



Board of Studies  
THE INSTITUTE OF CHARTERED  
ACCOUNTANTS OF INDIA

FINAL NEW COURSE

# Financial Reporting Vol. 1



FINAL COURSE STUDY MATERIAL

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PAPER 1

# Financial Reporting

Volume – 1



BOARD OF STUDIES  
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

This study material has been prepared by the faculty of the Board of Studies. The objective of the study material is to provide teaching material to the students to enable them to obtain knowledge and skills in the subject. Students should also supplement their study by reference to the recommended text book(s). In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein they may write to the Director of Studies.

All care has been taken to provide interpretations and discussions in a manner useful for the students. However, the study material has not been specifically discussed by the Council of the Institute or any of its Committees and the views expressed herein may not be taken to necessarily represent the views of the Council or any of its Committees.

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Published by Dr. T.P. Ghosh, Director of Studies, ICAI, C-1, Sector-1, NOIDA-201301

Typeset and designed by Gursharan K Madhwal and Renu Rawat at Board of Studies, The Institute of Chartered Accountants of India.



## PREFACE

The paper of Financial Reporting in the Final Course concentrates on understanding of the crucial aspects of preparing and analyzing financial statements. Students are expected to acquire advanced knowledge in this paper. The importance of the subject of financial reporting is growing over the years due to various factors like liberalization, flow of cross-border capital, emergence of global corporations and movement towards better corporate governance practices. Standardization of accounting policies and financial reporting norms are significant aspects that make the subject more interesting in the recent years. Various new Accounting Standards, Guidance Notes and Accounting Standards Interpretations have been formulated by the Institute of Chartered Accountants of India keeping in mind the growing importance of financial reporting in corporate scenario.

The students are required to develop understanding of the Accounting Standards, Accounting Standards Interpretations and the relevant Guidance notes and should gain ability to apply the provisions contained therein under the given practical situations. The last decade has witnessed a sea change in the global economic scenario. The emergence of transnational corporations in search of money, not only for fuelling growth, but to sustain ongoing activities has necessitated raising of capital from all parts of the world. When an enterprise decides to raise capital from the foreign markets, the rules and regulations of that country will apply and the enterprise should be able to understand the differences between the rules governing financial reporting in the foreign country as compared to that of its own country. Thus translations and re-instatements of financial statements are of great significance. Therefore, chapter based on overview of Indian Accounting Standards, International Accounting Standards/International Financial Reporting Standard and US GAAPs has also been introduced in the Final Course curriculum.

The book is divided into two volumes for ease of handling by the students. Volume – 1 contains Chapters 1 – 7 and Volume – 2 contains Chapters 8 – 10. Appendices containing text of Accounting Standards, Guidance Notes and Accounting Standards Interpretations have also been included in Volume – 2. Care has been taken to present the chapters in the same sequence as prescribed in the syllabus to facilitate easy understanding by the students. Small illustrations have been incorporated in each chapter/unit to explain the concepts/principles covered in the chapter/unit. Another helpful feature is the addition of self-examination questions which will help the students in preparing for the Final Course Examination.

Students are advised to practise the practical problems thoroughly. They are also advised to update themselves with the latest changes in the area of financial reporting. For this they may refer to academic updates in the monthly journal 'The Chartered Accountant' and the Students 'Newsletter' published by the Board of Studies, financial newspapers, SEBI and Corporate Law Journal, published financial statements of companies etc.

The concerned Faculty members of Board of Studies of Accounting have put their best efforts in making this study material lucid and student friendly. The Board has also received valuable inputs from CA. Yash Arya, Dr. Satyajit Dhar, CA. Prasun Rakshit, Dr. S. K. Chowdhry for which the Board is thankful to them.

In case students have any suggestions to make this study material more helpful, they are welcome to write to the Director of Studies, The Institute of Chartered Accountants of India, C-I, Sector-I, Noida-201 301.



# SYLLABUS

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## PAPER 1 : FINANCIAL REPORTING

*(One paper – Three hours – 100 marks)*

**Level of Knowledge:** Advanced knowledge

**Objectives:**

- (a) To gain ability to analyze financial statements including consolidated financial statements of group companies and financial reports of various types of entities,
- (b) To gain ability to apply valuation principles,
- (c) To familiarise with recent developments in the area of financial reporting,
- (d) To gain ability to solve financial reporting and valuation cases.

**Contents:**

1. Accounting Standards, Accounting Standards Interpretations and Guidance Notes on various accounting aspects issued by the ICAI and their applications.
2. Overview of International Accounting Standards (IAS) / International Financial Reporting Standards (IFRS), Interpretations by International Financial Reporting Interpretation Committee (IFRIC), Significant difference vis-a-vis Indian Accounting Standards.  
Understanding of US GAAP, Applications of IFRS and US GAAP.
3. Corporate Financial Reporting - Issues and problems with special reference to published financial statements.
4. Accounting for Corporate Restructuring (including inter-company holdings).
5. Consolidated Financial Statements of Group Companies  
Concept of a Group, purposes of consolidated financial statements, minority interest , Goodwill , Consolidation procedures – Minority interests, Goodwill, Treatment of pre-acquisition and post-acquisition profit .  
Consolidation with two or more subsidiaries, consolidation with foreign subsidiaries.  
Consolidated profit and loss account, balance sheet and cash flow statement.  
Treatment of investment in associates in consolidated financial statements.  
Treatment of investments in joint ventures in consolidated financial statements.

6. Accounting and reporting of financial instruments
  - Meaning, recognition, derecognition and offset, compound financial instruments
  - Measurement of financial instruments
  - Hedge accounting
  - Disclosures
7. Share based payments
  - Meaning, Equity settled transactions, Transaction with employees and non- employees
  - Determination of fair value of equity instruments
  - Vesting conditions
  - Modification, cancellation and settlement
  - Disclosures
8. Financial Reporting by Mutual funds, Non-banking finance companies, Merchant bankers, Stock and commodity market intermediaries.
9. Valuation
  - (a) Concept of Valuation
  - (b) Valuation of Tangible Fixed Assets
  - (c) Valuation of Intangibles including brand valuation and valuation of goodwill
  - (d) Valuation of liabilities
  - (e) Valuation of Shares
  - (f) Valuation of Business
10. Developments in Financial Reporting
  - (a) Value Added Statement
  - (b) Economic Value Added, Market Value Added, Shareholders' Value Added
  - (c) Human Resource Reporting
  - (d) Inflation accounting

**Note–** If either old Accounting Standards (ASs), Accounting Standards Interpretations (ASIs), Guidance Notes (GNs), Announcements and Limited Revisions to ASs are withdrawn or new ASs, GNs, Announcements and Limited Revisions to AS are issued by the Institute of Chartered Accountants of India in place of existing ASs, ASIs, GNs, Announcements and Limited Revisions to AS, the syllabus will accordingly include/exclude such new developments in the place of the existing ones with effect from the date to be notified by the Institute.

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## **ACCOUNTING STANDARDS AND GUIDANCE NOTES**

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### **UNIT 1**

#### **INTRODUCTION TO ACCOUNTING STANDARDS**

##### **1.1 OBJECTIVES OF ACCOUNTING STANDARDS**

Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. If the financial accounting process is not properly regulated, there is possibility of financial statements being misleading, tendentious and providing a distorted picture of the business, rather than the true state of affairs. In order to ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardize the accounting principles and policies. Accounting Standards provide framework and standard accounting policies so that the financial statements of different enterprises become comparable.

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance. The Accounting Standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises. The Accounting Standards deal with the issues of (i) recognition of events and transactions in the financial statements, (ii) measurement of these transactions and events, (iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader, and (iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

## **1.2 Financial Reporting**

Accounting Standards standardize diverse accounting policies with a view to eliminate, to the maximum possible extent, (i) the non-comparability of financial statements and thereby improving the reliability of financial statements, and (ii) to provide a set of standard accounting policies, valuation norms and disclosure requirements. The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards to ensure that the standard-setting process is fully consultative and transparent. The ASB considers the International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) while framing Indian Accounting Standards (ASs) and try to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The concept of Accounting Standards and the standards setting process in India has already been discussed, in detail, in PCC Advanced Accounting Study Material – Chapter 2.

### **1.2 BENEFITS AND LIMITATIONS**

Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards the accountant has following benefits:

- (i) Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.
- (ii) There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.
- (iii) The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

However, there are some limitations of setting of accounting standards:

- (i) Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- (ii) There may be a trend towards rigidity and away from flexibility in applying the accounting standards.
- (ii) Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.



### 1.3 STANDARD-SETTING PROCESS

The need for accounting standards specifically suitable for the country's economic environment was also felt in India. Recognising the need to harmonise the diverse accounting policies and practices in India and keeping in view the international developments in the field of accounting, the Council of the Institute of Chartered Accountants of India (ICAI) constituted the Accounting Standards Board (ASB) in April, 1977. The composition of ASB is such that due representation is given to industry, associations, banks, company law authorities, taxation authorities and the C&AG. The ASB now also has representatives from financial institutions, SEBI, Office of the Controller General of Accounts, management institutes and universities. In order to make ASB further broad based, the representatives of CBDT and Central Board of Excise and Customs have been invited to join the Board. While formulating the accounting standards, ASB duly considers the IASs issued by IASC and tries to integrate them, to the extent possible, in the light of the conditions and practices prevailing in India.

The procedure for formulation of accounting standards is designed to ensure the participation of all those who are interested in the formulation and implementation of these standards. The preliminary drafts of the standards are prepared by the Study Groups which take up specific subjects assigned to them. The draft so prepared is considered by ASB and sent to various outside bodies like FICCI, ASSOCHAM, SCOPE, CLB, C & AG, ICWAI, ICSI, CBDT etc. After taking into consideration their views, the draft of the standards is issued as an Exposure Draft (ED) for comments by members of ICAI and the public at large. The comments on the ED are considered by ASB and a final draft of the standard is submitted to the Council of the ICAI for its approval and is thereafter issued as a definitive standard.

### 1.4 HOW MANY AS?

The council of the Institute of Chartered Accountants of India has, so far, issued twenty nine Accounting Standards. However, AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Thus effectively, there are 28 Accounting Standards at present. The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

### 1.5 APPLICABILITY OF ACCOUNTING STANDARDS

For the purpose of **compliance of the Accounting Standards**, all enterprises in India are classified into three broad categories:

**Level I Enterprise:** Following enterprises are covered under this level:

- ◆ Enterprises, whose equity or debt securities are either listed or is in the process to be listed in India or outside India.

## 1.4 Financial Reporting

- ◆ Banks, Insurance Companies and Financial Institutions.
- ◆ All commercial, industrial and other reporting business enterprises, whose total turnover during the previous year is in excess of Rs. 50 crores (as per the audited financial statement).
- ◆ All commercial, industrial and other reporting business enterprises, whose total borrowings including public deposits during the previous year are in excess of Rs. 10 crores (as per the audited financial statement).
- ◆ Holding or subsidiary company of any of the above enterprises any time during the year.

**Level II Enterprise:** Following enterprises are covered under this level:

- ◆ All commercial, industrial and other reporting business enterprises, whose total turnover during the previous year exceeds Rs. 40 lakhs but within the limit of Rs. 50 crores (as per the audited financial statement).
- ◆ All commercial, industrial and other reporting business enterprises, whose total borrowings including public deposits during the previous year exceeds Rs. 1 crore but within the limit of Rs. 10 crores (as per the audited financial statement).
- ◆ Holding or subsidiary company of any of the above enterprises any time during the year.

**Level III Enterprise:** All the enterprises not covered in above two levels come under this level.

## 1.6 LIST OF ACCOUNTING STANDARDS

Following is the list of Accounting Standards with their respective date of applicability along with the scope.

| AS No. | AS Title                                                                                              | Date         | Scope      |
|--------|-------------------------------------------------------------------------------------------------------|--------------|------------|
| 1      | Disclosure of Accounting Policies                                                                     | 01/04/1993   | All Level  |
| 2      | Valuation of Inventories (Revised)                                                                    | 01/04/1999   | All Level  |
| 3      | Cash Flow Statement (Revised)                                                                         | 01/04/2001   | Level I    |
| 4      | Contingencies and Events Occurring<br>after the Balance Sheet Date                                    | 01/04/1998   | All Level  |
| 5      | Net Profit or Loss for the Period, Prior Period<br>Items and Changes in Accounting Policies (Revised) | 01/04/1996   | All Level  |
| 6      | Depreciation Accounting (Revised)                                                                     | 01/04/1995   | All Level  |
| 7      | Construction Contracts (Revised)                                                                      | 01/04/2002   | All Level  |
| 8      | Research & Development                                                                                | Now included | in AS – 26 |
| 9      | Revenue Recognition                                                                                   | 01/04/1993   | All Level  |

## Accounting Standards and Guidance Notes 1.5

|    |                                                                                |            |                                  |
|----|--------------------------------------------------------------------------------|------------|----------------------------------|
| 10 | Accounting for Fixed Assets                                                    | 01/04/1993 | All Level                        |
| 11 | The Effects of Changes in Foreign<br>Exchange Rates (Revised)                  | 01/04/2004 | All Level                        |
| 12 | Accounting for Government Grants                                               | 01/04/1994 | All Level                        |
| 13 | Accounting for Investments                                                     | 01/04/1995 | All Level                        |
| 14 | Accounting for Amalgamations                                                   | 01/04/1995 | All Level                        |
| 15 | Employee Benefits                                                              | 01/04/2006 | All Level                        |
| 16 | Borrowing Costs                                                                | 01/04/2000 | All Level                        |
| 17 | Segment Reporting                                                              | 01/04/2001 | Level I                          |
| 18 | Related Party Disclosures                                                      | 01/04/2001 | Level I                          |
| 19 | Leases                                                                         | 01/04/2001 | All Level                        |
| 20 | Earning Per Shares                                                             | 01/04/2001 | Level I                          |
| 21 | Consolidated Financial Statement                                               | 01/04/2001 | Enterprises<br>preparing<br>CFS* |
| 22 | Accounting for Taxes on Income                                                 | 01/04/2001 | Listed<br>Companies              |
|    |                                                                                | 01/04/2002 | Other<br>Companies               |
|    |                                                                                | 01/04/2006 | All Enterprises                  |
| 23 | Accounting for Investment in Associates in Consolidated<br>Financial Statement | 01/04/2002 | Enterprises<br>preparing CFS     |
| 24 | Discontinuing Operations                                                       | 01/04/2004 | Level I                          |
| 25 | Interim Financial Statement                                                    | 01/04/2002 | Level I                          |
| 26 | Intangible Assets                                                              | 01/04/2003 | All Level                        |
| 27 | Financial Reporting of Interests in Joint Ventures                             | 01/04/2002 | Enterprises<br>preparing CFS     |
| 28 | Impairment of Assets                                                           | 01/04/2004 | Level I                          |
|    |                                                                                | 01/04/2006 | Level II                         |

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\* CFS has been written for cash flow statement.

## 1.6 Financial Reporting

01/04/2008 Level III

- 29 Provisions, Contingent Liabilities and  
Contingent Assets

01/04/2004 All Level

All of the above mentioned standards AS 1 to AS 29( excluding AS 8) will be discussed in detail in the succeeding units of this chapter.

## 1.7 ACCOUNTING STANDARD INTERPRETATIONS

The **Accounting Standard Interpretations** address questions that arise in course of application of a standard. These are therefore issued after issue of the relevant standard. Authority of an interpretation is same as that of the Accounting Standard to which it relates. So far, 30 interpretations have been issued. These (ASIs) issued by ICAI should be read in conjunction with relevant accounting standards.

A brief summary of these interpretations is given below. The readers may refer appropriate units for details.

| No. | Related AS | Topic                                                                         |
|-----|------------|-------------------------------------------------------------------------------|
| 1   | 16         | Interpretation of the term 'substantial period'                               |
| 2   | 2, 10      | Treatment of machinery spares                                                 |
| 3   | 22         | Computation of deferred tax during tax holiday u/s 80-IA and 80-IB (Revised)  |
| 4   | 22         | Computation of deferred tax in respect of losses under the head Capital Gains |
| 5   | 22         | Computation of deferred tax during tax holiday u/s 10A and 10B                |
| 6   | 22         | Computation of current and deferred tax subject to MAT u/s 115JB              |
| 7   | 22         | Disclosure of deferred tax assets/liabilities in balance sheet                |
| 8   | 21, 23, 27 | Interpretation of the term 'near future'                                      |
| 9   | 22         | Interpretation of the term 'virtual certainty'                                |
| 10  | 16         | Computation of exchange difference to be treated as borrowing cost            |
| 11  | 22         | Computation of deferred tax in case of Amalgamations                          |
| 12  | 20         | Applicability of AS 20 to unlisted companies                                  |
| 13  | 18         | Aggregation of related party disclosures                                      |
| 14  | 9          | Manner of disclosure of excise duty                                           |
| 15  | 21         | Notes to the Consolidated Financial Statements (CFS)                          |
| 16  | 23         | Treatment in CFS: Dividend proposed by an associate                           |
| 17  | 23         | Treatment in CFS: Changes in equity not included in P & L A/c                 |

|    |        |                                                                                     |
|----|--------|-------------------------------------------------------------------------------------|
| 18 | 23     | Consideration of potential equity to ascertain whether the investee is an associate |
| 19 | 18     | Interpretation of the term 'intermediary'                                           |
| 20 | 17     | Disclosure of segment information in certain cases (Revised)                        |
| 21 | 18     | Non-executive directors; whether related parties                                    |
| 22 | 17     | Interest expenses; whether to treat as segment expenses                             |
| 23 | 18     | Remuneration paid to key management personnel; whether related party transaction    |
| 24 | 21     | Subsidiaries having two parents                                                     |
| 25 | 21     | Shares held as stock-in-trade                                                       |
| 26 | 21     | Consolidation of current and deferred tax                                           |
| 27 | 25     | Applicability of AS 25                                                              |
| 28 | 21, 27 | Disclosure of post-acquisition reserves in Consolidated Financial Statements        |
| 29 | 7      | Turnover in case of contractors                                                     |
| 30 | 29     | Applicability of AS 29 to onerous contracts                                         |

#### **Self Examination Questions**

1. What are the advantages of setting accounting standards?
2. How is an accounting standard developed in India?
3. Write short note on advantages and disadvantages of setting Accounting Standards.
4. Explain the classification of enterprises for the purpose of applicability of Accounting Standards.
5. What is meant by ASI? Explain in brief.

## 1.8 Financial Reporting

### UNIT 2

#### AS 1 : DISCLOSURE OF ACCOUNTING POLICIES

Reference: The students are advised to refer the full text of AS 1 "Disclosure of Accounting Policies" given in Appendix I at the end of the Study Material (Volume-II).

##### 2.1 INTRODUCTION

Irrespective of extent of standardisation, diversity in accounting policies is unavoidable for two reasons. First, accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard. Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time. The accounting standards therefore permit more than one policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements therefore suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all standards have been complied with. For these reasons, accounting standard 1 requires enterprises to disclose accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such statements.

##### 2.2 ACCOUNTING POLICIES

The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

Accountant has to make decisions from various options for recording or disclosing items in the books of accounts e.g.:

| Items to be disclosed         | Method of disclosure or valuation                                    |
|-------------------------------|----------------------------------------------------------------------|
| Inventories                   | FIFO, LIFO, Weighted Average etc.                                    |
| Cash Flow Statement           | Direct Method, Indirect Method                                       |
| Contingent Liabilities/Assets | Recorded, Provided for, Disclosed, Ignored...                        |
| Depreciation                  | Straight Line Method, Reducing Balance Method, Depletion Method etc. |

This list is exhaustive i.e. endless. For every item right from valuation of assets and liabilities to recognition of revenue, providing for expected losses, for each event, accountant need to form a principles and evolve a method to adopt those principles. This method of forming and applying accounting principles is known as accounting policies.

As we say that accounts is both science and art. It's a science because we have some tested accounting principles, which are applicable universally, but simultaneously the application of these principles depends on the personal ability of each accountant. Since different accountants may have different approach, we generally find that in different enterprise under same industry, different accounting policy is followed. Though ICAI along with Government is trying to reduce the number of accounting policies followed in India but still it cannot be reduced to one.

Since accounting policy adopted will have considerable effect on the financial results disclosed by the financial statement, it makes it almost difficult to compare two financial statements.

Financial statement in India includes the following:

**Balance Sheet:** It discloses the information regarding short term and long term solvency of the concern i.e. through balance sheet we can judge the financial status of an enterprise.

**Profit & Loss Account:** It reflects the net financial result of the functioning of an enterprise during the last financial year in terms of net profits or net losses.

**Cash Flow Statement for Specified Enterprises:** This not only gives the information for sources from where cash was acquired by the company to finance it's activities during the relevant year but also helps in determining the future cash requirements of the concern.

**Notes and Schedules forming the part of the above statements:** This is an inevitable part of a financial statement, since it discloses the information that is not possible to be disclosed in Profit & Loss Account or Balance Sheet and also it clarifies the points, absence of which might misguide the user of accounts.

During 1979, when ASB was established, the business environment in India was such that enterprises were reluctant to prepare accounting notes, few enterprises used to disclose the important accounting policies but the degree and method of disclosure varies considerably. Some enterprises used to disclose them as part of main financial statement, few others as a supplementary.

Therefore the main aim of this statement is not only to promote disclosure of accounting policies but also to determine that all accounting policies are disclosed at one place as main part of the financial statement. The main purpose of Accounting Standard 1, Disclosure of Accounting Policies, is to promote better understanding of financial statements by requiring disclosure of significant accounting policies in orderly manner. As explained in the preceding paragraph, such disclosures facilitate more meaningful comparison between financial

## 1.10 Financial Reporting

statements of different enterprises for same accounting periods. The standard also requires disclosure of changes in accounting policies such that the users can compare financial statements of same enterprise for different accounting periods.

### 2.3 APPLICABILITY

This AS was issued in 1979 and in the initial years, it was recommendatory in character. During this period, this standard was recommended for use by companies listed on a recognised stock exchange and other large commercial, industrial and business enterprises in the public and private sectors i.e. Level I enterprises. It may be noted that the standard is now mandatory and is applicable for all enterprises.

### 2.4 FUNDAMENTAL ACCOUNTING ASSUMPTIONS

The Accounting Standard 1 recognises three fundamental accounting assumptions. These are (a) Going Concern (b) Consistency and (c) Accrual. So long as these assumptions are followed in preparation of financial statements, no disclosure of such adherence is necessary. Any departure from any of these assumptions should however be disclosed.

(a) *Going Concern Assumption:* The enterprise is normally viewed as a going concern, i.e. as continuing operations for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or curtailing, materially its scale of operations. If an enterprise is not a going concern, valuation of its assets and liabilities on historical cost becomes irrelevant and as a consequence its profit/loss may not give reliable information.

For example: A Ltd. been acquired by B Ltd. during May 2006, since now B Ltd. is no more a going concern, this fact should be disclosed in the financial statement of B Ltd. for the year ended March 31, 2006.

(b) *Accrual Assumption:* Revenues and costs are recorded as they accrued, i.e., revenue items recognized as they are earned or incurred and recorded in the financial statements of the periods to which they relate even though payment and receipt of actual cash has not taken place. This assumption is the core of accrual accounting system.

For example: Credit sales of goods on March 01, 2006; money receivable after three months, are recognised as sales during the financial year 2005-06 itself and amount due is debited to the customer's account. Similarly credit purchase of goods is also recorded as purchases during the year when purchase takes place and amount payable is credited to the suppliers account.

(c) *Consistency Assumption:* It is assumed that accounting policies are consistent from one period to another. This adds the virtue of comparability to accounting data. If comparability is lost, the relevance of accounting data for users' judgment and decision-making is gone.



For example: If enterprise has opted for written down value method of charging depreciation then in the following years, it should stick to this method, unless under changed environment it is considered highly inappropriate to continue with it.

## 2.5 CONSIDERATIONS IN THE SELECTION OF ACCOUNTING POLICIES

The main consideration in selection of accounting policies is the presentation of true and fair picture. The financial picture presented by Balance Sheet and the net result shown by Profit & Loss Account should be true and fair. To ensure the true and fair consideration this statement issues following guidelines:

**Prudence:** As defined in the statement, prudence means recognising all losses immediately but ignoring anticipated profits. Business environment is highly dynamic, therefore, enterprises has to keep anticipate the future and take managerial decisions accordingly. This statement suggests that accounting policies should be such that no profit is recognised on the basis of anticipation but all anticipated losses are provided for.

For Example: If valuation of stock is always done at cost, consider a situation where market price of the relevant goods has reduced below the cost price, then valuing stock at cost price means ignoring anticipated losses. Similarly if stock is always valued at market price, then take a situation where cost price is below market price, indirectly we are recognising the anticipated gross profit on stock in the books. Therefore, accounting policy should be cost price or market price whichever is less, in this case we are ignoring anticipated profits (if any) but any anticipated losses would be taken care of.

**Substance over form:** While recording a transaction one should look into the substance of the transaction and not only the legal form of it.

For Example: The ownership of an asset purchased on hire purchase is not transferred till the payment of the last instalment is made but the asset is shown in the books of the hire purchaser. Similarly, in the case of the amalgamation, the entry for amalgamation in the books of the amalgamated company is recorded on the basis of the status of the shareholders of amalgamating company after amalgamation i.e. if all or almost all the shareholders of the amalgamated company has become shareholder of the amalgamating company by virtue of amalgamation, we record all the transactions as Amalgamation in nature of Merger otherwise it is recorded as Amalgamation in nature of Purchase.

**Materiality:** All the items which are material should be recorded. The materiality of an item is decided on the basis that whether non-disclosure of the item will effect the decision making of the user of accounts. If the answer is positive then the item is material and should be disclosed, in case answer is negative, item is immaterial. By this statement does not mean that immaterial item should not be disclosed, disclosure or non-disclosure of an immaterial item is left at the discretion of the accountant but disclosure of material item is been made mandatory.

## **1.12 Financial Reporting**

For Example, Any penalty paid by the enterprise should be disclosed separately even though the amount paid is negligible, payment of any tax also should be disclosed separately and not to be merged with office expenses or miscellaneous expense.

### **2.6 MANNER OF DISCLOSURE**

- (i) All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed .
- (ii) The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place. Note:

### **2.7 DISCLOSURE OF CHANGES IN ACCOUNTING POLICIES (PARAGRAPH 26)**

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 a later period 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.

### **2.8 DISCLOSURE OF DEVIATIONS FROM FUNDAMENTAL ACCOUNTING ASSUMPTIONS**

If the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The deviation from the principle of consistency therefore means a change in accounting policy, the disclosure requirements for which are covered by paragraph 26 of the standard.

### **2.9 ILLUSTRATIONS**

#### **Illustration 1**

A Ltd. has sold its building for Rs. 50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is Rs. 30 Lakhs. As on 31<sup>st</sup> March, 2006, the documentation and legal formalities are pending. The company has not recorded the sale and has shown the amount received as advance. Do you agree with this treatment?

#### **Solution**

The economic reality and substance of the transaction is that the rights and beneficial interest in the property has been transferred although legal title has not been transferred. A Ltd.

should record the sale and recognize the profit of Rs. 20 lakhs in its profit and loss account. The building should be eliminated from the balance sheet.

### Illustration 2

ABC Ltd. was making provision for non-moving stocks based on no issues for the last 12 months up to 31.3.2005.

The company wants to provide during the year ending 31.3.2006 based on technical evaluation:

|                                                         |                      |
|---------------------------------------------------------|----------------------|
| <i>Total value of stock</i>                             | <i>Rs. 100 lakhs</i> |
| <i>Provision required based on 12 months issue</i>      | <i>Rs. 3.5 lakhs</i> |
| <i>Provision required based on technical evaluation</i> | <i>Rs. 2.5 lakhs</i> |

Does this amount to change in Accounting Policy? Can the company change the method of provision?

### Solution

The decision of making provision for non-moving stocks on the basis of technical evaluation does not amount to change in accounting policy. Accounting policy of a company may require that provision for non-moving stocks should be made. The method of estimating the amount of provision may be changed in case a more prudent estimate can be made.

In the given case, considering the total value of stock, the change in the amount of required provision of non-moving stock from Rs.3.5 lakhs to Rs.2.5 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2005-06:

“The company has provided for non-moving stocks on the basis of technical evaluation unlike preceding years. Had the same method been followed as in the previous year, the profit for the year and the corresponding effect on the year end net assets would have been higher by Rs.1 lakh.”

### Illustration 3

Jagannath Ltd. had made a rights issue of shares in 2004. 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, 2006. 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,

### 1.14 Financial Reporting

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 crores.

- (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 2005-2006.

#### **Solution**

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.

### Self-examination Questions

1. What are accounting policies? Why should these policies be disclosed in the financial statements?
2. What are the main considerations in selection and application of accounting policies?
3. Is there any specific disclosure under AS 1 for liquidation of a company?
4. Indicate the requirements with regard to disclosure of accounting policies.
5. Indicate any three areas in which different accounting policies may be adopted by different enterprises.
6. ABC Ltd. has changed the method of inventory valuation in the current year from FIFO to weighted average. The change, however, has no material effect on the financial statements of the current period, though it is likely to have a material effect in the next financial year. Is a disclosure of change necessary in the current year?
7. Alpha Ltd. has taken a loan from SBI Bank for Rs. 10 lakhs. Its bankers Canara Bank has given guarantee to SBI Bank on its behalf. Alpha Ltd. has mortgaged its assets to Canara Bank. Alpha Ltd. has disclosed this loan in its balance sheet as unsecured loan on the grounds that no security has been given to the lender SBI Bank. Is the disclosure sufficient? Comment.
8. Omega Ltd. has a branch office in India since 1994. As of March 2004, it has decided to close operations in India. There is no disagreement on the going concern issue between the management and auditors. This is a branch office with skeleton operations there are no significant assets/liabilities. Besides the branch operates in a rented premises. Reply the following based on AS 1:
  - (a) Should the going concerned assumption be qualified?
  - (b) Will the assets and liabilities have to be restated/revalued?
  - (c) What if any and how are the disclosure requirements to be complied with?

## **UNIT 3**

### **AS 2 : VALUATION OF INVENTORIES**

Reference: The students are advised to refer the full text of AS 2 "Valuation of Inventories" (revised 1999) given in Appendix I at the end of the Study Material (Volume-II).

#### **3.1 INTRODUCTION**

AS 2(revised) supersedes the standard, issued in June, 1981. The revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1999 and is mandatory in nature.

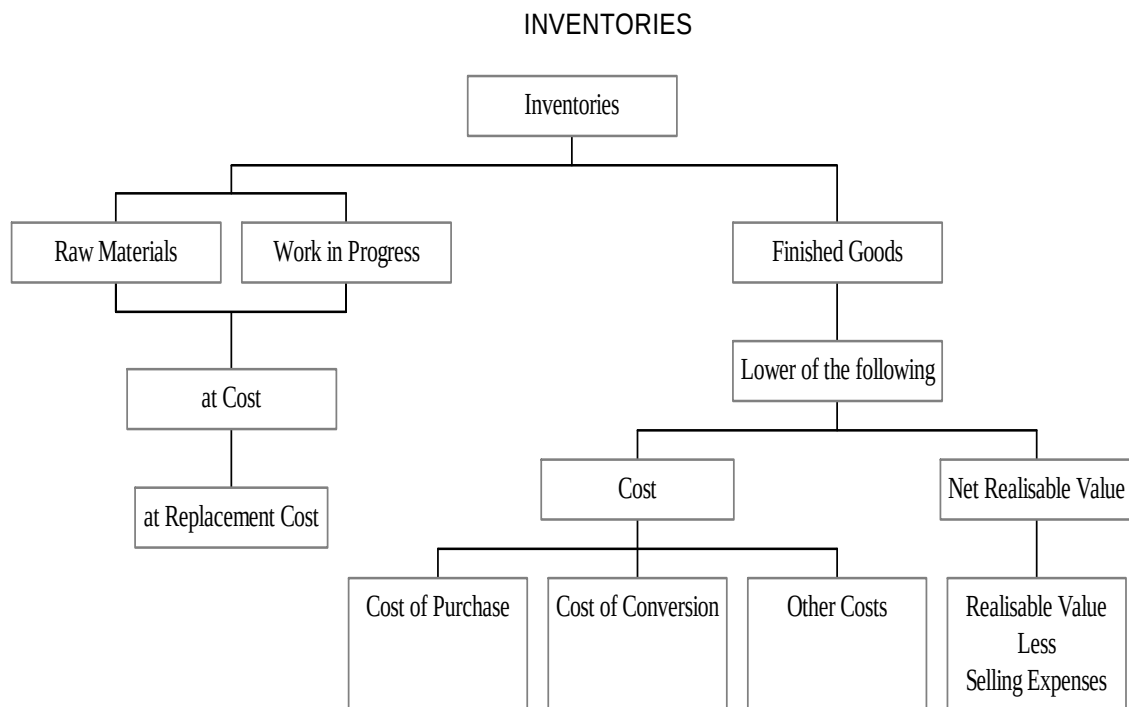
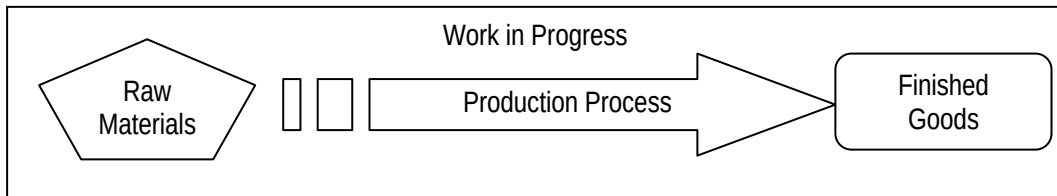
This Statement does not apply in accounting for the following inventories:

- (a) Work in progress arising under construction contracts, including directly related service contracts.
- (b) Work in progress arising in the ordinary course of business of service providers.
- (c) Shares, debentures and other financial instruments held as stock-in-trade and
- (d) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

#### **3.2 INVENTORIES**

Inventories are assets:

- (a) Held for sale in the ordinary course of business. It means finished goods ready for sale in case of a manufacturer and for traders, goods purchased by them with the intention of resale but not yet sold. These are known as Finished Goods.
- (b) In the process of production for such sale. These refers to the goods which are introduced to the production process but the production is not yet completed i.e. not fully converted into finished goods. These are known as Work-in-Progress.
- (c) In the form of materials or supplies to be consumed in the production process or in the rendering of services. It refers to all the materials and spares i.e. to be consumed in the process of production. These are known as Raw Materials.



### 3.3 MEASUREMENT OF INVENTORIES

Inventories should be valued at the lower of cost and net realisable value. Cost of goods is the summation of:

- (a) Cost of Purchase.
- (b) Cost of Conversion.
- (c) Other cost necessary to bring the inventory in present location and condition.

As shown in the above diagram, finished goods should be valued at cost or market price whichever is lower, in other words, finished goods are valued at the lower of cost or net realisable value.

## 1.18 Financial Reporting

Cost has three elements as discussed below:

Cost of Purchase: Cost of purchase includes the purchase price plus all other necessary expenses directly attributable to purchase of stock like, taxes, duties, carriage inward, loading/unloading excluding expenses recoverable from the supplier. From the above sum, following items are deducted, duty drawback, CENVAT, VAT, trade discount, rebates.

Cost of Conversion: For a trading company cost of purchase along with other cost (discussed below) constitutes cost of inventory, but for a manufacturer cost of inventory also includes cost of conversion. Readers can recollect the calculation of factory cost calculated in Cost Accounting:

Direct Material + Direct Labour = Prime Cost

Prime Cost + Factory Variable Overhead + Factory Fixed Overhead = Factory Cost.

Direct material is included in cost of purchase and the rest items i.e. direct labour and overheads are termed as cost of conversion. Direct labour is cost of workers in the unit who are directly associated with the production process, in other words we can say that direct labour is the cost of labour which can be directly attributed to the units of production.

Overheads are indirect expenses. Variable overheads are indirect expenses which is directly related to production i.e., it changes with the change in production in the same proportion. Fixed overheads generally remains constant, it varies only there is some major shift in production.

Since direct labour and variable overheads are directly with the production level, it is advisable to include them in cost of conversion on the basis of normal capacity. Because any difference between normal capacity and actual production will also bring in proportionate change in projected cost and actual cost.

For example: A unit is expected to produce 1 lacs units in a year with the projected labour cost Rs. 20 lacs and variable overhead Rs. 10 lacs. But the actual cost was only Rs. 18 lacs labour charges and Rs. 9 lacs overheads with production only 90,000 units. Now if we take these costs on normal capacity basis then direct labour is Rs. 20 per unit (20 lacs/1 lac) and variable overhead is Rs. 10 per unit (10 lacs/1 lac). Therefore in cost of conversion we include direct labour (90,000 x 20) Rs. 18 lacs and variable overheads (90,000 x 10) Rs. 9 lacs.

Fixed overheads are taken on the basis of normal capacity when actual production is equal to normal capacity or the difference is minor. In case when actual production increases normal capacity considerably, fixed overheads are included on the basis of actual capacity. When actual production is substantially less than normal capacity, fixed overhead is included on the basis of normal capacity. To understand the reason for such a provision we take an example:

ABC Ltd. has a plant with the capacity to produce 1 lac unit of a product per annum and the expected fixed overhead is Rs. 18 lacs. Fixed overhead on the basis of normal capacity is Rs. 18 (18 lacs/1 lac).



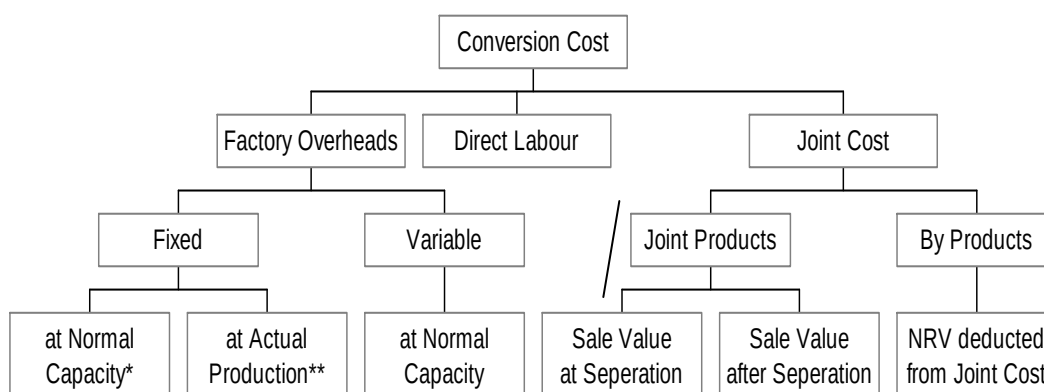
Case 1: Actual production is 1 lac units. Fixed overhead on the basis of normal capacity and actual overhead will lead to same figure of Rs. 18 lacs. Therefore it is advised to include this on normal capacity.

Case 2: Actual production is 90,000 units. Fixed overhead is not going to change with the change in output and will remain constant at Rs. 18 lacs, therefore, overheads on actual basis is Rs. 20 (18 lacs/ 90 thousands). Hence by valuing stock at Rs. 20 each for fixed overhead purpose, it will be overvalued and the losses of Rs. 1.8 lacs will also be included in closing stock leading to a higher gross profit than actually earned. Therefore, it is advisable to include fixed overhead on normal capacity (90,000 x 18) Rs. 16.2 lacs and rest Rs. 1.2 lacs will be transferred to Profit & Loss Account.

