GUIDANCE ANSWERS TO MAY / JUNE 2009 CA FINAL EXAMINATIONS

ADVANCED ACCOUNTING (Old Syllabus)

Question No.1(a): Valuation of Shares – Equity and Preference — 10 Marks

The following are the information relating to two Companies for the year ended 31st March –

Particulars	Aikya Ltd	Bakya Ltd
Equity Shares of Rs.10 each	Rs.8,00,000	Rs.10,00,000
10% Preference Shares of Rs.10 each	Rs.6,00,000	Rs. 4,00,000
Profit After Tax	Rs.3,00,000	Rs. 3,00,000

Assume that Market Expectation is 18% and that 80% Profits are distributed.

1. **What is the rate you would pay for the Equity Shares of each Company –**
   - **If you are buying a small lot;**
   - **If you are buying controlling interest shares.**
2. **If you plan to invest only in Preference Shares, which Company's Preference Shares would you prefer?**

Solution:

REPEAT OF NOVEMBER 2002 EXAM QUESTION
See Illustration 18, Page 1.99 of Padhuka's Students' Guide on Advanced Accounting

Note: For purchase of small lots, the Dividend–Yield method is appropriate. However, for purchase of controlling interest / majority holdings, the Earnings–Yield (or earnings capitalization) method shall be adopted.

1. Valuation of Equity Shares at 80% Profit Distribution

Particulars	Aikya	Bakya
Profit after Tax	Rs.3,00,000	Rs.3,00,000
Less: Preference Dividend at 10% of Rs.6,00,000; 4,00,000	Rs. 60,000	Rs. 40,000
Equity Earnings	Rs.2,40,000	Rs.2,60,000
Number of Equity Shares (Equity Share Capital÷Rs.10)	80,000 Shares	1,00,000 Shares
Earnings Per Share = Equity Earnings ÷ No. of Shares	Rs.3.00	Rs.2.60
Dividend Per Share = EPS × 80% Payout Ratio	Rs.2.40	Rs.2.08
Preference Dividend Coverage Ratio = [Profit After Tax ÷ Preference Dividend]	**5.00 times**	**7.50 times**
Value Per Equity Share for:		
(a) **Controlling Acquisition** = EPS ÷ Market Expectation	(Rs.3.00 ÷ 18%) = **Rs.16.67**	(Rs.2.60 ÷ 18%) = **Rs.14.44**
(b) **Small Acquisition** = DPS ÷ Market Expectation	(Rs.2.40 ÷ 18%) = **Rs.13.33**	(Rs.2.08 ÷ 18%) = **Rs.11.55**

2. Evaluation of Preference Shares:

Preference Dividend Coverage Ratio is higher in Bakya Ltd than in Aikya Ltd. Hence, risk element of Preference Shares is low in Bakya Ltd. So, an Investor will prefer Bakya Ltd's Preference Shares.

Question No.1(b): Valuation of Goodwill – Super Profits Method – 10 Marks

From the following particulars of three companies, ascertain the value of Goodwill. Terms and conditions are as follows —

1. **Assets are to be revalued.**
2. **Goodwill is to be valued at four years' purchase of Average Super Profit for three years. Such average is to be calculated after adjustment of depreciation at 10% on the amount of increase/decrease on revaluation of Fixed Assets. Income tax is to be ignored.**
3. **Normal Profit on Capital Employed is to be taken at 10%, Capital Employed being considered on the basis of Net Revaluation amounts of Tangible Assets.**

The summarised Balance Sheets as at 31st March and the relevant information are given below – (Rs.Lakhs)

Liabilities	P Ltd	Q Ltd	R Ltd	Assets	P Ltd	Q Ltd	R Ltd
Equity Share Capital (Rs.10 each)	12.00	14.00	6.00	Goodwill	–	1.00	–
Reserves	2.00	1.00	2.00	Net Tangible Block	16.00	12.00	10.00
10% Debentures	4.00	—	2.00	Current Assets	6.00	5.00	2.00
Trade and Expense Creditors	4.00	3.00	2.00				
Total Liabilities	22.00	18.00	12.00	Total Assets	22.00	18.00	12.00

Particulars	P Ltd	Q Ltd	R Ltd
Revaluation of Tangible Block	20,00,000	10,00,000	12,00,000
Revaluation of Current Assets	7,00,000	2,80,000	1,60,000
Average Annual Profit for 3 years before charging Debenture Int.	3,60,000	2,88,000	1,56,000

Solution:

REPEAT OF NOVEMBER 1987 EXAM QUESTION

(Areas relating to discharge of Purchase Consideration excluded)
See Illustration 13, Page 2.39 of Padhuka's Students' Guide on Advanced Accounting

1. Calculation of Capital Employed (Rs.Lakhs)

Particulars	P Ltd	Q Ltd	R Ltd
Net Tangible Block	20.00	10.00	12.00
Current Assets	7.00	2.80	1.60
10% Debentures	(4.00)	—	(2.00)
Trade and Expense Creditors	(4.00)	(3.00)	(2.00)
Net Equity Capital Employed	**19.00**	**9.80**	**9.60**
Normal Profits at 10% of Capital Employed	**1.90**	**0.98**	**0.96**

2. Computation of Depreciation on Revaluation Gain / Loss (Rs.Lakhs)

Particulars	P Ltd	Q Ltd	R Ltd
Revalued Value of Tangible Block	20.00	10.00	12.00
Book Value	16.00	12.00	10.00
Revaluation Gain / (Loss)	**4.00**	**(2.00)**	**2.00**
Depreciation (Increase) / Decrease (10% of Revaluation Gain / Loss)	(0.40)	0.20	(0.20)

