciation @ 20%	240.00
	Book value	960.00
31st March, 2003	*Less*: Depreciation @ 20%	192.00
	Book value	768.00
31st March, 2004	*Less*: Depreciation @ 20%	153.60

1st April, 2004	Book value	614.40
May, 2004	*Add*: Refund of grant	300.00
	Revised book value	914.40

Depreciation @ 20% on the revised book value amounting Rs. 914.40 lakhs is to be provided prospectively over the residual useful life of the asset i.e. years ended 31st March, 2005 and 31st March, 2006.

Alternative 2:

ABC Ltd. can also debit the refund amount of Rs. 300 lakhs in capital reserve of the company.

Question 20

(a) ABC Ltd. could not recover Rs. 10 lakhs from a debtor. The company is aware that the debtor is in great financial difficulty. The accounts of the company were finalized for the year ended 31.3.2005 by making a provision @ 20% of the amount due from the said debtor.

The debtor became bankrupt in April, 2005 and nothing is recoverable from him.

Do you advise the company to provide for the entire loss of Rs. 10 lakhs in the books of account for the year ended 31st March, 2005?

(b) X Co. Ltd. signed an agreement with its employees union for revision of wages in June, 2004. The wage revision is with retrospective effect from 1.4.2000. The arrear wages upto 31.3.2004 amounts to Rs. 80 lakhs. Arrear wages for the period from 1.4.2004 to 30.06.2004 (being the date of agreement) amounts to Rs. 7 lakhs.

Decide whether a separate disclosure of arrear wages is required.

(c) An intangible asset appears in Balance Sheet of A Co. Ltd. at Rs. 16 lakhs as on 31.3.2004. The asset was acquired for Rs. 40 lakhs in April, 1991. The Company has been amortising the asset value on straight line basis. The policy is to amortise for 20 years.

Do you advise the Company to amortise the entire asset value in the books of the company as on 31.3.2004?

(d) Ram Co. (P) Ltd. furnishes you the following information for the year ended 31.3.2005:

Depreciation for the year ended 31.3.2005 (under straight line method)	*Rs. 100 lakhs*
Depreciation for the year ended 31.3.2005 (under written down value method)	*Rs. 200 lakhs*
Excess of depreciation for the earlier years calculated under written down value method over straight line method	*Rs. 500 lakhs*

The Company wants to change its method of claiming depreciation from straight line method to written down value method.

Decide, how the depreciation should be disclosed in the Financial Statement for the year ended 31.3.2005.

(e) How refund of revenue grant received from the Government is disclosed in the Financial Statements? (4 Marks each) (PE-II – Nov. 2005)

Answer

(a) As per AS 4 'Contingencies and Events occurring after the Balance Sheet Date', adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the Balance Sheet date.

In the given case, bankruptcy of the debtor in April, 2005 and consequent non-recovery of debt is an event occurring after the balance sheet date which materially affects the determination of profits for the year ended 31.3.2005. Therefore, the company should be advised to provide for the entire amount of Rs. 10 lakhs according to para 8 of AS 4.

(b) It is given that revision of wages took place in June, 2004 with retrospective effect from 1.4.2000. The arrear wages payable for the period from 1.4.2000 to 30.6.2004 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item.

Additional wages liability of Rs. 87 lakhs (from 1.4.2000 to 30.6.2004) should be included in current year's wages.

It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Although abnormal in amount, such an expense does not qualify as an extraordinary item. However, as per Para 12 of AS 5 (Revised),' Net Profit or loss for the Period, Prior Period Items and Changes in the Accounting Policies', when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

However, wages payable for the current year (from 1.4.2004 to 30.6.2004) amounting Rs. 7 lakhs is not a prior period item, hence need not be disclosed separately. This may be shown as current year wages.

(c) AS 26 'Intangible Assets', came into effect for accounting periods commencing on or after 1.4.2003 and is mandatory in nature. Para 67 of the standard provides that if there is persuasive evidence that the life of the intangible asset is 20 years, then no adjustment is required at 1.4.2003. However, para 63 of the standard states that if it cannot be demonstrated that the life of the intangible asset is greater than 10 years, then

AS 26 would require the asset to be amortised over not more than 10 years. Since, in the given case, the amortisation period determined by applying para 63 has already expired as on 1.4.2003, the carrying amount of Rs. 16 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1.4.2003.

(d) As per para 21 of AS 26 'Intangible Assets', when a change in the method of depreciation is made, depreciation should be calculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation should be adjusted in the accounts in the year in which the method of depreciation is changed. The deficiency should be charged to profit and loss account. Similarly, any surplus should be credited in the statement of profit and loss. Such change is a change in the accounting policy, and its effect should be quantified and disclosed.

In the given case, the deficiency of Rs. 500 lakhs would be charged to the profit and loss account of 31.3.2005. In the notes to account, the fact of change in method of depreciation should be elaborated along with the effect of Rs. 500 lakhs. The current depreciation charge of 200 lakhs determined in accordance with the written down value method should be debited to the profit and loss account.

(e) The amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount should be charged to profit and loss statement. The amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

Question 21

(a) X Co. Limited purchased goods at the cost of Rs.40 lakhs in October, 2005. Till March, 2006, 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 31.3.2006.

(b) Explain the 'Accounting of Revaluation of Assets' with reference to AS 10.

(c) Arjun Ltd. sold farm equipments through its dealers. One of the conditions at the time of sale is, payment of consideration in 14 days and in the event of delay interest is chargeable @ 15% per annum. The Company has not realized interest from the dealers in the past. However, for the year ended 31.3.2006, it wants to recognise 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.