Case 3: Actual production is 1.2 lacs units. Fixed overhead is not going to change with the change in output and will remain constant at Rs. 18 lacs, therefore, overheads on actual basis is Rs. 15 (18 lacs/ 1.2 lacs). Hence by valuing stock at Rs. 18 each for fixed overhead purpose, we will be adding the element of cost to inventory which actual has not been incurred. At Rs. 18 total overhead will come to Rs. 21.6 lacs whereas actual overhead expense is only Rs. 18 lacs. Therefore, it is advisable to include fixed overhead on actual basis (1.2 lacs x 15) Rs. 18 lacs.

Sometimes, a single production process may result in more than one product. In case, this additional product is the intended and has a good market value, they are known as joint products. The cost of conversion incurred on all the production and not identifiable separately is allocated among the products on some rational and consistent basis. If this additional product doesn't have good market value then they are considered as by-products. In this case the net realisable value of the by-products are deducted from the total cost of conversion to calculate the cost of conversion for main product.

\* When actual production is almost equal or lower than normal capacity.



\*\* When actual production is higher than normal capacity.

## 1.20 Financial Reporting

Other Costs: Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

In determining the cost of inventories, it is appropriate to exclude the following costs and recognise them as expenses in the period in which they are incurred:

- (a) Abnormal amounts of wasted materials, labour, or other production costs.
- (b) Storage costs, unless those costs are necessary in the production process prior to a further production stage.
- (c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition and
- (d) Selling and distribution costs.

### Illustration 1

A Ltd. purchased 1,00,000 MT for Rs. 100 each MT of raw material and introduced in the production process to get 85,000 MT as output. Normal wastage is 5%. In the process, company incurred the following expenses:

|                                 |              |
|---------------------------------|--------------|
| Direct Labour                   | Rs.10,00,000 |
| Direct Variable Overheads       | Rs. 1,00,000 |
| Direct Fixed Overheads          | Rs. 1,00,000 |
| (Including interest Rs. 40,625) |              |

Of the above 80,000 MT was sold during the year and remaining 5,000 MT remained in closing stock. Due to fall in demand in market the selling price for the finished goods on the closing day was estimated to be Rs. 105 per MT. Calculate the value of closing stock.

### Solution:

#### Calculation of cost for closing stock

| Particulars                                                       | Rs.                |
|-------------------------------------------------------------------|--------------------|
| Cost of Purchase (1,00,000 x 100)                                 | 1,00,00,000        |
| Direct Labour                                                     | 10,00,000          |
| Variable Overhead                                                 | 1,00,000           |
| Fixed Overhead $\frac{(1,00,000 - 40,625) \times 85,000}{95,000}$ | <u>53,125</u>      |
| Cost of Production                                                | <u>1,11,53,125</u> |
| Cost of closing stock per unit (1,11,53,125/85,000)               | Rs. 131 (approx)   |
| Net Realisable Value per unit                                     | Rs. 105            |

Since net realisable value is less than cost, closing stock will be valued at Rs. 105. Therefore closing stock is Rs. 5,25,000 (5,000 x 105).

### 3.4 COST FORMULAE

Following are the various cost formulae suggested by the statement:

*Specific Identification Method:* It is suitable for the inventories where each unit of stock along with their associated cost can be separately identified. In other words, where one unit of stock is not interchangeable with another unit. Under this method each unit is valued specifically on its original cost. Examples for such goods are ship building, machinery building...

For items where are interchangeable, most appropriate method of cost valuation is either of the following two:

*FIFO (First In First Out):* It is assumed under this method that whatever is received first is issued first, which means, the stock left over belongs to the latest purchases. Closing stock is valued at the rates for the equivalent units purchased at last. During inflation stock is valued at higher price and during decrease in price, stock is valued at lower price.

*Weighted Average Price:* Under this method of stock valuation, to determine the cost per unit, total cost of production during the year is divided by total units. In other words, for price per unit of the closing stock we take the average price of the total goods purchased or produced during the year.

Following are cost formulae or techniques of measurement of cost suggested by AS for some special cases:

*Standard Cost Method:* Inventories are valued on the basis of the set standards, which are realistic and reviewed regularly and where necessary, revised in the light of the current conditions. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation.

*Adjusted Selling Price Method or Retail Method:* It is recommended for retail business or in the business where the inventory comprises of many items, the individual costs of which are not readily ascertainable. All the inventories are valued at the selling price, which is then adjusted with normal gross profit ratio and selling expenses to reach at its cost.

#### Illustration 2

Ambica Stores is a departmental store, which sell goods on retail basis. It makes a gross profit of 20% on net sales. The following figures for the year-end are available:

|                              |                          |                             |
|------------------------------|--------------------------|-----------------------------|
| Opening Stock Rs. 50,000     | Purchases Rs. 3,60,000   | Purchase Returns Rs. 10,000 |
| Freight Inwards Rs. 10,000   | Gross Sales Rs. 4,50,000 | Sales Returns Rs. 11,250    |
| Carriage Outwards Rs. 5,000. |                          |                             |

Compute the estimated cost of the inventory on the closing date.

## 1.22 Financial Reporting

### Solution:

#### Calculation of cost for closing stock

| <i>Particulars</i>                         | <i>Rs.</i>      |
|--------------------------------------------|-----------------|
| Opening Stock                              | 50,000          |
| Purchases less returns (3,60,000 – 10,000) | 3,50,000        |
| Freight Inwards                            | <u>10,000</u>   |
|                                            | 4,10,000        |
| Less: Net Sales (4,50,000 – 11,250)        | <u>4,38,750</u> |
|                                            | (28,750)        |
| Add: Gross Profits (4,38,750 x 20%)        | <u>87,750</u>   |
| Closing Stock                              | <u>59,000</u>   |

### 3.5 NET REALISABLE VALUE (NRV)

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

When we say that stock should be valued at the lower of cost or net realisable value, one should note that only under two circumstances cost of inventories will surpass its net realisable value:

1. The goods are damaged or obsolete and not expected to realise the normal sale price.
2. The cost necessary for the production of goods has gone up by greater degree.

Both the above cases we don't expect in the normal functioning of the business, hence whenever it is found that goods are valued at NRV, care should be taken to study the existing market position for the relevant products.

NRV of the goods are estimated on item to item basis and only items of the same characteristics are grouped together. Such estimation is made at the time of finalisation of accounts and circumstances existing on the date of balance sheet evident from the events after the balance sheet confirming the estimation should be taken into consideration. And assessment is made on each balance sheet date of such estimation.

While estimating the NRV, the purpose of holding the stock should also be taken into consideration. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance

with the principles enunciated in AS 4, Contingencies and Events Occurring After the Balance Sheet Date.

For example, concern has 10,000 units in stock, of which 6,000 is to be delivered for Rs. 40 each as per a contract with one of the customer. Cost of stock is Rs. 45 and NRV estimated to be Rs. 50. In this case 6,000 units will be valued @ Rs. 40 each and rest 4,000 units will be valued @ Rs. 45 each.

This provision of cost or NRV whichever is less, is applicable only those goods which are ready for sale i.e. finished goods. Since raw materials and work in progress are not available for sale, they don't have any realisable value and therefore NRV can never be estimated. For these goods statement suggests that these should always be valued at cost. Only exception is the case when the net realisable value of the relevant finished goods is higher than cost, in this case, the relevant raw materials and work in progress should be valued at replacement cost.

### Illustration 3

| <i>Particulars</i>            | <i>Kg.</i> | <i>Rs.</i> |
|-------------------------------|------------|------------|
| Opening Stock: Finished Goods | 1,000      | 25,000     |
| Raw Materials                 | 1,100      | 11,000     |
| Purchases                     | 10,000     | 1,00,000   |
| Labour                        |            | 76,500     |
| Overheads (Fixed)             |            | 75,000     |
| Sales                         | 10,000     | 2,80,000   |
| Closing Stock: Raw Materials  | 900        |            |
| Finished Goods                | 1200       |            |

The expected production for the year was 15,000 kg of the finished product. Due to fall in market demand the sales price for the finished goods was Rs. 20 per kg and the replacement cost for the raw material was Rs. 9.50 per kg on the closing day. You are required to calculate the closing stock as on that date.

### Solution

#### Calculation of cost for closing stock

| <i>Particulars</i>             | <i>Rs.</i> |
|--------------------------------|------------|
| Cost of Purchase (10,200 x 10) | 1,02,000   |
| Direct Labour                  | 76,500     |

## 1.24 Financial Reporting

|                                                  |                                       |                 |
|--------------------------------------------------|---------------------------------------|-----------------|
| Fixed Overhead                                   | $\frac{75,000 \times 10,200}{15,000}$ | <u>51,000</u>   |
| Cost of Production                               |                                       | <u>2,29,500</u> |
| Cost of closing stock per unit (2,29,500/10,200) |                                       | Rs. 22.50       |
| Net Realisable Value per unit                    |                                       | Rs. 20.00       |

Since net realisable value is less than cost, closing stock will be valued at Rs. 20.

As NRV of the finished goods is less than its cost, relevant raw materials will be valued at replacement cost i.e. Rs. 9.50.

|                                                                |                   |
|----------------------------------------------------------------|-------------------|
| Therefore, value of closing stock: Finished Goods (1,200 x 20) | Rs. 24,000        |
| Raw Materials (900 x 9.50)                                     | <u>Rs. 8,550</u>  |
|                                                                | <u>Rs. 32,550</u> |

## 3.6 DISCLOSURE

The financial statements should disclose:

- (a) The accounting policies adopted in measuring inventories, including the cost formula used; and
- (b) The total carrying amount of inventories and its classification appropriate to the enterprise.

Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are raw materials and components, work in progress, finished goods, stores and spares, and loose tools.

### Illustration 4

The closing inventory at cost of a company amounted to Rs. 2,84,700. The following items were included at cost in the total:

- (a) 400 coats, which had cost Rs. 80 each and normally sold for Rs. 150 each. Owing to a defect in manufacture, they were all sold after the balance sheet date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds.
- (b) 800 skirts, which had cost Rs. 20 each. These too were found to be defective. Remedial work in April cost Rs. 5 per skirt, and selling expenses for the batch totaled Rs. 800. They were sold for Rs. 28 each.

What should the inventory value be according to AS 2 after considering the above items?

**Solution****Valuation of Closing Stock**

| <i>Particulars</i>                                              | <i>Rs.</i>    | <i>Rs.</i>      |
|-----------------------------------------------------------------|---------------|-----------------|
| Closing Stock at cost                                           |               | 2,84,700        |
| Less :Cost of 400 coats (400 x 80)                              | 32,000        |                 |
| Less: Net Realisable Value (400 x 75) – 5%                      | <u>28,500</u> | <u>3,500</u>    |
|                                                                 |               | 2,81,200        |
| Provision for repairing cost to be incurred in future (800 x 5) |               | <u>4,000</u>    |
| Value of Closing Stock                                          |               | <u>2,77,200</u> |

### **3.7 ACCOUNTING STANDARDS INTERPRETATION (ASI) 2: ACCOUNTING FOR MACHINERY SPARES, ACCOUNTING STANDARD (AS) 2, VALUATION OF INVENTORIES**

Machinery spares which are not specific to a particular item of fixed asset but can be used generally for various items of fixed assets should be treated as inventories for the purpose of AS 2. Such machinery spares should be charged to the statement of profit and loss as and when issued for consumption in the ordinary course of operations.

### **3.8 ILLUSTRATIONS**

#### **Illustration 5**

State with reference to accounting standard, how will you value the inventories in the following cases:

- (i) Raw material was purchased at Rs. 100 per kilo. Price of raw material is on the decline. The finished goods in which the raw material is incorporated is expected to be sold at below cost. 10,000 kgs. of raw material is on stock at the year end. Replacement cost is Rs. 80 per kg.
- (ii) In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in a wastage of 300 MT. Cost per MT of input is Rs. 1,000. The entire quantity of waste is on stock at the year end.
- (iii) Per kg. of finished goods consisted of:
 

|                                     |                 |
|-------------------------------------|-----------------|
| Material cost                       | Rs. 100 per kg. |
| Direct labour cost                  | Rs. 20 per kg.  |
| Direct variable production overhead | Rs. 10 per kg.  |

Fixed production charges for the year on normal capacity of one lakh kgs. is Rs. 10 lakhs. 2,000 kgs. of finished goods are on stock at the year end.

## 1.26 Financial Reporting

### Solution

- (a) (i) As per para 24 of AS 2 (Revised) on Valuation of Inventories, materials and other supplies held for use in the production of inventories are not written down below cost if the finished product in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

Hence, in the given case, the stock of 10,000 kgs of raw material will be valued at Rs. 80 per kg. The finished goods, if on stock, should be valued at cost or net realisable value whichever is lower.

- (ii) As per para 13 of AS 2 (Revised), abnormal amounts of waste materials, labour or other production costs are excluded from cost of inventories and such costs are recognised as expenses in the period in which they are incurred.

In this case, normal waste is 250 MT and abnormal waste is 50 MT.

The cost of 250 MT will be included in determining the cost of inventories (finished goods) at the year end. The cost of abnormal waste amounting to Rs. 50,000 (50 MT x Rs. 1,000) will be charged in the profit and loss statement.

- (iii) In accordance with paras 8 and 9 of AS 2 (Revised), the costs of conversion include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Thus, cost per kg. of finished goods can be computed as follows:

|                                                                                 | Rs.        |
|---------------------------------------------------------------------------------|------------|
| Material cost                                                                   | 100        |
| Direct labour cost                                                              | 20         |
| Direct variable production overhead                                             | 10         |
| Fixed production overhead $\left( \frac{\text{Rs.10,00,000}}{1,00,000} \right)$ | 10         |
|                                                                                 | <hr/>      |
|                                                                                 | <u>140</u> |

Thus, the value of 2,000 kgs. of finished goods on stock at the year end will be Rs. 2,80,000 (2,000 kgs. x Rs. 140).



**Illustration 6**

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 Realisable Value of the items of closing stock are determined as follows:

| <i>Items</i> | <i>Historical Cost<br/>(Rs. in lakhs)</i> | <i>Net Realisable Value<br/>(Rs. in lakhs)</i> |
|--------------|-------------------------------------------|------------------------------------------------|
| A            | 40                                        | 28                                             |
| B            | 32                                        | 32                                             |
| C            | 16                                        | 24                                             |

What will be the value of Closing Stock?

**Solution**

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.

| <i>Items</i> | <i>Historical Cost<br/>(Rs. in lakhs)</i> | <i>Net Realisable Value<br/>(Rs. in lakhs)</i> | <i>Valuation of closing<br/>stock (Rs. in lakhs)</i> |
|--------------|-------------------------------------------|------------------------------------------------|------------------------------------------------------|
| A            | 40                                        | 28                                             | 28                                                   |
| B            | 32                                        | 32                                             | 32                                                   |
| C            | <u>16</u>                                 | <u>24</u>                                      | <u>16</u>                                            |
|              | <u>88</u>                                 | <u>84</u>                                      | <u>76</u>                                            |

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

**Self-Examination Questions**

1. What items of inventories are outside the scope of AS 2?
2. Can valuation of inventories including WIP be done above cost?
3. What are the components of costs of inventories? Explain in brief.
4. Give examples of items that are included in the cost of conversion for determining cost of inventories?
5. In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in a wastage of 3,000 MT. Cost per MT of input is RS. 1,500. The entire quantity of waste is on stock at the year end. State with reference to AS, how will you value these inventories?

## 1.28 Financial Reporting

6. 2,000 units of A and 1,000 units of B arise jointly from a production process, involving a total cost of 1,20,000. If the sales value at split-off point is Rs. 100 and Rs. 60 respectively for the products A and B, explain how the joint cost of conversion will be allocated to the products?
7. Alpha Industries produces four joint products L, M, N and P from a joint process, incurring a cost of Rs.5,71,200. How will you allocate the joint costs if the following information is given?

| Particulars                   | L        | M      | N     | P        |
|-------------------------------|----------|--------|-------|----------|
| Quantity Produced             | 10 kg.   | 12 kg. | 14 kg | 16 kg.   |
| Sales Price per kg            | Rs.13    | Rs.17  | Rs.19 | Rs.22    |
| Stock Quantity at end of year | 1,625 kg | 400 kg | Nil   | 1,550 kg |

Also determine the value of closing stock in respect of the above products.

8. Meghna Ltd. Dealing in timber finds it advantageous to store selected grades of timber for a prolonged period in order to improve their quality. It desires to include an actual interest cost of holding the timber as part of the value of unsold timber in inventory and consults you in order to determine whether, in your opinion, such a method of valuation would be fair and reasonable and in accordance with generally accepted accounting principles. You are required to indicate your opinion with reasons.

Would your answer be different if the company did not actually incur any interest charges for holding the timber but desired to include notional interest charges which could be imputed to the company's own paid-up capital and reserves which are invested in holding the timber for maturity?

9. Inventories of a car manufacturing Company include the value of items, required for the manufacture of a model, which was removed from the production line five years back, at cost price. As a company auditor, how would you react to the above?

## UNIT 4

### AS 3 :CASH FLOW STATEMENTS

Reference: The students are advised to refer the full text of AS 3 "Cash Flow Statements" (revised 1997) given in Appendix I at the end of the Study Material (Volume-II).

#### 4.1 INTRODUCTION

This statement comes into effect in respect of accounting periods commencing on or after 1-4-1997. This Standard supersedes Accounting Standard (AS) 3, 'Changes in Financial Position', issued in June 1981. This Standard is mandatory in nature in respect of accounting periods commencing on or after 1-4-2004 for the enterprises, which fall in the category of level I, at any time during the accounting period. For all other enterprises though it is not compulsory but it is encouraged to prepare such statements. Where an enterprise was not covered by this statement during the previous year but qualifies in the current accounting year, they are not suppose to disclose the figures for the corresponding previous years. Whereas, if an enterprises qualifies under this statement to prepare the cash flow statements during the previous year but now disqualified, will continue to prepare cash flow statements for another two consecutive years.

#### 4.2 OBJECTIVE

Cash flow Statement (CFS) is an additional information provided to the users of accounts in the form of an statement, which reflects the various sources from where cash was generated (inflow of cash) by an enterprise during the relevant accounting year and how these inflows were utilised (outflow of cash) by the enterprise. This helps the users of accounts:

- ◆ To identify the historical changes in the flow of cash & cash equivalents.
- ◆ To determine the future requirement of cash & cash equivalents.
- ◆ To assess the ability to generate cash & cash equivalents.
- ◆ To estimate the further requirement of generating cash & cash equivalents.
- ◆ To compare the operational efficiency of different enterprises.
- ◆ To study the insolvency and liquidity position of an enterprise.

Cash comprises cash on hand and demand deposits with banks.

Cash equivalents are:

- ◆ Short term (maximum three months of maturity from the date of acquisition),
- ◆ Highly liquid investments,

### 1.30 Financial Reporting

- ◆ Readily convertible,
- ◆ Convertible amounts of cash is known,
- ◆ Subject to an insignificant risk of changes in value.

For example, Share Capital is not considered as cash equivalent even though they are readily convertible into cash because, the amount that will be realized on sale of investment is not determinable unless investment is actually sold. Similarly, fixed deposit for one year is also not considered as cash equivalent because they are not readily convertible into cash, even though the amount is determinable.

One should not be confused with the concept of three months or less. As this standard states very clearly that three months or less from the date of acquisition, any investment which is not classified as cash equivalent cannot be reclassified as cash equivalent, even when the maturity period is less than three months. We should look at the status only on the date of acquisition and not later. Cash flows are inflows and outflows of cash and cash equivalents.

### 4.3 PRESENTATION OF A CASH FLOW STATEMENT

CFS should be prepared and presented by an enterprise for all the cash transactions of the relevant accounting year. These transactions are broadly classified into three major headings:

*Operating activities* are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

This includes all the transactions which are necessary in the day to day running of the business e.g., cash purchases, cash sales, payment to creditors, receipt from debtors, payment for rent, salary, office expenses etc.

*Investing activities* are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

These reflect all the transactions relating to the acquisition and sale of assets and investments, say, purchase/sale of land, purchase/sale of investment, receipt of interest/dividend on investments etc.

*Financing activities* are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

These are the transactions relating to the sources from where all the activities are initially financed, like, issue or repayment of share capital, debentures, long term loans, payment of interest or dividend etc.

So all the transactions should be classified under each of these heads and presented in CFS, this kind of presentation gives a very clear idea to the users regarding the major sources of cash inflows, from where all the activities are financed by the enterprises. Say if net cash flow

from operating activities is negative and net cash flow from investing activities is positive, this does not portray a good picture of the functioning of the enterprise. Sometimes, A single transaction may include cash flows that are classified differently. For example, when the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

### Illustration 1

Classify the following activities as (a) Operating Activities, (b) Investing Activities, (c) Financing Activities (d) Cash Equivalents.

- a. Purchase of Machinery.
- b. Proceeds from issuance of equity share capital
- c. Cash Sales.
- d. Proceeds from long-term borrowings.
- e. Proceeds from Debtors.
- f. Cash receipts from Debtors.
- g. Trading Commission received.
- h. Purchase of investment.
- i. Redemption of Preference Shares.
- j. Cash Purchases.
- k. Proceeds from sale of investment
- l. Purchase of goodwill.
- m. Cash paid to suppliers.
- n. Interim Dividend paid on equity shares.
- o. Wages and salaries paid.
- p. Proceed from sale of patents.
- q. Interest received on debentures held as investment.
- r. Interest paid on Long-term borrowings.
- s. Office and Administration Expenses paid
- t. Manufacturing Overheads paid.
- u. Dividend received on shares held as investments.

### 1.32 Financial Reporting

- v. Rent Received on property held as investment.
- w. Selling and distribution expense paid.
- x. Income tax paid
- y. Dividend paid on Preference shares.
- z. Underwritings Commission paid.
- aa. Rent paid.
- bb. Brokerage paid on purchase of investments.
- cc. Bank Overdraft
- dd. Cash Credit
- ee. Short-term Deposits
- ff. Marketable Securities
- gg. Refund of Income Tax received.

#### Solution

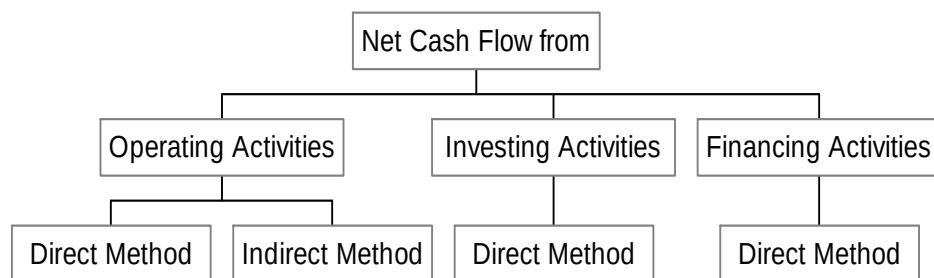
Operating Activities: c, e, f, g, j, m, o, s, t, w, x, aa & gg.

Investing Activities: a, h, k, l, p, q, u, v, bb & ee.

Financing Activities: b, d, i, n, r, y, z, cc & dd.

Cash Equivalent: ff.

Cash Flow during the Year is



### Operating Activities

As discussed earlier, operating activities are those activities which determines the profit/loss result of the enterprise, hence this head helps us to determine that whether the concern has sufficient cash inflow from their normal operations to support their operating cash outflow, and also the other cash outflow. Examples of operating activities are:

- a. Cash receipts from the sale of goods and the rendering of services.
- b. Cash receipts from royalties, fees, commissions and other revenue.
- c. Cash payments to suppliers for goods and services.
- d. Cash payments to and on behalf of employees.
- e. Cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits.
- f. Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities.
- g. Cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

There are few items extraordinary items, which are recorded in Profit and Loss Account, but are not to be classified as operating activity, such as, profit/loss on sale of fixed asset. Fixed assets are to be classified as investing activities, therefore any sale proceeds from such items will go to investing activities. If investments are held as stock in trade, in such a case we will disclose them as operating activities.

Net cash flow from operating activities can be reported either as direct method or as indirect method.

Direct method we take the gross receipts from sales, debtors and other operating inflows subtracted by gross payments for purchases, creditors and other expenses ignoring all non-cash items like depreciation, provisions. Indirect method we start from the net profit or loss figure, eliminate the effect of any non cash items, investing items and financing items from such profit figure i.e. all such expenses like depreciation, provisions, interest paid, loss on sale of assets etc. are added and interest received etc. are deducted. Adjustment for changes in working capital items are also made ignoring cash and cash equivalent to reach to the figure of net cash flow.

Direct method is preferred over and above indirect because, direct method gives us the clear picture of various sources of cash inflows and outflows which helps in estimating the future cash inflows and outflows.

### 1.34 Financial Reporting

Below is the format for Cash Flow Statement

#### Cash Flow Statement of X Ltd. for the year ended March 31, 20xx (Direct Method)

| <i>Particulars</i>                                                 | <i>Rs.</i> | <i>Rs.</i> |
|--------------------------------------------------------------------|------------|------------|
| <b><i>Operating Activities:</i></b>                                |            |            |
| Cash received from sale of goods                                   | xxx        |            |
| Cash received from Debtors                                         | xxx        |            |
| Cash received from sale of services                                | xxx        | xxx        |
| Less: Payment for Cash Purchases                                   | xxx        |            |
| Payment to Creditors                                               | xxx        |            |
| Payment for Operating Expenses<br>e.g. power, rent, electricity... | xxx        |            |
| Payment for wages & Salaries                                       | xxx        |            |
| Payment for Income Tax                                             | xxx        | xxx        |
|                                                                    |            | xxx        |
| Adjustment for Extraordinary Items                                 |            | xxx        |
| Net Cash Flow from Operating Activities                            |            | xxx        |

#### Cash Flow Statement of X Ltd. for the year ended March 31, 20xx (Indirect Method)

| <i>Particulars</i>                                                   | <i>Rs.</i> | <i>Rs.</i> |
|----------------------------------------------------------------------|------------|------------|
| <b><i>Operating Activities:</i></b>                                  |            |            |
| Closing balance of Profit & Loss Account                             | xxx        |            |
| Less: Opening balance of Profit & Loss Account                       | xxx        |            |
|                                                                      | xxx        |            |
| Reversal the effects of Profit & Loss Appropriation Account          | xxx        |            |
| Add: Provision for Income Tax                                        | xxx        |            |
| Effects of Extraordinary Items                                       | xxx        |            |
| Net Profit Before Tax and Extraordinary Items                        | xxx        |            |
| Reversal the effects of non-cash and non-operating items             | xxx        |            |
| Effects for changes in Working Capital except cash & cash equivalent | xxx        |            |
|                                                                      | xxx        |            |
| Les : Payment of Income Tax                                          | xxx        | xxx        |
| Adjustment for Extraordinary Items                                   |            | xxx        |
| Net Cash Flow from Operating Activities                              |            | xxx        |



**Illustration 2**

From the following information, calculate cash flow from operating activities:

**Summary of Cash Account for the year ended March 31, 2008**

| <i>Particulars</i>     | <i>Rs.</i>      | <i>Particulars</i>           | <i>Rs.</i>      |
|------------------------|-----------------|------------------------------|-----------------|
| To Balance b/d         | 1,00,000        | By Cash Purchases            | 1,20,000        |
| To Cash sales          | 1,40,000        | By Creditors                 | 1,57,000        |
| To Debtors             | 1,75,000        | By Office & Selling Expenses | 75,000          |
| To Trade Commission    | 50,000          | By Income Tax                | 30,000          |
| To Sale of Investment  | 30,000          | By Investment                | 25,000          |
| To Loan from Bank      | 1,00,000        | By Repay of Loan             | 75,000          |
| To Interest & Dividend | 1,000           | By Interest on loan          | 10,000          |
|                        |                 | By Balance c/d.              | 1,04,000        |
|                        | <u>5,96,000</u> |                              | <u>5,96,000</u> |

**Solution****Cash Flow Statement of ..... for the year ended March 31, 2008 (Direct Method)**

| <i>Particulars</i>                      | <i>Rs.</i>    | <i>Rs.</i>      |
|-----------------------------------------|---------------|-----------------|
| <b>Operating Activities:</b>            |               |                 |
| Cash received from sale of goods        | 1,40,000      |                 |
| Cash received from Debtors              | 1,75,000      |                 |
| Trade Commission received               | <u>50,000</u> | 3,65,000        |
| Less: Payment for Cash Purchases        | 1,20,000      |                 |
| Payment to Creditors                    | 1,57,000      |                 |
| Office and Selling Expenses             | 75,000        |                 |
| Payment for Income Tax                  | <u>30,000</u> | 3,82,000        |
| Net Cash Flow from Operating Activities |               | <u>(17,000)</u> |

### 1.36 Financial Reporting

#### Illustration 3

Ms. Joyti of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year 2006 :

|                                                             | (Rs. in Lakhs) |
|-------------------------------------------------------------|----------------|
| Net Profit                                                  | 25,000         |
| Dividend (including dividend tax) paid                      | 8,535          |
| Provision for Income tax                                    | 5,000          |
| Income tax paid during the year                             | 4,248          |
| Loss on sale of assets (net)                                | 40             |
| Book value of the assets sold                               | 185            |
| Depreciation charged to Profit & Loss Account               | 20,000         |
| Amortisation of Capital grant                               | 6              |
| Profit on sale of Investments                               | 100            |
| Carrying amount of Investment sold                          | 27,765         |
| Interest income on investments                              | 2,506          |
| Increase expenses                                           | 10,000         |
| Interest paid during the year                               | 10,520         |
| Increase in Working Capital (excluding Cash & Bank Balance) | 56,075         |
| Purchase of fixed assets                                    | 14,560         |
| Investment in joint venture                                 | 3,850          |
| Expenditure on construction work in progress                | 34,740         |
| Proceeds from calls in arrear                               | 2              |
| Receipt of grant for capital projects                       | 12             |
| Proceeds from long-term borrowings                          | 25,980         |
| Proceeds from short-term borrowings                         | 20,575         |
| Opening cash and Bank balance                               | 5,003          |
| Closing cash and Bank balance                               | 6,988          |

Required :

Prepare the Cash Flow Statement for the year 2006 in accordance with AS 3, Cash Flow Statements issued by the Institute of Chartered Accountants of India.

**Solution**

**Star Oils Limited**  
**Cash Flow Statement**  
**for the year ended 31st December, 2006**

*(Rs. in lakhs)***Cash flows from operating activities**

|                                                              |          |         |
|--------------------------------------------------------------|----------|---------|
| Net profit before taxation (25,000 + 5,000)                  | 30,000   |         |
| Adjustments for :                                            |          |         |
| Depreciation                                                 | 20,000   |         |
| Loss on sale of assets (Net)                                 | 40       |         |
| Amortisation of capital grant                                | (6)      |         |
| Profit on sale of investments                                | (100)    |         |
| Interest income on investments                               | (2,506)  |         |
| Interest expenses                                            | 10,000   |         |
| Operating profit before working capital changes              | 57,428   |         |
| Changes in working capital (Excluding cash and bank balance) | (56,075) |         |
| Cash generated from operations                               | 1,353    |         |
| Income taxes paid                                            | (4,248)  |         |
| Net cash used in operating activities                        |          | (2,895) |

**Cash flows from investing activities**

|                                              |          |          |
|----------------------------------------------|----------|----------|
| Sale of assets                               | 145      |          |
| Sale of investments (27,765 + 100)           | 27,865   |          |
| Interest income on investments               | 2,506    |          |
| Purchase of fixed assets                     | (14,560) |          |
| Investment in joint venture                  | (3,850)  |          |
| Expenditure on construction work-in progress | (34,740) |          |
| Net cash used in investing activities        |          | (22,634) |

**Cash flows from financing activities**

|                                        |          |        |
|----------------------------------------|----------|--------|
| Proceeds from calls in arrear          | 2        |        |
| Receipts of grant for capital projects | 12       |        |
| Proceeds from long-term borrowings     | 25,980   |        |
| Proceed from short-term borrowings     | 20,575   |        |
| Interest paid                          | (10,520) |        |
| Dividend (including dividend tax) paid | (8,535)  |        |
|                                        |          | 27,514 |

|                                                          |       |
|----------------------------------------------------------|-------|
| Net increase in cash and cash equivalents                | 1,985 |
| Cash and cash equivalents at the beginning of the period | 5,003 |
| Cash and cash equivalents at the end of the period       | 6,988 |

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#### Working note :

|                               |            |
|-------------------------------|------------|
| Book value of the assets sold | 185        |
| Less : Loss on sale of assets | 40         |
| Proceeds on sale              | <u>145</u> |

#### Assumption :

Interest income on investments Rs. 2,506 has been received during the year.

#### Illustration 4

From the following Summary Cash Account of X Ltd. prepare Cash Flow Statement for the year ended 31st March, 2006 in accordance with AS 3 (Revised) using the direct method. The company does not have any cash equivalents.

#### Summary Cash Account for the year ended 31.3.2006

|                         | Rs. '000     |                          | Rs. '000     |
|-------------------------|--------------|--------------------------|--------------|
| Balance on 1.4.2005     | 50           | Payment to Suppliers     | 2,000        |
| Issue of Equity Shares  | 300          | Purchase of Fixed Assets | 200          |
| Receipts from Customers | 2,800        | Overhead expense         | 200          |
| Sale of Fixed Assets    | 100          | Wages and Salaries       | 100          |
|                         |              | Taxation                 | 250          |
|                         |              | Dividend                 | 50           |
|                         |              | Repayment of Bank Loan   | 300          |
|                         |              | Balance on 31.3.2006     | <u>150</u>   |
|                         | <u>3,250</u> |                          | <u>3,250</u> |

#### Solution

#### X Ltd.

#### Cash Flow Statement for the year ended 31st March, 2006 (Using the direct method)

|                                             | Rs. '000   | Rs. '000   |
|---------------------------------------------|------------|------------|
| <b>Cash flows from operating activities</b> |            |            |
| Cash receipts from customers                | 2,800      |            |
| Cash payments to suppliers                  | (2,000)    |            |
| Cash paid to employees                      | (100)      |            |
| Cash payments for overheads                 | (200)      |            |
| Cash generated from operations              | <u>500</u> |            |
| Income tax paid                             | (250)      |            |
| Net cash from operating activities          |            | <u>250</u> |

**Cash flows from investing activities**

|                                       |       |       |
|---------------------------------------|-------|-------|
| Payments for purchase of fixed assets | (200) |       |
| Proceeds from sale of fixed assets    | 100   |       |
| Net cash used in investing activities |       | (100) |

**Cash flows from financing activities**

|                                         |       |      |
|-----------------------------------------|-------|------|
| Proceeds from issuance of equity shares | 300   |      |
| Bank loan repaid                        | (300) |      |
| Dividend paid                           | (50)  |      |
| Net cash used in financing activities   |       | (50) |
| Net increase in cash                    |       | 100  |
| Cash at beginning of the period         |       | 50   |
| Cash at end of the period               |       | 150  |

**Illustration 5**

The Balance Sheet of New Light Ltd. for the years ended 31st March, 2006 and 2007 are as follows:

| <i>Liabilities</i>              | <i>31st March<br/>2006<br/>(Rs.)</i> | <i>31st March<br/>2007<br/>(Rs.)</i> | <i>Assets</i>        | <i>31st March<br/>2006<br/>(Rs.)</i> | <i>31st March<br/>2007<br/>(Rs.)</i> |
|---------------------------------|--------------------------------------|--------------------------------------|----------------------|--------------------------------------|--------------------------------------|
| Equity share capital            | 12,00,000                            | 16,00,000                            | Fixed Assets         | 32,00,000                            | 38,00,000                            |
| 10% Preference<br>share capital | 4,00,000                             | 2,80,000                             | Less: Depreciation   | 9,20,000                             | 11,60,000                            |
| Capital Reserve                 | —                                    | 40,000                               | Investment           | 4,00,000                             | 3,20,000                             |
| General Reserve                 | 6,80,000                             | 8,00,000                             | Cash                 | 10,000                               | 10,000                               |
| Profit and Loss A/c             | 2,40,000                             | 3,00,000                             | Other current assets | 11,10,000                            | 13,10,000                            |
| 9% Debentures                   | 4,00,000                             | 2,80,000                             | Preliminary expenses | 80,000                               | 40,000                               |
| Current liabilities             | 4,80,000                             | 5,20,000                             |                      |                                      |                                      |
| Proposed dividend               | 1,20,000                             | 1,44,000                             |                      |                                      |                                      |
| Provision for Tax               | 3,60,000                             | 3,40,000                             |                      |                                      |                                      |
| Unpaid dividend                 | —                                    | 16,000                               |                      |                                      |                                      |
|                                 | <u>38,80,000</u>                     | <u>43,20,000</u>                     |                      | <u>38,80,000</u>                     | <u>43,20,000</u>                     |

**Additional information:**

- (i) The company sold one fixed asset for Rs. 1,00,000, the cost of which was Rs. 2,00,000 and the depreciation provided on it was Rs. 80,000.
- (ii) The company also decided to write off another fixed asset costing Rs. 56,000 on which depreciation amounting to Rs. 40,000 has been provided.
- (iii) Depreciation on fixed assets provided Rs. 3,60,000.

#### 1.40 Financial Reporting

- (iv) Company sold some investment at a profit of Rs. 40,000, which was credited to capital reserve.
- (v) Debentures and preference share capital redeemed at 5% premium.
- (vi) Company decided to value stock at cost, whereas previously the practice was to value stock at cost less 10%. The stock according to books on 31.3.2006 was Rs. 2,16,000. The stock on 31.3.2007 was correctly valued at Rs. 3,00,000.

Prepare Cash Flow Statement as per revised Accounting Standard 3 by indirect method.

#### Solution

**New Light Ltd.**  
**Cash Flow Statement for the year ended 31st March, 2007**

| <b>A. Cash Flow from operating activities</b>                                                        | <b>Rs.</b>        | <b>Rs.</b> |
|------------------------------------------------------------------------------------------------------|-------------------|------------|
| Profit after appropriation                                                                           |                   |            |
| Increase in profit and loss A/c after inventory adjustment [Rs.3,00,000 – (Rs.2,40,000 + Rs.24,000)] | 36,000            |            |
| Transfer to general reserve                                                                          | 1,20,000          |            |
| Proposed dividend                                                                                    | 1,44,000          |            |
| Provision for tax                                                                                    | <u>3,40,000</u>   |            |
| Net profit before taxation and extraordinary item                                                    | 6,40,000          |            |
| Adjustments for:                                                                                     |                   |            |
| Preliminary expenses written off                                                                     | 40,000            |            |
| Depreciation                                                                                         | 3,60,000          |            |
| Loss on sale of fixed assets                                                                         | 20,000            |            |
| Decrease in value of fixed assets                                                                    | 16,000            |            |
| Premium on redemption of preference share capital                                                    | 6,000             |            |
| Premium on redemption of debentures                                                                  | <u>6,000</u>      |            |
| Operating profit before working capital changes                                                      | 10,88,000         |            |
| Increase in current liabilities<br>(Rs.5,20,000 –Rs.4,80,000)                                        | 40,000            |            |
| Increase in other current assets<br>[Rs.13,10,000 – (Rs.11,10,000 + Rs.24,000)]                      | <u>(1,76,000)</u> |            |
| Cash generated from operations                                                                       | 9,52,000          |            |
| Income taxes paid                                                                                    | <u>(3,60,000)</u> |            |
| Net Cash from operating activities                                                                   |                   | 5,92,000   |

**B. Cash Flow from investing activities**

|                                    |                 |            |
|------------------------------------|-----------------|------------|
| Purchase of fixed assets           | (8,56,000)      |            |
| Proceeds from sale of fixed assets | 1,00,000        |            |
| Proceeds from sale of investments  | <u>1,20,000</u> |            |
| Net Cash from investing activities |                 | (6,36,000) |

**C. Cash Flow from financing activities**

|                                                                    |                   |               |
|--------------------------------------------------------------------|-------------------|---------------|
| Proceeds from issuance of share capital                            | 4,00,000          |               |
| Redemption of preference share capital<br>(Rs.1,20,000 + Rs.6,000) | (1,26,000)        |               |
| Redemption of debentures (Rs. 1,20,000 + Rs. 6,000)                | (1,26,000)        |               |
| Dividend paid                                                      | <u>(1,04,000)</u> |               |
| Net Cash from financing activities                                 |                   | <u>44,000</u> |
| Net increase/decrease in cash and cash equivalent during the year  |                   | Nil           |
| Cash and cash equivalent at the beginning of the year              |                   | <u>10,000</u> |
| Cash and cash equivalent at the end of the year                    |                   | <u>10,000</u> |

**Working Notes:**

1. Revaluation of stock will increase opening stock by Rs. 24,000.

$$\frac{2,16,000}{90} \times 10 = \text{Rs. } 24,000$$

Therefore, opening balance of other current assets would be as follows:

$$\text{Rs. } 11,10,000 + \text{Rs. } 24,000 = \text{Rs. } 11,34,000$$

Due to under valuation of stock, the opening balance of profit and loss account be increased by Rs. 24,000.