3. Computation of Adjusted Profits, Super Profits and Goodwill (Rs.Lakhs)

	Particulars	P Ltd	Q Ltd	R Ltd
	Average Profits Before Interest	3.60	2.88	1.56
Less:	Debenture Interest (10% of 4.00 L / 0.00 L / 2.00 L)	(0.40)	—	(0.20)
Less:	Additional Depreciation on Revaluation Gain	(0.40)	—	(0.20)
Add:	Reduction in Depreciation on Revaluation Loss	—	0.20	—
	Adjusted Annual Profits	2.80	3.08	1.16
Less:	Normal Profits	(1.90)	(0.98)	(0.96)
	Super Profits	0.90	2.10	0.20
	Goodwill at 4 Years Purchase of Super Profits	**3.60**	**8.40**	**0.80**

Question No.2: Takeover Without Liquidation – Uniform Accounting Policies – 16 Marks

Agni Ltd and Bayu Ltd, both engaged in similar merchanting activities since 2006, decide to amalgamate their business. Holding Company Chandrama Ltd would be formed on 1st January 2008 to acquire the entire share in both the companies.

From the information given below you are required to –
(1) Calculate the Purchase Consideration and
(2) Prepare the Balance Sheet of Chandrama Ltd after the transactions have been completed.

1. **The terms of the offer were:**
   - **Rs.100 15% Debentures for every 100 of Net Asset owned by each Company on 31st December 2007; and**
   - **Rs.100 Equity Shares based on two years purchase of Profit before Taxation. The profit is to be determined taking weighted average profits of 2006 and 2007 weights being 1 and 2 respectively.**
2. **It was agreed that the accounts of Bayu Ltd for the two years ended December 31, 2007 be adjusted, where necessary, to confirm with accounting policies followed by Agni Ltd.**
3. **The pre-tax profits, including investments income, of the two companies were as follows:**

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

4. **Agni Ltd values its Stock on FIFO basis while Bayu Ltd used different basis. To bring Bayu Ltd's values in line with those of Agni Ltd, its value will require to be reduced by Rs.36,000 at the end of 2006 and Rs.1,02,000 at the end of 2007.**
5. **Both the Companies use Straight – Line Method of depreciation.**
6. **Bayu Ltd deducts 1% from Trade Debtors as a general provision against Doubtful Debts.**
7. **Prepaid Expenses in Bayu Ltd include advertising expenditure carried forward of Rs.1,80,000 in 2006 and Rs.90,000 in 2007, being part of initial advertising in 2006 which is being written off over three years. Similar expenditure in Agni Ltd has been fully written off in 2006.**
8. **To bring Directors Remuneration on to a comparative basis, the profit of Bayu Ltd are to be reduced by Rs.1,20,000 in 2006 and Rs.1,80,000 in 2007 and the net assets are also to be adjusted accordingly.**

Balance Sheet as on 31st December 2006 and 2007 were as follows –

Balance Sheets of Agni Ltd. (information in Rs.)

Liabilities	2006	2007	Assets	2006	2007
Share Capital:			**Fixed Assets**		
Issued & Subscribed: 12,000 Shares of Rs.100 each fully paid	**12,00,000**	**12,00,000**	**Furniture & Fixtures: Cost**	**6,90,000**	**6,90,000**
			Less: Depreciation	**(69,000)**	**(1,38,000)**
Reserves & Surplus			**Investments: Quoted Invts**		
Capital Reserve	**-**	**2,10,000**	**at Market Value**	**-**	**7,80,000**
Revenue Reserve	**7,98,300**	**16,74,000**	**Current Assets**		
Current Liabilities & Provisions			**Stock At Cost**	**18,30,000**	**21,75,000**
Sundry Creditors	**15,02,700**	**18,21,000**	**Sundry Debtors**	**18,00,000**	**22,20,000**
Provision For Taxation	**8,40,000**	**9,60,000**	**Prepaid Expenses**	**30,000**	**42,000**
			Cash at Bank	**60,000**	**96,000**
Total	**43,41,000**	**58,65,000**	**Total**	**43,41,000**	**58,65,000**

Balance Sheets of Bayu Ltd. (information in Rs.)

Liabilities	2006	2007	Assets	2006	2007
Share Capital: Issued & Subscribed: 15,000 Equity Shares of Rs.100 each fully paid	**15,00,000**	**15,00,000**	**Fixed Assets at Cost Less Depreciation**	**9,60,000**	**9,60,000**
				(1,44,000)	**(2,88,000)**
			Investments – Quoted Invts		
Reserves & Surplus			**Market Value = 14,70,000**	**–**	**12,00,000**
Revenue Reserve	**8,58,000**	**21,42,000**	**Current Assets:**		
Current Liabilities & Provisions			**Stock – In – Trade At Cost**	**17,91,000**	**22,26,000**
Sundry Creditors	**14,70,000**	**14,82,000**	**Sundry Debtors**	**17,82,000**	**26,73,000**
Bank Overdraft	**-**	**5,10,000**	**Prepaid Expenses**	**2,16,000**	**1,44,000**
Provision For Taxation	**9,30,000**	**12,90,000**	**Cash at Bank**	**1,53,000**	**9,000**
Total	**47,58,000**	**69,24,000**	**Total**	**47,58,000**	**69,24,000**

Solution:

Same as Illustration 21, Page 2.55 of Padhuka's Students' Guide on Advanced Accounting