(d) *AB Ltd. launched a project for producing product X in October, 2004. The Company incurred Rs.20 lakhs towards Research and Development expenses upto 31st March, 2006. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years.*

Advise the Company as per the applicable Accounting Standard.

(4 Marks each) (PE-II May 2006)

Answer

(a) As per Para 5 of AS 2 "Valuation of Inventories", the inventories are to be valued at lower of cost and net realizable value.

In this case, the cost of inventory is Rs.10 lakhs. The net realizable value is 11,00,000 $\times$ 90% = Rs.9,90,000. So, the stock should be valued at Rs.9,90,000.

(b) As per Para 30 of AS 10 "Accounting for Fixed Assets", an increase in net book value arising on revaluation of fixed assets should be credited to owner's interests under the head of 'revaluation reserve, except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement, it may be credited to the profit and loss statement. A decrease in net book value arising on revaluation of fixed assets is charged directly to profit and loss statement except that to the extent such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilized , it may be charged directly to that account.

(c) As per AS 9 "Revenue Recognition", where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, the revenue recognition is postponed to the extent of uncertainty inverted. In such cases, the revenue is recognized only when it is reasonably certain that the ultimate collection will be made.

In this case, the company never realized interest for the delayed payments make by the dealers. Hence, it has to recognize the interest only if the ultimate collection is certain. The interest income hence is not to be recognized.

(d) As per Para 41 of AS 26 "Intangible Assets", expenditure on research should be recognized as an expense when it is incurred. An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the conditions specified in para 44 of the standard. An intangible asset (arising from development) should be derecognised when no future economic benefits are expected from its use according to para 87 of the standard. Therefore, the manager cannot defer the expenditure write off to future years.

Hence, the expenses amounting Rs. 20 lakhs incurred on the research and development project has to be written off in the current year ending 31st March, 2006.

Question 22

(a) *What are the costs that are to be included in Research and Development costs as per AS 8.*

(b) *The Company reviewed an actuarial valuation for the first time for its Pension Scheme, which revalued a surplus of Rs.12 lacs. It wants to spread the same over the next 2 years by reducing the annual contribution to Rs.4 lacs instead of Rs.10 lacs. The average remaining life of the employees, if estimated to be 6 years, you are required to advise the Company considering the accounting standards 5 and 15.*

(c) *X Ltd. entered into an agreement to sell its immovable property included in the Balance Sheet at Rs.10 lacs to another company for Rs.15 lacs. The agreement to sell was concluded on 28th February, 2006 and the sale deed was registered on 1st May, 2006. Comment with reference to AS 4.*

(d) *Define related party transaction under AS 18.* *(4 Marks each) (PE-II- Nov. 2006)*

Answer

(a) According to paras 41 and 43 of AS 26*, **"**No intangible asset arising from research (or from the research phase of an internal project) should be recognized in the research phase. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred.

Examples of research costs are:

- Costs of activities aimed at obtaining new knowledge;
- Costs of the search for, evaluation and final selection of, applications of research findings or other knowledge;
- Costs of the search for alternatives for materials, devices, products, processes, systems or services; and
- Costs of the activities involved in formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes systems or services."

According to paras 45 and 46 of AS 26, "In the development phase of a project, an enterprise can, in some instances, identify an intangible asset and demonstrate that future economic benefits from the asset are probable. This is because the development phase of a project is further advanced than the research phase.

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* AS 8 stands withdrawn w.e.f. 1st April, 2003 i.e. the date from which AS 26 'Intangible Assets' becomes mandatory. Therefore the above answer has been given as per AS 26.

Examples of development activities/costs are:

- Costs of the design, construction and testing of pre-production or pre-use prototypes and models;
- Costs of the design of tools, jigs, moulds and dies involving new technology;
- Costs of the design, construction ad operation of a pilot plant that is not of a scale economically feasible for commercial production; and
- Costs of the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services."

(b) According to para 92 of AS 15 (Revised 2005) on "Employee Benefits", any actuarial gains and losses should be recognized immediately in the statement of profit and loss account as income or expense.

In the given case, the amount of surplus from pension scheme of Rs. 12 lacs is an actuarial gain, which should be recognized as income in the profit and loss account of the current year and not to be adjusted from the amount of annual contribution.

The surplus arising due to review of actuarial valuation of pension scheme by a company should be treated as a change in accounting policy and disclosed in accordance with AS 5(Revised).

(c) According to para 13 of AS 4 "Contingences and Events occurring after the Balance Sheet Date", assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date.

In this case the sale of immovable property was carried out before the closure of the books of Accounts. This is clearly an event occurring after the balance sheet date. Agreement to sell was effected before the balance sheet date and the registration was done after the balance sheet date. So the adjustment for the sale of immovable property is necessary in the books of account for the year ended 31st March, 2006.

(d) According to AS 18, "Parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions."

A related party transaction involves a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Following are the examples of the related party transactions in respect of which disclosures may be made by a reporting enterprise:

- Purchases or sales of goods (finished or unfinished);
- Purchases or sales of fixed assets;
- Rendering or receiving of services;

- Agency arrangements;
- Leasing or hire purchase arrangements;
- Transfer of research and development;
- Licence agreements;
- Finance (including loans and equity contributions in cash or in kind);
- Guarantees and collateral etc.
- Management contracts including for deputation of employees.

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