The opening balance of profit and loss account after revaluation of stock will be

$$\text{Rs. } 2,40,000 + \text{Rs. } 24,000 = \text{Rs. } 2,64,000$$

**2. Investment Account**

|                                                             | Rs.             |                                             | Rs.             |
|-------------------------------------------------------------|-----------------|---------------------------------------------|-----------------|
| To Balance b/d                                              | 4,00,000        | By Bank A/c                                 | 1,20,000        |
| To Capital reserve A/c<br>(Profit on sale of<br>investment) | <u>40,000</u>   | (balancing figure being investment<br>sold) |                 |
|                                                             | <u>4,40,000</u> | By Balance c/d                              | <u>3,20,000</u> |
|                                                             |                 |                                             | <u>4,40,000</u> |

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### 3. Fixed Assets Account

|    |                                           | Rs.              |    |                                              | Rs.           | Rs.              |
|----|-------------------------------------------|------------------|----|----------------------------------------------|---------------|------------------|
| To | Balance b/d                               | 32,00,000        | By | Bank A/c (sale of assets)                    | 1,00,000      |                  |
| To | Bank A/c                                  | 8,56,000         | By | Accumulated depreciation A/c                 | 80,000        |                  |
|    | (balancing figure being assets purchased) |                  | By | Profit and loss A/c (loss on sale of assets) | <u>20,000</u> | 2,00,000         |
|    |                                           |                  | By | Accumulated depreciation A/c                 | 40,000        |                  |
|    |                                           |                  | By | Profit and loss A/c (assets written off)     | <u>16,000</u> | 56,000           |
|    |                                           |                  | By | Balance c/d                                  |               | <u>38,00,000</u> |
|    |                                           | <u>40,56,000</u> |    |                                              |               | <u>40,56,000</u> |

### 4. Accumulated Depreciation Account

|    |                  | Rs.              |    |                                                   | Rs.              |
|----|------------------|------------------|----|---------------------------------------------------|------------------|
| To | Fixed assets A/c | 80,000           | By | Balance b/d                                       | 9,20,000         |
| To | Fixed assets A/c | 40,000           | By | Profit and loss A/c (depreciation for the period) | <u>3,60,000</u>  |
| To | Balance c/d      | <u>11,60,000</u> |    |                                                   | <u>12,80,000</u> |
|    |                  | <u>12,80,000</u> |    |                                                   |                  |

5. Unpaid dividend is taken as non-current item and dividend paid is shown at Rs. 1,04,000 (Rs.1,20,000 – Rs.16,000).

**Note:** Alternatively, unpaid dividend can be assumed as current liability and hence, dividend paid can be shown at Rs. 1,20,000. Due to this assumption cash flow from operating activities would be affected. The cash flow from operating activities will increase by Rs. 16,000 to Rs. 6,08,000 and cash flow from financing activities will get reduced by Rs. 16,000 to Rs. 28,000.

### Self-examination Questions

- What are the main features of the Cash Flow Statement? Explain with special reference to AS 3?
- In the case of manufacturing company :
  - List the items of 'inflows' of cash receipts from operating activities;
  - List the items of "outflows" of investing activities.
- Explain the difference between direct and indirect methods of reporting cash flows from operating activities with reference to Accounting Standard 3, (AS 3) revised.
- Explain the classification of activities ( with two examples) as suggested in AS 3, to be used for preparing a cash flow statement..



5. An enterprise sold an asset (Book Value Rs.50,000) for Rs.36,000. The loss of Rs.14,000 was debited to the P & L Account. Is this transaction an operating activity?
6. Classify the following under operating, financing and investing activity as per AS 3 (Revised)
  - (i) Interest and dividends received by financial institutions .
  - (ii) Redemption of preference share capital.
  - (iii) Receipt from trade debtors.
  - (iv) Payment for acquisition of long term assets.
  - (v) Payment to employees.
  - (vi) Dividend paid to shareholders.
  - (vii) Acquisition of equity or debt securities.
7. From the following details relating to the Accounts of Grow More Ltd. prepare Cash Flow Statement:

|                         | 31.03.2007 (Rs.) | 31.03.2006 (Rs.) |
|-------------------------|------------------|------------------|
| <i>Liabilities</i>      |                  |                  |
| Share Capital           | 10,00,000        | 8,00,000         |
| Reserve                 | 2,00,000         | 1,50,000         |
| Profit and Loss Account | 1,00,000         | 60,000           |
| Debentures              | 2,00,000         | —                |
| Provision for taxation  | 1,00,000         | 70,000           |
| Proposed dividend       | 2,00,000         | 1,00,000         |
| Sundry Creditors        | <u>7,00,000</u>  | <u>8,20,000</u>  |
|                         | <u>25,00,000</u> | <u>20,00,000</u> |
| <i>Assets</i>           |                  |                  |
| Plant and Machinery     | 7,00,000         | 5,00,000         |
| Land and Building       | 6,00,000         | 4,00,000         |
| Investments             | 1,00,000         | —                |
| Sundry Debtors          | 5,00,000         | 7,00,000         |
| Stock                   | 4,00,000         | 2,00,000         |
| Cash on hand/Bank       | <u>2,00,000</u>  | <u>2,00,000</u>  |
|                         | <u>25,00,000</u> | <u>20,00,000</u> |

- (i) Depreciation @ 25% was charged on the opening value of Plant and Machinery.
- (ii) During the year one old machine costing 50,000 (WDV 20,000) was sold for Rs. 35,000.
- (iii) Rs. 50,000 was paid towards Income tax during the year.
- (iv) Building under construction was not subject to any depreciation.

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Prepare Cash flow Statement.

8. From the following Balance Sheet and information, prepare Cash Flow Statement of Ryan Ltd. for the year ended 31st March, 2007:

##### Balance Sheet

|                                   | 31st March,<br>2007<br>Rs. | 31st March,<br>2006<br>Rs. |
|-----------------------------------|----------------------------|----------------------------|
| <i>Liabilities</i>                |                            |                            |
| Equity Share Capital              | 6,00,000                   | 5,00,000                   |
| 10% Redeemable Preference Capital | —                          | 2,00,000                   |
| Capital Redemption Reserve        | 1,00,000                   | —                          |
| Capital Reserve                   | 1,00,000                   | —                          |
| General Reserve                   | 1,00,000                   | 2,50,000                   |
| Profit and Loss Account           | 70,000                     | 50,000                     |
| 9% Debentures                     | 2,00,000                   | —                          |
| Sundry Creditors                  | 95,000                     | 80,000                     |
| Bills Payable                     | 20,000                     | 30,000                     |
| Liabilities for Expenses          | 30,000                     | 20,000                     |
| Provision for Taxation            | 95,000                     | 60,000                     |
| Proposed Dividend                 | <u>90,000</u>              | <u>60,000</u>              |
|                                   | <u>15,00,000</u>           | <u>12,50,000</u>           |

|                               | 31st March,2007<br>Rs. | 31st March,2006<br>Rs. |
|-------------------------------|------------------------|------------------------|
| <i>Assets</i>                 |                        |                        |
| Land and Building             | 1,50,000               | 2,00,000               |
| Plant and Machinery           | 7,65,000               | 5,00,000               |
| Investments                   | 50,000                 | 80,000                 |
| Inventory                     | 95,000                 | 90,000                 |
| Bills Receivable              | 65,000                 | 70,000                 |
| Sundry Debtors                | 1,75,000               | 1,30,000               |
| Cash and Bank                 | 65,000                 | 90,000                 |
| Preliminary Expenses          | 10,000                 | 25,000                 |
| Voluntary Separation Payments | <u>1,25,000</u>        | <u>65,000</u>          |
|                               | <u>15,00,000</u>       | <u>12,50,000</u>       |

Additional Information:

- (i) A piece of land has been sold out for Rs. 1,50,000 (Cost – Rs. 1,20,000) and the balance land was revalued. Capital Reserve consisted of profit on sale and profit on revaluation.
- (ii) On 1st April, 2006a plant was sold for Rs. 90,000 (Original Cost – Rs. 70,000 and W.D.V. – Rs. 50,000) and Debentures worth Rs. 1 lakh was issued at par as part consideration for plant of Rs. 4.5 lakhs acquired.
- (iii) Part of the investments (Cost – Rs. 50,000) was sold for Rs. 70,000.
- (iv) Pre-acquisition dividend received Rs. 5,000 was adjusted against cost of investment.
- (v) Directors have proposed 15% dividend for the current year.
- (vi) Voluntary separation cost of Rs. 50,000 was adjusted against General Reserve.
- (vii) Income-tax liability for the current year was estimated at Rs. 1,35,000.
- (viii) Depreciation @ 15% has been written off from Plant account but no depreciation has been charged on Land and Building.

## UNIT 5

### AS 4: CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

*Reference:* The students are advised to refer the full text of AS 4 "Contingencies\* and Events occurring after the Balance Sheet Date" (revised 1995) given in Appendix I at the end of the Study Material (Volume-II).

#### 5.1 INTRODUCTION

Pursuant to AS 29 'Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1st April, 2004, all paragraphs of AS 4 dealing with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by any other Indian AS. The project of revision of this standard by ASB in the light of newly issued AS 29 is under progress. Thus, the present standard (AS 4) deals with the treatment and disclosure requirements in the financial statements of events occurring after the balance sheet. Events occurring after the balance sheet date are those significant events (favourable as well unfavourable) that occur between the balance sheet date and the date on which financial statements are approved by the approving authority (i.e. board of directors in case of a company) of any entity.

This revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1995 and is mandatory in nature.

#### 5.2 CONTINGENCIES

Contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events. (Refer to unit 29 for discussion on AS 29)

#### 5.3 EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

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, by the corresponding approving authority in the case of any other entity.

For example, for the year ending on 31<sup>st</sup> March 2006, financial statement is finalized and approved by the company in its AGM held on 04<sup>th</sup> September 2006. In this case the events

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\* Pursuant to AS 29 'Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1st April, 2004, all paragraphs of AS 4 dealing with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by any other Indian AS.

taking place between 01<sup>st</sup> April 2006 to 04<sup>th</sup> September 2006 are termed as events occurring after the balance sheet date if the events are:

- a. those which provide further evidence of conditions that existed at the balance sheet date. A debtor declared insolvent and estate unable to pay full amount against whom provision for doubtful debt was created.
- b. those which are indicative of conditions that arose subsequent to the balance sheet date. An event which ceases the enterprise from been a going concern.

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. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date. Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions. 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. Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern.

#### 5.4 DISCLOSURE

Disclosure of events occurring after the balance sheet date require the following information should be provided:

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

#### 5.5 ILLUSTRATIONS

##### Illustration 1

Pure Oil Ltd. closed the books of accounts on March 31, 2006 for which financial statement was finalized by the Board of Directors on September 04, 2006. During the month of December 2005, company under took the project of laying a pipeline across the country and during May 2006 engineers realized that due to unexpected heavy rain, the total cost of the

## **1.48 Financial Reporting**

project will be inflated by Rs. 50 lakhs. How this should be provided for in the balance sheet of 2005-06 accordance to AS 4?

### **Solution**

This event occurred after March 31, 2006 but before September 04, 2006 it is event occurring after the balance sheet date. But this event is not affecting financial position on the date of balance sheet therefore it should be disclosed in the financial statement by the directors.

### **Illustration 2**

In preparing the financial statements of R Ltd. for the year ended 31st March, 2006, you come across the following information. State with reasons, how you would deal with this in the financial statements:

The company invested 100 lakhs in April, 2006 in the acquisition of another company doing similar business, the negotiations for which had started during the year.

### **Solution**

(b) Para 3.2 of AS 4 (Revised) defines "Events occurring after the balance sheet date" as 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. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2006. Applying para 15 which clearly states that/disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of Rs. 100 lakhs in April, 2006 in the acquisition of another company should be disclosed in the report of the Board of Directors to enable users of financial statements to make proper evaluations and decisions.

### **Illustration 3**

A Limited Company closed its accounting year on 30.6.2006 and the accounts for that period were considered and approved by the board of directors on 20th August, 2006. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2006 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of Rs. 80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.2006.

### **Solution**

Para 3.2 of AS 4 (Revised) on Contingencies and Events Occurring after the Balance Sheet Date defines 'events occurring after the balance sheet date' as 'significant events, both

favourable and unfavourable, that occur between the balance sheet date and the date on which financial statements are approved by the Board of Directors in the case of a company'. The given case is discussed in the light of the above mentioned definition and requirements given in paras 13-15 of the said AS 4 (Revised).

In this case the incidence, which was expected to push up cost became evident after the date of approval of the accounts. So that was not an 'event occurring after the balance sheet date'. However, this may be mentioned in the Directors' Report.

#### **Illustration 4**

While preparing its final accounts for the year ended 31st March, 2006 a company made a provision for bad debts @ 5% of its total debtors. In the last week of February, 2006 a debtor for Rs. 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 2006 the debtor became a bankrupt. Can the company provide for the full loss arising out of insolvency of the debtor in the final accounts for the year ended 31st March, 2006?

#### **Solution**

As per paras 8.2 and 13 of Accounting Standard 4 on Contingencies 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 estimation of amounts relating to conditions existing at the balance sheet date.

So full provision for bad debt amounting to Rs. 2 lakhs should be made to cover the loss arising due to the insolvency in the Final Accounts for the year ended 31<sup>st</sup> March, 2006. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31<sup>st</sup> March, 2006, then mere disclosure required as per para 15, would have been sufficient.

#### **Self-examination questions**

1. All events occurring after the balance sheet date should be considered in drawing up and finalising the balance sheet. Comment.
2. What do you mean by events occurring after the balance sheet?
3. Subsequent to the Balance sheet date of the Company, a Company has lost an important asset by fire. How will you deal with the above in the accounts?
4. In one of the manufacturing units of Ashoka Ltd., 40% of the total assets (of Ashoka Ltd.) were destroyed in a fire for which there was no insurance cover. The Chief Accountant of the Company contends that the destruction of the unit took place only after the date of the Balance Sheet and therefore there was no need to make disclosure of loss in the annual Accounts as at the Balance Sheet Date. Comment.

### **1.50 Financial Reporting**

5. A claim for damages of Rs.10 lakhs for breach of patents and copy rights had been served on Balan Ltd in January. The Directors sought competent legal advice on the eligibility of the claim and were advised that the claim was highly frivolous, without any basis and would not survive even in the first trial court. The Company, however, anticipates a long drawn legal battle and huge legal costs. The Company's accounting year ended on 31<sup>st</sup> March and the accounts for that period were considered and approved by the Board of Directors on 15<sup>th</sup> May. How will you treat the above in the accounts for the year ended 31<sup>st</sup> March?
4. Swami Ltd entered into an agreement to sell its immovable property included in the Balance sheet at Rs.5 lakhs to another Company for Rs.20 lakhs. The agreement to sell was concluded on 31<sup>st</sup> January but the sale deed was registered only on 30<sup>th</sup> April. The Company's accounting year ended on 31<sup>st</sup> March and the accounts for that period were considered and approved by the Board of Directors on 15<sup>th</sup> May. How will you treat the above in the accounts for the year ended 31<sup>st</sup> March?



## UNIT 6

### AS 5: NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES

Reference: The students are advised to refer the full text of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" (revised 1997) given in Appendix I at the end of the Study Material (Volume-II)

#### 6.1 INTRODUCTION

This revised standard AS 5 comes into effect in respect of accounting periods commencing on or after 1.4.1996 and is mandatory in nature. This Statement does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

#### 6.2 NET PROFIT OR LOSS FOR THE PERIOD

The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

**(a) Profit or loss from ordinary activities:** Any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities. For example profit on sale of merchandise, loss on sale of unsold stock at the end of the season.

**(b) Extraordinary items:** Income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. For example, profit on sale of furniture or heavy loss of goods due to fire.

Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived. Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an

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insurance enterprise that insures against such risks.

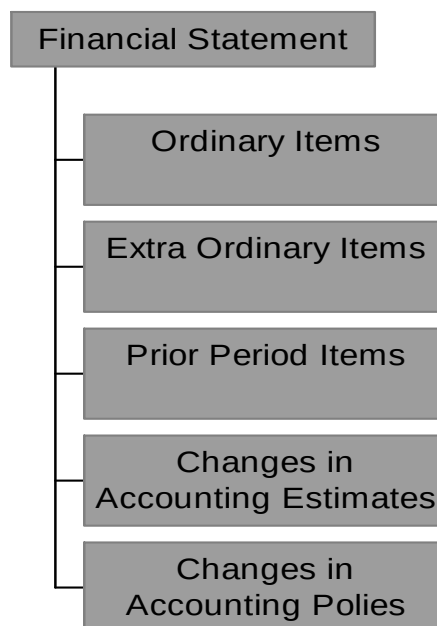
When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Circumstances which may give rise to the separate disclosure of items of income and expense include:

- (a) The write-down of inventories to net realisable value as well as the reversal of such write-downs.
- (b) A restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring.
- (c) Disposals of items of fixed assets.
- (d) Disposals of long-term investments.
- (e) Legislative changes having retrospective application.
- (f) Litigation settlements.
- (g) Other reversals of provisions.

### 6.3 PRIOR PERIOD ITEMS

Prior period items are income or expenses which arise in the current period as a result of

Disclosure under Following Category



errors or omissions in the preparation of the financial statements of one or more prior periods. Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

For example, Mr. Sachin purchased a new machine costing Rs. 10 lacs. Useful life was taken to be for 10 years therefore depreciation was charged at 10% on original cost each year. After 5 years when carrying amount was Rs. 5 lacs for the machine, management realizes that machine can work for another 2 years only and they decide to write off Rs. 2.5 lacs each year. This is not an example of prior period item but change in accounting estimate. In the same example management by mistake calculates the depreciation in the fifth year as 10% of Rs. 6,00,000 i.e. Rs. 60,000 instead of Rs. 1,00,000 and in the next year decides to write off Rs. 1,40,000. Rs. 1,00,000 current year's depreciation and Rs. 40,000 as prior period item.

#### 6.4 CHANGES IN ACCOUNTING ESTIMATES

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, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

- (a) The period of the change, if the change affects the period only; or
- (b) The period of the change and future periods, if the change affects both.

To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item.

#### 6.5 CHANGES IN ACCOUNTING POLICIES

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements. A change in an accounting policy should be made only if the adoption of a different accounting policy 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 presentation of the financial statements of the enterprise.

The following are not changes in accounting policies:

## **1.54 Financial Reporting**

(a) The adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement;

(b) The adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Accounting Policies can be changed only in the following cases:

- I. Compliance with Provisions of any Act.
- II. Compliance with any AS.
- III. New Policies presents more True and Fair Picture.

## **6.6 MISCELLANEOUS ILLUSTRATIONS**

### **Illustration 1**

The company has to pay delayed cotton clearing charges over and above the negotiated price for taking delayed delivery of cotton from the Suppliers' Godown. Upto 2004-05, the company has regularly included such charges in the valuation of closing stock. This being in the nature of interest the company has decided to exclude it from closing stock valuation for the year 2005-06. This would result into decrease in profit by Rs. 7.60 lakhs

### **Solution**

Para 29 of AS 5 (Revised) 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' states that a change in an accounting policy should be made only if the adoption of a different accounting policy 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 presentation of the financial statements of an enterprise. Therefore the change in the method of stock valuation is justified in view of the fact that the change is in line with the recommendations of AS 2 (Revised) 'Valuation of Inventories' and would result in more appropriate preparation of the financial statements. As per AS 2, this accounting policy adopted for valuation of inventories including the cost formulae used should be disclosed in the financial statements.

Also, appropriate disclosure of the change and the amount by which any item in the financial statements is affected by such change is necessary as per AS 1, AS 2 and AS 5. Therefore, the under mentioned note should be given in the annual accounts.

"In compliance with the Accounting Standards issued by the ICAI, delayed cotton clearing charges which are in the nature of interest have been excluded from the valuation of closing stock unlike preceding years. Had the company continued the accounting practice followed earlier, the value of closing stock as well as profit before tax for the year would have been higher by Rs. 7.60 lakhs."

**Illustration 2**

Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of Rs. 5.30 lakhs for the period October, 2000 to September, 2004 has been received and paid in February, 2005.

**Solution**

The final bill having been paid in February, 2005 should have been accounted for in the annual accounts of the company for the year ended 31st March, 2005. However it seems that as a result of error or omission in the preparation of the financial statements of prior period i.e., for the year ended 31st March 2005, this material charge has arisen in the current period i.e., year ended 31st March, 2006. Therefore it should be treated as 'Prior period item' as per para 16 of AS 5. As per para 19 of AS 5 (Revised), prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

It may be mentioned that it is an expense arising from the ordinary course of business. Although abnormal in amount or infrequent in occurrence, such an expense does not qualify an extraordinary item as per Para 10 of AS 5 (Revised). For better understanding, the fact that power bill is accounted for at provisional rates billed by the state electricity board and final adjustment thereof is made as and when final bill is received may be mentioned as an accounting policy.

**Illustration 3**

Sagar Limited belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31.03.96. You are required to advise the company on the following item from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards:

An audit stock verification during the year revealed that the opening stock of the year was understated by Rs. 3 lakhs due to wrong counting.

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### Solution

The wrong counting of opening stock of the current year/closing stock of the previous year must have also resulted in lowering of profits of previous year, brought forward to the current year. The adjustments are required to be made in the current year in respect of these errors in the preparation of the financial statements of the prior period and should therefore be treated as prior period adjustments as per AS 5 (Revised). Accordingly, the rectifications relating to both opening stock of the current year and profit brought forward from the previous year should be separately disclosed in the current statement of profit and loss together with their nature and amount in a manner that their impact on current profit or loss can be perceived.

### Illustration 4

There was a major theft of stores valued at Rs. 10 lakhs in the preceding year which was detected only during current financial year (2005-2006). How will you deal with this information in preparing the financial statements of R Ltd. for the year ended 31st March, 2006.

### Solution

Due to major theft of stores in the preceding year (2004-2005) which was detected only during the current financial year (2005-2006), there was overstatement of closing stock of stores in the preceding year. This must have also resulted in the overstatement of profits of previous year, brought forward to the current year. The adjustments are required to be made in the current year as 'Prior Period Items' as per AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies. Accordingly, the adjustments relating to both opening stock of the current year and profit brought forward from the previous year should be separately disclosed in the statement of profit and loss together with their nature and amount in a manner that their impact on the current profit or loss can be perceived.

**Note:** Alternatively, it may be assumed that in the preceding year, the value of stock of stores as found out by physical verification of stocks was considered in the preparation of financial statements of the preceding year. In such a case, only the disclosure as to the theft and the resulting loss is required in the notes to the accounts for the current year i.e., year ended 31st March, 2006.

### Illustration 5

- (i) During the year 2005-2006, a medium size manufacturing company wrote down its inventories to net realisable value by Rs. 5,00,000. Is a separate disclosure necessary?
- (ii) A Limited company has been including interest in the valuation of closing stock. In 2005-2006 the management of the company decided to follow AS 2 and accordingly interest has been excluded from the valuation of closing stock. This has resulted in a decrease in profits by Rs. 3,00,000. Is a disclosure necessary? If so, draft the same.
- (iii) A company signed an agreement with the Employees Union on 1.9.2005 for revision of

wages with retrospective effect from 30.9.2004. This would cost the company an additional liability of Rs. 5,00,000 per annum. Is a disclosure necessary for the amount paid in 2005-06 ?

### Solution

(i) Although the case under consideration does not relate to extraordinary item, but the nature and amount of such item may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Para 12 of AS 5 (Revised in 1997) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies states that :

“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.”

Circumstances which may give to separate disclosure of items of income and expense in accordance with para 12 of AS 5 include the write-down of inventories to net realisable value as well as the reversal of such write-downs.

(ii) As per AS 5 (Revised), change in accounting policy can be made for many reasons, one of these is for compliance with an accounting standard. In the instant case, the company has changed its accounting policy in order to conform with the AS 2 (Revised) on Valuation of Inventories. Therefore, a disclosure is necessary in the following lines by way of notes to the annual accounts for the year 2005-2006.

“To be in conformity with the Accounting Standard on Valuation of Inventories issued by ICAI, interest has been excluded from the valuation of closing stock unlike preceding years. Had the same principle been followed in previous years, profit for the year and its corresponding effect on the year end net assets would have been higher by Rs. 3,00,000.”

(iii) It is given that revision of wages took place on 1st September, 2006 with retrospective effect from 30.9.2005. Therefore wages payable for the half year from 1.10.2006 to 31.3.2006 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. 7,50,000 (for 1½ years @ Rs. 5,00,000 per annum) 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), 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

## **1.58 Financial Reporting**

nature and amount of such items should be disclosed separately.

### **Illustration 6**

While preparing its final accounts for the year ended 31st March, 2007 Rainbow Limited created a provision for Bad and Doubtful debts at 2% on trade debtors. A few weeks later the company found that payments from some of the major debtors were not forthcoming. Consequently the company decided to increase the provision by 10% on the debtors as on 31st March, 2007 as the accounts were still open awaiting approval of the Board of Directors. Is this to be considered as an extra-ordinary item or prior period item ? Comment.

### **Solution**

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 does not bring the resulting amount within the definition either of prior period item or of an extraordinary item [para 21, AS 5 (Revised)].

In the given case, Rainbow Limited created a provision for bad and doubtful debts at 2% on trade debtors while preparing its final accounts for the year ended 31st March, 2006. Subsequently, the company decided to increase the provision by 10%. 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 a material effect in the current period should be disclosed and quantified. Any change in an accounting estimate which is expected to have a material effect in later periods should also be disclosed.

### **Illustration 7**

The company finds that the stock sheets of 31.3.2006 did not include two pages containing details of inventory worth Rs. 14.5 lakhs. State, how you will deal with the following matters in the accounts of Omega Ltd. for the year ended 31st March, 2007 .

### **Solution**

Paragraph 4 of Accounting Standard 5 on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, defines Prior Period items as "income or expenses which 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".

Rectification of error in stock valuation is a prior period item vide Para 4 of AS 5. Rs.14.5 lakhs must be added to the opening stock of 1/4/2006. It is also necessary to show Rs. 14.5 lakhs as a prior period adjustment in the Profit and loss Account below the line. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.



**Self-examination Questions**

1. Define the following terms for the purpose of AS 5:
  - (a) Ordinary activities.
  - (b) Extraordinary Activities.
  - (c) Prior-period items.
  - (d) Accounting policies.
2. How should net profit or loss for a particular accounting period be recognized?
3. When should profit or loss from an ordinary activity be disclosed separately/
4. A change in an accounting estimate requires the same treatment in the financial statements as required for a prior period item. comment.
5. The accounts of a Company for the year 2003 – 04 were adopted by the Board of Directors on 31.8.2004. the Auditors had also audited the accounts and had signed the accounts on 1.9.2004. These audited accounts were adopted at the Shareholders' AGM on 30.9.2004.
6. Later the Directors found that the position reflected in the annual accounts is not reflected in the books of account and there is a variation in the figure of sales reported in annual accounts and sales as recorded in books of account. The Directors have decided to rectify this mistake. State, as an auditor whether the company can re-open and revise the audited and adopted accounts for the year 2003 – 04.

## UNIT 7

### AS 6: DEPRECIATION ACCOUNTING

Reference: The students are advised to refer the full text of AS 6 "Depreciation Accounting" (revised 1994) given in Appendix I at the end of the Study Material (Volume-II).

#### 7.1 INTRODUCTION

This revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1996 and is mandatory in nature.

This Statement deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply: -

- (i) Forests, plantations and similar regenerative natural resources;
- (ii) Wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;
- (iii) Expenditure on research and development;
- (iv) Goodwill;
- (v) Live stock.

This statement also does not apply to land unless it has a limited useful life for the enterprise.

#### 7.2 DEPRECIATION

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

#### 7.3 DEPRECIABLE ASSETS

Depreciable assets are assets which

- (i) Are expected to be used during more than one accounting period. Dies and blocks are written off on first year itself as their useful life ends within one year.
- (ii) Have a limited useful life. Depreciation is not charged on land as the useful of land cannot be determined, it is endless.
- (iii) Are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the

ordinary course of business. Depreciation is not charged on computers purchased for the purpose of resale but could not be sold till the end of the accounting year.

#### 7.4 DEPRECIABLE AMOUNT

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

Depreciable Amount = Historical Cost – Residual Value.

Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

- (i) Historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;
- (ii) Expected useful life of the depreciable asset; and
- (iii) Estimated residual value of the depreciable asset.

#### 7.5 HISTORICAL COST

Historical cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof.

For example, Mr. Rahul imported machine from Germany on the condition that machine will be run on trial basis for 15 days, if machine works perfectly it will be purchased or else it will be rejected. Now since trial run is the necessary condition for acquisition of the machinery, the cost incurred for trial run net of any revenue generated will be capitalized i.e. added to the historical cost of the machine.

The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

#### Illustration 1

Mr. X set up a new factory in the backward area and purchased plant for Rs. 500 lakhs for the purpose. Purchases were entitled for the CENVAT credit of Rs. 10 lakhs and also Government agreed to extend the 25% subsidy for backward area development. Determine the depreciable value for the asset.

#### Solution

| Particulars       | Rs.(in lakhs) |
|-------------------|---------------|
| Cost of the plant | 500           |
| Less: CENVAT      | <u>10</u>     |
|                   | 490           |
| Less: Subsidy     | <u>98</u>     |
| Depreciable Value | <u>392</u>    |

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### 7.6 USEFUL LIFE

Useful life of a depreciable asset is shorter than its physical life. Useful life is either

- (i) The period over which a depreciable asset is expected to be used by the enterprise; or
- (ii) The number of production or similar units expected to be obtained from the use of the asset by the enterprise.

### 7.7 ADDITIONS TO EXISTING ASSETS

Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life.

For example, the engine of an aircraft is replace, in this case since the life of engine is not depended on the life of the aircraft body, depreciation charged on both is recorded separately.

### 7.8 AMOUNT OF DEPRECIATION

The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

### 7.9 METHODS OF DEPRECIATION

There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straightline method and the reducing balance method. The management of a business selects the most appropriate method(s). A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired, e.g. books.

- (a) *Straight Line Method*: An equal amount is written off every year during the working life on an asset so as to reduce the cost of the asset to NIL or to its residual value at the end of its useful life.

$$\text{Straight Line Depreciation} = \frac{\text{Cost of Asset} - \text{Scrap Value}}{\text{Useful Life}}$$

$$\text{Depreciation Rate} = \frac{\text{Straight Line Depreciation} \times 100}{\text{Cost of Asset}}$$

This method of charging depreciation is recommended mostly for power generating units or for the assets where danger of obsolescence is low.

- (b) *Reducing Balance Method*: A fixed percentage of the diminishing value of the asset is written off each year so as to reduce the asset to its salvage value at the end of its life.

$$\text{Depreciation Rate} = \frac{1}{n} \left[ \frac{\text{Residual Value}}{\text{Cost of Asset}} \times 100 \right]$$

n = useful life.

This method is highly recommended mainly for manufacturing units though it is recommended for most of the enterprises.

Distinction between Straight Line and Written Down Value Method:

| Straight Line Method                                                                                   | Written Down Value                                                                                    |
|--------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------|
| 1. Amount of depreciation is calculated at a fixed percentage on the original cost of the fixed asset. | Amount of depreciation is calculated at a fixed percentage on written down value of the fixed amount. |
| 2. Amount of depreciation remains same year to year.                                                   | Amount of depreciation decreases year to year.                                                        |
| 3. At the end of the life, the value of asset can be zero.                                             | The value of assets never comes to zero.                                                              |
| 4. It is also known as Fixed Instalment Method or Constant Charge Method.                              | It is also known as Reducing or Diminishing Balance Method.                                           |
| 5. It is easy to calculate.                                                                            | It is difficult to calculate.                                                                         |
| 6. Depreciation + Repair keeps increasing.                                                             | Depreciation + Repairs more or less remains constant.                                                 |
| 7. Suitable for the assets that requires fewer repairs.                                                | Suitable for assets, which requires more repairs with passage of time.                                |

(c) *Sum of the Year Digit Method (SYD)*: Under this method, the rate of depreciation is charged on the original cost. However, the rate of depreciation for each year is a fraction in which the denominator is the sum of the year digits from 1 to n and numerator for the first year is n, for the second year n-1, for the third year n-2 and so on.

$$\text{Rate of Depreciation for each year is} = \frac{n - (x - 1)}{n(n + 1) / 2}$$

## 1.64 Financial Reporting

Where,  $n$  = useful life of the asset.

$x$  = number of years asset is in use.

- (d) *Machine Hour Method*: Where it is practically possible to keep a record of the actual running hours of each machine, depreciation may be calculated on the basis of hours that the concerned machine worked.

$$\text{Depreciation for year 'n'} = \frac{\text{Hours worked in n} \times (\text{Cost} - \text{Salvage Value})}{\text{Total Estimated Working Hours}}$$

This method is recommended for the assets mainly machinery, where in the cost of the asset was determined mainly based on the useful working hours of the machine.

- (e) *Depletion Method*: This method is used in case of mines, quarries etc. containing only a certain quantity of product. The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available.

$$\text{Depreciation for year 'n'} = \frac{\text{Qty. Extracted / Produced in 'n'} \times (\text{Cost} - \text{Residual Value})}{\text{Total Estimated Quantity}}$$

- (f) *Annuity Method*: This is a method of depreciation which also takes into account the element of interest on capital outlay and seeks to write off the value of the asset as well as the interest lost over the life of the asset. On that basis, the amount of depreciation to be annually provided in the account is ascertained from the Annuity Tables. Though the amount written off annually is constant, the interest in the earlier years being greater, only small amount of the capital outlay is written off. This proportion is reversed with the passage of time.

This method of charging depreciation is mostly recommended for leasehold assets.

- (g) *Sinking Fund Method*: If the sum involved in replacing the asset is large, than just providing for depreciation will not be sufficient, as because the concern may not have the ready fund available to replace the assets. For this purpose a Sinking Fund Account is created, a depreciation amount is credited to it. The amount is invested in some Government Securities. Every year the process is repeated, the interest received from such securities are also reinvested and these securities are sold at the end of the life of the asset, so that the concern has the ready fund to replace the asset.

## 7.10 BASIS FOR COMPUTATION OF DEPRECIATION

The statute governing an enterprise may provide the basis for computation of the depreciation. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that

envisaged by the statute can be applied only in accordance with requirements of the statute.

### 7.11 DISPOSAL OF ASSETS

Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, is disclosed separately.

### 7.12 CHANGE IN METHOD OF DEPRECIATION

When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective re-computation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed and it is charged or credited to Profit & Loss Account as per the case. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

#### Illustration 2

Mr. A purchased a machine on 01.04.2000 for Rs. 1,00,000. On 01.07.2001 he purchased another machine for Rs.1,50,000. On 01.10.2002, he purchased the third machine for Rs. 2,00,000 and on 31.12.2003 he sold the second machine for Rs. 1,25,000. On 31.03.2005 he decided to change the method of charging depreciation from Straight Line Method @ 10% p.a. to Written Down Value Method @ 15%.

#### Solution

*Working Note 1: Depreciation charged under old method:*

| Particulars                                       | Rs.     | Rs.           |
|---------------------------------------------------|---------|---------------|
| Purchase of first machine                         | 100,000 |               |
| Depreciation for 4 years (1,00,000 x 10% x 4)     |         | 40,000        |
| Purchase of third machine                         | 200,000 |               |
| Depreciation for 1.5 years (2,00,000 x 10% x 1.5) |         | 30,000        |
| Total Depreciation charged                        |         | <u>70,000</u> |

*Working Note 2: Depreciation to be charged under new method:*

| Year    | Opening WDV | Purchases          | Balance | Depreciation   | Closing WDV |
|---------|-------------|--------------------|---------|----------------|-------------|
|         | Rs.         | Rs.                | Rs.     | Rs.            | Rs.         |
| 2000-01 | ---         | 100,000            | 100,000 | 15,000         | 85,000      |
| 2001-02 | 85,000      | ---                | 85,000  | 12,750         | 72,250      |
| 2002-03 | 72,250      | 200,000            | 272,250 | 40,838         | 231,412     |
| 2003-04 | 231,412     | ---                | 231,412 | 34,712         | 196,700     |
|         |             | Total Depreciation |         | <u>103,300</u> |             |

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### Machine Account

| <i>Dr.</i>  |                    |                | <i>Cr.</i>  |                                  |                |
|-------------|--------------------|----------------|-------------|----------------------------------|----------------|
| <i>Date</i> | <i>Particulars</i> | <i>Rs.</i>     | <i>Date</i> | <i>Particulars</i>               | <i>Rs.</i>     |
| 01.04.2000  | To Bank            | 100,000        | 31.03.2001  | By Depreciation                  | 10,000         |
|             |                    |                |             | By Balance C/d.                  | 90,000         |
|             |                    | <u>100,000</u> |             |                                  | <u>100,000</u> |
| 01.04.2001  | To Balance B/d.    | 90,000         | 31.03.2002  | By Depreciation                  | 21,250         |
| 01.07.2001  | To Bank            | 150,000        |             | By Balance C/d.                  | 218,750        |
|             |                    | <u>240,000</u> |             |                                  | <u>240,000</u> |
| 01.04.2002  | To Balance B/d.    | 218,750        | 31.03.2003  | By Depreciation                  | 35,000         |
| 01.10.2002  | To Bank            | 200,000        |             | By Balance C/d.                  | 383,750        |
|             |                    | <u>418,750</u> |             |                                  | <u>418,750</u> |
| 01.04.2003  | To Balance B/d.    | 383,750        | 31.12.2003  | By Bank                          | 125,000        |
| 31.12.2003  | To Profit on Sale  | 12,500         | 31.03.2004  | By Depreciation                  | 41,250         |
|             |                    |                |             | By Balance C/d.                  | 230,000        |
|             |                    | <u>396,250</u> |             |                                  | <u>396,250</u> |
| 01.04.2004  | To Balance B/d.    | 230,000        | 31.03.2005  | By Profit & Loss A/c.            | 33,300         |
|             |                    |                |             | By Depreciation (1,96,700 x 15%) | 29,505         |
|             |                    |                |             | By Balance C/d.                  | 167,195        |
|             |                    | <u>230,000</u> |             |                                  | <u>230,000</u> |
| 01.04.2005  | To Balance B/d.    | 167,195        |             |                                  |                |

### 7.13 DISCLOSURE

The depreciation methods used, the total depreciation for the period for each class of assets, the gross amount of each class of depreciable assets and the related accumulated depreciation are disclosed in the financial statements along with the disclosure of other accounting policies. The depreciation rates or the useful lives of the assets are disclosed only if they are different from the principal rates specified in the statute governing the enterprise. In case the depreciable assets are revalued, the provision for depreciation is based on the revalued amount on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect on the amount of depreciation, the same is disclosed separately in the year in which revaluation is carried out. A change in the method of depreciation is treated as a change in an accounting policy and is disclosed accordingly.