1. Statement of Adjusted Net Profits of Bayu Ltd (Amount in Rs.)

Particulars		Year 2006		Year 2007	
	Details of Adjustment	**(Less)**	**Add**	**(Less)**	**Add**
	Net Profit as reported above	–	17,88,300	–	25,74,000
Adjts:	Reduction In Stock In Trade	(36,000)	–	(1,02,000)	36,000
	Sundry Debtors	–	(WN 1) 18,000	–	27,000
	Advertising	(1,80,000)	–	–	90,000
	Directors' Remuneration	(1,20,000)	–	(1,80,000)	–
	Depreciation	–	(WN2)48,000	–	48,000
	Appreciation In Investment	–	–	–	2,70,000
	Total of above	(3,36,000)	18,54,300	(2,82,000)	30,45,000
	Adjusted Net Profit		**15,18,300**		**27,63,000**

Notes:

1. **Debtors:** Debtors as per B/s = Rs.17,82,000 and Rs.26,73,000 are after charging 1% provision. Hence, Provision to be added back = (Rs.17,82,000 ÷ 99%) × 1% = Rs.18,000 for Year 2006.
2. **Depreciation:** SLM Depreciation Rates of the Companies are (Rs.69,000 ÷ Rs.6,90,000) = 10% for Agni and (Rs.1,44,000 ÷ Rs.9,60,000) = 15% for Bayu. To ensure uniformity in accounting, the difference of 5% in depreciation (Rs.9,60,000 × 5%) = Rs.48,000 is added back, to the profits of Bayu Ltd.

2. Adjustment of Net Assets of Bayu Ltd.

Particulars			**Rs.**	**Rs.**
	Furniture & Fixtures		9,60,000	
Less:	Depreciation at 10% for 2 years		1,92,000	7,68,000
	Quoted Investments (now taken at Market Value)			14,70,000
	Stock	(22,26,000 – 1,02,000)		21,24,000
	Debtors (provision reversed)	(26,73,000 + 27,000)		27,00,000
	Prepaid Expenses	(1,44,000 – 90,000)		54,000
	Cash at Bank			9,000
	Total Assets			71,25,000
Less:	Current Liabilities		32,82,000	
	Liability For Directors' Remuneration		3,00,000	35,82,000
	Adjusted Net Assets of Bayu Ltd			**35,43,000**

3. Issue of Equity Shares equal to two years purchase of Average Profits

	Agni Ltd			**Bayu Ltd**		
Year	**Rs.**	**Weight**	**Rs.**	**Rs.**	**Weight**	**Rs.**
2006	16,38,000	1	16,38,000	15,18,300	1	15,18,300
2007	18,36,000	2	36,72,000	27,63,000	2	55,26,000
Total Profits of above		**3**	**53,10,000**		**3**	**70,44,300**
Average Profits (divided by 3)			17,70,000			23,48,100
Two Years Purchase (Goodwill)			35,40,000			46,96,200
Net Assets as Adjusted **(Note)**			30,84,000			35,43,000
Total Purchase Consideration			**66,24,000**			**82,39,200**

Discharge of Purchase Consideration: Shares will be issued for Goodwill and 15% Debentures for Net Assets.

Note: Adjusted Net Assets = Total Assets Rs.58,65,000 – Creditors Rs.18,21,000 and Tax Provision Rs.9,60,000 = Rs.30,84,000.

4. Statement of Purchase Consideration

Particulars		**Rs.**
To Shareholders of Agni Ltd		
In Equity Shares (for Goodwill)	35,400 Equity Shares of Rs.100 each of Chandrama Ltd, issued at Par as fully paid up	35,40,000
In Debentures (for Net Assets)	30,840 15% Debentures of Rs.100 each of Chandrama Ltd, issued at Par, as fully paid up	30,84,000
	Total Purchase Consideration	**66,24,000**

To Shareholders of Bayu Ltd		
In Equity Shares (for Goodwill)	46,962 Equity Shares of Rs.100 each of Chandrama Ltd, issued at Par as fully paid up	46,96,200
In Debentures (for Net Assets)	35,430 15% Debentures of Rs.100 each of Chandrama Ltd, issued at Par, as fully paid up	35,43,000
	Total Purchase Consideration	**82,39,200**

5. Balance Sheet of Chandrama Ltd. as on 1st January 2008

Liabilities	Rs.	Assets	Rs.
Share Capital: Issued & Subscribed		**Investments** at Cost	
82,362 Shares of Rs. 100 Each Fully Paid		Shares in Agni Ltd.	66,24,000
(Issued For Consideration Other Than Cash)	82,36,200	Shares in Bayu Ltd.	82,39,200
Secured Loans: 66,270 Debentures (Rs.100) fully paid	66,27,000		
Total	**1,48,63,200**	**Total**	**1,48,63,200**

Question No.3(a): Accounting for Securitisation – 6 Marks

Parikshit Ltd holds Rs.1,00,000 of loans yielding 18% interest p.a. for their estimated lives of 9 years. The Fair Value of these loans, after considering the interest yield is estimated at Rs.1,10,000.

The Company securitises the principal component of the loan plus the right to receive interest at 14% to Susovana Corporation, a Special Purpose Entity, for Rs.1,00,000.

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

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

Solution:

Same as Illustration 9, Page 6.69 of Padhuka's Students' Guide on Advanced Accounting

1. Fair Value of securitised component of Loan

	Particulars	Rs.	Rs.
	Fair Value of Loan		1,10,000
Less:	Fair Value of Servicing Asset	3,500	
	Fair Value of Interest Strip	6,500	10,000
	Fair Value of securitised component of Loan		**1,00,000**

2. Apportionment of Carrying Amount based on Relative Fair Values

Particulars	Fair Values Rs.	% to Total Fair Value	Proportionate Carrying Amount Rs.
(1)	(2)	(3)	(4) = Rs.1,00,000 × (3)
Fair Value of Securitised Component of the Loan	1,00,000	90.91%	90,910
Fair Value of Servicing Asset	3,500	3.18%	3,180
Fair Value of Interest Strip	6,500	5.91%	5,910
Total Fair Value	**1,10,000**	**100.00%**	**1,00,000**

3. Profit on Securitisation = Net Proceeds from Securitisation **Less** Apportioned Carrying Amount
= Rs.1,00,000 **Less** Rs.90,910 = **Rs.9,090**

4. Journal Entries in the books of Originator

S.No.	Particulars	Debit Rs.	Credit Rs.
1	Bank A/c Dr.	1,00,000	
	To Loans (Cost of Securitised Component)		90,910
	To Profit on Securitisation		9,090
	(Being Securitisation of Principal and right to 14% interest)		
2	Servicing Asset A/c Dr.	3,180	
	Interest Strip A/c Dr.	5,910	
	To Loans		9,090
	(Being creation of Servicing Asset and Interest Strip Receivable)		

Question No.3(b): Not For Profit Organisations – Annuity Income Funds – 5 Marks

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

Draft the journal entries in the University's books.

Solution:

Similar to Illustration 2, Page 4.9 / Exercise 2, Page 4.22 of Padhuka's Students' Guide on Advanced Accounting

	Particulars		Dr.	Cr.
1.	Bank A/c	Dr.	20,00,000	
	Investments A/c	Dr.	15,00,000	
	To Annuity Fund			35,00,000
	(Being Receipt of Annuity Based Gift – in the form of Cash and Marketable Securities)			
2.	Bank A/c	Dr.	38,500	
	To Annuities Payable A/c			25,000
	To Annuity Fund			13,500
	(Being Monthly Investment Income Received from the Fund and Surplus after meeting the annuity payable, transferred to Fund)			
3.	Annuities Payable A/c	Dr.	25,000	
	To Bank			25,000
	(Being monthly annuity payment made)			

Question No.3(c): Corporate Social Reporting – 5 Marks

Harihar Ltd. provides you the following information relating to staff and community benefits. Prepare a statement classifying the various items under the appropriate heads, required under Corporate Social Reporting.

Particulars	Rs.Lakhs	Particulars	Rs.Lakhs
Environmental Improvements	36,18	Concessional Transport, Water Supply	20.25
Medical Facilities	9.00	Generation of business	45.00
Training Programmes	18.45	Leave Encashment and Leave Travel Benefits	93.60

Generation of Job Opportunities	**109.35**	**Education facilities for children of staff members**	**38.88**
Municipal Taxes	**19.26**	**Subsidised Canteen facilities**	**25.92**
Increase in cost of living in the vicinity due to Company's operations	**29.79**	**Extra work put in by Staff and Officers for drought relief**	**33,30**

Solution:

Similar to Illustration 1 Page 5.39 / Same as Exercise 1 Page 5.40 (Numbers Divided by 2) of Padhuka's Students' Guide on Advanced Accounting

Statement relating to Staff and Community Benefits

Particulars	Rs.Lakhs
I. SOCIAL BENEFITS AND COST TO STAFF	
A. Social Benefits to Staff	
1. Medical Facilities	9.00
2. Training Programmes	18.45
3. Concessional Transport and Water Supply	20.25
4. Leave encashment and Leave Travel Benefits	93.60
5. Educational Facilities for Children of Staff Members	38.88
6. Subsidised Canteen Facilities	25.92
Total	**206.10**
Less: **B. Social costs to Staff:** Extra work put in by Staff and Officers for drought relief	(33.30)
Net Social Benefits to Staff (A – B)	**172.80**
II. SOCIAL BENEFITS AND COST TO COMMUNITY	
A. Social Benefits to Community	
1. Environmental Improvements	36.18
2. Generation of Job Opportunities	109.35
3. Municipal Taxes	19.26
4. Generation of Business	45.00
Total	**209.79**
Less: **B. Social costs to Community:** Increase in cost of living due to a Company's Operations	(29.79)
Net Social Benefits to Community (A – B)	**180.00**
Total Net Social Benefits to Staff and Community (I + II)	**352.80**

Question No.4(a): AS 16 – Borrowing Costs – 10 Marks

The borrowings profile of Santra Pharmaceuticals Ltd set up for the manufacture of antibiotics at Navi Mumbai is as under —

Date	Nature of Borrowings	Amount Borrowed (Rs.Lakhs)	Purpose of Borrowings	Incidental Expenses
01.01.2008	15% Demand Loan	60.00	Acquisition of Fixed Assets	8.33%
01.07.2008	14.5% Term Loan	40.00	Acquisition of Plant and Machinery	5.00%
01.10.2008	14% Bonds	50.00	Acquisition of Fixed Assets	8.00%

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

Fixed Assets considered as Qualifying Assets are as under —

Sterile Manufacturing Shed	**Rs.10,00,000**
Plant and Machinery (Total)	**Rs.90,00,000**
Other Fixed Assets	**Rs.10,00,000**

The project is completed on 01.01.2009 and is ready for commercial production. Show the capitalization of borrowing costs.