### Self-examination Questions

1. What is depreciation and why is it provided?



2. What factors are considered while assessing and charging depreciation?
3. Gamma Ltd. has debited the building account with the cost of land on which the building stands and has provided for depreciation on such cost. As an auditor, how would you deal with the above matter?
4. How is useful life of an asset determined?
5. What are the methods available for computing and allocating depreciation?
6. Xeta Ltd. has set up its main plant on costal land. In view of the corrosive climate, the company felt that its machine life was reducing faster. Can the company charge a higher rate of depreciation?
7. In view A plant was depreciated under two different methods as under:

| Year | SLM<br>(Rs. in lakhs) | W.D.V.<br>(Rs. in lakhs) |
|------|-----------------------|--------------------------|
| 1    | 7.80                  | 21.38                    |
| 2    | 7.80                  | 15.80                    |
| 3    | 7.80                  | 11.68                    |
| 4    | <u>7.80</u>           | <u>8.64</u>              |
|      | <u>31.20</u>          | <u>57.50</u>             |
| 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.

## UNIT 8

### AS 7: CONSTRUCTION CONTRACTS

Reference: The students are advised to refer the full text of AS 7 "Construction Contracts" (revised 2002) given in Appendix I at the end of the Study Material (Volume-II).

#### 8.1 INTRODUCTION

AS 7, comes into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature. This Statement should be applied in accounting for construction contracts in the financial statements of contractors. The standard prescribes the accounting treatment of revenue and costs associated with construction contracts by laying down the guidelines regarding allocation of contract revenue and contract costs to the accounting periods in which the construction work is performed, since the construction activity is generally contracted and completed in more than one accounting period.

#### 8.2 DEFINITIONS OF THE TERMS USED IN THE STANDARD

**A construction contract** is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

**A fixed price contract** is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

**A cost plus contract** is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

#### 8.3 COMBINING AND SEGMENTING CONSTRUCTION CONTRACTS

When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

- (a) Separate proposals have been submitted for each asset;
- (b) Each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- (c) The costs and revenues of each asset can be identified.

A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

- (a) The group of contracts is negotiated as a single package;

- (b) The contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
- (c) The contracts are performed concurrently or in a continuous sequence.

A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

- (a) The asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
- (b) The price of the asset is negotiated without regard to the original contract price.

#### **8.4 CONTRACT REVENUE**

Contract revenue should comprise:

- (a) The initial amount of revenue agreed in the contract; and
- (b) Variations in contract work, claims and incentive payments:
  - (i) To the extent that it is probable that they will result in revenue; and
  - (ii) They are capable of being reliably measured.

Contract revenue is measured at the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

- (a) A contractor and a customer may agree to variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;
- (b) The amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;
- (c) The amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or
- (d) When a fixed price contract involves a fixed price per unit of output, contract revenue increases as the number of units is increased.

#### **8.5 CONTRACT COSTS**

Contract costs should comprise:

- (a) Costs that relate directly to the specific contract;
  - 1. Site labour costs, including site supervision;

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2. Costs of materials used in construction;
  3. Depreciation of plant and equipment used on the contract;
  4. Costs of moving plant, equipment and materials to and from the contract site;
  5. Costs of hiring plant and equipment;
  6. Costs of design and technical assistance that is directly related to the contract;
  7. The estimated costs of rectification and guarantee work, including expected warranty costs; and
  8. Claims from third parties.
- (b) Costs that are attributable to contract activity in general and can be allocated to the contract; and
1. Insurance;
  2. Costs of design and technical assistance that is not directly related to a specific contract; and
  3. Construction overheads.
- (c) Such other costs as are specifically chargeable to the customer under the terms of the contract.

Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

- (a) General administration costs for which reimbursement is not specified in the contract;
- (b) Selling costs;
- (c) Research and development costs for which reimbursement is not specified in the contract; and
- (d) Depreciation of idle plant and equipment that is not used on a particular contract.

## **8.6 RECOGNITION OF CONTRACT REVENUE AND EXPENSES**

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately.

In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

- (a) Total contract revenue can be measured reliably;

- (b) It is probable that the economic benefits associated with the contract will flow to the enterprise;
- (c) Both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
- (d) The contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

- (a) It is probable that the economic benefits associated with the contract will flow to the enterprise; and
- (b) The contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue. The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

- (a) The proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or
- (b) Surveys of work performed; or
- (c) Completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

When the outcome of a construction contract cannot be estimated reliably:

- (a) Revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and
- (b) Contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should be recognised as an expense immediately. During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recovered. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, even though the outcome of the contract cannot be estimated

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reliably, it may be probable that total contract costs will exceed total contract revenue. In such cases, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately.

The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate.

## **8.7 DISCLOSURE**

An enterprise should disclose:

- (a) The amount of contract revenue recognised as revenue in the period;
- (b) The methods used to determine the contract revenue recognised in the period; and
- (c) The methods used to determine the stage of completion of contracts in progress.

An enterprise should disclose the following for contracts in progress at the reporting date:

- (a) The aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;
- (b) The amount of advances received; and
- (c) The amount of retentions.

An enterprise should present:

- (a) The gross amount due from customers for contract work as an asset; and
- (b) The gross amount due to customers for contract work as a liability.

## **8.8 ILLUSTRATIONS**

### **Illustration 1**

B undertook a contract for Rs. 15,00,000 on an arrangement that 80% of the value of work done as certified by the architect of the contractee, should be paid immediately and that the remaining 20% be retained until the contract was completed.

In 2005, the amounts expended were Rs. 3,60,000; the work was certified for Rs. 3,00,000 and 80% of this was paid as agreed. It was estimated that future expenditure to complete the contract would be Rs. 10,00,000

In 2006, the amounts expended were Rs. 4,75,000. Three-fourths of the contract was certified as done by December 31<sup>st</sup> and 80% of this was received accordingly. It was estimated that future expenditure to complete the contract would be Rs. 4,00,000

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In 2007, the amounts expended were Rs. 3,10,000 and on June 30<sup>th</sup> the whole contract was completed.

Show how the contract revenue would be recognised in the profit & loss account for each year.

### Solution

| Particulars                   | 2005      | 2006      | 2007      |
|-------------------------------|-----------|-----------|-----------|
| Contract Price                | 1,500,000 | 1,500,000 | 1,500,000 |
| Less: Expenditure till date   | 360,000   | 835,000   | 1,145,000 |
|                               | 1,140,000 | 665,000   | 355,000   |
| Less: Expected Future Profits | 1,000,000 | 400,000   | -         |
| Profits                       | 140,000   | 265,000   | 355,000   |

|                         |     |         |         |
|-------------------------|-----|---------|---------|
| Stage of Completion     | 20% | 75%     | 100%    |
| Profit to be recognised | NIL | 133,163 | 355,000 |

### Illustration 2

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2007.

|                                      | (Rs. in lakhs) |
|--------------------------------------|----------------|
| Total Contract Price                 | 1,000          |
| Work Certified                       | 500            |
| Work not Certified                   | 105            |
| Estimated further Cost to Completion | 495            |
| Progress Payment Received            | 400            |
| To be Received                       | 140            |

The firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS 7 (Revised) issued by your institute.

### Solution

|                                                    |               |
|----------------------------------------------------|---------------|
| (a) Amount of foreseeable loss                     | (Rs in lakhs) |
| Total cost of construction (500 + 105 + 495)       | 1,100         |
| Less: Total contract price                         | <u>1,000</u>  |
| Total foreseeable loss to be recognized as expense | <u>100</u>    |

According to para 35 of AS 7 (Revised 2002), when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

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|                                                                            |                      |
|----------------------------------------------------------------------------|----------------------|
| (b) Contract work-in-progress i.e. cost incurred to date are Rs. 605 lakhs | <i>(Rs in lakhs)</i> |
| Work certified                                                             | 500                  |
| Work not certified                                                         | <u>105</u>           |
|                                                                            | <u>605</u>           |

This is 55% ( $605/1,100 \times 100$ ) of total costs of construction.

- (c) Proportion of total contract value recognised as revenue as per para 21 of AS 7 (Revised).

55% of Rs. 1,000 lakhs = Rs. 550 lakhs

- (d) Amount due from/to customers = Contract costs + Recognised profits – Recognised losses – (Progress payments received + Progress payments to be received)
- = [605 + Nil – 100 – (400 + 140)] Rs. in lakhs
- = [605 – 100 – 540] Rs. in lakhs
- Amount due to customers = Rs. 35 lakhs

The amount of Rs. 35 lakhs will be shown in the balance sheet as liability.

- (e) The relevant disclosures under AS 7 (Revised) are given below:

|                                                      |                     |
|------------------------------------------------------|---------------------|
|                                                      | <i>Rs. in lakhs</i> |
| Contract revenue                                     | 550                 |
| Contract expenses                                    | 605                 |
| Recognised profits less recognized losses            | (100)               |
| Progress billings (400 + 140)                        | 540                 |
| Retentions (billed but not received from contractee) | 140                 |
| Gross amount due to customers                        | 35                  |

#### Illustration 3

On 1st December, 2005, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for Rs. 85 lakhs. On 31st March, 2006 the company found that it had already spent Rs. 64,99,000 on the construction. Prudent estimate of additional cost for completion was Rs. 32,01,000. What amount should be charged to revenue in the final accounts for the year ended 31st March, 2006 as per provisions of Accounting Standard 7 (Revised)?



**Solution**

| (a)                                                | Rs.              |
|----------------------------------------------------|------------------|
| Cost incurred till 31 <sup>st</sup> March, 2006    | 64,99,000        |
| Prudent estimate of additional cost for completion | <u>32,01,000</u> |
| Total cost of construction                         | 97,00,000        |
| Less: Contract price                               | <u>85,00,000</u> |
| Total foreseeable loss                             | <u>12,00,000</u> |

According to para 35 of AS 7 (Revised 2002), the amount of Rs. 12,00,000 is required to be recognized as an expense.

$$\text{Contract work in progress} = \frac{\text{Rs. } 64,99,000 \times 100}{97,00,000} = 67\%$$

Proportion of total contract value recognized as turnover as per para 21 of AS 7 (Revised) on Construction Contracts.

$$= 67\% \text{ of Rs. } 85,00,000 = \text{Rs. } 56,95,000.$$

**Self-examination Questions**

1. Define Fixed price contract and Cost plus contract under AS 7.
2. Write short note on combining and segmenting construction contracts.
3. What are the components of contract revenue?
4. How is the stage of completion determined?
5. Compute the percentage of completion and the Contract Revenues and Costs to be recognized from the following data.
  - ◆ Contract Price – Rs.75 lakhs
  - ◆ Materials issued to the Contract – Rs.18 lakhs of which materials costing Rs.3 lakhs is still lying unused at the end of the period.
  - ◆ Labour paid for workers engaged at site – Rs.12 lakhs (Rs.2 lakhs is still payable)
  - ◆ Specific Contract Costs – Rs.6 lakhs; Sub-Contract Costs for work executed – Rs.5 lakhs; Advances paid to sub-contractors- Rs.3 lakhs.
  - ◆ Cost estimated to be incurred to complete the contract – Rs.30 lakhs.
6. A company undertakes a number of contracts. Following particulars are extracted in respect of certain loss-making contracts. Determine the amount of expected loss that should be recognized in the accounts for the year. (information in Rs. Lakhs)

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| <i>Contract</i>                                        | <i>A</i> | <i>B</i> | <i>C</i> |
|--------------------------------------------------------|----------|----------|----------|
| Contract Price                                         | 15.00    | 12.50    | 87.50    |
| Cost incurred till date                                | 12.00    | 10.90    | 2.50     |
| Costs expected to be incurred to complete the contract | 4.00     | 3.60     | 88.00    |

## UNIT 9

### AS 9: REVENUE RECOGNITION

Reference: The students are advised to refer the full text of AS 9 "Revenue Recognition" (issued 1985) given in Appendix I at the end of the Study Material (Volume-II).

#### 9.1 INTRODUCTION

This statement was issued by ICAI in the year 1985 and in the initial years it was recommendatory for only level I enterprises and but was made mandatory for enterprise in India from April 01, 1993.

#### 9.2 REVENUE

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

This Statement does not deal with the following aspects of revenue recognition to which special considerations apply:

- (i) Revenue arising from construction contracts;
- (ii) Revenue arising from hire-purchase, lease agreements;
- (iii) Revenue arising from government grants and other similar subsidies;
- (iv) Revenue of insurance companies arising from insurance contracts.

Examples of items not included within the definition of "revenue" for the purpose of this Statement are:

- (i) Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;
- (ii) Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;
- (iii) Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;
- (iv) Realised gains resulting from the discharge of an obligation at less than its carrying amount;

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- (v) Unrealised gains resulting from the restatement of the carrying amount of an obligation.

### 9.3 SALE OF GOODS

A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Statement, are sometimes recognised in the statement of profit and loss and appropriately described.

### 9.4 RENDERING OF SERVICES

Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

**Proportionate completion method** is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract. Here performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act.

**Completed service contract method** is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed. In this method performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable

### 9.5 INTEREST, ROYALTIES AND DIVIDENDS

The use by others of such enterprise resources gives rise to:

- (i) Interest: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognized on a time proportion basis taking into account the amount outstanding and the rate applicable. For example, debenture interest payable on every June 30<sup>th</sup> and December 31<sup>st</sup>. On March 31<sup>st</sup> when books will be closed, though interest

has not fallen due but still interest for the period January, February and March will be recognised on time basis.

- (ii) **Royalties:** charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognized on an accrual basis in accordance with the terms of the relevant agreement. If agreement is signed for royalty payable on the basis of the number of copies of the book published, it will be recognised on that basis only.
- (iii) **Dividends:** rewards from the holding of investments in shares. Revenue is recognized when the owner's right to receive payment is established. Unless company declare dividend on the shares, it is not certain. Therefore it is recognised only when directors actually decides to pay dividend to their shareholders.

## 9.6 EFFECT OF UNCERTAINTIES ON REVENUE RECOGNITION

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. In such cases:

When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

## 9.7 DISCLOSURE

An enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

### Revised ASI 14, Disclosure of Revenue from Sales Transactions (Re.: AS 9):

The amount of turnover should be disclosed in the following manner on the face of the statement of profit and loss:

|                   |              |
|-------------------|--------------|
| Turnover (Gross)  | XXXXX        |
| Less: Excise Duty | <u>XXXXX</u> |
| Turnover (Net)    | <u>XXXXX</u> |

The amount of excise duty to be shown as deduction from turnover should be the total excise duty for the year except the excise duty related to the difference between the closing stock and opening stock. The excise duty related to the difference between the closing stock and opening stock should be recognised separately in the statement of profit and loss, with an explanatory note in the

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notes to accounts to explain the nature of the two amounts of excise duty.

### 9.8 ILLUSTRATIONS

#### Illustration 1

The stages of production and sale of a producer are as follows (all in Rupees):

| Stage | Activity         | Costs to date | Net Realisable Value |
|-------|------------------|---------------|----------------------|
| A     | Raw Materials    | 10,000        | 8,000                |
| B     | WIP 1            | 12,000        | 13,000               |
| C     | WIP 2            | 15,000        | 19,000               |
| D     | Finished Product | 17,000        | 30,000               |
| E     | Ready for Sale   | 17,000        | 30,000               |
| F     | Sale Agreed      | 17,000        | 30,000               |
| G     | Delivered        | 18,000        | 30,000               |
| H     | Paid For         | 18,000        | 30,000               |

State and explain the stage at which you think revenue will be recognized and how much would be gross profit and net profit on a unit of this product?

#### Solution

According to AS – 9, sales will be recognized only following two conditions are satisfied:

- (i) The sale value is fixed and determinable.
- (ii) Property of the goods is transferred to the customer.

Both these conditions are satisfied only at Stage F when sales are agreed upon at a price and goods allocated for delivery purpose.

Gross Profit will be determined at Stage E, when goods are ready for sale after all necessary process for production is over i.e. Rs. 13,000 (30,000 – 17,000).

Net Profit will be determined at Stage H, when goods are delivered and payment collected i.e. Rs. 12,000 (30,000 – 18,000).

#### Illustration 2

A public sector company is trading gold in India for its customers, after purchasing gold the price of gold is fixed within 120 days as per rules and regulations of Indian Bullion Market by the customer. At the close of year, price of some gold was not fixed on March 31, 2006. The details are given below:

|                                                                                     |   |                    |
|-------------------------------------------------------------------------------------|---|--------------------|
| Quantity of Gold                                                                    | = | 10,000 TT Bars     |
| Gold Rate as on March 31, 2006                                                      | = | Rs. 275 per TT Bar |
| Gold Rate was fixed on June 26, 2006 before the finalization of accounts of company | = | Rs. 273 per TT Bar |

Calculate the amount of sales regarding 10,000 TT Bars to be booked in the company's account for the year ended March 31, 2006.

### **Solution**

We need to refer to AS 5 along with AS 9 in this case, since gold is an item which has ready market hence they should be valued at the market price. So, as event occurring after the balance sheet date, the price of gold is fixed at Rs. 273 per TT Bar, gold will be valued at that rate.

### **Illustration 3**

The Board of Directors decided on 31.3.2006 to increase the sale price of certain items retrospectively from 1st January, 2006. In view of this price revision with effect from 1st January 2006, the company has to receive Rs. 15 lakhs from its customers in respect of sales made from 1st January, 2006 to 31st March, 2006 and the Accountant cannot make up his mind whether to include Rs. 15 lakhs in the sales for 2005-2006.

### **Solution**

Price revision was effected during the current accounting period 2005-2006. As a result, the company stands to receive Rs. 15 lakhs from its customers in respect of sales made from 1st January, 2006 to 31st March, 2006. If the company is able to assess the ultimate collection with reasonable certainty, then additional revenue arising out of the said price revision may be recognised in 2005-2006 vide Para 10 of AS 9.

### **Illustration 4**

Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. received Rs. 10 lakhs and Rs. 15 lakhs as interest and royalties respectively from Y Co. Ltd. during the year 2006-07. You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.

### **Solution**

As per para 13 of AS 9 on Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest and royalties should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

- (i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable.
- (ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement.

## **1.82 Financial Reporting**

### **Illustration 5**

A claim lodged with the Railways in March, 2004 for loss of goods of Rs. 2,00,000 had been passed for payment in March, 2000 for Rs. 1,50,000. No entry was passed in the books of the Company, when the claim was lodged. Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 2007.

#### **Solution**

Prudence suggests non-consideration of claim as an asset in anticipation. So receipt of claims is generally recognised on cash basis. Para 9.2 of AS 9 on Revenue Recognition states that where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. Para 9.5 of AS 9 states that when recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised. In this case it may be assumed that collectability of claim was not certain in the earlier periods. This is supposed from the fact that only Rs. 1,50,000 were collected against a claim of Rs. 2,00,000. So this transaction can not be taken as a Prior Period Item.

In the light of revised AS 5, it will not be treated as extraordinary item. However, para 12 of AS 5 (Revised) states that 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. Accordingly, the nature and amount of this item should be disclosed separately as per para 12 of AS 5 (Revised).

### **Illustration 6**

SCL Ltd., sells agriculture products to dealers. One of the condition of sale is that interest is payable at the rate of 2% p.m., for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2005-2006 the company wants to recognise the entire interest receivable. Do you agree?

#### **Solution**

As per para 9.2 of AS 9 on Revenue Recognition, where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc, revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

Thus, SCL Ltd. cannot recognise the interest amount unless the company actually receives it. 10% rate of recovery on overdue outstandings is also an estimate and is not certain. Hence, the company is advised to recognise interest receivable only on receipt basis.



**Self-examination Questions**

1. Write short note on effect of uncertainties on revenue recognition.
2. List the items of revenue that are covered by AS 9.
3. When is revenue from sale of goods recognised?
4. When is revenue from the use by others of enterprise resources yielding interest , royalties and dividends recognised?
5. Victory Ltd. purchased goods on credit from Lucky Ltd. for Rs.250 crores for export. The export order was cancelled. Victory Ltd. decided to sell the same goods in the local market with a price discount. Lucky Ltd. was requested to offer a price discount of 15%. The Chief Accountant of Lucky Ltd. wants to adjust the sales figure to the extent of the discount requested by Victory Ltd. Discuss whether this treatment is justified.
6. Bottom Ltd. entered into a sale deed for its immovable property before the end of the year. But registration was done with registrar subsequent to Balance Sheet date. But before finalisation, is it possible to recognise the sale and the gain at the Balance Sheet date? Give your view with reasons.
7. A company has purchased plant and machinery in the year 2001-2002 for Rs. 45 lakhs. A balance of Rs. 5 lakhs is still payable to the suppliers for the same. The supplier waived off the balance amount during the financial year 2004-2005. The company treated it as income and credited to profit and loss account during 2004-2005.

Whether accounting treatment of the company is correct. If not, state with reasons.

## UNIT 10

### AS 10: ACCOUNTING FOR FIXED ASSETS

Reference: The students are advised to refer the full text of AS 10 "Accounting for Fixed Assets" (issued 1985) given in Appendix I at the end of the Study Material (Volume-II).

#### 10.1 INTRODUCTION

The standard deals with the disclosure of the status of the fixed assets in terms of value. The standard does not take into consideration the specialized aspect of accounting for fixed assets reflected with the effects of price escalations but applies to financial statements on historical cost basis. It is important to note that after introduction of AS 16; 19 & 26, provisions relating to respective AS are held withdrawn and the rest is mandatory from the accounting year 1-4-2000. An entity should disclose (i) the gross and net book values of fixed assets at beginning and end of an accounting period showing additions, disposals, acquisitions and other movements, (ii) expenditure incurred on account of fixed assets in the course of construction or acquisition, (iii) revalued amounts substituted for historical costs of fixed assets with the method applied in computing the revalued amount.

This statement does not deal with accounting for the following items to which special considerations apply:

- (i) Forests, plantations and similar regenerative natural resources.
- (ii) Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.
- (iii) Expenditure on real estate development and
- (iv) Livestock.

#### 10.2 IDENTIFICATION OF FIXED ASSETS

Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business. Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.

#### 10.3 ACCOUNTING STANDARDS INTERPRETATION (ASI 2):

Whether to capitalise a machinery spare or not will depend on the facts and circumstances of each case. However, the machinery spares of the following types should be capitalised being of the nature of capital spares/insurance spares -

- ◆ Machinery spares which are specific to a particular item of fixed asset, i.e., they can be used only in connection with a particular item of the fixed asset and their use is expected to be irregular.
- ◆ Machinery spares of the nature of capital spares/insurance spares should be capitalised separately at the time of their purchase whether procured at the time of purchase of the fixed asset concerned or subsequently. The total cost of such capital spares/insurance spares should be allocated on a systematic basis over a period not exceeding the useful life of the principal item, i.e., the fixed asset to which they relate.
- ◆ When the related fixed asset is either discarded or sold, the written down value less disposal value, if any, of the capital spares/insurance spares should be written off.
- ◆ The stand-by equipment is a separate fixed asset in its own right and should be depreciated like any other fixed asset.

#### 10.4 COMPONENTS OF COST

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value. The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement.

#### 10.5 SELF-CONSTRUCTED FIXED ASSETS

Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.

##### Illustration 1

ABC Ltd. is constructing a fixed asset. Following are the expenses incurred on the construction:

|                 |               |
|-----------------|---------------|
| Materials       | Rs. 10,00,000 |
| Direct Expenses | Rs. 2,50,000  |

## 1.86 Financial Reporting

|                                                                                  |              |
|----------------------------------------------------------------------------------|--------------|
| Total Direct Labour                                                              | Rs. 5,00,000 |
| (1/10 <sup>th</sup> of the total labour time was chargeable to the construction) |              |
| Total office & administrative expenses                                           | Rs. 8,00,000 |
| (5% is chargeable to the construction)                                           |              |
| Depreciation on the assets used for the construction of this assets              | Rs. 10,000   |
| Calculate the cost of fixed assets.                                              |              |

### Solution

#### Calculation of the cost of construction of Assets

| <i>Particulars</i>               | <i>Rs.</i>       |
|----------------------------------|------------------|
| Direct Materials                 | 1,000,000        |
| Direct Labour                    | 50,000           |
| Direct Expenses                  | 250,000          |
| Office & Administrative Expenses | 40,000           |
| Depreciation                     | 10,000           |
| Cost of the Asset                | <u>1,350,000</u> |

## 10.6 NON-MONETARY CONSIDERATION

When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. When a fixed asset is acquired in exchange for shares or other securities in the enterprise, it is usually recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

Fair market value is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

## 10.7 IMPROVEMENTS AND REPAIRS

Any expenditure that increase 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. A computer with 20GB hard disk crashed and was replaced with a 80GB hard disk, will be capitalised and added to the cost of the computer. The cost of an addition or extension to an existing asset, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately. Current engine of an aircraft replaced with the new one on being damaged beyond repairs will be treated as a separate asset, as it has its own separate identity.

### 10.8 AMOUNT SUBSTITUTED FOR HISTORICAL COST

The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation. Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the different categories of fixed assets. In such cases, it is necessary to disclose the gross book value included on each basis. It is not appropriate for the revaluation of a class of assets to result in the net book value of that class being greater than the recoverable amount of the assets of that class. An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. Journal entry is as follow:

Fixed Asset Account Dr.

To Revaluation Reserve Account

A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve.

For example, Journal entry for decrease in the value of the asset on revaluation from Rs. 1,00,000 to Rs. 70,000, if Revaluation Reserve is appearing at Rs. 10,000 will be done as:

Revaluation Reserve Account Dr. Rs. 10,000

Loss on Revaluation Account Dr. Rs. 20,000

To Fixed Assets Account

Rs. 30,000

### 10.9 RETIREMENTS AND DISPOSALS

Items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Any expected loss is recognised immediately in the profit and loss statement. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve.

For example, the journal entries for the sale of an asset for Rs. 1,00,000 appearing in the books at Rs. 1,15,000, if Revaluation Reserve is appearing at Rs. 20,000 will be as follow:.

## 1.88 Financial Reporting

|                             |     |              |              |
|-----------------------------|-----|--------------|--------------|
| Bank Account                | Dr. | Rs. 1,00,000 |              |
| Revaluation Reserve Account | Dr. | Rs. 15,000   |              |
| To Fixed Assets Account     |     |              | Rs. 1,15,000 |
| Revaluation Reserve Account | Dr. | Rs. 5,000    |              |
| To General Reserve Account  |     |              | Rs. 5,000    |

### 10.10 HIRE PURCHASES

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 narration to indicate that the enterprise does not have full ownership thereof.

### 10.11 JOINT OWNERSHIP

Where an enterprise owns fixed assets jointly with others, the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation 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.

### 10.12 GOODWILL

Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

### 10.13 DISCLOSURE

- (i) Gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;
- (ii) Expenditure incurred on account of fixed assets in the course of construction or acquisition; and
- (iii) Revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of any indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

### 10.14 ILLUSTRATIONS

#### Illustration 2

On March 01, 2007, X Ltd. purchased Rs. 5 lakhs worth of land for a factory site. Company

demolished an old building on the property and sold the material for Rs. 10,000. Company incurred additional cost and realized salvaged proceeds during the March 2007 as follows:

|                                                          |            |
|----------------------------------------------------------|------------|
| Legal fees for purchase contract and recording ownership | Rs. 25,000 |
| Title guarantee insurance                                | Rs. 10,000 |
| Cost for demolition of building                          | Rs. 50,000 |

Compute the balance to be shown in the land account on March 31, 2007 balance sheet.

### Solution

#### Calculation of the cost for Purchase of Land

| Particulars                     | Rs.            |
|---------------------------------|----------------|
| Cost of Land                    | 500,000        |
| Legal Fees                      | 25,000         |
| Title Insurance                 | 10,000         |
| Cost of Demolition              | 50,000         |
| Less: Salvage value of Material | <u>10,000</u>  |
| Cost of the Asset               | <u>575,000</u> |

### Illustration 3

- (i) T. Ltd. imported fixed assets worth Rs. 1,000 lacs on 1.4.2005, when the exchange rate was Rs. 40 per US \$. The assets were fully financed by foreign currency loan repayable in five equal annual installments. As on 31.3.2006, the first installment was paid at the Exchange Rate of Rs. 42.
- (ii) The company's fixed assets stood at Rs. 3,000 lacs as on 1.4.2005. It provides depreciation at 10% per annum under the WDV method. However it noticed that about Rs. 500 lacs worth of non-imported assets acquired on 1.4.2005 will be obsolete in 2 years time. It wants to write off these assets over 2 years.
- (iii) A few days after the beginning of the year, the company acquired assets for Rs. 500 lacs on which it received a government grant of 10%.

Prepare a schedule as on 31.3.2006 in respect of the above three categories of assets and support the schedule with relevant accounting standards.

## 1.90 Financial Reporting

### Solution

*In the Books of T Ltd.*

#### **Schedule of Fixed Assets as on 31st March, 2006**

(Amount in Rs. lacs)

| Fixed Assets                     | Gross Block (at cost) |              |         |              |           | Depreciation |            |            | Net Block    |              |
|----------------------------------|-----------------------|--------------|---------|--------------|-----------|--------------|------------|------------|--------------|--------------|
|                                  | As at                 | Additi       | Deducti | As at        | Up to     | For the      | On         | Total upto | As at        | As at        |
|                                  | 1.4.2005              | ons          | ons     | 31.3.2006    | 31.3.2005 | year         | Deductions | 31.3.2006  | 31.3.2006    | 31.3.2005    |
| Imported Assets                  | –                     | 1,000        | –       | 1,000        | –         | 100          | –          | 100        | 900          | –            |
| Non - Imported                   | –                     | 500          | –       | 500          | –         | 250          | –          | 250        | 250          | –            |
| Assets (acquired<br>on 1.4.2005) |                       |              |         |              |           |              |            |            |              |              |
| Other Assets                     | <u>3,000</u>          | <u>450</u>   | –       | <u>3,450</u> | –         | <u>345</u>   | –          | <u>345</u> | <u>3,105</u> | <u>3,000</u> |
| Total                            | <u>3,000</u>          | <u>1,950</u> | –       | <u>4,950</u> | –         | <u>695</u>   | –          | <u>695</u> | <u>4,255</u> | <u>3,000</u> |

- (1) As per para 13 of AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognized as income/expense in the period in which they arise.

Calculation of Exchange Difference:

$$\text{Foreign currency loan} = \frac{\text{Rs.1,000 lacs}}{\text{Rs. 40}}$$

$$= 25 \text{ lacs US \$}$$

$$\text{Exchange difference} = 25 \text{ lacs US \$} \times (42 - 40)$$

$$= \text{Rs. 50 lacs (including exchange loss on payment of first instalment)}$$

Thus, exchange loss of Rs. 50 lakhs should be recognized as expense in the profit and loss account for the year ended 31st March, 2006.

- (2) It was noticed that about Rs. 500 lacs worth of non-imported assets acquired on 1.4.2005 will be obsolete in two years time. Hence, these assets have been written off at the rate of 50%.
- (3) Para 14 of AS 12 on Accounting for Government Grants regards two methods of presentation of grants related to specific fixed assets in financial statements. Under the first method which has been applied in the given case, the grant is shown as a deduction from the gross value of the fixed assets in arriving at its book value. Thus, only 90% of the cost of fixed assets has been shown as addition after adjusting the grant amount.



Alternatively, the grant can be treated as a deferred income which should be recognised in the profit and loss statement over the useful life of fixed assets in the proportions in which depreciation on the assets will be charged.

**Note:** As regards fixed assets standing at Rs. 3,000 lacs as on 1.4.2005, in the absence of information in respect of cost and depreciation amount provided upto 31.3.2005, the entire given amount has been shown under gross block as at 1.4.2005.

#### Illustration 4

J Ltd. purchased machinery from K Ltd. on 30.09.2005. The price was Rs. 370.44 lakhs after charging 8% Sales-tax and giving a trade discount of 2% on the quoted price. Transport charges were 0.25% on the quoted price and installation charges come to 1% on the quoted price.

A loan of Rs. 300 lakhs was taken from the bank on which interest at 15% per annum was to be paid.

Expenditure incurred on the trial run was Materials Rs. 35,000, Wages Rs. 25,000 and Overheads Rs. 15,000.

Machinery was ready for use on 1.12.2005. However, it was actually put to use only on 1.5.2006. Find out the cost of the machine and suggest the accounting treatment for the expenses incurred in the interval between the dates 1.12.2005 to 1.5.2006. The entire loan amount remained unpaid on 1.5.2006.

#### Solution

| (a)                                                                        | Rs. (in Lakhs) | (Rs. in Lakhs) |
|----------------------------------------------------------------------------|----------------|----------------|
| Quoted price (refer to working note)                                       | 350.00         |                |
| Less: 2% Trade Discount                                                    | <u>7.00</u>    |                |
|                                                                            | 343.00         |                |
| Add: 8% Sales tax (8% × Rs. 343 lakhs)                                     | <u>27.44</u>   | 370.44         |
| Transport charges (0.25% × Rs. 350 lakhs)                                  |                | 0.88 (approx.) |
| Installation charges (1% × Rs. 350 lakhs)                                  |                | 3.50           |
| Financing cost (15% on Rs.300 Lakhs) for the period 30.9.2005 to 1.12.2005 |                | 7.50           |
| Trial Run Expenses                                                         |                |                |
| Material                                                                   | 0.35           |                |
| Wages                                                                      | 0.25           |                |
| Overheads                                                                  | <u>0.15</u>    | <u>0.75</u>    |
| Total cost                                                                 |                | <u>383.07</u>  |

## 1.92 Financial Reporting

Interest on loan for the period 1.12.2005 to 1.05.2006 is Rs. 300 lakhs  $\times \frac{15}{100} \times \frac{5}{12}$

= Rs.18.75 lakhs

This expenditure may be charged to Profit and Loss Account or deferred for amortization between say three to five years. It has been assumed that no other expenses are incurred on the machine during this period.

### Working Note:

Let the quoted price 'X'

Less: Trade Discount 0.02X.

Actual Price = 0.98X.

Sale Tax @8% = 1.08 × 0.98X

or  $X = \frac{\text{Rs. 370.44 lakhs}}{1.08 \times 0.98} = \text{Rs. 350 lakhs}$

### Self-examination Questions

1. When is an item of expenditure capitalised as a fixed asset?
2. ABC Ltd. wants to know the correct accounting policy relating to machinery spares which can be used only in connection with an item of fixed assets and whose use is expected to be irregular. Presently these costs are being charged to revenue. Advise.
3. What are the components of historical cost of fixed assets?
4. Are administrative overheads included as part of fixed asset cost?
5. Discuss the procedure for determination of cost of fixed assets acquired in exchange for other fixed assets.
6. Discuss the treatment of revaluation of fixed assets when historical costs are substituted.
7. During the current year, Mudra Ltd. Made the following expenditure relating to its Plant Building: (in Rs. Lakhs) Routine Repairs – 4.00; Repainting – 1.00; Partial replacement of roof tiles – 0.50; Substantial improvement to the electrical wiring system, which will increase efficiency 10.00. What amount should be capitalised?
8. An old car of a company having a very nominal book value has impressed a buyer, who is willing to pay Rs.1 lakh for it. The Company proposes not to sell the car, but to neglect its valuation in its accounts at Rs.1 lakh. Can the company do so?
9. Mukesh Ltd. Transferred Land from "Fixed Assets" to "Current Assets" at market price and adjusted the excess value under "Capital Reserve" instead of "Revaluation Reserve". In

subsequent years, the value was written down gradually as "Decline in Market Value". Comment on the validity of this accounting treatment.

10. A Computerised Machinery was purchased by two companies jointly. The price was shared equally. It was also agreed that both companies would use the machinery equally and show in their balance sheets, 50% of the value of machinery and charge 50% of the depreciation in their respective books of accounts. Comment on this accounting treatment.

## UNIT 11

### AS 11: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

Reference: The students are advised to refer the full text of AS 11 "The Effects of Changes in Foreign Exchange Rates" (revised 2003) given in Appendix I at the end of the Study Material (Volume-II).

#### 11.1 INTRODUCTION

AS 11, (revised 2003), comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The standard deals with the issues involved in accounting for foreign currency transactions and foreign operations i.e., to decide which exchange rate to use and how to recognize the financial effects of changes in exchange rates in the financial statements. The standard requires the enterprises to disclose (i) the amount of exchange differences included in the net profit or loss for the period (ii) the amount of exchange differences adjusted in the carrying amount of fixed assets, (iii) the amount of exchange differences in respect of forward exchange contracts to be recognized in the profit or loss in one or more subsequent accounting periods (over the life of the contract).

#### 11.2 SCOPE

This Statement should be applied:

- (a) In accounting for transactions in foreign currencies.
- (b) In translating the financial statements of foreign operations.
- (c) This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.

This Statement does not:

- (a) Specify the currency in which an enterprise presents its financial statements.
- (b) Deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation.
- (c) Deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

#### 11.3 DEFINITIONS OF THE TERMS USED IN THE STANDARD

**A foreign currency transaction** is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

- (a) Buys or sells goods or services whose price is denominated in a foreign currency.

- (b) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.
- (c) Becomes a party to an unperformed forward exchange contract or
- (d) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

**Monetary items** are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. For example, cash, receivables and payables.

**Non-monetary items** are assets and liabilities other than monetary items. For example, fixed assets, inventories and investments in equity shares.

**Foreign operation** is a subsidiary, associate, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

**Integral foreign operation** is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations.

**Non-integral foreign operation** is a foreign operation that is not an integral foreign operation. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

**Forward exchange contract** means an agreement to exchange different currencies at a forward rate.

**Forward rate** is the specified exchange rate for exchange of two currencies at a specified future date.

#### 11.4 INITIAL RECOGNITION

A foreign currency transaction on initial recognition should be recorded by applying the foreign currency at the date of the transaction. A rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

#### 11.5 TREATMENT AT EACH BALANCE SHEET DATE

- (a) Foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the

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amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from or required to disburse, such item at the balance sheet date.

- (b) Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction.
- (c) Non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.
- (d) The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

### 11.6 RECOGNITION OF EXCHANGE DIFFERENCES

**Exchange difference** is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

### 11.7 TRANSLATION OF FOREIGN INTEGRAL OPERATIONS

The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate.

### 11.8 TRANSLATION OF NON-INTEGRAL FOREIGN INTEGRAL OPERATIONS

In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:

- (a) The assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;
- (b) Income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and
- (c) All resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.
- (d) For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period, is often used to translate income and expense items of a foreign operation.
- (e) Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate.
- (f) A contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.
- (g) The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (AS 21 and AS 27). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations.
- (h) When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise (AS 21).
- (i) The exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

## **1.98 Financial Reporting**

- (j) An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down.

The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

- (a) While the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise.
- (b) Transactions with the reporting enterprise are not a high proportion of the foreign operation's activities.
- (c) The activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise.
- (d) Costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency.
- (e) The foreign operation's sales are mainly in currencies other than the reporting currency.
- (f) Cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation.
- (g) Sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation.
- (h) There is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

### **11.9 CHANGE IN THE CLASSIFICATION OF A FOREIGN OPERATION**

When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve. When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which



have been deferred are not recognised as income or expenses until the disposal of the operation.

#### 11.10 TAX EFFECTS OF EXCHANGE DIFFERENCES

Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22.

#### 11.11 FORWARD EXCHANGE CONTRACT

An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period. In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

##### Illustration 1

Mr. A bought a forward contract for three months of US\$ 1,00,000 on 1<sup>st</sup> December at 1 US\$ = Rs. 47.10 when exchange rate was US\$ 1 = Rs. 47.02. On 31<sup>st</sup> December when he closed his books exchange rate was US\$ 1 = Rs. 47.15. On 31<sup>st</sup> January, he decided to sell the contract at Rs. 47.18 per dollar. Show how the profits from contract will be recognized in the books.

##### Solution

Since the forward contract was for speculation purpose the premium on contract i.e. the difference between the spot rate and contract rate will not be recorded in the books. Only when the contract is sold the difference between the contract rate and sale rate will be recorded in the Profit & Loss Account.

|                                |                  |
|--------------------------------|------------------|
| Sale Rate                      | Rs. 47.18        |
| Less: Contract Rate            | <u>Rs. 47.10</u> |
| Premium on Contract            | <u>Rs. 0.08</u>  |
| Contract Amount                | US\$ 1,00,000    |
| Total Profit (1,00,000 x 0.08) | Rs. 8,000        |

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### **11.12 DISCLOSURE**

An enterprise should disclose:

- (a) The amount of exchange differences included in the net profit or loss for the period.
- (b) Net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

- (a) The nature of the change in classification;
- (b) The reason for the change;
- (c) The impact of the change in classification on shareholders' funds; and
- (d) The impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

### **11.13 MISCELLANEOUS ILLUSTRATIONS**

#### **Illustration 2**

A Ltd. purchased fixed assets costing Rs. 3,000 lakhs on 1.1.2006 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = Rs. 40.00 and Rs. 42.50 as on 1.1.2006 and 31.12.2006 respectively. First instalment was paid on 31.12.2006. The entire difference in foreign exchange has been capitalized.

You are required to state, how these transactions would be accounted for.

#### **Solution**

As per para 13 of AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or expenses in the period in which they arise. Thus exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognized as income or expense.

Calculation of Exchange Difference:

$$\text{Foreign currency loan} = \frac{\text{Rs. 3,000 lakhs}}{\text{Rs. 40}} = 75 \text{ lakhs US Dollars}$$

$$\begin{aligned} \text{Exchange difference} &= 75 \text{ lakhs US Dollars} \times (42.50 - 40.00) \\ &= \text{Rs. 187.50 lakhs} \end{aligned}$$

(including exchange loss on payment of first instalment)

Therefore, entire loss due to exchange differences amounting Rs. 187.50 lakhs should be charged to profit and loss account for the year.

### Illustration 3

Assets and liabilities and income and expenditure items in respect of foreign branches are translated into Indian rupees at the prevailing rate of exchange at the end of the year. The resultant exchange differences in the case of profit, is carried to other Liabilities Account and the Loss, if any, is charged to revenue. Comment.

### Solution

The financial statements of an integral foreign operation (for example, dependent foreign branches) should be translated using the principles and procedures described in paragraphs 8 to 16 of AS 11 (Revised 2003). The individual items in the financial statements of a foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself.

Individual items in the financial statements of the foreign operation are translated at the actual rate on the date of transaction. For practical reasons, a rate that approximates the actual rate at the date of transaction is often used, for example, an average rate for a week or a month may be used for all transactions in each foreign currency during the period. The foreign currency monetary items (for example cash, receivables, payables) should be reported using the closing rate at each balance sheet date. Non-monetary items (for example, fixed assets, inventories, investments in equity shares) which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of transaction. Thus the cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If the fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate.

Exchange difference arising on the translation of the financial statements of integral foreign operation should be charged to profit and loss account. Exchange difference arising on the translation of the financial statement of foreign operation may have tax effect which should be dealt as per AS 22 'Accounting for Taxes on Income'.

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Thus, the treatment by the management of translating all assets and liabilities; income and expenditure items in respect of foreign branches at the prevailing rate at the year end and also the treatment of resultant exchange difference is not in consonance with AS 11 (Revised 2003).

**Note:** For the purpose of translation of assets, liabilities, income and expenditure items of foreign operations, AS 11 (Revised 2003) classifies the foreign operation into two types – Integral foreign operation, Non-integral foreign operation. Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. Non-integral foreign operation is a foreign operation that is not an integral foreign operation. The above answer has been given on the basis that the foreign branches referred in the question are integral foreign operations.

#### Self-examination Questions

1. Define the following terms in context of AS-11 (Revised);
  - (a) Monetary items.
  - (b) Non-monetary items.
  - (c) Reporting currency.
  - (d) Foreign currency.
  - (e) Exchange rate.
  - (f) Average rate
  - (g) Forward rate.
  - (h) Closing rate
2. Describe the accounting treatment for recording foreign currency transactions on initial recognition.
3. Write short note on Monetary items and its treatment on the balance sheet date.
4. Explain the accounting treatment for recognising exchange differences on settlement of foreign currency transactions.
5. Alok Ltd., imported certain stock worth USD 1,00,000 on 30<sup>th</sup> June, 2006 when 1 USD = Rs.45.00. The payment is made on 31<sup>st</sup> December, 2006 when 1 USD = Rs.46.05. The stock is in hand and lying unsold as on 30<sup>th</sup> September, 2006 when other company closes its accounts. Give journal entry under AS-11 if the rate on the Balance Sheet date was 1 USD = Rs.44.05.
6. Mohan Ltd. Had imported raw materials worth USD 2,50,000 on 15<sup>th</sup> January, when the exchange rate was Rs.46 per USD. The Company had recorded the transaction at that rate. The payment for the imports was made only on 15<sup>th</sup> April, when the exchange rate was Rs.49 per USD. However, on 31<sup>st</sup> March, the rate of exchange was Rs.50 per USD.

The Company passed an entry on 31<sup>st</sup> March, adjusting the cost of raw materials consumed for the difference between Rs.49 and Rs.46 per USD. As an auditor, state your views on the above.

7. Distinguish between integral Foreign Operation (IFO) and Non Integral Foreign Operation (NFO).
8. Explain the procedure for translation of Financial Statements of both IFO and NFO in brief.
9. Suman Ltd. Based in India has branches in London. The Vice-President (Accounts) is of the opinion that the net exchange difference of Rs.20 lakhs on the translation of items in financial statements of London Branches should be credited to the P&L Account of the Company and disclosed as follows-

|                                                                                                             |                    |
|-------------------------------------------------------------------------------------------------------------|--------------------|
| Favourable exchange differences on items other than Fixed Assets                                            | Rs.50 lakhs        |
| Less: Unfavourable exchange difference on account of increase in Term Liability on purchase of Fixed Assets | <u>Rs.30 lakhs</u> |
| Net Exchange Difference transferred to P & L account                                                        | <u>Rs.20 lakhs</u> |

Do you agree with the Vice-President (Accounts)? Give reasons.

10. What are the principles of translation or conversion of Foreign Currency to Rupee Currency for accounting of exports, imports and incorporation of transactions of Overseas Branches?
11. A company had imported raw materials worth US Dollars 6,00,000 on 5<sup>th</sup> January, 2005, when the exchange rate was Rs.43 per US Dollar. The company had recorded the transaction in the books at the above mentioned rate. The payment for the import transaction was made on 5<sup>th</sup> April, 2005 when the exchange rate was Rs.47 per US Dollar. However, on 31<sup>st</sup> March, 2005, the rate of exchange was Rs.48 per US Dollar. The company passed an entry on 31<sup>st</sup> March, 2005 adjusting the cost of raw materials consumed for the difference between Rs.48 and Rs.43 per US Dollar.

In the background of the relevant accounting standard, is the company's accounting treatment correct? Discuss.

## UNIT 12

### AS 12: ACCOUNTING FOR GOVERNMENT GRANTS

Reference: The students are advised to refer the full text of AS 12 "Accounting for Government Grants" (issued 1991) given in Appendix I at the end of the Study Material (Volume-II)..

#### 12.1 INTRODUCTION

The Standard comes into effect in respect of accounting periods commencing on or after 1.4.1992 and will be recommendatory in nature for an initial period of two years. AS 12 deals with accounting for government grants and specifies that the government grants should not be recognized until there is reasonable assurance that the enterprise will comply with the conditions attached to them, and the grant will be received. The standard also describes the treatment of non-monetary government grants; presentation of grants related to specific fixed assets, related to revenue, related to promoters' contribution; treatment for refund of government grants etc. The enterprises are required to disclose (i) the accounting policy adopted for government grants including the methods of presentation in the financial statements; (ii) the nature and extent of government grants recognized in the financial statements, including non-monetary grants of assets given either at a concessional rate or free of cost.

This Statement does not deal with:

- (i) The special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature.
- (ii) Government assistance other than in the form of government grants.
- (iii) Government participation in the ownership of the enterprise.

The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefore is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period. This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

#### 12.2 ACCOUNTING TREATMENT OF GOVT. GRANTS

Two broad approaches may be followed for the accounting treatment of government grants: the 'capital approach', under which a grant is treated as part of shareholders' funds, and the 'income approach', under which a grant is taken to income over one or more periods.

Those in support of the '**capital approach**' argue as follows:

- (i) Many government grants are in the nature of promoters' contribution, i.e., they are given by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants.
- (ii) They are not earned but represent an incentive provided by government without related costs.

Arguments in support of the '**income approach**' are as follows:

- (i) The enterprise earns grants through compliance with their conditions and meeting the envisaged obligations. They should therefore be taken to income and matched with the associated costs which the grant is intended to compensate.
- (ii) As income tax and other taxes are charges against income, it is logical to deal also with government grants, which are an extension of fiscal policies, in the profit and loss statement.
- (iii) In case grants are credited to shareholders' funds, no correlation is done between the accounting treatment of the grant and the accounting treatment of the expenditure to which the grant relates.

It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants.

### 12.3 RECOGNITION OF GOVERNMENT GRANTS

Government grants available to the enterprise are considered for inclusion in accounts:

- (i) Where there is reasonable assurance that the enterprise will comply with the conditions attached to them; and
- (ii) Where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

Mere receipt of a grant is not necessarily a conclusive evidence that conditions attaching to the grant have been or will be fulfilled.

### 12.4 NON-MONETARY GOVERNMENT GRANTS

Government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value.

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### **12.5 PRESENTATION OF GRANTS RELATED TO SPECIFIC FIXED ASSETS**

Two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives.

Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description, e.g., 'Deferred government grants'.

### **12.6 PRESENTATION OF GRANTS RELATED TO REVENUE**

Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense.

### **12.7 PRESENTATION OF GRANTS OF THE NATURE OF PROMOTERS' CONTRIBUTION**

Where the government grants are of the nature of promoters' contribution, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

### **12.8 REFUND OF GOVERNMENT GRANTS**

Government grants sometimes become refundable because certain conditions are not fulfilled and is treated as an extraordinary item (AS 5). The amount refundable in respect of a government grant related to revenue is 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 is charged immediately to profit and loss statement. 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 or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.



## 12.9 DISCLOSURE

- (i) The accounting policy adopted for government grants, including the methods of presentation in the financial statements;
- (ii) The nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

## 12.10 MISCELLANEOUS ILLUSTRATIONS

### Illustration 1

Sagar Limited belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31.03.2006. You are required to advise the company on the following item from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards:

The company purchased on 01.04.2005 a special purpose machinery for Rs. 25 lakhs. It received a Central Government Grant for 20% of the price. The machine has an effective life of 10 years.

### Solution

AS 12 'Accounting for Government Grants' regards two methods of presentation, of grants related to specific fixed assets, in financial statements as acceptable alternatives. Under the first method, the grant can be shown as a deduction from the gross book value of the machinery in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.

Under the second method, it can be treated as deferred income which should be recognised in the profit and loss statement over the useful life of 10 years in the proportions in which depreciation on machinery will be charged. The deferred income pending its apportionment to profit and loss account should be disclosed in the balance sheet with a suitable description e.g., 'Deferred government grants' to be shown after 'Reserves and Surplus' but before 'Secured Loans'.

The following should also be disclosed:

- (i) the accounting policy adopted for government grants, including the methods of presentation in the financial statements;
- (ii) the nature and extent of government grants recognised in the financial statement of Rs. 6 lakhs is required to be credited to the profit and loss statement of the current year.

### Illustration 2

Top & Top Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment. Having fulfilled all the conditions under the scheme, the company on its investment of Rs. 50 crore in capital assets, received Rs. 10 crore from the Government in January, 2005 (accounting period

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being 2004-2005). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 2005.

Keeping in view the relevant Accounting Standard, discuss whether this action is justified or not.

#### Solution

As per para 10 of AS 12 'Accounting for Government Grants', where the government grants are of the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

In the given case, the subsidy received is neither in relation to specific fixed asset nor in relation to revenue. Thus it is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs. The correct treatment is to credit the subsidy to capital reserve. Therefore, the accounting treatment followed by the company is not proper.

#### Illustration 3

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.?

#### Solution

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%                        | <u>240.00</u>  |
|                  | Book value                                      | 960.00         |
| 31st March, 2003 | Less: Depreciation @ 20%                        | <u>192.00</u>  |
|                  | Book value                                      | 768.00         |
| 31st March, 2004 | Less: Depreciation @ 20%                        | <u>153.60</u>  |

|                 |                      |               |
|-----------------|----------------------|---------------|
| 1st April, 2004 | Book value           | 614.40        |
| May, 2004       | Add: Refund of grant | <u>300.00</u> |
|                 | Revised book value   | <u>914.40</u> |

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.

### Self-examination Questions

1. Define Government grant as per AS 12.
2. What are the two approaches for accounting of government grants? Explain in brief.
3. When are the government grants recognized?
4. Discuss the treatment for non-monetary government grants.
5. Explain the accounting treatment of Government Grants for –
  - (1) Grants not yet received;
  - (2) Grants relating to past losses.
  - (3) Specific Grants to provide immediate financial support.
6. Ganga Ltd. purchased a special purpose machinery on 1<sup>st</sup> April, 2006 for Rs.20 lakhs. It received a Government Grant for 25% of the price. The machine has an effective life of 10 years. Advise the company for accounting treatment.
7. Should grants be shown separately in the cash flows statement by an enterprise?
8. How are grants related to revenue presented in the financial statements. Explain in brief.
9. ABC Ltd. received a grant of Rs.30 lakhs being 5% of the total investment for setting up a factory in some backward area. Out of it Rs.14 lakhs was distributed as dividend. Comment.
10. Mahadev Ltd. applied for a Government Grant for purchase of a special machinery. The machinery costs Rs.80 lakhs and the grant was Rs.30 lakhs. The machinery has an useful life of 10 years and the Company follows SLM Depreciation. The grant was promptly received but certain conditions regarding production were attached to it. Four years later, an amount of Rs.4 lakhs become refundable to the Government since the Company did not adhere to the conditions imposed earlier. Explain the accounting treatment.

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11. Three years ago, Asha Ltd. had had received subsidy of Rs.25 lakhs from Government by way of contribution towards its total capital outlay. However, due to non-fulfillment of some specified conditions, Rs.16 lakhs was recovered by the government during the current accounting year. Discuss the accounting treatment.

## UNIT 13

### AS:13 ACCOUNTING FOR INVESTMENTS

*Reference:* The students are advised to refer the full text of AS 13 "Accounting for Investments" (issued 1993) given in Appendix I at the end of the Study Material (Volume-II).

#### 13.1 INTRODUCTION

This Accounting Standard comes into effect for financial statements covering periods commencing on or after April 1, 1995. The statement deals with accounting for investments in the financial statements of enterprises and related disclosure requirements. The enterprises are required to disclose the current investments (realizable in nature and intended to be held for not more than one year from the date of its acquisition) and long terms investments (other than current investments) distinctly in their financial statements. An investment property should be accounted for as long-term investments. The cost of investments should include all acquisition costs (including brokerage, fees and duties) and on disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to profit and loss statement.

This Statement does not deal with:

- a. The bases for recognition of interest, dividends and rentals earned on investments which are covered by AS 9.
- b. Operating or finance leases.
- c. Investments of retirement benefit plans and life insurance enterprises and
- d. Mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956.

#### 13.2 DEFINITION OF THE TERMS USED IN THE STANDARD

**Investments** are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not 'investments'

**Fair value** is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

**Market value** is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

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### **13.3 FORMS OF INVESTMENTS**

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity. Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings). For some investments, an active market exists from which a market value can be established. For other investments, an active market does not exist and other means are used to determine fair value.

### **13.4 CLASSIFICATION OF INVESTMENTS**

**A current investment** is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

**A long term investment** is an investment other than a current investment.

### **13.5 COST OF INVESTMENTS**

The cost of an investment includes acquisition charges such as brokerage, fees and duties. If an investment is acquired, or partly acquired, by the issue of shares or other securities or another assets, the acquisition cost is the fair value of the securities issued or assets given up. The fair value may not necessarily be equal to the nominal or par value of the securities issued. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

### **13.6 CARRYING AMOUNT OF INVESTMENTS**

The carrying amount for current investments is the lower of cost and fair value. Valuation of current investments on overall basis is not considered appropriate. The more prudent and appropriate method is to carry investments individually at the lower of cost and fair value. Any reduction to fair value and any reversals of such reductions are included in the Profit & Loss Statement.

Long-term investments are usually carried at cost. Where there is a decline, other than temporary,

in the carrying amounts of long term investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

### 13.7 INVESTMENT PROPERTIES

An **investment property** is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

### 13.8 DISPOSAL OF INVESTMENTS

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.

### 13.9 RECLASSIFICATION OF INVESTMENTS

Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

### 13.10 DISCLOSURE

The following disclosures in financial statements in relation to investments are appropriate: -

- a. The accounting policies for the determination of carrying amount of investments.
- b. The amounts included in profit and loss statement for:
  - i. Interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid.
  - ii. Profits and losses on disposal of current investments and changes in carrying amount of such investments.
  - iii. Profits and losses on disposal of long term investments and changes in the carrying amount of such investments.
- c. Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.

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- d. The aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments.
- e. Other disclosures as specifically required by the relevant statute governing the enterprise.

### **13.11 ILLUSTRATIONS**

#### **Illustration 1**

An unquoted long term investment is carried in the books at a cost of Rs. 2 lakhs. The published accounts of the unlisted company received in May, 2006 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than Rs. 20,000. How will you deal with this in preparing the financial statements of R Ltd. for the year ended 31st March, 2006?

#### **Solution**

As it is stated in the question that financial statements for the year ended 31st March, 1998 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. Para 17 of AS 13 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to Rs. 20,000 in the financial statements for the year ended 31st March, 2006.

#### **Self-examination Questions**

1. Are shares, debentures and other securities held as stock-in-trade covered by AS 13?
2. How are cost of investments determined?
3. Alfa Ltd. is planning to deduct loss on sale of investments directly from investment reserves. Comment on this accounting treatment?
4. How are current investments carried in accounts?
5. A Ltd. acquired 2,000 debentures in B Ltd. by issue of 10,000 equity shares having a face of Rs.100 each, whose market value is Rs.150 per share. The debentures of B Ltd were listed at Rs.800 but the face value is Rs.500 only. What should be the cost of the investments? Ignore pre-acquisition interest.



6. On 1<sup>st</sup> April, Ramesh Ltd. purchased 12% Debentures in Somesh Ltd. for Rs.7,50,000. The face value of these debentures were Rs.5,00,000. Interest on debentures falls due for payment on 30<sup>th</sup> June, and 31<sup>st</sup> December. Compute the cost of acquisition of debentures.
7. A temporary fall in the value of long-term investments is not provided for. Is it correct?
8. How are long term investment carried in accounts?
9. Can long term investments be reclassified as current investments? How are they treated?
10. Describe the disclosure requirements for long term investments in the financial statements.

## UNIT 14

### AS 14: ACCOUNTING FOR AMALGAMATIONS

*Reference:* The students are advised to refer the full text of AS 14 "Accounting for Amalgamations" (issued 1994) given in Appendix I at the end of the Study Material (Volume-II).

#### 14.1 INTRODUCTION

This standard will come into effect in respect of accounting periods commencing on or after 1.4.1995 and will be mandatory in nature. AS 14 deals with accounting for amalgamation and the treatment of any resultant goodwill or reserves and is directed principally to companies although some of its requirements also apply to financial statements of other enterprises. An amalgamation may be either in the nature of merger or purchase. The standard specifies the conditions to be satisfied by an amalgamation to be considered as amalgamation in nature of merger. An amalgamation in nature of merger is accounted for as per pooling of interests method and in nature of purchase is dealt under purchase method. The standard describes the disclosure requirements for both types of amalgamations in the first financial statements. This statement is directed principally to companies although some of its requirements also apply to financial statements of other enterprises. We will discuss the other amalgamation aspects in detail in the next paragraphs of this unit.

This statement does not deal with cases of acquisitions. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

#### 14.2 DEFINITION OF THE TERMS USED IN THE STANDARD

**Amalgamation** means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.

**Transferor company** means the company which is amalgamated into another company.

**Transferee company** means the company into which a transferor company is amalgamated.

#### 14.3 TYPES OF AMALGAMATIONS

Amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. These are known as Amalgamation in nature of merger. Other is known as Amalgamation in nature of purchase.

**14.4 Amalgamation in the nature of merger** is an amalgamation which satisfies all the following conditions.

- (i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

- (ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
- (iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
- (iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
- (v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

**14.5 Amalgamation in the nature of purchase** is an amalgamation which does not satisfy any one or more of the conditions specified above.

#### **14.6 METHODS OF ACCOUNTING FOR AMALGAMATIONS**

There are two main methods of accounting for amalgamations the pooling of interests method and the purchase method.

##### **14.6.1 Pooling of interests**

Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts.

If, at the time of the 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.

##### **14.6.2 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. *Consideration* for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

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Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable [AS 4].

#### **14.7 TREATMENT OF RESERVES ON AMALGAMATION**

If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company is adjusted in reserves in the financial statements of the transferee company.

If the amalgamation is an 'amalgamation in the nature of purchase', the amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the result of the computation is positive, the difference is credited to Capital Reserve. In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity. Certain reserves may have been created by the transferor company pursuant to the requirements of certain acts, referred to hereinafter as 'statutory reserves'. Such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Account') which is disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

#### **14.8 TREATMENT OF GOODWILL ARISING ON AMALGAMATION**

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

## 14.9 DISCLOSURE

For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

- a. Names and general nature of business of the amalgamating companies;
- b. Effective date of amalgamation for accounting purposes;
- c. The method of accounting used to reflect the amalgamation; and
- d. Particulars of the scheme sanctioned under a statute.

For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate 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;
- b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate 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.

## 14.10 MISCELLANEOUS ILLUSTRATIONS

### Illustration 1

A Ltd. take over B Ltd. on April 01, 2007 and discharges consideration for the business as follows:

- (i) Issued 42,000 fully paid equity shares of Rs. 10 each at par to the equity shareholders of B Ltd.
- (ii) Issued fully paid up 15% preference shares of Rs. 100 each to discharge the preference shareholders (Rs. 1,70,000) of B Ltd. at a premium of 10%.
- (iii) It is agreed that the debentures of B Ltd. (Rs. 50,000) will be converted into equal number and amount of 13% debentures of A Ltd.

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### Solution

| Particulars                 | Rs.           | Rs.             |
|-----------------------------|---------------|-----------------|
| Equity Shares (42,000 x 10) |               | 4,20,000        |
| Preference Share Capital    | 1,70,000      |                 |
| Add: Premium on Redemption  | <u>17,000</u> | <u>1,87,000</u> |
| Purchase Consideration      |               | <u>6,07,000</u> |

### Illustration 2

The following are the Balance Sheets of Big Ltd. and Small Ltd. as at 31.3.06:

| (Rs. In lakhs)    |             |             |                                             |             |             |
|-------------------|-------------|-------------|---------------------------------------------|-------------|-------------|
|                   | Big Ltd.    | Small Ltd.  |                                             | Big Ltd.    | Small Ltd.  |
|                   | Rs.         | Rs.         |                                             | Rs.         | Rs.         |
| Share Capital     | 40          | 15          | Sundry Assets<br>(including cost of shares) | 56          | 20          |
| Profit & Loss A/c | 7.5         | --          | Goodwill                                    | 4           | 5           |
| Sundry Creditors  | <u>12.5</u> | <u>12.5</u> | Profit and Loss A/c                         | <u>--</u>   | <u>2.5</u>  |
|                   | <u>60.0</u> | <u>27.5</u> |                                             | <u>60.0</u> | <u>27.5</u> |

Additional Information:

- The two companies agree to amalgamate and form a new company, Medium Ltd.
- Big Ltd. holds 10,000 shares in Small Ltd. acquired at a cost of Rs.2,50,000 and Small Ltd. holds 5,000 shares in Big Ltd. acquired at a cost of Rs.7,00,000.
- The shares of Big Ltd. are of Rs.100 and are fully paid and the shares of Small Ltd. are of Rs.50 each on which Rs.30 has been paid-up.
- It is agreed that the goodwill of Big Ltd. would be valued at Rs.1,50,000 and that of Small Ltd. at Rs.2,50,000.
- The shares which each company holds in the other are to be valued at book value having regard to the goodwill valuation decided as given in (iv).
- The new shares are to be of a nominal value of Rs.50 each credited as Rs.25 paid.

You are required to:

- Prepare the Balance Sheet of Medium Ltd., as at 31<sup>st</sup> March, 2006 after giving effect to the above transactions; and
- Prepare a statement showing the shareholdings in the new company attributable to the shareholders of the merged companies.

**Solution****(i) Balance Sheet of Medium Ltd. as on 31<sup>st</sup> March, 2006**

| <i>Liabilities</i>                                                                        | <i>Rs.</i>       | <i>Assets</i>                                  | <i>Rs.</i>       |
|-------------------------------------------------------------------------------------------|------------------|------------------------------------------------|------------------|
| 1,82,000 shares of Rs.50/- each, Rs.25 paid up [Issued for consideration other than cash] | 45,50,000        | Goodwill<br>(Rs.1,50,000+Rs.2,50,000)          | 4,00,000         |
| Sundry Creditors                                                                          | <u>25,00,000</u> | Sundry Assets<br>(Rs. 53,50,000+ Rs.13,00,000) | <u>66,50,000</u> |
|                                                                                           | <u>70,50,000</u> |                                                | <u>70,50,000</u> |

**(ii) Statement of Shareholding in Medium Ltd.**

|                                                                                                   | <i>Big Ltd.</i><br><i>Rs.</i> | <i>Small Ltd.</i><br><i>Rs.</i> |
|---------------------------------------------------------------------------------------------------|-------------------------------|---------------------------------|
| Total value of Assets                                                                             | 44,20,513                     | 8,52,564                        |
| Less: Pertaining to shares held by the other company                                              | <u>5,52,564</u>               | <u>1,70,513</u>                 |
|                                                                                                   | <u>38,67,949</u>              | <u>6,82,051</u>                 |
| Rounded off to                                                                                    | 38,67,950                     | 6,82,050                        |
| Shares of new company (at Rs. 25 per share)                                                       | <u>1,54,718</u>               | <u>27,282</u>                   |
| Total purchase consideration to be paid to Big Ltd and Small Ltd.<br>(Rs.38,67,950 + Rs.6,82,050) |                               | Rs. 45,50,000                   |
| Number of shares in Big Ltd. (40,00,000/100)                                                      |                               | 40,000 shares                   |
| Number of shares in Small Ltd. (15,00,000/30)                                                     |                               | 50,000 shares                   |
| Holding of Small Ltd. in Big Ltd. (5,000/40,000)                                                  |                               | 1/8                             |
| Holding of Big Ltd. in Small Ltd. (10,000/50,000)                                                 |                               | 1/5                             |
| Number of shares held by outsiders in Big Ltd. (40,000 – 5,000) =                                 |                               | 35,000                          |
| Number of shares held by outsiders in Small Ltd. (50,000 – 10,000)                                |                               | 40,000                          |

**Workings Note:****Calculation of Book Value of Shares**

|                                                                            | <i>Big Ltd</i><br><i>Rs.</i> | <i>Small Ltd.</i><br><i>Rs.</i> |
|----------------------------------------------------------------------------|------------------------------|---------------------------------|
| Goodwill                                                                   | 1,50,000                     | 2,50,000                        |
| Sundry Assets other than shares in other company<br>(56,00,000 – 2,50,000) | <u>53,50,000</u>             |                                 |
| (20,00,000 – 7,00,000)                                                     |                              | <u>13,00,000</u>                |
|                                                                            | 55,00,000                    | 15,50,000                       |

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|                        |                  |                  |
|------------------------|------------------|------------------|
| Less: Sundry Creditors | <u>12,50,000</u> | <u>12,50,000</u> |
|                        | <u>42,50,000</u> | <u>3,00,000</u>  |

If "x" is the Book Value of Assets of Big Ltd and "y" of Small Ltd.

$$x = 42,50,000 + \frac{1}{5}y$$

$$y = 3,00,000 + \frac{1}{8}x$$

$$x = 42,50,000 + \frac{1}{5}(3,00,000 + \frac{1}{8}x)$$

$$= 42,50,000 + 60,000 + \frac{1}{40}x$$

$$\frac{39}{40}x = 43,10,000$$

$$x = 43,10,000 \times \frac{40}{39}$$

$$x = 44,20,513 \text{ (approx.)}$$

$$y = 3,00,000 + \frac{1}{8}(44,20,513)$$

$$= 3,00,000 + 5,52,564$$

$$= \text{Rs. } 8,52,564 \text{ (approx.)}$$

$$\text{Book Value of one share of Big Ltd.} = \frac{44,20,513}{40,000} = \text{Rs. } 110.513 \text{ (approx.)}$$

$$\text{Book Value of one share of Small Ltd.} = \frac{8,52,564}{50,000} = \text{Rs. } 17.05 \text{ (approx.)}$$

### Illustration 3

A Ltd. and B Ltd. were amalgamated on and from 1st April, 2005. A new company C Ltd. was formed to take over the business of the existing companies. The Balance Sheets of A Ltd. and B Ltd. as on 31st March, 2005 are given below:



## Accounting Standards and Guidance Notes 1.123

|                                      | (Rs. in lakhs) |               |                                    |                         |
|--------------------------------------|----------------|---------------|------------------------------------|-------------------------|
| <i>Liabilities</i>                   | <i>A Ltd.</i>  | <i>B Ltd.</i> | <i>Assets</i>                      |                         |
| Share Capital                        |                |               | Fixed Assets                       |                         |
| Equity Shares of Rs. 100 each        | 800            | 750           | Land and Building                  | 550      400            |
| 12% Preference shares of Rs.100 each | 300            | 200           | Plant and Machinery                | 350      250            |
| Reserves and Surplus                 |                |               | Investments                        | 150      50             |
| Revaluation Reserve                  | 150            | 100           | Current Assets, Loans and Advances |                         |
| General Reserve                      | 170            | 150           | Stock                              | 350      250            |
| Investment Allowance Reserve         | 50             | 50            | Sundry Debtors                     | 250      300            |
| Profit and Loss Account              | 50             | 30            | Bills Receivable                   | 50      50              |
| Secured Loans                        |                |               | Cash and Bank                      | 300      200            |
| 10% Debentures (Rs. 100 each)        | 60             | 30            |                                    |                         |
| Current Liabilities and provisions   |                |               |                                    |                         |
| Sundry Creditors                     | 270            | 120           |                                    |                         |
| Bills Payable                        | <u>150</u>     | <u>70</u>     |                                    |                         |
|                                      | <u>2,000</u>   | <u>1,500</u>  |                                    | <u>2,000      1,500</u> |

### Additional Information:

- (1) 10% Debentureholders of A Ltd. and B Ltd. are discharged by C Ltd. issuing such number of its 15% Debentures of Rs. 100 each so as to maintain the same amount of interest.
- (2) Preference shareholders of the two companies are issued equivalent number of 15% preference shares of C Ltd. at a price of Rs. 150 per share (face value of Rs. 100).
- (3) C Ltd. will issue 5 equity shares for each equity share of A Ltd. and 4 equity shares for each equity share of B Ltd. The shares are to be issued @ Rs. 30 each, having a face value of Rs. 10 per share.
- (4) Investment allowance reserve is to be maintained for 4 more years.

Prepare the Balance Sheet of C Ltd. as on 1st April, 2005 after the amalgamation has been carried out on the basis of Amalgamation in the nature of purchase.

## 1.124 Financial Reporting

### Solution

#### Balance Sheet of C Ltd. as at 1st April, 2005

|                                                                                                                                                              |              | (Rs. In lakhs)                                                        |              |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|-----------------------------------------------------------------------|--------------|
| Liabilities                                                                                                                                                  | Amount       | Assets                                                                | Amount       |
| SHARE CAPITAL                                                                                                                                                |              | FIXED ASSETS                                                          |              |
| 70,00,000 Equity shares of Rs.10 each                                                                                                                        | 700          | Goodwill                                                              | 20           |
| 5,00,000 Preference shares of Rs. 100 each (all the above shares are allotted as fully paid-up pursuant to contracts without payment being received in cash) | 500          | Land and Building                                                     | 950          |
|                                                                                                                                                              |              | Plant and Machinery                                                   | 600          |
|                                                                                                                                                              |              | INVESTMENTS                                                           | 200          |
| RESERVES AND SURPLUS                                                                                                                                         |              | CURRENT ASSETS, LOANS AND ADVANCES                                    |              |
| Securities Premium Account                                                                                                                                   | 1,650        | A Current Assets                                                      |              |
| Investment Allowance Reserve                                                                                                                                 | 100          | Stock                                                                 | 600          |
| SECURED LOANS                                                                                                                                                |              | Sundry debtors                                                        | 550          |
| 15% Debentures                                                                                                                                               | 60           | Cash and Bank                                                         | 500          |
| UNSECURED LOANS                                                                                                                                              | —            | B Loans and Advances                                                  |              |
| CURRENT LIABILITIES AND PROVISIONS                                                                                                                           |              | Bills Receivable                                                      | 100          |
| A Current Liabilities                                                                                                                                        |              | MISCELLANEOUS EXPENDITURE (to the extent not written off or adjusted) |              |
| Acceptances                                                                                                                                                  | 220          | Amalgamation Adjustment Account                                       | 100          |
| Sundry Creditors                                                                                                                                             | 390          |                                                                       |              |
| B Provisions                                                                                                                                                 | —            |                                                                       |              |
|                                                                                                                                                              | <u>3,620</u> |                                                                       | <u>3,620</u> |

#### Working Notes:

(Rs. in lakhs)  
A Ltd.                      B Ltd.

(1) Computation of Purchase consideration

(a) Preference shareholders:

$$\left( \frac{3,00,00,000}{100} \text{ i.e. 3,00,000 shares} \right) \times \text{Rs. 150 each} = 450$$

|                                  |                                                                                                                             |              |
|----------------------------------|-----------------------------------------------------------------------------------------------------------------------------|--------------|
|                                  | $\left( \frac{2,00,00,000}{100} \text{ i.e. } 2,00,000 \text{ shares} \right) \times \text{Rs. } 150 \text{ each}$          | 300          |
| (b) Equity shareholders:         |                                                                                                                             |              |
|                                  | $\left( \frac{8,00,00,000 \times 5}{100} \text{ i.e. } 40,00,000 \text{ shares} \right) \times \text{Rs. } 30 \text{ each}$ | 1,200        |
|                                  | $\left( \frac{7,50,00,000 \times 4}{100} \text{ i.e. } 30,00,000 \text{ shares} \right) \times \text{Rs. } 30 \text{ each}$ | <u>900</u>   |
| Amount of Purchase Consideration | <u>1,650</u>                                                                                                                | <u>1,200</u> |
| (2) Net Assets Taken Over        |                                                                                                                             |              |
| Assets taken over:               |                                                                                                                             |              |
| Land and Building                | 550                                                                                                                         | 400          |
| Plant and Machinery              | 350                                                                                                                         | 250          |
| Investments                      | 150                                                                                                                         | 50           |
| Stock                            | 350                                                                                                                         | 250          |
| Sundry Debtors                   | 250                                                                                                                         | 300          |
| Bills receivable                 | 50                                                                                                                          | 50           |
| Cash and bank                    | <u>300</u>                                                                                                                  | <u>200</u>   |
|                                  | 2,000                                                                                                                       | 1,500        |
| Less: Liabilities taken over:    |                                                                                                                             |              |
| Debentures                       | 40                                                                                                                          | 20           |
| Sundry Creditors                 | 270                                                                                                                         | 120          |
| Bills payable                    | <u>150</u>                                                                                                                  | <u>70</u>    |
|                                  | <u>460</u>                                                                                                                  | <u>210</u>   |
| Net assets taken over            | 1,540                                                                                                                       | 1,290        |
| Purchase consideration           | <u>1,650</u>                                                                                                                | 1,200        |
| Goodwill                         | <u>110</u>                                                                                                                  |              |
| Capital reserve                  |                                                                                                                             | <u>90</u>    |

**Note:**

Since Investment Allowance Reserve is to be maintained for 4 more years, it is carried forward by a corresponding debit to Amalgamation Adjustment Account in accordance with AS-14.

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### Self-examination Questions

1. Define the following terms in the context of AS 14;
  - (a) Amalgamation
  - (b) Transferee company
  - (c) Purchase Considerations.
  - (d) Statutory Reserves.
  - (e) Pooling of interest method.
  - (f) Amalgamation in the nature of purchase.
2. Distinguish between amalgamation in the nature of purchase and amalgamation in the nature of merger.
3. Describe the conditions required for amalgamation in the nature of merger.
4. How are reserves treated in amalgamation?
5. Explain the treatment of goodwill arising on amalgamation?
6. How are balances in P&L account treated in the books of Transferee Company?
7. What is the effect of amalgamation after the balance sheet date?
8. The following are the Balance Sheets of Big Ltd. and Small Ltd. for the year ending on 31st March, 2006. (Figures in crores of rupees):

|                                                                     | Big Ltd.   | Small Ltd. |
|---------------------------------------------------------------------|------------|------------|
| Equity share capital – in equity shares of Rs. 10 each              | 50         | 40         |
| Preference share capital – in 10% preference shares of Rs. 100 each | –          | 60         |
| Reserves and Surplus                                                | <u>200</u> | <u>150</u> |
|                                                                     | 250        | 250        |
| Loans – Secured                                                     | <u>100</u> | <u>100</u> |
| Total funds                                                         | <u>350</u> | <u>350</u> |
| Applied for: Fixed assets at cost less depreciation                 | 150        | 150        |
| Current assets less current liabilities                             | <u>200</u> | <u>200</u> |
|                                                                     | <u>350</u> | <u>350</u> |

The present worth of fixed assets of Big Ltd. is Rs. 200 crores and that of Small Ltd. is Rs. 429 crores. Goodwill of Big Ltd. is Rs. 40 crores and of Small Ltd. is 75 crores.

Small Ltd. absorbs Big Ltd. by issuing equity shares at par in such a way that intrinsic net worth is maintained.

Goodwill account is not to appear in the books. Fixed assets are to appear at old figures.

- (a) Show the Balance Sheet after absorption.
- (b) Draft a statement of valuation of shares on intrinsic value basis and prove the accuracy of your workings.