Solution:

1. Computation of Total Borrowing Cost

Loan Type	Amount	Period Outstanding	Interest	Incidental Cost	Total Cost
15% Demand Loan	60.00	12 Months	60 × 12/12 × 15% = 9.00	60 × 8.33% = 5.00	14.00
14.5% Term Loan	40.00	6 Months	40 × 6/12 × 14.5% = 2.90	40 × 5% = 2.00	4.90
14% Bonds	50.00	3 Months	50 × 3/12 × 14% = 1.75	50 × 8% = 4.00	5.75
					24.65

2. Computation of Capitalization Rate

(a) Computation of Weighted Average General Borrowings

Loan Type	Date	Amount	Cumulative Amount	Period Outstanding	Product
15% Demand Loan	01.01.2008	60.00	60.00	9 Months	540.00
14% Bonds	01.10.2008	50.00	110.00	3 Months	330.00
					870.00

Weighted Average General Borrowings = Rs.870 Lakhs ÷ 12 Months = Rs.72.50 Lakhs

(b) Capitalization Rate

Capitalisation Rate = Borrowing Cost on General Borrowings ÷ Weighted Average General Borrowings
= (Rs.24.65 Lakhs – Rs.4.90 Lakhs) ÷ Rs.72.50 Lakhs = Rs.19.75 ÷ Rs.72.50 = **27.24%**

3. Capitalisation of Borrowing Costs

Asset	Amount Spent	Specific Borrowings	General Borrowings	Cost for Specific Borrowings	Cost for General Borrowings	Total Borrowing Cost
Sterile Manufacturing Shed	10,00,000	—	10,00,000	—	10 L × 27.24% = 2,72,400	2,72,400
Plant and Machinery	90,00,000	40,00,000	50,00,000	4,90,000	50 L × 27.24% = 13,62,000	18,52,000
Other Fixed Assets	10,00,000	—	10,00,000	—	10 L × 27.24% = 2,72,400	2,72,400
Borrowing Cost Capitalized						**23,96,800**

Note: In the absence of details regarding actual date of incurrence of expenditure on Qualifying Assets, it is assumed that all sums have been incurred on 01.01.2008. Borrowing costs should be capitalized by applying the Capitalisation Rate on the amount and the period so incurred

It is assumed that incidental costs are written–off completely in the very first year, and not amortized over a longer period of time.

Balance of Rs.68,200 of Borrowing Cost (Total Rs.24,65,000 – Capitalized Rs.23,96,800) will be expensed off during the year.

Question No.4(b): AS 5, 9 and 29 – Evaluation of Accounting Treatment – 6 Marks

A Company is engaged in the business of ship building and ship repair. On completion of the repair work, a work completion certificate is prepared and countersigned by the ship owner (customer). Subsequently, invoice is prepared based on the work completion certificate describing the nature of work done together with the rate and the amount. Customer scrutinizes the invoice and any variation is informed to the Company. Negotiations take place between the Company and the customer. The negotiations may result in a deduction being allowed from the invoiced amount either as a lumpsum or as a percentage of the invoiced amount.

The accounting treatment followed by the Company is as follows —

(a) When invoice is raised, the customer's account is debited and ship repair income is credited with the invoiced amount.

(b) Deduction, if any, arrived after negotiation is treated as Trade Discount by debiting the Ship Repair Income account.

(c) At the close of the year, negotiation in respect of certain invoices had not been completed. In such cases, based on past experience, a provision for anticipated loss is created by debiting the Profit and Loss Account. The provision is disclosed in the Balance Sheet.

Following two aspects are settled in negotiations —

(a) Errors in billing arising on account of variation between the quantities as per Work Completion Certificate and the Invoice, and other clerical errors in preparing the invoice.

(b) Disagreement between the Company and customer about the rate / cost on which prior agreement has not been reached between them.

Comment –

(a) Whether the accounting treatment of deductions as trade discount is correct? If not, state the correct accounting treatment.

(b) Whether the disclosure of the provision for anticipated loss in Balance Sheet is correct; if not, state the correct accounting treatment.

Solution:

1. **Meaning:**
   (a) **Trade Discount:** Trade Discounts are discounts related to volume of purchase, frequency of purchase or other similar business considerations, which are given at the time of issue of invoice itself. These are shown as a deduction in the invoice, and only the net amount is recognized as revenue.
   (b) **Prior Period Item:** These are income or expenditure that arise in the current period as a result of errors or omissions in the preparations of the financial statement of one or more prior years.

2. **Analysis:**
   (a) **Reduction in Bill Value due to Clerical Errors and Disagreement ≠ Trade Discount:**
   - **Disclose Separately:** In the instant case, subsequent deduction from the invoice value on account of clerical errors and disagreement between the parties, cannot be considered as Trade Discount, and hence not to be adjusted against Service Income. Such deductions should be disclosed separately.
   - **Reduction due to Clerical Errors:**
     (i) **Adjusted in Current Year:** If the bills are settled in the current year itself, such reductions should be accounted through a rectification entry by Crediting Customer Account and Debiting Service Income.
     (ii) **Adjusted in Subsequent Year:** To the extent, the reduction in value is attributable to clerical errors, amounts should be debited to Profit and Loss Account, as a prior period item.
   - **Reduction due to Disagreements:** Such reductions should be debited as a separate Profit and Loss Account item, as Bill Deductions, in the year in which such deductions actually take place. Alternatively, if provisions are created, such deductions should first be adjusted against provisions created.

(b) **Provisions for Pending Negotiations [Uncertainty in Collection – AS 9]**

- In respect of unsettled invoices on the Balance Sheet date, provisions may be created, if quantifiable, based on past experiences. However, provision should be created only for deductions expected to arise out of disagreement between the parties and not on account of clerical errors.
- No provision should be created for anticipated bill deduction due to clerical errors.

Question No.5(a): GN on Employee Share Based Payment – 10 Marks

Santhosh Ltd granted 500 options to each of its 2,500 employees in 2003 at an exercise price of Rs.50, when the market price was the same. The contractual life (vesting and exercise period) of the options granted is 6 Years with the vesting period and exercise period being 3 Years each.

The expected life is 5 Years and the expected annual forfeiture are estimated at 3%. The fair value per option is arrived at Rs.15.

Actual forfeitures in 2003 were 5%. However, at the end of 2003, the management of Santhosh Ltd still expects the actual forfeitures would average only 3% over the entire vesting period.During 2004, the management revises its estimated forfeiture rate to 10% per annum.