9. Given below is the Balance Sheet of H Ltd. as on 31.3.2006:

| <i>(Figures in Rs. lakhs)</i>     |              |                                        |                 |
|-----------------------------------|--------------|----------------------------------------|-----------------|
| Equity share capital              | 4.00         | Block assets less depreciation to date | 6.00            |
| (in equity shares of Rs. 10 each) |              | Stock and debtors                      | 5.30            |
| 10% preference share capital      | 3.00         | Cash and bank                          | 0.70            |
| General reserve                   | 1.00         |                                        |                 |
| Profit and loss account           | 1.00         |                                        |                 |
| Creditors                         | <u>3.00</u>  |                                        | <u>        </u> |
|                                   | <u>12.00</u> |                                        | <u>12.00</u>    |

M Ltd. another existing company holds 25% of equity share capital of H Ltd. purchased at Rs. 10 per share.

It was agreed that M Ltd. should take over the entire undertaking of H Ltd. on 30.09.2006 on which date the position of current assets (except cash and bank balances) and creditors was as follows:

|                   |         |
|-------------------|---------|
| Stock and debtors | 4 lakhs |
| Creditors         | 2 lakhs |

Profits earned for half year ended 30.09.2006 by H Ltd. was Rs. 70,500 after charging depreciation of Rs. 32,500 on block assets. H Ltd. declared 10% dividend for 2005-2006 on 30.08.2006 and the same was paid within a week.

Goodwill of H Ltd. was valued at Rs. 80,000 and block assets were valued at 10% over their book value as on 31.3.2006 for purposes of take over. Preference shareholders of H Ltd. will be allotted 10% preference shares of Rs. 10 each by M Ltd. Equity shareholders of H Ltd. will receive requisite number of equity shares of Rs. 10 each from M Ltd. valued at Rs. 10 per share.

- (a) Compute the purchase consideration.
- (b) Explain, how the capital reserve or goodwill, if any, will appear in the Balance Sheet of M Ltd. after absorption.

## UNIT 15

### AS 15: EMPLOYEE BENEFITS

*Reference:* The students are advised to refer the full text of AS 15 (Revised "Employee Benefits" (revised 2005) given in Appendix I at the end of the Study Material (Volume-II).

#### 15.1 INTRODUCTION

The revised Accounting Standard 15 - 'Employee Benefits' (AS 15), generally deals with all forms of employee benefits (other than stock compensation for which a separate guidance note is promulgated), many of which were not dealt with by pre-revised AS 15. The Standard addresses only the accounting of employee benefits by employers. The Standard makes four things very clear at the outset: (i) the Standard is applicable to benefits provided to all types of employees (whether full-time, part-time, or casual staff); (ii) employee benefits can be paid in cash or in kind ;(iii) employee benefits include benefits provided to employees and their dependents (spouses, children and others); and (iv) payment can be made directly to employees, their dependent or to any other party (e.g., insurance companies, trust etc.).

Employee benefits include:

- (a) short-term employee benefits (e.g. wages, salaries, paid annual leave and sick leave, bonuses etc.);
- (b) Post-employment benefits (e.g., gratuity, pension, provident fund, post-employment medical care etc.);
- (c) long-term employee benefits (e.g., long-service leave, long-term disability benefits etc.); and
- (d) termination benefits (e.g. VRS payments)

The Standard lays down recognition and measurement criteria and disclosure requirements for the above four types of employee benefits separately.

#### 15.2 APPLICABILITY

The Standard applies from April 1, 2006 in its entirety for all Level 1 enterprises. Certain exemptions are given to other than Level 1 enterprises, depending upon whether they employ 50 or more employees. Listed companies that have to report quarterly as per SEBI requirements, will have to deal with all the issues in their first quarter of April-June 2006. This standard is applicable predominantly for Level 1 enterprises, and does not consider exemptions available to other than Level 1 enterprises.

### 15.3 MEANING OF THE TERM “EMPLOYEE BENEFITS”

The term employee is not defined under the standard AS 15 does not define who is an ‘employee’, but states in that: “An employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include directors and other management personnel”. This suggests that the intention was for the term ‘employee’ to apply more widely than simply to persons with a contract of employment as ‘casual’ and ‘temporary’ staff may frequently not have such contracts.

The following indicators may suggest an employee relationship may be more likely to exist, and may help in making individual judgements:

- ◆ A contract of employment exists;
- ◆ Individuals are considered employees for legal/tax/social security purposes;
- ◆ There is a large amount of oversight and direction by the employer and necessary tools, equipment and materials are provided by the employer;
- ◆ Services are performed at a location specified by the employer;

Services provided through an entity are in substance services provided by a specific individual, indications of which could be that the entity:

- ◆ Has no other clients;
- ◆ Has served the employer for a long period;
- ◆ Faces little or no financial risk;
- ◆ Requires the explicit permissions of the employer to concurrently undertake additional employment elsewhere.

### 15.4 SHORT-TERM EMPLOYEE BENEFITS

Short-term employee benefits are payable within twelve months after the period when the service is rendered. Accounting for these benefits is generally straightforward because no actuarial assumptions are required to measure the obligation or cost. Short-term employee benefits are broadly classified into four categories:

- (i) regular period benefits (e.g., wages, salaries);
- (ii) short-term compensated absences (e.g., paid annual leave, maternity leave, sick leave etc.);
- (iii) profit sharing and bonuses payable within twelve months; and
- (iv) non-monetary benefits (e.g., medical care, housing, cars etc.)

The Standard lays down a general recognition criteria for all short-term employee benefits. There are further requirements in respect of short-term compensated absences and profit sharing and

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bonus plans. The general criteria says that an enterprise should recognize as an expense (unless another accounting standard permits a different treatment) the undiscounted amount of all short-term employee benefits attributable to services that have been already rendered in the period and any difference between the amount of expenses so recognized and cash payments made during the period should be treated as a liability or prepayment (asset) as appropriate.

The expected cost of accumulating compensated absences should be recognized when employees render the service that increases their entitlement to future compensated absences. 'An enterprise should measure the expected cost of accumulating compensated absences as the *additional amount* that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date'. No distinction should be made between vesting and non-vesting entitlements. However, in measuring non-vesting entitlements, the possibility of employees leaving the enterprise before receiving them should be taken into account.

Non-accumulating compensated absences (e.g., maternity leave) do not carry forward and are not directly linked to the services rendered by employees in the past. Therefore, an enterprise recognizes no liability or expense until the time of the absence. In other words the cost of non-accumulating absences should be recognized as and when they arise.

Recognition of expenses for profit sharing and bonus plans would depend on fulfillment of conditions mentioned in the Standard. The conditions are:

- (a) Enterprise has a present obligation to make such payments as a result of past events; and
- (b) Reliable estimate of the obligation can be made.

The second condition can be satisfied only when the profit sharing and bonus plans contained a formula for determining the amount of benefit. The enterprise should recognize the expected cost of profit sharing and bonus payments in the financial statements.

### 15.5 POST EMPLOYMENT BENEFITS : DEFINED CONTRIBUTION VS DEFINED BENEFITS

Defined contribution plans are post-employment benefit plans under which an enterprise pays fixed contributions into a separate fund and will have no obligation to pay further contributions. Under defined contribution plans, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. In defined benefit plans, the actuarial and investment risk fall on the employer.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

In defined contribution plans, the contribution is charged to income statement, whereas in defined benefit plans, detailed actuarial calculation is performed to determine the charge.

### 15.6 IS THE GRATUITY SCHEME A DEFINED CONTRIBUTION OR DEFINED BENEFIT SCHEME?

An enterprise may pay insurance premiums to fund a post-employment benefit plan. The enterprise



should treat such a plan as a defined contribution plan unless the enterprise will have an obligation to either:

- (a) pay the employee benefits directly when they fall due;
- (b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

On the asset side, a question arises as to whether the funds under the scheme as certified by LIC would be treated as plan assets or reimbursement rights. The distinction is important (though both are measured on fair valuation basis) because plan assets are reduced from the defined benefit obligation and the net amount is disclosed in the balance sheet, whereas, in the case of reimbursement rights, the defined benefit obligation and the reimbursement rights are shown separately as liability and asset on the balance sheet. This would have the impact of making the balance sheet heavy both on the asset side as well as the liabilities side.

### 15.7 OTHER LONG TERM EMPLOYEE BENEFITS

Other long-term employee benefits include, for example:

- (a) long-term compensated absences such as long-service or sabbatical leave;
- (b) jubilee or other long-service benefits;
- (c) long-term disability benefits;
- (d) profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related services and
- (e) deferred compensation paid twelve months or more after the end of the period in which it is earned.

### 15.8 TERMINATION BENEFITS

Termination Benefits are employee benefits payable as a result of either an enterprise's decision to terminate an employee's employment before the normal retirement date or an employee's decision to accept voluntary redundancy in exchange for those benefits (e.g., payments under VRS). Termination benefits are recognized by an enterprise as a liability and an expense only when the enterprise has (i) a detailed formal plan for the termination which is duly approved, and (ii) a reliable estimate can be made of the amount of the obligation. Where the termination benefits fall due within twelve months after the balance sheet date, an *undiscounted* amount of such benefits should be recognized as liability in the balance sheet with a corresponding charge to Profit & Loss Account. However, when the termination benefits fall due more than twelve months after the balance sheet date, such benefits should be discounted using an appropriate discount rate. Where an offer has been made to encourage voluntary redundancy, the termination benefits should be measured by reference to the number of employees expected to accept the offer. Where there is uncertainty with regard to the number of employees who will accept an offer of voluntary

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redundancy, a contingent liability exists and should be so disclosed as per AS 29 'Provisions, Contingent Liabilities and Contingent Assets'.

#### 15.9 ACCOUNTING TREATMENT

In the Balance Sheet of the enterprise, 'the amount recognized as a defined benefit liability should be the net total of the following amounts:

- (a) the present value of the defined benefit obligation at the balance sheet date;
- (b) *minus* any past service cost not yet recognized;
- (c) *minus* the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly.'

In case where fair value of plan assets is high, it may so happen that the net amount under defined benefit liability turns negative (giving rise to net assets). A S 15 states that the enterprise, in such a situation, should measure the resulting asset at the lower of:-

- (i) the amount so determined; and
- (ii) the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The recognition of expenses relating to defined benefits in the Profit and Loss Account is stated in Para 61 of the Standard. The Standard identifies seven components of defined employee benefit costs:

- (a) current service cost;
- (b) interest cost;
- (c) the expected return on any plan assets (and any reimbursement rights);
- (d) actuarial gains and losses (to the extent they are recognized);
- (e) past service cost (to the extent they are recognized);
- (f) the effect of any curtailments or settlements; and
- (g) the extent to which the negative net amount of defined benefit liability exceeds the amount mentioned in Para 59(ii) of the Standard.

The item (f) above needs explanation. A settlement occurs when an employer enters into a transaction that eliminates all further legal or constructive obligations for part or whole of the benefits provided under a defined benefit plan. For example, the commuted portion of pension. A curtailment occurs when an employer either commits to reduce the number of employees covered by a plan or reduces the benefits under a plan. The gains or losses on the settlement or curtailment of a defined benefit plan should be recognized when the settlement or curtailment occurs.

### 15.10 DISCLOSURE

Where there is uncertainty about the number of employees who will accept an offer of termination benefits, a contingent liability exists.

As required by AS 29, *"Provisions, Contingent Liabilities and Contingent Assets"* an enterprise discloses information about the contingent liability unless the possibility of an outflow in settlement is remote.

As required by AS 5, *"Net Profit or Loss for the Period, Prior Period items and Changes in Accounting Policies"* an enterprise discloses the nature and amount of an expense if it is of such size, nature or incidence that its disclosure is relevant to explain the performance of the enterprise for the period.

Termination benefits may result in an expense needing disclosure in order to comply with this requirement.

Where required by AS 18, *"Related Party Disclosures"*, an enterprise discloses information about termination benefits for key management personnel

When drafting AS 15 (revised), the standard setters felt that merely on the basis of a detailed formal plan, it would not be appropriate to recognise a provision since a liability cannot be considered to be crystallized at this stage. See Chart 5 for its recognition and measurement as per the standard. Accordingly, the revised AS 15 (2005) requires more certainty for recognition of termination cost, for example, if the employee has sign up for the termination scheme.

As per the transitional provision of revised AS 15, as regards VRS as paid upto 31 March, 2009, there is a choice to defer it over pay back period, subject to prohibition on carry forward to periods commencing on or after 1 April, 2010.

### 15.11 ACTUARIAL ASSUMPTIONS

Actuarial assumptions comprising demographic assumptions and financial assumptions should be unbiased and mutually compatible.

Financial assumptions should be based on market expectations, at the balance sheet date, for the period over which the obligations are to be settled.

Therefore assumption relating to inflation, salary growth rates, labour turnover, etc. are based on long term indications, which could be materially different from current or short term statistics. For example, current salary growth rates may be very high, but over a very long term it is inconceivable to expect that trend to be sustained.

The rate used to discount post-employment benefit obligations (both funded and unfunded) should be determined by reference to market yields at the balance sheet date on government bonds (Risk free rate). The currency and term of the government bonds should be consistent with the currency and estimated term of the post employment benefit obligations.

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Therefore, the discount rate for determining actuarial liability in the case of a company in India, cannot be based for example, on US treasury bill rates. The discount rate should be long term government bond rates applicable in India.

### **15.12 ACTUARIAL GAINS AND LOSSES**

In determining actuarial liability for post employment benefit schemes, significant assumptions are made in respect of interest rate, expected return on plan assets, salary growth rate, attrition rate, etc. Actuarial gains and losses are experience adjustments to the assumptions used and effect of changes in actuarial assumptions.

#### **Illustration 1**

Omega Limited belongs to the engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of Rs. 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to Rs. 2 lakhs instead of Rs. 5 lakhs. The average remaining life of the employees is estimated to be 6 years. You are required to advise the company on the following items from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards.

#### **Solution**

According to AS 15 (Revised 2005) 'Employee Benefits', actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus amount of Rs. 6 lakhs is required to be credited to the profit and loss statement of the current year.

#### **Self-examination Questions**

1. Define the following terms in the context of AS 15 (Revised):
  - (a) Short-term employee benefits.
  - (b) Post-employment benefit plans.
  - (c) Defined contribution plans.
  - (d) Termination benefits.
  - (e) Plan assets.
  - (f) Vested employee benefits.
  - (g) Actuarial gains and losses.
2. How are short term employee benefits recognized and measured?
3. What are the disclosure requirements for multi-employer plans?
4. What is the accounting treatment for insurance premiums paid by employer to fund a post employment benefit plan?

5. Explain the recognition and measurement provisions for termination benefits as per AS 15 (Revised).
6. 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.

## UNIT 16

### AS 16: BORROWING COSTS

Reference: The students are advised to refer the full text of AS 16 "Borrowing Costs" (issued 2000) given in Appendix I at the end of the Study Material (Volume-II).

#### 16.1 INTRODUCTION

The standard prescribes the accounting treatment for borrowing costs (i.e. interest and other costs) incurred by an enterprise in connection with the borrowing of funds. Borrowing costs are required to be capitalized as part of a qualifying asset (an asset that takes a substantial period of time to get ready for its intended use), if it is directly attributable towards its acquisition, construction or production. Upon such capitalization, the carrying amount of assets should be assessed as to whether it is greater than its recoverable amount or net realizable value and adjustments are required to be made in accordance with other standards. The amount of borrowing costs eligible for capitalization should be determined in accordance with AS 16 and other borrowing costs (not eligible for capitalization) should be recognized as expenses in the period in which they are incurred. This Standard comes into effect in respect of accounting periods commencing on or after 1-4-2000 and is mandatory in nature. This Statement does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

**16.2 Borrowing costs** are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

Borrowing costs may include:

- a. Interest and commitment charges on bank borrowings and other short-term and long-term borrowings;
- b. Amortisation of discounts or premiums relating to borrowings;
- c. Amortisation of ancillary costs incurred in connection with the arrangement of borrowings;
- d. Finance charges in respect of assets acquired under finance leases or under other similar arrangements; and
- e. Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

**16.3 A qualifying asset** is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

#### 16.4 ACCOUNTING STANDARDS INTERPRETATION (ASI 1):

The issue as to what constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale should be considered.

The following assets ordinarily take twelve months or more to get ready for intended use or sale unless the contrary can be proved by the enterprise:

- ◆ Assets that are constructed or otherwise produced for an enterprise's own use, e.g., assets constructed under major capital expansions.
- ◆ Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (for example, ships or real estate developments).

In case of inventories, substantial period of time is considered to be involved where time is the major factor in bringing about a change in the condition of inventories. For example, liquor is often required to be kept in store for more than twelve months for maturing.

#### 16.5 BORROWING COSTS ELIGIBLE FOR CAPITALISATION

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified. It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period. The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

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### **16.6 ACCOUNTING STANDARDS INTERPRETATION (ASI 10):**

Exchange differences on the amount of principal of the foreign currency borrowings to the extent of difference between interest on local currency borrowings and interest on foreign currency borrowings. For this purpose, the interest rate for the local currency borrowings should be considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings. If the difference between the interest on local currency borrowings and the interest on foreign currency borrowings is equal to or more than the exchange difference on the amount of principal of the foreign currency borrowings, the entire amount of exchange difference is covered.

### **16.7 EXCESS OF THE CARRYING AMOUNT OF THE QUALIFYING ASSET OVER RECOVERABLE AMOUNT**

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Accounting Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Accounting Standards.

### **16.8 COMMENCEMENT OF CAPITALISATION**

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

- a. *Expenditure for the acquisition, construction or production of a qualifying asset is being incurred:* Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.
- b. *Borrowing costs are being incurred.*
- c. *Activities that are necessary to prepare the asset for its intended use or sale are in progress:* The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place.

### **16.9 SUSPENSION OF CAPITALISATION**

Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding



partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

### 16.10 CESSATION OF CAPITALISATION

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.

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.

### 16.11 DISCLOSURE

The financial statements should disclose:

- a. The accounting policy adopted for borrowing costs; and
- b. The amount of borrowing costs capitalised during the period.

### 16.12 ILLUSTRATIONS

#### Illustration 1

| <i>Particulars</i>                                       | <i>Amount (Rs.)</i> |
|----------------------------------------------------------|---------------------|
| Expenditure incurred till 31-03-2006                     | 7,00,000            |
| Interest cost capitalized for the financial year 2005-06 | 30,000              |
| Amount borrowed till 31-03-06                            | 4,00,000            |
| Amount transferred to construction during 2006-07        | 2,00,000            |
| Cash payment during 2006-07                              | 1,00,000            |
| Progress payment received                                | 5,00,000            |
| New borrowing during 2006-07 @ 15%                       | 3,00,000            |
| Calculate the amount of borrowing to be capitalized.     |                     |

#### Solution

Total Borrowing Cost = 7,00,000 X 0.15 = Rs. 1,05,000

| <i>Particulars</i>                                                   | <i>Amount</i>   |
|----------------------------------------------------------------------|-----------------|
| Expenditure incurred including previously capitalized borrowing cost | 7,30,000        |
| Cash payment during 2006-07                                          | 1,00,000        |
| Asset transferred during 2006-07                                     | <u>1,00,000</u> |
|                                                                      | 9,30,000        |

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|                                 |                 |
|---------------------------------|-----------------|
| Less: Progress payment received | <u>5,00,000</u> |
|                                 | <u>4,30,000</u> |

Money borrowed including previously capitalized interest cost = Rs. 7,30,000

Borrowing cost to be capitalized =  $4,30,000 / 7,30,000 \times 1,05,000$  = Rs. 61,849.32

#### Illustration 2

PRM Ltd. obtained a loan from a bank for Rs. 50 lakhs on 30-04-2005. It was utilized as follows:

| <i>Particulars</i>            | <i>Amount (Rs.in lakhs)</i> |
|-------------------------------|-----------------------------|
| Construction of a shed        | 50                          |
| Purchase of a machinery       | 40                          |
| Working Capital               | 20                          |
| Advance for purchase of truck | 10                          |

Construction of shed was completed in March 2006. The machinery was installed on the same date. Delivery truck was not received. Total interest charged by the bank for the year ending 31-03-2006 was Rs.18 lakhs. Show the treatment of interest.

#### Solution

Qualifying Asset as per AS-16 = Rs. 50 lakhs (construction of a shed)

Borrowing cost to be capitalized =  $18 \times 50 / 120$  = Rs. 7.5 lakhs

Interest to be debited to Profit or Loss account = Rs. (18 – 7.5) lakhs  
= Rs. 10.5 lakhs

#### Illustration 3

The company has obtained Institutional Term Loan of Rs. 580 lakhs for modernisation and renovation of its Plant & Machinery. Plant & Machinery acquired under the modernisation scheme and installation completed on 31st March, 2006 amounted to Rs. 406 lakhs, Rs. 58 lakhs has been advanced to suppliers for additional assets and the balance loan of Rs. 116 lakhs has been utilised for working capital purpose. The Accountant is on a dilemma as to how to account for the total interest of Rs. 52.20 lakhs incurred during 2005-2006 on the entire Institutional Term Loan of Rs. 580 lakhs.

#### Solution

As per para 6 of AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognized as an expense in the period in which they are incurred. Borrowing costs should be expensed except where they are directly attributable to acquisition, construction or production of qualifying asset.

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A qualifying asset is an asset that necessarily takes a substantial period of time\* to get ready for its intended use or sale.

The treatment for total interest amount of Rs. 52.20 lakhs can be given as:

| <i>Purpose</i>                                      | <i>Nature</i>          | <i>Interest to be charged to profit and loss account</i> | <i>Interest to be charged to profit and loss account</i> |
|-----------------------------------------------------|------------------------|----------------------------------------------------------|----------------------------------------------------------|
|                                                     |                        |                                                          | <i>Rs. in lakhs</i>                                      |
|                                                     |                        | $^{**}52.20 \times \frac{58}{580} = 5.22$                |                                                          |
|                                                     |                        | <i>Rs. in lakhs</i>                                      |                                                          |
| Modernisation and renovation of plant and machinery | Qualifying asset       | $^{**}52.20 \times \frac{406}{580} = 36.54$              |                                                          |
| Advance to supplies for additional assets           | Qualifying asset       |                                                          |                                                          |
| Working Capital                                     | Not a qualifying asset |                                                          | $52.20 \times \frac{116}{580} = 10.44$                   |
|                                                     |                        | <u>41.76</u>                                             | <u>10.44</u>                                             |

\*Accounting Standards Interpretation (ASI) 1 deals with the meaning of expression 'substantial period of time'. A substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case.

\*\* It is assumed in the above solution that the modernization and renovation of plant and machinery will take substantial period of time (i.e. more than twelve months). Regarding purchase of additional assets, the nature of additional assets has also been considered as qualifying assts. Alternatively, the plant and machinery and additional assets may be assumed to be non-qualifying assts on the basis that the renovation and installation of additional assets will not take substantial period of time. In that case, the entire amount of interest, Rs. 52.20 lakhs will be recognized as expense in the profit and loss account for year ended 31st March, 2006.

### Illustration 4

The notes to accounts of X Ltd. for the year 2005-2006 include the following:

"Interest on bridge loan from banks and Financial Institutions and on Debentures specifically

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obtained for the Company's Fertiliser Project amounting to Rs. 1,80,80,000 has been capitalized during the year, which includes approximately Rs. 1,70,33,465 capitalised in respect of the utilization of loan and debenture money for the said purpose." Is the treatment correct? Briefly comment.

#### Solution

The treatment done by the company is not in accordance with AS 16 'Borrowing Costs'. As per para 10 of AS 16, to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period. Hence, the capitalisation of borrowing costs should be restricted to the actual amount of interest expenditure i.e. Rs. 1,70,33,465. Thus, there is an excess capitalisation of Rs. 10,46,535. This has resulted in overstatement of profits by Rs. 10,46,535 and amount of fixed assets has also gone up by this amount.

#### Illustration 5

XYZ Ltd., has undertaken a project for expansion of capacity as per the following details:

|                 | <i>Plan</i> | <i>Actual</i> |
|-----------------|-------------|---------------|
|                 | <i>Rs.</i>  | <i>Rs.</i>    |
| April, 2006     | 2,00,000    | 2,00,000      |
| May, 2006       | 2,00,000    | 3,00,000      |
| June, 2006      | 10,00,000   | —             |
| July, 2006      | 1,00,000    | —             |
| August, 2006    | 2,00,000    | 1,00,000      |
| September, 2006 | 5,00,000    | 7,00,000      |

The company pays to its bankers at the rate of 12% p.a., interest being debited on a monthly basis. During the half year company had Rs. 10 lakhs overdraft upto 31st July, surplus cash in August and again overdraft of over Rs. 10 lakhs from 1.9.2006. The company had a strike during June and hence could not continue the work during June. Work was again commenced on 1st July and all the works were completed on 30th September. Assume that expenditure were incurred on 1st day of each month. Calculate:

- (i) Interest to be capitalised.
- (ii) Give reasons wherever necessary.

Assume:

- (a) Overdraft will be less, if there is no capital expenditure.

- (b) The Board of Directors based on facts and circumstances of the case has decided that any capital expenditure taking more than 3 months as substantial period of time.

### Solution

| (a) XYZ Ltd.    |                       |                         |                   |
|-----------------|-----------------------|-------------------------|-------------------|
| Month           | Actual<br>Expenditure | Interest<br>Capitalised | Cumulative Amount |
|                 | Rs.                   | Rs.                     | Rs.               |
| April, 2006     | 2,00,000              | 2,000                   | 2,02,000          |
| May, 2006       | 3,00,000              | 5,020                   | 5,07,020          |
| June, 2006      | –                     | 5,070                   | 5,12,090          |
| July, 2006      | –                     | 5,120                   | 5,17,210          |
| August, 2006    | 1,00,000              | –                       | 6,17,210          |
| September, 2006 | <u>7,00,000</u>       | <u>10,000</u>           | <u>13,27,210</u>  |
|                 | <u>13,00,000</u>      | <u>27,210</u>           | <u>13,27,210</u>  |

### Note:

1. There would not have been overdraft, if there is no capital expenditure. Hence, it is a case of specific borrowing as per AS 16 on Borrowing Costs.
2. The company had a strike in June and hence could not continue the work during June. As per para 14 (c) of AS 16, the activities that are necessary to prepare the asset for its intended use or sale are in progress. The strike is not during extended period. Thus during strike period, interest need to be capitalised.
3. During August, the company did not incur any interest as there was surplus cash in August. Therefore, no amount should be capitalised during August as per para 14(b) of AS 16.
4. During September, it has been taken that actual overdraft is Rs. 10 lakhs only. Hence, only Rs. 10,000 interest has been capitalised even though actual expenditure exceeds Rs. 10 lakhs.

Alternatively, interest may be charged on total amount of (Rs. 6,17,210 + Rs. 7,00,000 = 13,17,210) for the month of September, 2006 as it is given in the question that overdraft was over Rs. 10 lakhs from 1.9.2006 and not exactly Rs. 10 lakhs. In that case, interest amount Rs. 13,172 will be capitalised for the month of September.

### Self-examination Questions

1. Briefly indicate the items, which are included in the expression "borrowing cost" as explained in AS 16.

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2. What is the qualifying assets? Explain with the help of an example?
3. Mukul Ltd. capitalizes interest cost of holding investments and adds to cost of the investment every year, thereby understating interest cost in Profit & Loss Account. Comment on the accounting treatment followed by the Company.
4. What is meant by substantial period of time for the purpose of AS 16?
5. How are borrowing costs recognized?
6. How do you treat excess of carrying amount of qualifying asset over its recoverable amount, if any?
7. Cost of an inventory item is Rs.90,000. Borrowing Cost capitalised as per AS – 16 is Rs.12,000. What will be accounting treatment if the NRV of this item is (a) Rs.1,00,000?
8. What are the conditions to be satisfied for commencement of capitalization?
9. X Co. Ltd., has obtained an Institutional Loan of Rs. 680 lakhs for modernisation and renovation of its plant & machiney, Plant & machinery acquired under the modernisation scheme and installation completed on 31.3.2006 amounted to Rs. 520 lakhs, 30 lakhs has been advanced to suppliers for additional assets and the balance loan of Rs. 130 lakhs has been utilized for working capital purpose. The total interest paid for the above loan amounted to Rs. 62 lakhs during 2005-06.  
  
You are required to state how the interest on the institutional loan is to be accounted for in the year 2005-06.
10. In May, 2004 Speed Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2005 and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was Rs. 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2005 amounted to Rs. 25 lakhs.

Can Rs. 25 lakhs be treated as part of the cost of factory building and thus be capitalized on the plea that the loan was specifically taken for the construction of factory building?

## UNIT 17

### AS 17: SEGMENT REPORTING

*Reference:* The students are advised to refer the full text of AS 17 "Segment Reporting" (issued 2000) given in Appendix I at the end of the Study Material (Volume-II).

#### 17.1 INTRODUCTION

This Standard comes into effect in respect of accounting periods commencing on or after 1.4.2001 and is mandatory in nature, from that date, in respect of the following:

- (i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.
- (ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

This standard establishes principles for reporting financial information about different types of products and services an enterprise produces and different geographical areas in which it operates. The information is expected to help users of financial statements, to better understand the performance and assess the risks and returns of the enterprise and make more informed judgements about the enterprise as a whole. The standard is more relevant for assessing risks and returns of a diversified or multilocal enterprise which may not be determinable from the aggregated data.

#### 17.2 OBJECTIVE

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. The objective of this Statement is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements:

- (a) Better understand the performance of the enterprise;
- (b) Better assess the risks and returns of the enterprise; and
- (c) Make more informed judgements about the enterprise as a whole.

#### 17.3 SCOPE

An enterprise should comply with the requirements of this Statement fully and not selectively. If a single financial report contains both consolidated financial statements and the separate financial

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statements of the parent, segment information need be presented only on the basis of the consolidated financial statements. In the context of reporting of segment information in consolidated financial statements, the references in this Statement to any financial statement items should be construed to be the relevant item as appearing in the consolidated financial statements.

### 17.4 DEFINITION OF THE TERMS USED IN THE ACCOUNTING STANDARD

**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** is a distinguishable component of an enterprise that is engaged in providing products 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.

The risks and returns of an enterprise are influenced both by the geographical location of its operations and also by the location of its customers. The definition allows geographical segments to be based on either:

- a. The location of production or service facilities and other assets of an enterprise; or
- b. The location of its customers.

**A reportable segment** is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Statement.



The predominant sources of risks affect how most enterprises are organised and managed. Therefore, the organisational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments.

**Segment revenue** is the aggregate of

- (i) The portion of enterprise revenue that is directly attributable to a segment,
- (ii) The relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and
- (iii) Revenue from transactions with other segments of the enterprise.

Segment revenue does not include:

- a. Extraordinary items as defined in AS 5.
- b. Interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and
- c. Gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

**Segment expense** is the aggregate of

- (i) The expense resulting from the operating activities of a segment that is directly attributable to the segment, and
- (ii) The relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment,
- (iii) Including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

- a. Extraordinary items as defined in AS 5.
- b. Interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature.
- c. Losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature.
- d. Income tax expense; and
- e. General administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

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**Segment assets** are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets. Segment assets do not include income tax assets. Segment assets are determined after deducting related allowances/provisions that are reported as direct offsets in the balance sheet of the enterprise.

**Segment liabilities** are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities. Segment liabilities do not include income tax liabilities.

### 17.5 ACCOUNTING STANDARDS INTERPRETATION (ASI 22)

The interest expense relating to overdrafts and other operating liabilities identified to a particular segment should not be included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories as per paragraph below.

In case interest is included as a part of the cost of inventories where it is so required as per AS 16, read with AS 2, Valuation of Inventories, and those inventories are part of segment assets of a particular segment, such interest should be considered as a segment expense. In this case, the amount of such interest and the fact that the segment result has been arrived at after considering such interest should be disclosed by way of a note to the segment result.

### 17.6 ALLOCATION

An enterprise looks to its internal financial reporting system as the starting point for identifying those items that can be directly attributed, or reasonably allocated, to segments. There is thus a presumption that amounts that have been identified with segments for internal financial reporting purposes are directly attributable or reasonably allocable to segments for the purpose of measuring the segment revenue, segment expense, segment assets, and segment liabilities of reportable segments.

In some cases, however, a revenue, expense, asset or liability may have been allocated to segments for internal financial reporting purposes on a basis that is understood by enterprise management but that could be deemed arbitrary in the perception of external users of financial statements. Conversely, an enterprise may choose not to allocate some item of revenue, expense, asset or liability for internal financial reporting purposes, even though a reasonable basis for doing so exists. Such an item is allocated pursuant to the definitions of segment revenue, segment expense, segment assets, and segment liabilities in this Statement. Segment revenue, segment

expense, segment assets and segment liabilities are determined before intra-enterprise balances and intra-enterprise transactions are eliminated as part of the process of preparation of enterprise financial statements, except to the extent that such intra-enterprise balances and transactions are within a single segment. While the accounting policies used in preparing and presenting the financial statements of the enterprise as a whole are also the fundamental segment accounting policies, segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as identification of segments, method of pricing inter-segment transfers, and basis for allocating revenues and expenses to segments.

### **17.7 PRIMARY AND SECONDARY SEGMENT REPORTING FORMATS**

The dominant source and nature of risks and returns of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments. Internal organisation and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer should normally be the basis for identifying the predominant source and nature of risks and differing rates of return facing the enterprise and, therefore, for determining which reporting format is primary and which is secondary, except as provided paragraphs below:

- a. If risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates, as evidenced by a 'matrix approach', then the enterprise should use business segments as its primary segment reporting format and geographical segments as its secondary reporting format; and
- b. If internal organisational and management structure of an enterprise are based neither on individual products or services or groups of related products/services nor on geographical areas, it should be determined whether the risks and returns of the enterprise are related more to the products and services it produces or to the geographical areas in which it operates and accordingly, choose segments.

### **17.8 MATRIX PRESENTATION**

A 'matrix presentation' both business segments and geographical segments as primary segment reporting formats with full segment disclosures on each basis will often provide useful information if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates. This Statement does not require, but does not prohibit, a 'matrix presentation'.

### **17.9 BUSINESS AND GEOGRAPHICAL SEGMENTS**

Generally Business and Geographical segments are determined on the basis of internal financial reporting to the board of directors and the chief executive officer. But if such segment does not satisfy the definitions given in AS, then following points should be considered for:

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- a. If one or more of the segments reported internally to the directors and management is a business segment or a geographical segment based on the factors in the definitions but others are not, paragraph below should be applied only to those internal segments that do not meet the definitions.
- b. For those segments reported internally to the directors and management that do not satisfy the definitions, management of the enterprise should look to the next lower level of internal segmentation that reports information along product and service lines or geographical lines, as appropriate under the definitions and
- c. If such an internally reported lower-level segment meets the definition of business segment or geographical segment, the criteria for identifying reportable segments should be applied to that segment.

### **17.10 IDENTIFYING REPORTABLE SEGMENTS**

A business segment or geographical segment should be identified as a reportable segment if:

- a. Its revenue from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or
- b. Its segment result, whether profit or loss, is 10 per cent or more of –
  - (i) The combined result of all segments in profit, or
  - (ii) The combined result of all segments in loss,
  - (iii) Whichever is greater in absolute amount; or
- c. Its segment assets are 10 per cent or more of the total assets of all segments.

A business segment or a geographical segment which is not a reportable segment as per above paragraph, 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 per cent of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 per cent thresholds, until at least 75 per cent of total enterprise revenue is included in reportable segments.

A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10 per cent thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10 per cent thresholds.

If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10 per cent thresholds, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to reflect the newly reportable

segment as a separate segment, even if that segment did not satisfy the 10 per cent thresholds in the preceding period.

#### **17.11 SEGMENT ACCOUNTING POLICIES**

Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. This Statement does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements provided that (a) the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance and (b) the basis of measurement for this additional information is clearly described. Assets and liabilities that relate jointly to two or more segments should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.

#### **17.12 PRIMARY REPORTING FORMAT**

An enterprise should disclose the following for each reportable segment:

- a. Segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;
- b. Segment result;
- c. Total carrying amount of segment assets;
- d. Total amount of segment liabilities;
- e. Total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);
- f. Total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and
- g. Total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.

An enterprise is encouraged, but not required, to disclose the nature and amount of any items of segment revenue and segment expense that are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the segment for the period. Such disclosure is not intended to change the classification of any such items of revenue or expense from ordinary to extraordinary or to change the measurement of such items. The disclosure, however, does change the level at which the significance of such items is evaluated for disclosure purposes from the enterprise level to the segment level.

AS 3, recommends that an enterprise present a cash flow statement that separately reports cash flows from operating, investing and financing activities. Disclosure of information regarding

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operating, investing and financing cash flows of each reportable segment is relevant to understanding the enterprise's overall financial position, liquidity, and cash flows. Disclosure of segment cash flow is, therefore, encouraged, though not required. An enterprise that provides segment cash flow disclosures need not disclose depreciation and amortisation expense and non-cash expenses.

An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements. In presenting the reconciliation, segment revenue should be reconciled to enterprise revenue; segment result should be reconciled to enterprise net profit or loss; segment assets should be reconciled to enterprise assets; and segment liabilities should be reconciled to enterprise liabilities.

### **17.13 SECONDARY SEGMENT INFORMATION**

If primary format of an enterprise for reporting segment information is business segments, it should also report the following information:

- a. Segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue;
- b. The total carrying amount of segment assets by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments; and
- c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments.

If primary format of an enterprise for reporting segment information is geographical segments (whether based on location of assets or location of customers), it should also report the following segment information for each business segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue or whose segment assets are 10 per cent or more of the total assets of all business segments:

- a. Segment revenue from external customers;
- b. The total carrying amount of segment assets; and
- c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets).

If primary format of an enterprise for reporting segment information is geographical segments that are based on location of assets, and if the location of its customers is different from the location of its assets, then the enterprise should also report revenue from sales to external customers for each customer-based geographical segment whose revenue from sales to external customers is 10 per

cent or more of enterprise revenue.

If primary format of an enterprise for reporting segment information is geographical segments that are based on location of customers, and if the assets of the enterprise are located in different geographical areas from its customers, then the enterprise should also report the following segment information for each asset-based geographical segment whose revenue from sales to external customers or segment assets are 10 per cent or more of total enterprise amounts:

- a. The total carrying amount of segment assets by geographical location of the assets.
- b. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by location of the assets.

#### 17.14 DISCLOSURES

In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.

Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable.

An enterprise should indicate the types of products and services included in each reported business segment and indicate the composition of each reported geographical segment, both primary and secondary, if not otherwise disclosed in the financial statements.

#### 17.15 MISCELLANEOUS ILLUSTRATIONS

##### Illustration 1

The Chief Accountant of Sports Ltd. gives the following data regarding its six segments:

|                 | <i>Rs. In lakhs</i> |      |    |    |     |    |       |
|-----------------|---------------------|------|----|----|-----|----|-------|
| Particulars     | M                   | N    | O  | P  | Q   | R  | Total |
| Segment Assets  | 40                  | 80   | 30 | 20 | 20  | 10 | 200   |
| Segment Results | 50                  | -190 | 10 | 10 | -10 | 30 | -100  |
| Segment Revenue | 300                 | 620  | 80 | 60 | 80  | 60 | 1,200 |

The Chief accountant is of the opinion that segments "M" and "N" alone should be reported. Is he justified in his view? Discuss.

##### Solution

As per para 27 of AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

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- (i) Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or
- (ii) Its segment result whether profit or loss is 10% or more of:
  - (1) The combined result of all segments in profit; or
  - (2) The combined result of all segments in loss, whichever is greater in absolute amount; or
- (iii) Its segment assets are 10% or more of the total assets of all segments.

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

- (a) On the basis of turnover criteria segments M and N are reportable segments.
- (b) On the basis of the result criteria, segments M, N and R are reportable segments (since their results in absolute amount is 10% or more of Rs.200 lakhs).
- (c) On the basis of asset criteria, all segments except R are reportable segments.

Since all the segments are covered in atleast one of the above criteria all segments have to be reported upon in accordance with Accounting Standard (AS) 17. Hence, the opinion of chief accountant is wrong.

### Illustration 2

Prepare a segmental report for publication in Diversifiers Ltd. from the following details of the company's three divisions and the head office:

|                                     | Rs.('000)     |
|-------------------------------------|---------------|
| <i>Forging Shop Division</i>        |               |
| <i>Sales to Bright Bar Division</i> | 4,575         |
| <i>Other Domestic Sales</i>         | 90            |
| <i>Export Sales</i>                 | <u>6,135</u>  |
|                                     | <u>10,800</u> |
| <i>Bright Bar Division</i>          |               |
| <i>Sales to Fitting Division</i>    | 45            |
| <i>Export Sales to Rwanda</i>       | <u>300</u>    |
|                                     | <u>345</u>    |
| <i>Fitting Division</i>             |               |
| <i>Export Sales to Maldives</i>     | <u>270</u>    |



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| Particulars                  | Head Office | Forging Shop Division | Bright Bar Division | Fitting Division |
|------------------------------|-------------|-----------------------|---------------------|------------------|
|                              | Rs. ('000)  | Rs. ('000)            | Rs. ('000)          | Rs. ('000)       |
| Pre-tax operating result     |             | 240                   | 30                  | (12)             |
| Head office cost reallocated |             | 72                    | 36                  | 36               |
| Interest costs               |             | 6                     | 8                   | 2                |
| Fixed assets                 | 75          | 300                   | 60                  | 180              |
| Net current assets           | 72          | 180                   | 60                  | 135              |
| Long-term liabilities        | 57          | 30                    | 15                  | 180              |

**Solution**

**Diversifiers Ltd.  
Segmental Report**

|                                                           |               |            |            |                            | (Rs. '000)         |
|-----------------------------------------------------------|---------------|------------|------------|----------------------------|--------------------|
| Particulars                                               | Divisions     |            |            |                            |                    |
|                                                           | Forging shop  | Bright Bar | Fitting    | Inter Segment Eliminations | Consolidated Total |
| <i>Segment revenue</i>                                    |               |            |            |                            |                    |
| <i>Sales:</i>                                             |               |            |            |                            |                    |
| Domestic                                                  | 90            | —          | —          | —                          | 90                 |
| Export                                                    | <u>6,135</u>  | <u>300</u> | <u>270</u> | <u>—</u>                   | <u>6,705</u>       |
| External Sales                                            | 6,225         | 300        | 270        | —                          | 6,795              |
| Inter-segment sales                                       | <u>4,575</u>  | <u>45</u>  | <u>—</u>   | <u>4,620</u>               | <u>—</u>           |
| Total revenue                                             | <u>10,800</u> | <u>345</u> | <u>270</u> | <u>4,620</u>               | <u>6,795</u>       |
| Segment result (given)                                    | 240           | 30         | (12)       |                            | 258                |
| Head office expenses                                      |               |            |            |                            | <u>(144)</u>       |
| Operating profit                                          |               |            |            |                            | 114                |
| Interest expense                                          |               |            |            |                            | <u>(16)</u>        |
| Profit before tax                                         |               |            |            |                            | <u>98</u>          |
| <i>Information in relation to assets and liabilities:</i> |               |            |            |                            |                    |
| Fixed assets                                              | 300           | 60         | 180        | —                          | 540                |
| Net current assets                                        | <u>180</u>    | <u>60</u>  | <u>135</u> | <u>—</u>                   | <u>375</u>         |

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|                                           |            |            |            |          |              |
|-------------------------------------------|------------|------------|------------|----------|--------------|
| Segment assets                            | <u>480</u> | <u>120</u> | <u>315</u> | <u>—</u> | 915          |
| Unallocated corporate assets<br>(75 + 72) | —          | —          | —          | —        | <u>147</u>   |
| Total assets                              |            |            |            |          | <u>1,062</u> |
| Segment liabilities                       | 30         | 15         | 180        | —        | 225          |
| Unallocated corporate liabilities         |            |            |            |          | <u>57</u>    |
| Total liabilities                         |            |            |            |          | <u>282</u>   |

#### Sales Revenue by Geographical Market

|                |                       |                                                            |                                 |                               |                               |
|----------------|-----------------------|------------------------------------------------------------|---------------------------------|-------------------------------|-------------------------------|
|                |                       |                                                            |                                 |                               | (Rs. '000)                    |
|                | <i>Home<br/>Sales</i> | <i>Export Sales<br/>(by forging<br/>shop<br/>division)</i> | <i>Export<br/>to<br/>Rwanda</i> | <i>Export to<br/>Maldives</i> | <i>Consolidated<br/>Total</i> |
| External sales | 90                    | 6,135                                                      | 300                             | 270                           | 6,795                         |

#### Self-examination Questions

- Define the following terms in the context of AS 17:
  - Business segment;
  - Geographical segment.
  - Reportable segment.
  - Segment result.
  - Segment assets.
- How are geographical segments identified? Can geographical segment exists within the same country?
- How are items allocated or attributed directly to a segment?
- Explain the principles of allocation of segment revenue and expenses.
- Can interest Expense relating to overdrafts and other operating liabilities identified to a particular segment, be included in the segment expense?
- How are intra enterprise transactions treated when preparing segment reports?
- When does a business or geographical segment become a reportable segment?
- Write short note on Accounting Policies followed in segment reporting.
- Explain the disclosure requirements of AS 17.

10. Mala Ltd. has the following business/geographical segments. Examine which of these are reportable segments under AS 17.

| <i>Segments</i> | <i>(information in Rs.000's)</i> |                      |               |
|-----------------|----------------------------------|----------------------|---------------|
|                 | <i>Revenue</i>                   | <i>Profit/(Loss)</i> | <i>Assets</i> |
| A               | 9,600                            | 1.750                | 4,100         |
| B               | 300                              | 180                  | 450           |
| C               | 100                              | 70                   | 450           |

## UNIT 18

### AS 18: RELATED PARTY DISCLOSURES

Reference: The students are advised to refer the full text of AS 18 "Related Party Disclosures" (issued 2000) given in Appendix I at the end of the Study Material (Volume-II).

#### 18.1 INTRODUCTION

This Standard comes into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature. The standard prescribes the requirements for disclosure of related party relationship and transactions between the reporting enterprise and its related parties. The requirements of the standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company. Since the standard is more subjective, particularly with respect to identification of related parties [though provisions related to related party concept are given under sections 297 / 299 / 301 of the Companies Act, 1956 and section 40A (2)(b) of the Income Tax Act, 1961], obtaining corroborative evidence becomes very difficult for the auditors. Thus successful implementation of AS 18 is dependent upon how transparent the management is and how vigilant the auditors are.

#### 18.2 OBJECTIVE

The objective of this Statement is to establish requirements for disclosure of:

- (a) Related party relationships and
- (b) Transactions between a reporting enterprise and its related parties.

#### 18.3 SCOPE

This Statement should be applied in reporting related party relationships and transactions between a reporting enterprise and its related parties. The requirements of this Statement apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company.

This Statement deals only with related party relationships described in (a) to (e) below:

- a. Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries).
- b. Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture.

- c. Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual.
- d. Key management personnel and relatives of such personnel and
- e. Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

#### 18.4 DEFINITIONS OF THE TERMS USED IN THE ACCOUNTING STANDARD

In the context of this Statement, the following are deemed not to be related parties:

- a. Two companies simply because they have a director in common, notwithstanding paragraph (d) or (e) above (unless the director is able to affect the policies of both companies in their mutual dealings).
- b. A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence and
- c. The parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):
  - (i) Providers of finance.
  - (ii) Trade unions.
  - (iii) Public utilities.
  - (iv) Government departments and government agencies including government sponsored bodies.

Related party disclosure requirements as laid down in this Statement do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.

Disclosure of transactions between members of a group is unnecessary in consolidated financial statements because consolidated financial statements present information about the holding and its subsidiaries as a single reporting enterprise. No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

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

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**Related party:** 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.

#### Illustration

Identify the related parties in the following cases as per AS-18

A Ltd. holds 51% of B Ltd.

B Ltd holds 51% of O Ltd.

Z Ltd holds 49% of O Ltd.

#### Solution

A Ltd., B Ltd. & O Ltd. are related to each other. Z Ltd. & O Ltd. are related to each other by virtue of Associate relationship. However, neither A Ltd. nor B Ltd. is related to Z Ltd. and vice versa.

**Control:** (a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or (b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or (c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

For the purpose of this Statement, an enterprise is considered to **control the composition** of the board of directors of a company or governing body of an enterprise, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors/members of that company/enterprise. An enterprise is deemed to have the power to appoint, if any of the following conditions is satisfied:

- (a) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid or
- (b) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise or
- (c) The director/member is nominated by that enterprise; in case that enterprise is a company, the director is nominated by that company/subsidiary thereof.

An enterprise/individual is considered to have a **substantial interest** in another enterprise if that enterprise or individual owns, directly or indirectly, 20 per cent or more interest in the voting power of the other enterprise.

**An Associate:** An enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.

**Significant influence:** Participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies.

It may be exercised in several ways, by representation on the board of directors, participation in the policy making process, material inter-company transactions, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investing party holds, directly or indirectly through intermediaries, 20 per cent or more of the voting power of the enterprise, it is presumed that the investing party does have significant influence, unless it can be clearly demonstrated that this is not the case, vice versa. A substantial or majority ownership by another investing party does not necessarily preclude an investing party from having significant influence.

**Key management personnel:** Those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

**Relative:** In relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

#### **18.5 ACCOUNTING STANDARDS INTERPRETATION (ASI 21)**

A non-executive director of a company should not be considered as a key management person by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

The requirements of this standard should not be applied in respect of a non executive director even if he participates in the financial and/or operating policy decision of the enterprise, unless he falls in any of the other categories.

#### **18.6 ACCOUNTING STANDARDS INTERPRETATION (ASI 23)**

Remuneration paid to key management personnel should be considered as a related party transaction requiring disclosures. In case non-executive directors on the Board of Directors are not related parties, remuneration paid to them should not be considered a related party transaction.

#### **18.7 THE RELATED PARTY ISSUE**

Without related party disclosures, there is a general presumption that transactions reflected in financial statements are consummated on an arm's-length basis between independent parties. However, that presumption may not be valid when related party relationships exist because related parties may enter into transactions which unrelated parties would not enter into. Also, transactions between related parties may not be effected at the same terms and conditions as between unrelated parties.

The operating results and financial position of an enterprise may be affected by a related party relationship even if related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the reporting enterprise with other parties.

In view of the aforesaid, the resulting accounting measures may not represent what they usually

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would be expected to represent. Thus, a related party relationship could have an effect on the financial position and operating results of the reporting enterprise.

### **18.8 DISCLOSURE**

Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.

If there have been transactions between related parties, during the existence of 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.
- (viii) Items of a similar nature may be disclosed in aggregate by type of related party.

### **18.9 MISCELLANEOUS ILLUSTRATIONS**

#### **Illustration 1**

Narmada Ltd. sold goods for Rs.90 lakhs to Ganga Ltd. during financial year ended 31-3-2006. The Managing Director of Narmada Ltd. own 100% of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct?

#### **Solution**

As per paragraph 13 of AS 18 'Related Party Disclosures', Enterprises over which a key management personnel is able to exercise significant influence are related parties. This includes enterprises owned by directors or major shareholders of the reporting enterprise that have a member of key management in common with the reporting enterprise.



In the given case, Narmada Ltd. and Ganga Ltd are related parties and hence disclosure of transaction between them is required irrespective of whether the transaction was done at normal selling price.

Hence the contention of Chief Accountant of Narmada Ltd is wrong.

### **Illustration 2**

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?

### **Solution**

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.

### **Illustration 3**

X Ltd. sold goods to its associate Company for the 1st quarter ending 30.6.2006. 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.

### **Solution**

As per para 23 of AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.2006 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.

### **Self- Examination Questions**

1. What is meant by related party relationships? Explain in brief.
2. Explain the meaning of substantial interest and its effect on significant influence?
3. A husband and wife are controlling 34% of voting power in Xeta Ltd. They have a separate partnership firm, which supplies the main raw material to the company. The management says that the above transaction need not be disclosed. How will you deal with the above situation?
4. Define (1) Associate (2) Joint Venture (3) Joint Control (4) Holding Company (5) Subsidiary Company and (6) Fellow Subsidiary.

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5. How can related party transactions and relationships affect the financial position and results of a reporting enterprise?
6. If a parent company owns along with its subsidiary more than one-half of the voting power in an enterprise, whether that enterprise will be considered as a related party of the parent?
7. Whether a Non-Executive Director can be considered as a related party under AS-18 when he participates in the financial and/or operating policy decisions of an enterprise?
8. A company is in the process of preparation of its financial statements. How can the company ensure completeness of related party disclosures in its financial statements?
9. Would a provider of finance be exempt from being classified as a related party when such party gives a loan to an enterprise in which the party has substantial interest?
10. X Limited sold to Y Limited goods having a sales value of Rs. 25 lakhs during the financial year ended 31.03.2004. Mr. A, the Managing Director and Chief Executive of X Limited owns nearly 100 percent of the capital of Y Limited. The sales were made to Y Limited at the normal selling price of X Limited. The Chief Accountant of X Limited does not consider that these sales should be treated differently from any other sale made by the company despite being made to a controlled company, because the sales were made at normal and, that too, at arms' length prices.

Discuss the above issue from the view point of AS 18.

## UNIT 19

### AS 19 : LEASES

Reference: The students are advised to refer the full text of AS 19 "Leases" (issued 2001) given in Appendix I at the end of the Study Material (Volume-II).

#### 19.1 INTRODUCTION

This Standard comes into effect in respect of all assets leased during accounting periods commencing on or after 1.4.2001 and is mandatory in nature. AS 19 prescribes the accounting and disclosure requirements for both finance leases and operating leases in the books of the lessor and lessee. The classification of leases adopted in this standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor and the lessee. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. An operating lease is a lease other than finance lease. At the inception of the lease, assets under finance lease are capitalized in the books of lessee with corresponding liability for lease obligations as against the operating lease, wherein lease payments are recognized as an expense in profit and loss account on a systematic basis (i.e. straight line) over the lease term without capitalizing the asset. The lessor should recognise receivable at an amount equal to net investment in the lease in case of finance lease, whereas under operating lease, the lessor will present the leased asset under fixed assets in his balance sheet besides recognizing the lease income on a systematic basis (i.e. straight line) over the lease term. The person (lessor/lessee) presenting the leased asset in his balance sheet should also consider the additional requirements of AS 6 and AS 10.

#### 19.2 SCOPE

This Statement should be applied in accounting for all leases other than:

- a. Lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights and
- b. Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights and
- c. Lease agreements to use lands.

AS 19 applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other hand, this Statement does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other. The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are

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commonly known as hire purchase agreements. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

### 19.3 DEFINITION OF THE TERMS USED UNDER AS 19

**A lease** is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

**A finance lease** is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

**An operating lease** is a lease other than a finance lease.

**A non-cancellable lease** is a lease that is cancellable only:

- a. Upon the occurrence of some remote contingency or
- b. With the permission of the lessor or
- c. If the lessee enters into a new lease for the same or an equivalent asset with the same lessor;
- d. Upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

**The inception of the lease** is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

**The lease term** is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

**Minimum lease payments** are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

- a. In the case of the lessee, any residual value guaranteed by or on behalf of the lessee or
- b. In the case of the lessor, any residual value guaranteed to the lessor:
  - (i) By or on behalf of the lessee or
  - (ii) By an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise

this purchase option.

Mr. X took mine on lease from Mr. Y on the terms that he would pay Rs. 10,000 or Rs. 10 per ton extracted during the year, whichever ever is less. Rs. 10 per ton being contingent cannot be included in minimum lease payment calculation.

**Economic life** is either:

- a. The period over which an asset is expected to be economically usable by one or more users;
- b. The number of production or similar units expected to be obtained from the asset by one or more users.

**Useful life** of a leased asset is either:

- a. The period over which the leased asset is expected to be used by the lessee or
- b. The number of production or similar units expected to be obtained from the use of the asset by the lessee.

**Residual value** of a leased asset is the estimated fair value of the asset at the end of the lease term.

**Guaranteed residual value** is:

- a. In the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable) and
- b. In the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

**Unguaranteed residual value** of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

We can say that:

Residual Value of the Assets = Guaranteed Residual Value + Unguaranteed Residual Value

**Gross investment** in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

**Unearned finance income** is the difference between:

- a. The gross investment in the lease and
- b. The present value of
  - (i) The minimum lease payments under a finance lease from the standpoint of the lessor and

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- (ii) Any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

**Net investment** in the lease is the gross investment in the lease less unearned finance income.

**The interest rate implicit** in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of

- a. The minimum lease payments under a finance lease from the standpoint of the lessor and
- b. Any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

**The lessee's incremental borrowing rate of interest** is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

**Contingent rent** is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

## 19.4 CLASSIFICATION OF LEASES

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. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

- a. The lease transfers ownership of the asset to the lessee by the end of the lease term.
- b. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.
- c. The lease term is for the major part of the economic life of the asset even if title is not transferred.
- d. At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset and
- e. The leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

- a. If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
- b. Gains or losses from the fluctuation in the fair value of the residual fall to the lessee and
- c. The lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification, had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term. Changes in estimates or changes in circumstances, however, do not give rise to a new classification of a lease for accounting purposes.

## **19.5 FINANCE LEASES**

### **19.5.1 Leases in the Financial Statements of Lessees**

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 a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

In the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset;

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otherwise the asset is depreciated over the lease term or its useful life, whichever is shorter.

### **19.5.2 Disclosure**

The lessee should make the following disclosures for operating leases:

- a. The total of future minimum lease payments under non-cancellable operating leases for each of the following periods:
  - (i) Not later than one year;
  - (ii) Later than one year and not later than five years;
  - (iii) Later than five years;
- b. The total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;
- c. Lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;
- d. Sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;
- e. A general description of the lessee's significant leasing arrangements including, but not limited to, the following:
  - (i) The basis on which contingent rent payments are determined;
  - (ii) The existence and terms of renewal or purchase options and escalation clauses; and
  - (iii) Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

### **19.5.3 Leases in the Financial Statements of Lessors**

The lessor should recognise assets given under a finance lease in its balance sheet as a receivable and sales in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. The transaction is recorded at the commencement of a finance lease term by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded is the present value so computed. The difference between the sales revenue and the cost of sale is the selling profit, which is recognised in accordance with the policy followed by the enterprise for sales.

Manufacturers or dealers may offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

- a. The profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts;



- b. The finance income over the lease term.

Lease payments relating to the accounting period, excluding costs for services, are reduced from both the principal and the unearned finance income. Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the remaining lease term is revised and any reduction in respect of amounts already accrued is recognised immediately. An upward adjustment of the estimated residual value is not made.

Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged and balance will be adjusted with the finance income over the lease term.

Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

#### 19.5.4 Disclosure

The lessor should make the following disclosures for finance leases:

- a. A reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:
  - (i) Not later than one year;
  - (ii) Later than one year and not later than five years;
  - (iii) Later than five years;
- b. Unearned finance income;
- c. The unguaranteed residual values accruing to the benefit of the lessor;
- d. The accumulated provision for uncollectible minimum lease payments receivable;
- e. Contingent rents recognised in the statement of profit and loss for the period;
- f. A general description of the significant leasing arrangements of the lessor; and
- g. Accounting policy adopted in respect of initial direct costs.

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### Illustration (finance lease)

'A' leased a machine from 'B' on the following terms:

- The ownership of the machine will be transferred to 'A' on expiry of the lease period at Rs. 8,900.
- Installation cost of the machine Rs. 5,000.
- The cost of the machine is Rs. 1,09,240.
- Lease agreement is signed for 5 years.
- Minimum Lease Payment is Rs. 28,000 p.a.
- First installment is Payable on 01.04.2007.
- Depreciation is charged @ 25% p.a. on WDV.

You are required to show the complete chart of principle amount and implicit rate of interest for 5 years and also the journal entries in the books of 'A and B' for the period 01.04.2007 to 31.03.2012.

### Solution

First for the students is to calculate the implicit rate of return, i.e. the rate of Present Value at which the PV of Minimum Lease Payment equals to Market Price of the Assets on the date of lease agreement.

| <i>Lease Payment</i> | <i>Present Value Factor @ 12%</i> | <i>Present Value of Lease Payment</i> | <i>Present Value Factor @ 14%</i> | <i>Present Value of Lease Payment</i> |
|----------------------|-----------------------------------|---------------------------------------|-----------------------------------|---------------------------------------|
| 28,000               | 1                                 | 28,000                                | 1                                 | 28,000                                |
| 28,000               | 0.893                             | 25,000                                | 0.877                             | 24,561                                |
| 28,000               | 0.797                             | 22,321                                | 0.769                             | 21,545                                |
| 28,000               | 0.712                             | 19,930                                | 0.675                             | 18,899                                |
| 28,000               | 0.636                             | 17,795                                | 0.592                             | 16,578                                |
| 8,900                | 0.567                             | 5,050                                 | 0.519                             | 4,622                                 |
|                      |                                   | <u>118,096</u>                        |                                   | <u>114,206</u>                        |

| <i>Installment</i> | <i>Opening Balance</i> | <i>Interest Amount</i> | <i>Principle Amount</i> | <i>Closing Balance</i> |
|--------------------|------------------------|------------------------|-------------------------|------------------------|
| 1                  | 114,240                | -                      | 28,000                  | 86,240                 |
| 2                  | 86,240                 | 12,074                 | 15,926                  | 70,314                 |
| 3                  | 70,314                 | 9,844                  | 18,156                  | 52,158                 |
| 4                  | 52,158                 | 7,302                  | 20,698                  | 31,460                 |
| 5                  | 31,460                 | 4,404                  | 23,596                  | 7,864                  |
|                    | 7,864                  | 1,036                  | 7,864                   | (0)                    |

**Journal Entries:**

| <i>In the Books of Mr. A</i>                               |                          |            |            | <i>In the Books of Mr. B</i> |            |            |
|------------------------------------------------------------|--------------------------|------------|------------|------------------------------|------------|------------|
| <i>Date</i>                                                | <i>Particulars</i>       | <i>Dr.</i> | <i>Cr.</i> | <i>Particulars</i>           | <i>Dr.</i> | <i>Cr.</i> |
| <b><u>Purchase of Machine on Lease:</u></b>                |                          |            |            |                              |            |            |
| 2007                                                       |                          |            |            |                              |            |            |
| 01-Apr                                                     | Machine on Lease A/c Dr. | 114,240    |            | Mr. A A/c Dr.                | 109,240    |            |
|                                                            | To Mr. B A/c             |            | 109,240    | To Lease Sales A/c           |            | 109,240    |
|                                                            | To Bank A/c              |            | 5,000      |                              |            |            |
| <b><u>Payment of First Installment:</u></b>                |                          |            |            |                              |            |            |
|                                                            | Mr. B A/c Dr.            | 28,000     |            | Bank A/c Dr.                 | 28,000     |            |
|                                                            | To Bank A/c              |            | 28,000     | To Mr. A A/c                 |            | 28,000     |
| <b><u>Interest due for the First Year @ 14% p.a.:</u></b>  |                          |            |            |                              |            |            |
| 2008                                                       |                          |            |            |                              |            |            |
| 31-Mar                                                     | Interest A/c Dr.         | 12,074     |            | Mr. A A/c Dr.                | 12,074     |            |
|                                                            | To Mr. B A/c             |            | 12,074     | To Interest A/c              |            | 12,074     |
| <b><u>Charging Depreciation:</u></b>                       |                          |            |            |                              |            |            |
|                                                            | Depreciation A/c Dr.     | 28,560     |            |                              |            |            |
|                                                            | To Machine A/c           |            | 28,560     |                              |            |            |
| <b><u>Transfer to Profit &amp; Loss Account:</u></b>       |                          |            |            |                              |            |            |
|                                                            | Profit & Loss A/c Dr.    | 40,634     |            | Interest A/c Dr.             | 12,074     |            |
|                                                            | To Interest A/c          |            | 12,074     | To Profit & Loss A/c         |            | 12,074     |
|                                                            | To Depreciation A/c      |            | 28,560     |                              |            |            |
| <b><u>Payment of Second Installment:</u></b>               |                          |            |            |                              |            |            |
| 01-Apr                                                     | Mr. B A/c Dr.            | 28,000     |            | Bank A/c Dr.                 | 28,000     |            |
|                                                            | To Bank A/c              |            | 28,000     | To Mr. A A/c                 |            | 28,000     |
| <b><u>Interest due for the Second Year @ 14% p.a.:</u></b> |                          |            |            |                              |            |            |
| 2009                                                       |                          |            |            |                              |            |            |
| 31-Mar                                                     | Interest A/c Dr.         | 9,844      |            | Mr. A A/c Dr.                | 9,844      |            |
|                                                            | To Mr. B A/c             |            | 9,844      | To Interest A/c              |            | 9,844      |

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### Charging Depreciation:

|                      |        |
|----------------------|--------|
| Depreciation A/c Dr. | 21,420 |
| To Machine A/c       | 21,420 |

### Transfer to Profit & Loss Account:

|                       |        |                      |       |
|-----------------------|--------|----------------------|-------|
| Profit & Loss A/c Dr. | 31,264 | Interest A/c Dr.     | 9,844 |
| To Interest A/c       | 9,844  | To Profit & Loss A/c | 9,844 |
| To Depreciation A/c   | 21,420 |                      |       |

### Payment of Third Installment:

|                      |        |              |        |
|----------------------|--------|--------------|--------|
| 01-Apr Mr. B A/c Dr. | 28,000 | Bank A/c Dr. | 28,000 |
| To Bank A/c          | 28,000 | To Mr. A A/c | 28,000 |

### Interest due for the Third Year @ 14% p.a.:

2010

|                         |       |                 |       |
|-------------------------|-------|-----------------|-------|
| 31-Mar Interest A/c Dr. | 7,302 | Mr. A A/c Dr.   | 7,302 |
| To Mr. B A/c            | 7,302 | To Interest A/c | 7,302 |

### Charging Depreciation:

|                      |        |
|----------------------|--------|
| Depreciation A/c Dr. | 16,065 |
| To Machine A/c       | 16,065 |

### Transfer to Profit & Loss Account:

|                       |        |                      |       |
|-----------------------|--------|----------------------|-------|
| Profit & Loss A/c Dr. | 23,367 | Interest A/c Dr.     | 7,302 |
| To Interest A/c       | 7,302  | To Profit & Loss A/c | 7,302 |
| To Depreciation A/c   | 16,065 |                      |       |

### Payment of Fourth Installment:

|                      |        |              |        |
|----------------------|--------|--------------|--------|
| 01-Apr Mr. B A/c Dr. | 28,000 | Bank A/c Dr. | 28,000 |
| To Bank A/c          | 28,000 | To Mr. A A/c | 28,000 |

### Interest due for the Fourth Year @ 14% p.a.:

2011

|                         |       |                 |       |
|-------------------------|-------|-----------------|-------|
| 31-Mar Interest A/c Dr. | 4,404 | Mr. A A/c Dr.   | 4,404 |
| To Mr. B A/c            | 4,404 | To Interest A/c | 4,404 |

**Charging Depreciation:**

|                      |        |        |
|----------------------|--------|--------|
| Depreciation A/c Dr. | 12,049 |        |
| To Machine A/c       |        | 12,049 |

**Transfer to Profit & Loss Account:**

|                       |        |                  |                      |       |
|-----------------------|--------|------------------|----------------------|-------|
| Profit & Loss A/c Dr. | 16,453 | Interest A/c Dr. | 4,404                |       |
| To Interest A/c       |        | 4,404            | To Profit & Loss A/c | 4,404 |
| To Depreciation A/c   | 12,049 |                  |                      |       |

**Payment of Fifth Installment:**

|        |               |        |              |        |
|--------|---------------|--------|--------------|--------|
| 01-Apr | Mr. B A/c Dr. | 28,000 | Bank A/c Dr. | 28,000 |
|        | To Bank A/c   | 28,000 | To Mr. A A/c | 28,000 |

**Interest due for the Last Year @ 14% p.a.:**

2012

|        |                  |       |                 |       |
|--------|------------------|-------|-----------------|-------|
| 31-Mar | Interest A/c Dr. | 1,036 | Mr. A A/c Dr.   | 1,036 |
|        | To Mr. B A/c     | 1,036 | To Interest A/c | 1,036 |

**Charging Depreciation:**

|                      |       |       |
|----------------------|-------|-------|
| Depreciation A/c Dr. | 9,037 |       |
| To Machine A/c       |       | 9,037 |

**Transfer to Profit & Loss Account:**

|                       |        |                      |       |
|-----------------------|--------|----------------------|-------|
| Profit & Loss A/c Dr. | 10,073 | Interest A/c Dr.     | 1,036 |
| To Interest A/c       | 1,036  | To Profit & Loss A/c | 1,036 |
| To Depreciation A/c   | 9,037  |                      |       |

**Purchase of Asset on expiry of Lease Term:**

|               |       |              |       |
|---------------|-------|--------------|-------|
| Mr. B A/c Dr. | 8,900 | Bank A/c Dr. | 8,900 |
| To Bank A/c   | 8,900 | To Mr. A A/c | 8,900 |

**19.6 OPERATING LEASES****19.6.1 Leases in the Financial Statements of Lessors**

The lessor should present an asset given under operating lease in its balance sheet under fixed assets.

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Lease income should be recognised 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 in which benefit derived from the use of the leased asset is diminished. Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Initial direct costs incurred are either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or are recognised as an expense in the statement of profit and loss in the period in which they are incurred. For charging depreciation and impairment of assets, relevant Accounting Standards should be followed.

### 19.6.2 Disclosures

- a. For each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and
  - (i) The depreciation recognised in the statement of profit and loss for the period;
  - (ii) Impairment losses recognised in the statement of profit and loss for the period;
  - (iii) Impairment losses reversed in the statement of profit and loss for the period;
- b. The future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:
  - (i) Not later than one year;
  - (ii) Later than one year and not later than five years;
  - (iii) Later than five years;
- c. Total contingent rents recognised as income in the statement of profit and loss for the period;
- d. A general description of the lessor's significant leasing arrangements; and
- e. Accounting policy adopted in respect of initial direct costs.

### Illustration (operating lease):

Geeta purchased a computer for Rs. 44,000 and leased out it to Sita for four years on leases basis, after the lease period, value of the computer was estimated to be Rs. 3,000; which she realised after selling it in the second hand market. Lease amount payable at the beginning of each year is Rs. 22,000; Rs. 13,640; Rs. 6,820 & Rs. 3,410. Depreciation was charged @ 40% p.a. You are required to pass the necessary journal entries in the books of both Geeta and Sita.

### Solution

| <i>In the Books of Geeta</i>         |                    |            |            | <i>In the Books of Sita</i> |            |            |
|--------------------------------------|--------------------|------------|------------|-----------------------------|------------|------------|
| <i>Date</i>                          | <i>Particulars</i> | <i>Dr.</i> | <i>Cr.</i> | <i>Particulars</i>          | <i>Dr.</i> | <i>Cr.</i> |
| <b><u>Purchase of computers:</u></b> |                    |            |            |                             |            |            |
| 1st                                  | Computer A/c. Dr.  | 44,000     |            |                             |            |            |
|                                      | To Bank A/c        |            | 44,000     |                             |            |            |

## Accounting Standards and Guidance Notes 1.177

### Payment of first year's lease:

|                    |        |                          |        |
|--------------------|--------|--------------------------|--------|
| Bank A/c. Dr.      | 22,000 | Lease Rent Paid A/c. Dr. | 22,000 |
| To Lease Rent A/c. | 22,000 | To Bank A/c.             | 22,000 |

### Depreciation for first year:

|                      |        |
|----------------------|--------|
| Depreciation A/c Dr. | 17,600 |
| To Machine A/c       | 17,600 |

### Transfer to profit & loss account:

|                       |        |                         |        |
|-----------------------|--------|-------------------------|--------|
| Profit & Loss A/c Dr. | 17,600 | Profit & Loss A/c. Dr.  | 22,000 |
| To Depreciation A/c   | 17,600 | To Lease Rent Paid A/c. | 22,000 |
| Lease Rent A/c. Dr.   | 22,000 |                         |        |
| To Profit & Loss A/c. | 22,000 |                         |        |

### Payment of second year's lease:

|                               |        |                          |        |
|-------------------------------|--------|--------------------------|--------|
| 2 <sup>nd</sup> Bank A/c. Dr. | 13,640 | Lease Rent Paid A/c. Dr. | 13,640 |
| To Lease Rent A/c.            | 13,640 | To Bank A/c.             | 13,640 |

### Depreciation for second year:

|                      |        |
|----------------------|--------|
| Depreciation A/c Dr. | 10,560 |
| To Machine A/c       | 10,560 |

### Transfer to profit & loss account:

|                       |        |                         |        |
|-----------------------|--------|-------------------------|--------|
| Profit & Loss A/c Dr. | 10,560 | Profit & Loss A/c. Dr.  | 13,640 |
| To Depreciation A/c   | 10,560 | To Lease Rent Paid A/c. | 13,640 |
| Lease Rent A/c. Dr.   | 13,640 |                         |        |
| To Profit & Loss A/c. | 13,640 |                         |        |

### Payment of third year's lease:

|                               |       |                          |       |
|-------------------------------|-------|--------------------------|-------|
| 3 <sup>rd</sup> Bank A/c. Dr. | 6,820 | Lease Rent Paid A/c. Dr. | 6,820 |
| To Lease Rent A/c.            | 6,820 | To Bank A/c.             | 6,820 |

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### Depreciation for third year:

|                      |       |       |
|----------------------|-------|-------|
| Depreciation A/c Dr. | 6,336 |       |
| To Machine A/c       |       | 6,336 |

### Transfer to profit & loss account:

|                       |       |                         |       |
|-----------------------|-------|-------------------------|-------|
| Profit & Loss A/c Dr. | 6,336 | Profit & Loss A/c. Dr.  | 6,820 |
| To Depreciation A/c   |       | To Lease Rent Paid A/c. | 6,820 |

|                       |       |       |
|-----------------------|-------|-------|
| Lease Rent A/c. Dr.   | 6,820 |       |
| To Profit & Loss A/c. |       | 6,820 |

### Payment of fourth year's lease:

|                               |       |                          |       |
|-------------------------------|-------|--------------------------|-------|
| 4 <sup>th</sup> Bank A/c. Dr. | 3,410 | Lease Rent Paid A/c. Dr. | 3,410 |
| To Lease Rent A/c.            |       | To Bank A/c.             | 3,410 |

### Depreciation for fourth year:

|                      |       |       |
|----------------------|-------|-------|
| Depreciation A/c Dr. | 3,802 |       |
| To Machine A/c       |       | 3,802 |

### Transfer to profit & loss account:

|                       |       |                         |       |
|-----------------------|-------|-------------------------|-------|
| Profit & Loss A/c Dr. | 3,802 | Profit & Loss A/c. Dr.  | 3,410 |
| To Depreciation A/c   |       | To Lease Rent Paid A/c. | 3,410 |

|                       |       |       |
|-----------------------|-------|-------|
| Lease Rent A/c. Dr.   | 3,410 |       |
| To Profit & Loss A/c. |       | 3,410 |

### Sale of lease asset:

|                       |       |       |
|-----------------------|-------|-------|
| Bank Account Dr.      | 3,000 |       |
| Loss on Sale A/c. Dr. | 2,702 |       |
| To Computer A/c.      |       | 5,702 |

## 19.7 SALE AND LEASEBACK TRANSACTIONS

A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same 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 leaseback transaction depends upon the type of lease involved. If a sale and leaseback transaction results in a



finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset. If a sale and leaseback transaction results in an 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.

For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

## 19.8 MISCELLANEOUS ILLUSTRATIONS

### Illustration 1

A Ltd. Leased a machinery to B Ltd. on the following terms:

|                             | (Rs. in Lakhs) |
|-----------------------------|----------------|
| Fair value of the machinery | 20.00          |
| Lease term                  | 5 years        |
| Lease Rental per annum      | 5.00           |
| Guaranteed Residual value   | 1.00           |
| Expected Residual value     | 2.00           |
| Internal Rate of Return     | 15%            |

Depreciation is provided on straight line method @ 10% per annum. Ascertain unearned financial income and necessary entries may be passed in the books of the Lessee in the First year.

### Solution

#### Computation of Unearned Finance Income

As per AS 19 on Leases, **unearned finance income** is the difference between (a) the **gross investment** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

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where :

- (a) **Gross investment** in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

$$\begin{aligned}
 \text{Gross investment} &= \text{Minimum lease payments} + \text{Unguaranteed residual value} \\
 &= (\text{Total lease rent} + \text{Guaranteed residual value}) + \\
 &\quad \text{Unguaranteed residual value} \\
 &= [(\text{Rs. } 5,00,000 \times 5 \text{ years}) + \text{Rs. } 1,00,000] + \text{Rs. } 1,00,000 \\
 &= \text{Rs. } 27,00,000
 \end{aligned}$$

- (b) Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV).

| Year | MLP inclusive of URV          | Internal rate of return (Discount factor 15%) | Present Value        |
|------|-------------------------------|-----------------------------------------------|----------------------|
|      | Rs.                           |                                               | Rs.                  |
| 1    | 5,00,000                      | .8696                                         | 4,34,800             |
| 2    | 5,00,000                      | .7561                                         | 3,78,050             |
| 3    | 5,00,000                      | .6575                                         | 3,28,750             |
| 4    | 5,00,000                      | .5718                                         | 2,85,900             |
| 5    | 5,00,000                      | .4972                                         | 2,48,600             |
|      | 1,00,000                      | .4972                                         | 49,720               |
|      | (guaranteed residual value)   |                                               | <hr/>                |
|      |                               |                                               | 17,25,820 (i)        |
|      | 1,00,000                      | .4972                                         | 49,720 (ii)          |
|      | (unguaranteed residual value) |                                               | <hr/>                |
|      |                               | (i) + (ii)                                    | <u>17,75,540</u> (b) |

$$\begin{aligned}
 \text{Unearned Finance Income} &= (a) - (b) \\
 &= \text{Rs. } 27,00,000 - \text{Rs. } 17,75,540 \\
 &= \text{Rs. } 9,24,460
 \end{aligned}$$

**Journal Entries in the books of B Ltd.**

|                                                                                                                                   |     | Rs.        | Rs.       |
|-----------------------------------------------------------------------------------------------------------------------------------|-----|------------|-----------|
| <i>At the inception of lease</i>                                                                                                  |     |            |           |
| Machinery account                                                                                                                 | Dr. | 17,25,820* |           |
| To A Ltd.'s account                                                                                                               |     |            | 17,25,820 |
|                                                                                                                                   |     |            | *         |
| (Being lease of machinery recorded at present value of MLP)                                                                       |     |            |           |
| <hr/>                                                                                                                             |     |            |           |
| <i>At the end of the first year of lease</i>                                                                                      |     |            |           |
| Finance charges account (Refer Working Note)                                                                                      | Dr. | 2,58,873   |           |
| To A Ltd.'s account                                                                                                               |     |            | 2,58,873  |
| (Being the finance charges for first year due)                                                                                    |     |            |           |
| <hr/>                                                                                                                             |     |            |           |
| A Ltd.'s account                                                                                                                  | Dr. | 5,00,000   |           |
| To Bank account                                                                                                                   |     |            | 5,00,000  |
| (Being the lease rent paid to the lessor which includes outstanding liability of Rs. 2,41,127 and finance charge of Rs. 2,58,873) |     |            |           |
| <hr/>                                                                                                                             |     |            |           |
| Depreciation account                                                                                                              | Dr. | 1,72,582   |           |
| To Machinery account                                                                                                              |     |            | 1,72,582  |

---

\* As per para 11 of AS 19, the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payments from the standpoint of lessee, the amount recorded should be the present value of these minimum lease payments. Therefore, in this case, as the fair value of Rs. 20,00,000 is more than the present value amounting Rs. 17,25,820, the machinery has been recorded at Rs. 17,25,820 in the books of B Ltd. (the lessee) at the inception of the lease. According to para 13 of the standard, at the inception of the lease, the asset and liability for the future lease payments are recognised in the balance sheet at the same amounts.