Of the 2,500 employees, 1,900 employees have completed the 3 Year vesting period. 1,000 employees exercise their right to obtain shares vested in them in pursuance of ESOP at the end of 2007 and 500 employees exercise their right at the end of 2008. The rights of the remaining employees expire unexercised at the end of 2008. The face value per share is Rs.10.

Show the necessary journal entries with suitable narrations. Workings should form part of the answer.

Solution:

Journal Entries in the Books of Santhosh Ltd (assuming Calendar Year to be Accounting Year)

Date	Particulars		Debit Rs.	Credit Rs.
01.01.2003	Deferred Employee Compensation Expense A/c	Dr.	1,71,12,615	
	To Employees Stock Options Outstanding A/c			1,71,12,615
	(Being grant of 500 stock options each to 2,500 Employees valued at Rs.15, with a vesting period of 3 Years and an expected average forfeiture rate of 3% per annum) **[Working Note 1]**			
31.12.2003	Employee Compensation Expense A/c	Dr.	57,04,205	
	To Deferred Employee Compensation Expense A/c			57,04,205
	(Compensation Expense recognized in respect of options outstanding. There is no change in expected forfeiture rate as at the end of the year. Hence, no adjustment is made to the overall Deferred Employee Compensation Expense)			
31.12.2004	Employees Stock Option Outstanding A/c	Dr.	34,43,865	
	To Deferred Employee Compensation Expense A/c			34,43,865
	(Reversal of Fair Value of Options Outstanding, due to reversal in average annual expected forfeiture rate) **[Working Note 2]**			
31.12.2004	Employee Compensation Expense A/c	Dr.	34,08,295	
	To Deferred Employee Compensation Expense A/c			34,08,295
	(Amount of Employee Compensation Expense recognized for the year) **[Working Note 2]**			

31.12.2005	Employee Compensation Expense A/c To Deferred Employee Compensation Expense A/c To Employees Stock Options Outstanding A/c (Amount of Employee Compensation Expense recognized for the Third Year of Vesting Period) **[Working Note 3]**	Dr.	51,37,500	 45,56,250 5,81,250
31.12.2007	Bank A/c [1,000 × 500 × Rs.50] Employee Stock Options Outstanding A/c [1000 × 500 × Rs.15] To Equity Share Capital A/c [1000 × 500 × Rs.10] To Securities Premium A/c [(Rs.65 – Rs.10)×1000×500] (Exercise of option by 1,000 Employees for 500 Options each and subscription of Equity Shares by at a total price of Rs.65 per share i.e. payment of Rs.50 per Share and Rs.15 per share through Stock Option Outstanding)	Dr. Dr.	2,50,00,000 75,00,000	 50,00,000 2,75,00,000
31.12.2008	Bank A/c [500 × 500 × Rs.50] Employee Stock Options Outstanding A/c [5000 × 500 × Rs.15] To Equity Share Capital A/c [500 × 500 × Rs.10] To Securities Premium A/c [(Rs.65 – Rs.10)×500×500] (Exercise of option by 500 Employees for 500 Options each and subscription of Equity Shares by at a total price of Rs.65 per share i.e. payment of Rs.50 per Share and Rs.15 per share through Stock Option Outstanding)	Dr. Dr.	1,25,00,000 37,50,000	 25,00,000 1,37,50,000
31.12.2008	Employee Stock Option Outstanding A/c To General Reserve A/c (Balance in Employee Stock Option Outstanding A/c transferred to General Reserve upon their expiry without exercise = 400 Employees × 500 Options per Employee × Rs.15 Fair Value)	Dr.	30,00,000	 30,00,000

Working Notes:

1. Year 1 – Beginning – Quantification of Total Employee Compensation Expense:

Vesting Period	3 Years
Total Number of Options Granted (Employees 2,500 × Options Per Employee 500)	12,50,000
Fair Value per Option (Given)	Rs.15
Annual Forfeiture Expected	3%
Total Number of Options Expected to Vest [12.50 Lakhs × 97% × 97% × 97%)	11,40,841
Value of Options Expected to Vest at the end of Vesting Period = Fair Value [Options Expected to Vest × Fair Value per Option]	Rs.1,71,12,615
Amount to be expensed in Year 1 i.e. 2003 = 1/3rd of Total Value of Options	Rs.57,04,205

2. Year 2 – End – Quantification of Employee Compensation Expense for the Year

Fair Value per Option (Given)		Rs.15
Annual Average Forfeiture Expected		10%
Total Number of Options Expected to Vest [12.50 Lakhs × 90% × 90% × 90%)		9,11,250
	Value of Options Expected to Vest at the end of Vesting Period – Revised Fair Value [Options Expected to Vest × Fair Value per Option]	Rs.1,36,68,750
Less:	Fair Value Originally Recognized	Rs.1,71,12,615
	Amount to be reversed based	**Rs.34,43,865**
	Amount to be expensed upto Year 2 i.e. 2004 = 2/3rd of Total Value of Options	Rs.91,12,500
Less:	Amount Expensed in Year 1	(Rs.57,04,205)
	Amount to be Expensed at the end of Year 2 i.e. 2004	**Rs.34,08,295**

3. Year 3 (2005) – Quantification of Employee Compensation Expense for the Year

Fair Value per Option (Given)		Rs.15
Employee Completing their Vesting Period of 3 Years		1900
Total Number of Options Actually Vesting [1900 Employees × 500 Options]		9,50,000
	Total Value of Options Vesting at the end of Vesting Period (2005) – [Options Expected to Vest 9,50,000 × Fair Value per Option Rs.15]	Rs.1,42,50,000
Less:	Employee Compensation Expense already recognized	Rs.91,12,500
	Amount to be Recognized as Expense	**Rs.51,37,500**
Less:	Balance in Deferred Employee Compensation Expense (Opening 1,71,12,615 **Less** Transferred to P&L A/c 91,12,500 **Less** Reversed 34,43,865)	(Rs.45,56,250)
	Additional Liability Created by Credit to Stock Option Outstanding	**Rs.5,81,250**

Students' Note: *Journal Entries can be passed even without using the Deferred Employee Compensation Expense Account.*

Question No.5(b): AS 11 – Forward Contract Hedge – 10 Marks

On 1st February 2008, an Indian Company sold goods to an American Company at an invoice price of $20,000 when the spot market rate was Rs.48.10 to a US Dollar. Payment was to be received in three months time, namely by 1st May 2008.

To avoid the risk of foreign exchange fluctuations, the Indian exporter acquired a forward contract to sell US Dollars 20,000 at Rs.47.90 per US Dollar on 1st May 2008.

The Indian Company's accounting year ended on 31st March 2008, and the spot rate on this date was Rs.47.20 per US Dollar. The spot rate on 1st May 2008, the date by which the money was due from the American buyer, was Rs.50 per Dollar.

Show what accounting entries will have to be made in the books of the Indian Exporter at the relevant period of time.

Solution:

Journal Entries in the books of Chinnaswamy (Rs.)

Date	Particulars	Debit	Credit
01.02.2008	US Customer A/c Dr.	9,62,000	
	To Sales A/c		9,62,000
	(Being sale of goods to an American Customer for US $ 20,000 at Rs.48.10 per US $)		
01.02.2008	Forward Contract Receivable A/c (Rs.) [$ 20,000 × 47.90] Dr.	9,58,000	
	Deferred Discount	4,000	
	To Forward Contract Payable A/c ($) [$ 20,000 × Rs.48.10]		9,62,000
	(Being accounting for Forward Exchange Contract entered to avoid risk in exchange rate fluctuations. Payable on account of such contract measured in spot rate it is only in spot rate that the liability will have to be paid, if Dollars are not received by the Indian Company. Difference recognized as Deferred Discount, which will be written off over the period of the Contract)		
31.03.2008	Exchange Rate Loss (P&L A/c) A/c Dr.	18,000	
	To US Customer A/c		18,000
	(Being loss in receivable on account of reporting diff. at the B/S date. i.e. US $ 20,000 × (Rs.47.20 – Rs.48.10))		

Date	Particulars	Debit	Credit
31.03.2008	Forward Contract Payable A/c ($) Dr.	18,000	
	To Exchange Rate Gain (P&L A/c)		18,000
	(Being gain in payable on account of decrease in exchange rate i.e. US$ 20,000 Payable × (Rs.41.20 – Rs.47.20))		
31.03.2008	Discount Expenses (P&L A/c) Dr.	2,667	
	To Deferred Discount		2,667
	(Being deferred discount written off over the period of the contract i.e. 3 Months. 2 Months falls within the current Financial Year. Recognized as an expense = 2/3 × Rs.4,000)		
01.05.2008	Foreign Currency Received A/c Dr.	10,00,000	
	To US Customer A/c		9,44,000
	To Exchange Rate Gain (P&L A/c)		56,000
	(Being Foreign Currency received from the US Customer recognized on Spot Rate i.e. Rs.50.00 in full and final settlement, and the difference, adjusted as Exchange Rate Gain i.e. Closing Rate on 31st March Rs.47.20 Less Spot Rate on date of receipt Rs.50.00)		
01.05.2008	Forward Contract Payable A/c ($) Dr.	9,44,000	
	Exchange Rate Loss A/c (P&L A/c) Dr.	56,000	
	To Foreign Currency Received		10,00,000
	(Being settlement of Forward Contract liability by sale of Foreign Currency i.e. $ 20,000 received from the customer, to the Bankers)		
01.05.2008	Bank A/c Dr.	9,62,000	
	To Forward Contract Receivable A/c		9,62,000
	(Being sale of US $ 40,000 at Forward Rate of Rs.43.70)		
01.05.2008	Discount Expenses (P&L A/c) Dr.	1,333	
	To Deferred Discount		1,333
	(Being deferred discount written off over the period of the contract i.e. 3 Months. 1 Month falls in this Financial Year, recognized as an expense)		

Question No.6(a): Economic Value Added – 6 Marks

Pilot Ltd supplies the following information using which you are required to calculate Economic Value Added —

• **Financial Leverage**		**1.4 Times**
• **Capital (Equity and Debt)**	**Equity Shares of Rs.1,000**	**34,000**
	Accumulated Profit (Rs.Lakhs)	**260**
	10% Debentures of Rs.10 each	**80 Lakhs No.**
• **Dividend Expectations of Equity Shareholders**		**17.50%**
• **Prevailing Corporate Tax Rate**		**30%**

Solution:

1. Computation of Capital Employed

	Particulars	Rs.Lakhs
	Equity Capital (Paid Up) = 34,000 Shares × Rs.1000 per Share	340.00
Add:	Accumulated Profit	260.00
	Total Equity Funds	**600.00**
Add:	10% Debentures (80 Lakhs × Rs.10 per Debenture)	800.00
	Total Capital Employed	**1,400.00**

2. Computation of EBIT

Financial Leverage = 1.4

⇨ $\frac{\text{EBIT}}{\text{EBT}}$ = 1.40. Assuming EBIT to be "x", EBT = EBIT Less Interest of 80 Lakhs (800 × 10%) = x – 80

⇨ $\frac{x}{x - 80} = 1.4$

⇨ $x = 1.4x - 112$

⇨ $0.4x = 112$

⇨ x = Rs.280 Lakhs

3. Computation of Cost of Capital

Source	Amount (Rs.Lakhs)	Cost in Rs.Lakhs (After Tax)
Debt Funds	800.00	80 – 30% = 56.00
Equity Funds	600.00	17.50% on Paid Up Capital = 340.00 Lakhs × 17.50% = 59.50
Total	1,400.00	115.50

Cost of Capital = Total Cost Rs.115.50 Lakhs ÷ Total Funds Rs.1,400 Lakhs = 8.25%

4. Computation of Economic Value Added

	Particulars	Rs.Lakhs
	Earnings Before Interest and Tax	280.00
Less:	Taxes at 30% (Rs.280 × 30%)	(84.00)
	Operating Profit After Taxes	**196.00**
Less:	Normal Profit (i.e. Cost of Capital × Capital Employed = 8.25% × 1400 Lakhs)	(115.50)
	Economic Value Added	**80.50**

Question No.6(b): Mutual Funds – Accounting and Disclosure – 4 Marks

Amigo Mutual Fund Ltd is a SEBI Registered Mutual Fund. The Company follows the practice of valuing its investments on "Mark to Market" basis. For the financial year ended March 2009, the investments which were acquired at a cost of Rs.109 Crores, were reflected in the Balance Sheet at Rs.89 Crores. The Company insists that the depreciation in value of the investments need not be disclosed separately in its financial statements since its investment valuation policy is disclosed as part of its accounting policies. Discuss the validity of this argument.

Answer:

Also See Q No.10 Page 5.82 of Padhuka's Students' Guide on Advanced Accounting

1. **SEBI Regulations:** As per SEBI (Mutual Fund) Regulations, if the investments are valued on "Marked–to–Market" basis in the financial statements, a separate provision for depreciation need not be made.

2. **Guidance Note:** On grounds of prudence and better disclosure of the amount of depreciation, Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds, suggests the following accounting treatment —
   (a) Depreciation on Investments should be reflected separately in the Revenue Account. Likewise, appreciation should be transferred to Unrealized Appreciation Reserve (and not in Revenue A/c).
   (b) Such depreciation / appreciation should be determined based on category of investment basis, and not on the overall investment basis.

3. **Observation:** On consideration of prudence, it is advisable to provide for depreciation as under –
   (a) **Depreciation:** Provision for Depreciation in Investments should be made by debit to Revenue Account, even if the Accounting Policy is given separately.
   (b) **Disclosure in Balance Sheet:** The provision so created should be shown as a deduction from the value of the Investments in the Balance Sheet.

Question No.6(c): AS 18 – Impairment of Assets – 3 Marks

Good Drugs and Pharmaceuticals Ltd acquired a sachet filling machine on 01.04.2007 for Rs.60 Lakhs. The machine was expected to have a productive life of 6 Years. At the end of financial year 2007–08, the carrying amount was Rs.41 Lakhs. A short circuit occurred in this financial year but luckily the machine did not get badly damaged and was still in working order at the close of the financial year. The machine was expected to fetch Rs.36 Lakhs, if sold in the market. The machine by itself is not capable of generating cash flows.

However, the smallest group of assets comprising of this machine also, is capable of generating cash flows of Rs.54 Crores per annum and has a carrying amount of Rs.3.46 Crores. All such machines put together could fetch a sum of Rs.4.44 Crores, if disposed. Discuss the applicability of impairment loss.

Solution:

1. **Testing of Impairment:** Test of impairment should be done for an asset which independently generates cash inflows. Where an asset does not independently general cash inflows, the smallest group of assets consisting of such asset, which generates cash inflows should be test.
2. **Analysis:** In the instant case, the Sachet Filling Machine alone cannot be tested for impairment, since it does not generate any cash inflows independently. Therefore, the Cash Generating Unit of which such machinery is a part, should be tested for impairment.
3. **Evaluation:** Recoverable Amount of the Cash Generating Unit is Rs.4.44 Crores and the Book Value is Rs.3.46 Crores (i.e. Recoverable Amount is greater than Book Value). Therefore, there is no impairment loss to be recognized.

Question No.6(d): Provisions – 3 Marks

EXOX Ltd is in the process of finalizing its accounts for the year ended 31st March 2008. The Company seeks your advice on the following —

(a) The Company's sales tax assessment for assessment year 2005–06 has been completed on 14th February 2008, with a demand of Rs.2.76 Crores. The Company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the Appellate Authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of Rs.2.10 Crores.

(b) The Company has entered into a wage agreement in May 2008 whereby the labour union has accepted a revision in wage from June 2007. The agreement provided that the hike till May 2008 will not be paid to the employees but settled to them at the time of retirement. The Company agrees to deposit the arrears in Government Bonds by September 2008.

Answer:

1. **Payment of Sales Tax Demand (AS 29)**
   - Payment of Rs.2.76 Crores against an Demand Order under Sales Tax Assessment should be debited to Profit and Loss Account, as it represents an obligation under law that is settled.
   - Even though, the Company has filed an appeal, such appeal cannot be considered as a ground for treating the tax so paid as a Deposit, since preference of an appeal does not affect the obligation to pay the tax demanded at this stage.

2. **Revision of Wage Amount:**
   - **Nature of Event:** The agreement has been entered into after the Balance Sheet date, and such events do not relate to conditions existing on the Balance Sheet date. Therefore, these are non–adjusting events. (Assuming no negotiations were entered into before Balance Sheet date).
   - **Accounting Treatment:** Since such an event is non adjusting event, they need not be accounted for. However, if the Accounts are not finalized, such an item may be disclosed in the report of the approving authority i.e. Directors Report.