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(Being the depreciation provided @ 10%  
p.a. on straight line method)

|                                                                                           |     |          |          |
|-------------------------------------------------------------------------------------------|-----|----------|----------|
| Profit and loss account                                                                   | Dr. | 4,31,455 |          |
| To Depreciation account                                                                   |     |          | 1,72,582 |
| To Finance charges account                                                                |     |          | 2,58,873 |
| (Being the depreciation and finance<br>charges transferred to profit and loss<br>account) |     |          |          |

### Working Note:

Table showing apportionment of lease payments by B Ltd. between the finance charges and the reduction of outstanding liability.

| Year | Outstanding liability<br>(opening balance) | Lease rent | Finance charge  | Reduction in<br>outstanding liability | Outstanding liability<br>(closing balance) |
|------|--------------------------------------------|------------|-----------------|---------------------------------------|--------------------------------------------|
|      | Rs.                                        | Rs.        | Rs.             | Rs.                                   | Rs.                                        |
| 1    | 17,25,820                                  | 5,00,000   | 2,58,873        | 2,41,127                              | 14,84,693                                  |
| 2    | 14,84,693                                  | 5,00,000   | 2,22,704        | 2,77,296                              | 12,07,397                                  |
| 3    | 12,07,397                                  | 5,00,000   | 1,81,110        | 3,18,890                              | 8,88,507                                   |
| 4    | 8,88,507                                   | 5,00,000   | 1,33,276        | 3,66,724                              | 5,21,783                                   |
| 5    | 5,21,783                                   | 5,00,000   | <u>78,267</u>   | <u>5,21,783</u>                       | 1,00,050*                                  |
|      |                                            |            | <u>8,74,230</u> | <u>17,25,820</u>                      |                                            |

\* The difference between this figure and guaranteed residual value (Rs. 1,00,000) is due to approximation in computing the interest rate implicit in the lease.

### Illustration 2

Global Ltd. has initiated a lease for three years in respect of an equipment costing Rs.1,50,000 with expected useful life of 4 years. The asset would revert to Global Limited under the lease agreement. The other information available in respect of lease agreement is:

- The unguaranteed residual value of the equipment after the expiry of the lease term is estimated at Rs.20,000.
- The implicit rate of interest is 10%.
- The annual payments have been determined in such a way that the present value of the lease payment plus the residual value is equal to the cost of asset.

Ascertain in the hands of Global Ltd.

- (i) The annual lease payment.
- (ii) The unearned finance income.
- (iii) The segregation of finance income, and also,
- (iv) Show how necessary items will appear in its profit and loss account and balance sheet for the various years.

### Solution

#### (a) (i) Calculation of Annual Lease Payment\*

|                                                                                 | Rs.           |
|---------------------------------------------------------------------------------|---------------|
| Cost of the equipment                                                           | 1,50,000      |
| Unguaranteed Residual Value                                                     | 20,000        |
| PV of residual value for 3 years @ 10% (Rs.20,000 x 0.751)                      | 15,020        |
| Fair value to be recovered from Lease Payment<br>(Rs.1,50,000 – Rs.15,020)      | 1,34,980      |
| PV Factor for 3 years @ 10%                                                     | 2.487         |
| Annual Lease Payment (Rs. 1,34,980 / PV Factor for 3 years @ 10%<br>i.e. 2.487) | <u>54,275</u> |

#### (ii) Unearned Financial Income

|                                                              |                 |
|--------------------------------------------------------------|-----------------|
| Total lease payments [Rs. 54,275 x 3]                        | 1,62,825        |
| Add: Residual value                                          | <u>20,000</u>   |
| Gross Investments                                            | 1,82,825        |
| Less: Present value of Investments (Rs.1,34,980 + Rs.15,020) | <u>1,50,000</u> |
| Unearned Financial Income                                    | <u>32,825</u>   |

#### (iii) Segregation of Finance Income

| Year | Lease Rentals   | Finance Charges @<br>10% on outstanding<br>amount of the year | Repayment       | Outstanding<br>Amount |
|------|-----------------|---------------------------------------------------------------|-----------------|-----------------------|
|      | Rs.             | Rs.                                                           | Rs.             | Rs.                   |
| 0    | -               | -                                                             | -               | 1,50,000              |
| I    | 54,275          | 15,000                                                        | 39,275          | 1,10,725              |
| II   | 54,275          | 11,073                                                        | 43,202          | 67,523                |
| III  | <u>74,275**</u> | <u>6,752</u>                                                  | <u>67,523</u>   | --                    |
|      | <u>1,82,825</u> | <u>32,825</u>                                                 | <u>1,50,000</u> |                       |

\* Annual lease payments are considered to be made at the end of each accounting year.

\*\* Rs. 74,275 includes unguaranteed residual value of equipment amounting Rs. 20,000.

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### (iv) Profit and Loss Account ( Relevant Extracts)

| <i>Credit side</i> |                   | <i>Rs.</i>    |
|--------------------|-------------------|---------------|
| I Year             | By Finance Income | <u>15,000</u> |
| II year            | By Finance Income | <u>11,073</u> |
| III year           | By Finance Income | <u>6,752</u>  |

### Balance Sheet ( Relevant Extracts)

| <i>Assets side</i>                | <i>Rs.</i>    | <i>Rs.</i>      |
|-----------------------------------|---------------|-----------------|
| I year Lease Receivable           | 1,50,000      |                 |
| Less: Amount Received             | <u>39,275</u> | <u>1,10,725</u> |
| II year Lease Receivable          | 1,10,725      |                 |
| Less: Received                    | <u>43,202</u> | <u>67,523</u>   |
| III year :Lease Amount Receivable | 67,523        |                 |
| Less: Amount received             | 47,523        |                 |
| Residual value                    | <u>20,000</u> | <u>NIL</u>      |

### Notes to Balance Sheet

|                                             |                 |
|---------------------------------------------|-----------------|
| <i>Year 1</i>                               | <i>Rs.</i>      |
| Minimum Lease Payments (54,275 + 54,275)    | 1,08,550        |
| Residual Value                              | <u>20,000</u>   |
|                                             | 1,28,550        |
| Unearned Finance Income(11,073+ 6,752)      | <u>17,825</u>   |
| Lease Receivables                           | <u>1,10,725</u> |
| <i>Classification:</i>                      |                 |
| Not later than 1 year                       | 43,202          |
| Later than 1 year but not more than 5 years | <u>67,523</u>   |
| Total                                       | <u>1,10,725</u> |
| <i>Year II:</i>                             |                 |
| Minimum Lease Payments                      | 54,275          |
| Residual Value (Estimated)                  | <u>20,000</u>   |
|                                             | 74,275          |
| Unearned Finance Income                     | <u>6,752</u>    |
| Lease Receivables (not later than 1year)    | 67,523          |

III Year:

|                                              |               |
|----------------------------------------------|---------------|
| Lease Receivables (including residual value) | 67,523        |
| Amount Received                              | <u>67,523</u> |
|                                              | <u>NIL</u>    |

### Self-examination Questions

- Define the following terms in the context of As 19:
  - Operating Lease.
  - Finance Lease.
  - Inception of the lease.
  - Lease term.
- Define the terms Minimum lease payment and contingent rent .
- Distinguish between cancelable and non-cancellable lease.
- What is residual value? Distinguish between guaranteed residual value and unguaranteed residual value.
- What are the basic criteria for classification of lease into operating and finance lease.
- Explain the accounting treatment for finance leases in financial statements of lessees, during the period of lease.
- Discuss the accounting treatment in respect of operating leases in financial statements of lessees.
- A Ltd. has taken a machinery costing Rs.15 lakhs on lease for 8 years, the effective life of the plant is 20 years. Annual lease rentals payable are Rs.1.8 lakhs each. If implicit rate of interest is 14%, how should the lease be accounted for in the books of A Ltd.
- What are the disclosure requirements in case of operating leases, in the financial statements of the lessor?
- An equipment is leased for 3 years and its useful life is 5 years. Both the cost and the fair value of the equipment are Rs. 3,00,000. The amount will be paid in 3 instalments and at the termination of lease lessor will get back the equipment. The unguaranteed residual value at the end of 3 years is Rs. 40,000. The (internal rate of return) IRR of the investment is 10%. The present value of annuity factor of Re. 1 due at the end of 3rd year at 10% IRR is 2.4868. The present value of Re. 1 due at the end of 3rd year at 10% rate of interest is 0.7513.
  - State with reason whether the lease constitutes finance lease.
  - Calculate unearned finance income.

## UNIT 20

### AS 20: EARNINGS PER SHARE

*Reference:* The students are advised to refer the full text of AS 20 "Earnings per Share" (issued 2001) given in Appendix I at the end of the Study Material (Volume-II).

#### 20.1 INTRODUCTION

AS 20 comes into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature. The objective of this standard is to describe principles for determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise. Earnings per share (EPS) is a financial ratio indicating the amount of profit or loss for the period attributable to each equity share and AS 20 gives computational methodology for determination and presentation of basic and diluted earnings per share. This Statement should be applied by enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share should calculate and disclose earnings per share in accordance with this Statement.

#### 20.2 ACCOUNTING STANDARDS INTERPRETATION (ASI 12):

Every company, which is required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

#### 20.3 DEFINITION OF THE TERMS USED IN THE ACCOUNTING STANDARD

**An equity share** is a share other than a preference share.

**A preference share** is a share carrying preferential rights to dividends and repayment of capital.

**A financial instrument** is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

For this purpose, a financial asset is any asset that is

- a. Cash;
- b. A contractual right to receive cash or another financial asset from another enterprise;
- c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or
- d. An equity share of another enterprise.



**A financial liability** is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

**A potential equity share** is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

Examples of potential equity shares are:

- a. Debt instruments or preference shares, that are convertible into equity shares;
- b. Share warrants;
- c. Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and
- d. Shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

**Share warrants or options** are financial instruments that give the holder the right to acquire equity shares.

An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

As 20 requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

#### 20.4 BASIC EARNINGS PER SHARE

Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to equity shareholders by the weighted average number of equity shares outstanding during the period. All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless AS – 5 requires or permits otherwise. The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

The amount of preference dividends for the period that is deducted from the net profit for the period is:

- a. The amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

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- b. The full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

The weighted average number of equity shares is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighting factor. The time-weighting factor is the number of days for which the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

### Illustration

| <i>Date</i>  | <i>Particulars</i>           | <i>Purchased</i> | <i>Sold</i> | <i>Balance</i> |
|--------------|------------------------------|------------------|-------------|----------------|
| 1st January  | Balance at beginning of year | 1,800            | -           | 1,800          |
| 31st May     | Issue of shares for cash     | 600              | -           | 2,400          |
| 1st November | Buy Back of shares           | -                | 300         | 2,100          |

Calculate Weighted Number of Shares.

### Solution

Computation of Weighted Average:

$$(1,800 \times 5/12) + (2,400 \times 5/12) + (2,100 \times 2/12) = 2,100 \text{ shares.}$$

The weighted average number of shares can alternatively be computed as follows:

$$(1,800 \times 12/12) + (600 \times 7/12) - (300 \times 2/12) = 2,100 \text{ shares}$$

In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable, for example:

- Equity shares issued in exchange for cash are included when cash is receivable;
- Equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;
- Equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;
- Equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

- e. Equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and
- f. Equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

Equity shares issued as part of the consideration in an **amalgamation in the nature of purchase** are included in the weighted average number of shares as of the date of the acquisition and in an **amalgamation in the nature of merger** are included in the calculation of the weighted average number of shares from the beginning of the reporting period.

**Partly paid equity shares** are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

Where an enterprise has equity shares of **different nominal values** but with the same dividend rights, the number of equity shares is calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

- a. A bonus issue;
- b. A bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;
- c. A share split; and
- d. A reverse share split (consolidation of shares).

In case of a **bonus issue or a share split**, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported.

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#### Illustration 1

| <i>Date</i>  | <i>Particulars</i>           | <i>No. of Share<br/>Face Value</i> | <i>Paid up<br/>Value</i> |        |
|--------------|------------------------------|------------------------------------|--------------------------|--------|
| 1st January  | Balance at beginning of year | 1,800                              | Rs. 10                   | Rs. 10 |
| 31st October | Issue of Shares              | 600                                | Rs. 10                   | Rs. 5  |

Calculate Weighted Number of Shares.

#### Solution

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.

Computation of weighted average would be as follows:

$$(1,800 \times 12/12) + (300 \times 2/12) = 1,850 \text{ shares.}$$

In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported.

#### Illustration 2

|                                                                                                            |               |
|------------------------------------------------------------------------------------------------------------|---------------|
| Net profit for the year 2005                                                                               | Rs. 18,00,000 |
| Net profit for the year 2006                                                                               | Rs. 60,00,000 |
| No. of equity shares outstanding until 30th September 2006                                                 | 20,00,000     |
| Bonus issue 1st October 2006 was 2 equity shares for each equity share outstanding at 30th September, 2006 |               |

Calculate Basic Earnings Per Share.

#### Solutio

No. of Bonus Issue  $20,00,000 \times 2 = 40,00,000$  shares

$$\begin{aligned} \text{Earnings per share for the year 2006} &= \frac{\text{Rs. } 60,00,000}{(20,00,000 + 40,00,000)} \\ &= \text{Re. } 1.00 \end{aligned}$$

$$\begin{aligned} \text{Adjusted earnings per share for the year 2005} &= \frac{\text{Rs. } 18,00,000}{(20,00,000 + 40,00,000)} \\ &= \text{Re. } 0.30 \end{aligned}$$

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2005, the earliest period reported.

In a **rights issue**, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following adjustment factor:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex - rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights.

### Illustration 3

|                                                 |                 |
|-------------------------------------------------|-----------------|
| Net profit for the year 2005                    | Rs. 11,00,000   |
| Net profit for the year 2006                    | Rs. 15,00,000   |
| No. of shares outstanding prior to rights issue | 5,00,000 shares |
| Rights issue price                              | Rs. 15.00       |
| Last date to exercise rights                    | 1st March 2006  |

Rights issue is one new share for each five outstanding (i.e. 1,00,000 new shares)

Fair value of one equity share immediately prior to exercise of rights on 1st March 2006 was Rs. 21.00. Compute Basic Earnings Per Share.

### Solution

$$\frac{\text{Fair value of shares immediately prior to exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise} + \text{Number of shares issued in the exercise}}$$

$$\frac{(\text{Rs. } 21.00 \times 5,00,000 \text{ shares}) + (\text{Rs. } 15.00 \times 1,00,000 \text{ Shares})}{5,00,000 \text{ Shares} + 1,00,000 \text{ Shares}}$$

Theoretical ex-rights fair value per share = Rs. 20.00

*Computation of adjustment factor:*

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex - rights value per share}}$$

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$$\frac{\text{Rs.}(21.00)}{\text{Rs.}(20.00)} = 1.05$$

*Computation of earnings per share:*

EPS for the year 2005 as originally reported: Rs. 11,00,000/5,00,000 shares = Rs. 2.20

EPS for the year 2005 restated for rights issue: Rs. 11,00,000/ (5,00,000 shares x 1.05) = Rs. 2.10

EPS for the year 2006 including effects of rights issue:

$$(5,00,000 \times 1.05 \times 2/12) + (6,00,000 \times 10/12) = 5,87,500 \text{ shares}$$

$$\text{EPS} = 15,00,000/5,87,500 = \text{Rs. } 2.55$$

## 20.5 DILUTED EARNINGS PER SHARE

In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

- a. The net profit for the period attributable to equity shares is:
  - i. Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;
  - ii. Increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and
  - iii. Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.
- b. The weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

For the purpose of this Statement, share application money pending allotment or any advance share application money as at the balance sheet date, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in Basic Earnings Per Share is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

- a. A contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and
- b. A contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

In order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

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### Illustration 4

|                                                     |                 |
|-----------------------------------------------------|-----------------|
| Net profit for the current year                     | Rs. 1,00,00,000 |
| No. of equity shares outstanding                    | 50,00,000       |
| Basic earnings per share                            | Rs. 2.00        |
| No. of 12% convertible debentures of Rs. 100 each   | 1,00,000        |
| Each debenture is convertible into 10 equity shares |                 |
| Interest expense for the current year               | Rs. 12,00,000   |
| Tax relating to interest expense (30%)              | Rs. 3,60,000    |
| Compute Diluted Earnings Per Share.                 |                 |

### Solution

Adjusted net profit for the current year  $(1,00,00,000 + 12,00,000 - 3,60,000) = \text{Rs. } 1,08,40,000$

No. of equity shares resulting from conversion of debentures: 10,00,000 Shares

No. of equity shares used to compute diluted EPS:  $(50,00,000 + 10,00,000) = 60,00,000$  Shares

Diluted earnings per share:  $(1,08,40,000/60,00,000) = \text{Rs. } 1.81$

## 20.6 RESTATEMENT

If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

## 20.7 DISCLOSURE

An enterprise should disclose the following:

- The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;
- The weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and
- The nominal value of shares along with the earnings per share figures.



If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with this Statement. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

**Illustration 5**

|                                                                           |                 |
|---------------------------------------------------------------------------|-----------------|
| Net profit for the year 2005                                              | Rs. 12,00,000   |
| Weighted average number of equity shares outstanding during the year 2005 | 5,00,000 shares |
| Average fair value of one equity share during the year 2005               | Rs. 20.00       |
| Weighted average number of shares under option during the year 2005       | 1,00,000 shares |
| Exercise price for shares under option during the year 2005               | Rs. 15.00       |
| Compute Basic and Diluted Earnings Per Share.                             |                 |

**Solution****Computation of earnings per share**

|                                                                                    | <i>Earnings</i>  | <i>Shares</i>   | <i>Earnings/<br/>Share</i> |
|------------------------------------------------------------------------------------|------------------|-----------------|----------------------------|
|                                                                                    | <i>Rs.</i>       |                 | <i>Rs.</i>                 |
| Net profit for the year 2005                                                       | 12,00,000        |                 |                            |
| Weighted average no. of shares during year 2005                                    |                  | 5,00,000        |                            |
| Basic earnings per share                                                           |                  |                 | 2.40                       |
| Number of shares under option                                                      |                  | 1,00,000        |                            |
| Number of shares that would have been issued at fair value (100,000 x 15.00)/20.00 |                  | <u>(75,000)</u> |                            |
| Diluted earnings per share                                                         | <u>12,00,000</u> | <u>5,25,000</u> | <u>2.29</u>                |

**Illustration 6**

|                                                                                                            |               |
|------------------------------------------------------------------------------------------------------------|---------------|
| Net profit for the year 2006                                                                               | Rs. 18,00,000 |
| Net profit for the year 2007                                                                               | Rs. 60,00,000 |
| No. of equity shares outstanding until 30th September 2007                                                 | 20,00,000     |
| Bonus issue 1st October 2007 was 2 equity shares for each equity share outstanding at 30th September, 2007 |               |

### 1.196 Financial Reporting

Calculate Basic Earnings Per Share.

#### Solution

No. of Bonus Issue  $20,00,000 \times 2 = 40,00,000$  shares

Earnings per share for the year 2007  $\frac{\text{Rs. } 60,00,000}{(20,00,000 + 40,00,000)}$

= Re. 1.00

Adjusted earnings per share for the year 2006  $\frac{\text{Rs. } 18,00,000}{(20,00,000 + 40,00,000)}$

= Re. 0.30

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year was 2006, the earliest period reported.

#### Illustration 7

From the Books of Bharati Ltd., following informations are available as on 1.4.2005 and 1.4.2006:

- |                                                                                                                                                      |          |
|------------------------------------------------------------------------------------------------------------------------------------------------------|----------|
| (1) Equity Shares of Rs. 10 each                                                                                                                     | 1,00,000 |
| (2) Partly paid Equity Shares of Rs. 10 each Rs. 5 paid                                                                                              | 1,00,000 |
| (3) Options outstanding at an exercise price of Rs. 60 for one equity share Rs. 10 each. Average Fair Value of equity share during both years Rs. 75 | 10,000   |
| (4) 10% convertible preference shares of Rs. 100 each. Conversion ratio 2 equity shares for each preference share                                    | 80,000   |
| (5) 12% convertible debentures of Rs. 100. Conversion ratio 4 equity shares for each debenture                                                       | 10,000   |
| (6) 10% dividend tax is payable for the years ending 31.3.2007 and 31.3.2006.                                                                        |          |
| (7) On 1.10.2006 the partly paid shares were fully paid up                                                                                           |          |
| (8) On 1.1.2007 the company issued 1 bonus share for 8 shares held on that date.                                                                     |          |

Net profit attributable to the equity shareholders for the years ending 31.3.2007 and 31.3.2006 were Rs. 10,00,000. Assume Tax rate at 30% for both the years.

Calculate :

- (i) Earnings per share for years ending 31.3.2007 and 31.3.2006.
- (ii) Diluted earnings per share for years ending 31.3.2007 and 31.3.2006.

- (iii) Adjusted earnings per share and diluted EPS for the year ending 31.3.2006, assuming the same information for previous year, also assume that partly paid shares are eligible for proportionate dividend only.

**Solution****(i) Earnings per share**

|                                                                                                                             | <i>Year ended<br/>31.3.2007</i> | <i>Year ended<br/>31.3.2006</i> |
|-----------------------------------------------------------------------------------------------------------------------------|---------------------------------|---------------------------------|
| Net profit attributable to equity shareholders                                                                              | Rs. 10,00,000                   | Rs.<br>10,00,000                |
| Weighted average<br>number of equity shares<br>[(W.N. 1) – without considering bonus issue<br>for the year ended 31.3.2002] | 2,00,000                        | 1,50,000                        |
| Earning per share                                                                                                           | Rs. 5                           | Rs. 6.667                       |

**(ii) Diluted earnings per share**

Options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 12% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered (as per W.N. 2).

|                                                       | <i>Year ended 31.3.2007</i>                                               |                                     | <i>Year ended 31.3.2006</i>                                  |                                                                                       |                                                                  |
|-------------------------------------------------------|---------------------------------------------------------------------------|-------------------------------------|--------------------------------------------------------------|---------------------------------------------------------------------------------------|------------------------------------------------------------------|
|                                                       | <i>Net profit<br/>attributable<br/>to equity<br/>shareholders<br/>Rs.</i> | <i>No. of<br/>equity<br/>shares</i> | <i>Net Profit<br/>attributable<br/>per<br/>share<br/>Rs.</i> | <i>No. of<br/>equity<br/>shares<br/>(without<br/>considering<br/>bonus<br/>issue)</i> | <i>Net<br/>Profit<br/>attributable<br/>per<br/>share<br/>Rs.</i> |
| As reported (for years ended 31.3.2007 and 31.3.2006) | 10,00,000                                                                 | 2,00,000                            | 5                                                            | 1,50,000                                                                              | 6.667                                                            |
| Options                                               | <u>10,00,000</u>                                                          | <u>2,00,000</u><br><u>2,02,000</u>  | 4.95<br>Dilutive                                             | <u>2,000</u><br><u>1,52,000</u>                                                       | 6.579<br>Dilutive                                                |
| 12% Convertible debentures                            | <u>84,000</u><br><u>10,84,000</u>                                         | <u>40,000</u><br><u>2,42,000</u>    | 4.48<br>Dilutive                                             | <u>40,000</u><br><u>1,92,000</u>                                                      | 5.646<br>Dilutive                                                |
| 10% Convertible Preference Shares                     | <u>8,80,000</u><br><u>19,64,000</u>                                       | <u>1,60,000</u><br><u>4,02,000</u>  | 4.886<br>Anti-Dilutive                                       | <u>1,60,000</u><br><u>3,52,000</u>                                                    | 5.58<br>Dilutive                                                 |

## 1.198 Financial Reporting

Since diluted earnings per share is increased when taking the convertible preference shares into account (Rs. 4.48 to Rs. 4.886), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share for the year ended 31.3.2007. Therefore, diluted earnings per share for the year ended 31st March, 2007 is Rs. 4.48.

For the year ended 31st March, 2006, Options, 12% Convertible debentures and Convertible preference shares will be considered dilutive and diluted earnings per share will be taken as Rs. 5.58.

|                                                                                                        | <i>Year ended 31.3.2007</i> | <i>Year ended 31.3.2006</i> |
|--------------------------------------------------------------------------------------------------------|-----------------------------|-----------------------------|
| Diluted earnings per Share                                                                             | 4.48                        | 5.58                        |
| <b>(iii) Adjusted earnings per share and diluted earnings per share for the year ending 31.3.2006.</b> |                             |                             |

|                                                |               |
|------------------------------------------------|---------------|
| Net profit attributable to equity shareholders | Rs. 10,00,000 |
|------------------------------------------------|---------------|

|                                                                               |          |
|-------------------------------------------------------------------------------|----------|
| Weighted average number of equity shares [(W.N. 1) – considering bonus issue] | 1,75,000 |
|-------------------------------------------------------------------------------|----------|

|                             |           |
|-----------------------------|-----------|
| Adjusted earnings per share | Rs. 5.714 |
|-----------------------------|-----------|

Calculation of adjusted diluted earnings per share

|                                   | <i>Net profit attributable to equity shareholders</i> | <i>No. of equity shares (after considering bonus issue)</i> | <i>Net profit attributable per share</i> |
|-----------------------------------|-------------------------------------------------------|-------------------------------------------------------------|------------------------------------------|
|                                   | <i>Rs.</i>                                            |                                                             | <i>Rs.</i>                               |
| As reported                       | 10,00,000                                             | 1,75,000                                                    | 5.714                                    |
| Options                           | <u>          </u>                                     | <u>2,000</u>                                                |                                          |
|                                   | <u>10,00,000</u>                                      | <u>1,77,000</u>                                             | 5.65                                     |
|                                   |                                                       |                                                             | Dilutive                                 |
| 12% Convertible Debentures        | <u>84,000</u>                                         | <u>40,000</u>                                               |                                          |
|                                   | <u>10,84,000</u>                                      | <u>2,17,000</u>                                             | 4.995                                    |
|                                   |                                                       |                                                             | Dilutive                                 |
| 10% Convertible Preference Shares | <u>8,80,000</u>                                       | <u>1,60,000</u>                                             |                                          |
|                                   | <u>19,64,000</u>                                      | <u>3,77,000</u>                                             | 5.21 Anti – Dilutive                     |

Since diluted earnings per share is increased when taking the convertible preference shares into account (from Rs. 4.995 to Rs. 5.21), the convertible preference shares are

anti-dilutive and are ignored in the calculation of diluted earnings per share. Therefore, adjusted diluted earnings per share for year ended 31.3.2006 is Rs. 4.995.

Adjusted diluted earnings per share Rs. 4.995

### Working Notes:

#### 1. Weighted average number of equity shares

|                                                                | 31.3.20073      | 31.3.2006         |
|----------------------------------------------------------------|-----------------|-------------------|
|                                                                | No. of Shares   | No. of Shares     |
| (a) Fully paid equity shares                                   | 1,00,000        | 1,00,000          |
| (b) Partly paid equity shares*                                 |                 | 50,000            |
| Partly paid equity shares                                      | 25,000          |                   |
| Fully paid equity shares                                       | 50,000          |                   |
| (Partly paid shares converted into fully paid up on 1.10.2006) |                 |                   |
| (c) Bonus Shares**                                             | <u>25,000</u>   | <u>          </u> |
| Weighted average number of equity shares                       | <u>2,00,000</u> | <u>1,50,000</u>   |
| (without considering bonus issue for year ended 31.3.2006)     |                 |                   |
| Bonus Shares                                                   |                 | <u>25,000</u>     |
| Weighted average number of equity shares                       |                 | <u>1,75,000</u>   |
| (after considering bonus issue for year ended 31.3.2006)       |                 |                   |

\*Since partly paid equity shares are entitled to participate in dividend to the extent of amount paid, 1,00,000 equity shares of Rs. 10 each, Rs. 5 paid up will be considered as 50,000 equity shares for the year ended 31st March, 2006.

On 1st October, 2006 the partly paid shares were converted into fully paid up. Thus, the weighted average equity shares (for six months ended 30th September, 2006) will be calculated as

$$50,000 \times \frac{6}{12} = 25,000 \text{ shares}$$

Weighted average shares (for six months ended 31st March, 2007) will be calculated as

$$1,00,000 \times \frac{6}{12} = 50,000 \text{ shares}$$

\*\* Total number of fully paid shares on 1st January, 2007

|                                                                  |                 |
|------------------------------------------------------------------|-----------------|
| Fully paid shares on 1st April, 2006                             | 1,00,000        |
| Partly paid shares being made fully paid up on 1st October, 2006 | <u>1,00,000</u> |
|                                                                  | <u>2,00,000</u> |

## 1.200 Financial Reporting

The company issued 1 bonus share for 8 shares held on 1st January, 2007.

Thus  $2,00,000/8 = 25,000$  bonus shares will be issued.

Bonus is an issue without consideration, thus it will be treated as if it had occurred prior to the beginning of 1st April, 2005, the earliest period reported.

### 2. Increase in earnings attributable to equity shareholders on conversion of potential equity shares

|                                                                                                                                                                             | <i>Increase in<br/>earnings</i> | <i>Increase in<br/>number of<br/>equity shares</i> | <i>Earnings per<br/>incremental<br/>share</i> |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|----------------------------------------------------|-----------------------------------------------|
|                                                                                                                                                                             | (1)                             | (2)                                                | (3) = (1) ÷ (2)                               |
|                                                                                                                                                                             | Rs.                             |                                                    | Rs.                                           |
| <i>Options</i>                                                                                                                                                              |                                 |                                                    |                                               |
| Increase in earnings                                                                                                                                                        | Nil                             |                                                    |                                               |
| No. of incremental shares issued<br>for no consideration<br>[ $10,000 \times (75 - 60)/75$ ]                                                                                |                                 | 2,000                                              | Nil                                           |
| <i>Convertible Preference Shares</i>                                                                                                                                        |                                 |                                                    |                                               |
| Increase in net profit attributable to<br>equity shareholders as adjusted by<br>attributable dividend tax<br>[(Rs. $10 \times 80,000$ ) + 10%<br>(Rs. $10 \times 80,000$ )] | 8,80,000                        |                                                    |                                               |
| No. of incremental shares<br>( $2 \times 80,000$ )                                                                                                                          |                                 | 1,60,000                                           | 5.50                                          |
| <i>12% Convertible Debentures</i>                                                                                                                                           |                                 |                                                    |                                               |
| Increase in net profit<br>[(Rs. $10,00,000 \times 0.12 \times (1 - 0.30)$ )]                                                                                                | 84,000                          |                                                    |                                               |
| No. of incremental shares<br>( $10,000 \times 4$ )                                                                                                                          |                                 | 40,000                                             | 2.10                                          |

### Illustration 8

X Co. Ltd. supplied the following information. You are required to compute the basic earning per share:

(Accounting year 1.1.2005 – 31.12.2005)

|            |   |                           |
|------------|---|---------------------------|
| Net Profit | : | Year 2005: Rs. 20,00,000  |
|            | : | Year 2006 : Rs. 30,00,000 |

|                                                                                    |   |                                                                |
|------------------------------------------------------------------------------------|---|----------------------------------------------------------------|
| No. of shares outstanding prior to Right Issue                                     | : | 10,00,000 shares                                               |
| Right Issue                                                                        | : | One new share for each four outstanding i.e., 2,50,000 shares. |
|                                                                                    |   | Right Issue price – Rs. 20                                     |
|                                                                                    |   | Last date of exercise rights – 31.3.2006.                      |
| Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2006 | : | Rs. 25                                                         |

**Solution**

**Computation of Basic Earnings Per Share**  
(as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)

|                                                                                                                                                           | Year<br>2005 | Year<br>2006 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|--------------|
|                                                                                                                                                           | Rs.          | Rs.          |
| <b>EPS for the year 2005 as originally reported</b>                                                                                                       |              |              |
| = $\frac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$ |              |              |
| = (Rs. 20,00,000 / 10,00,000 shares)                                                                                                                      | 2.00         |              |
| <b>EPS for the year 2005 restated for rights issue</b>                                                                                                    |              |              |
| = [Rs. 20,00,000 / (10,00,000 shares × 1.04*)]                                                                                                            | 1.92         |              |
|                                                                                                                                                           | (approx.)    |              |
| <b>EPS for the year 2006 including effects of rights issue</b>                                                                                            |              |              |
| $\frac{\text{Rs. 30,00,000}}{(10,00,000 \text{ shares} \times 1.04 \times 3/12) + (12,50,000 \text{ shares} \times 9/12)}$                                |              |              |
| $\frac{\text{Rs. 30,00,000}}{11,97,500 \text{ shares}}$                                                                                                   |              | 2.51         |
|                                                                                                                                                           |              | (approx.)    |

**Working Notes:**

## 1. Computation of theoretical ex-rights fair value per share

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise} + \text{Number of shares issued in the exercise}}$$

---

\* Refer working note 2.

## 1.202 Financial Reporting

$$\begin{aligned} &= \frac{(\text{Rs. } 25 \times 10,00,000 \text{ shares}) + (\text{Rs. } 20 \times 2,50,000 \text{ shares})}{10,00,000 \text{ shares} + 2,50,000 \text{ shares}} \\ &= \frac{\text{Rs. } 3,00,00,000}{12,50,000 \text{ shares}} = \text{Rs. } 24 \end{aligned}$$

### 2. Computation of adjustment factor

$$\begin{aligned} &= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex - rights value per share}} \\ &= \frac{\text{Rs. } 25}{\text{Rs. } 24 \text{ (Refer Working Note 1)}} = 1.04 \text{ (approx.)} \end{aligned}$$

## Self-examination Questions

1. Define the following terms in the context of AS 20.
  - (a) Preference share
  - (b) Potential equity share.
  - (c) Share warrant.
2. Explain the procedure for calculation of basic and diluted earning per share in brief.
3. How will you determine the weighted average number of equity shares?
4. Should appropriation to mandatory reserves be excluded from net profit attributable to equity shareholders?
5. Kashyap Ltd. is engaged in manufacturing industrial packaging equipment. As per the terms of an agreement entered into with its debentureholders, the company is required to appropriate adequate portion of its profits to a specific reserve over the period of maturity of the debentures such that, at the redemption date, the Reserve constitutes at least half the value of such debentures. As such, appropriations are not available for distribution to the equity shareholders. Kashyap Ltd. has excluded this from the numerator in the computation of basis EPS. Is this treatment correct?
6. Would completely vested options to purchase shares of a company be included in the computation of basic EPS?
7. Explain the calculation of weighted average number of equity shares in case of a bonus issue or share split.
8. Bhima Ltd. provides the following information. Compute basic EPS as per AS 20.

Number of equity shares outstanding as at beginning of the period = 5,00,000.

Bonus issue on 1<sup>st</sup> July of current year = 3 shares for every 1 share held



**Accounting Standards and Guidance Notes 1.203**

Net Profit for current year and previous reporting period = Rs.160 lakhs and Rs.50 lakhs.

9. 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

## UNIT 21

### AS 21: CONSOLIDATED FINANCIAL STATEMENTS

Reference: The students are advised to refer the full text of AS 21 "Consolidated Financial Statements" (issued 2001) given in Appendix I at the end of the Study Material (Volume-II).

#### 21.1 INTRODUCTION

This AS comes into effect in respect of accounting periods commencing on or after 1-4-2001. AS 21 lays down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by a parent (holding company) to provide financial information about the economic activities of the group as a single economic entity. A parent which presents consolidated financial statements should present their statements in accordance with this standard but in its separate financial statements, investments in subsidiaries should be accounted as per AS 13.

#### 21.2 OBJECTIVE

The objective of this Statement is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated Financial Statement is prepared by the holding/parent company to provide financial information regarding the economic resources controlled by its group and results achieved with these resources. This consolidated financial statement is prepared by the parent company in addition to the financial statement prepared by the parent company for only its own affairs. Hence parent company prepares two financial statements, one for only its own affairs and one for taking the whole group as one unit in the form of consolidated financial statement. Consolidated financial statements usually comprise the following:

- ◆ Consolidated Balance Sheet
- ◆ Consolidated Profit & Loss Statement
- ◆ Notes to Accounts, other statements and explanatory material
- ◆ Consolidated Cash Flow Statement, if parent company presents its own cash flow statement.

While preparing the consolidated financial statement, all other ASs and Accounting Policies will be applicable as they are applied in parent company's own financial statement.

#### 21.3 SCOPE

This statement applies to the financial statement prepared by the parent company including the financial information of all its subsidiaries taken as one single financial unit. One should refer to this AS for the investment in subsidiaries to be disclosed in the financial statement prepared by the parent company separately. But this statement does not deal with:

- a. Methods of accounting for amalgamations and their effects on consolidation, including goodwill arising on amalgamation (AS – 14).
- b. Accounting for investments in associates (AS – 13) and
- c. Accounting for investments in joint ventures (AS – 13).

#### 21.4 DEFINITIONS OF THE TERMS USED IN THE ACCOUNTING STANDARD

A **subsidiary** is an enterprise that is controlled by another enterprise (known as the parent). A **parent** is an enterprise that has one or more subsidiaries.

A **group** is a parent and all its subsidiaries.

**Equity** is the residual interest in the assets of an enterprise after deducting all its liabilities. **Minority interest** is that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiary (ies), by the parent.

**Consolidated financial statements** are the financial statements of a group presented as those of a single enterprise.

**21.5 Circumstances under which preparation of consolidated financial statements are prepared.** Consolidated Financial Statement will be prepared by the parent company for all the companies that are controlled by the parent company either directly or indirectly, situated in India or abroad except in the following cases:

- a. Control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future.

As per ASI – 25, in view of the above, merely holding all the shares as 'stock-in-trade', is not sufficient to be considered as temporary control. It is only when all the shares held as 'stock-in-trade' are acquired and held exclusively with a view to their subsequent disposal in the near future, that control would be considered to be temporary within the meaning of the paragraph.

The term 'Near Future' is expressed in ASI – 8 as a period not exceeding 12 months in normal case. For the above purpose, one should note the intention at the time of making the investment, if the intention is to continue with the equity for longer period then even though it is disposed off within 12 months, investee company would still be considered as subsidiary. On the other hand, if intention at the time of purchase is dispose it in near future, but the parent company was not able to dispose of the shares even after the end of 12 months, shares will continue to be considered as stock.

- b. Or subsidiary company operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the parent.

## 1.206 Financial Reporting

When the parent company has some restrictions on bringing the resources of the subsidiary company to its main resources then consolidated financial statement is not required, as the control is not resulting in extra cash flow to parent company other than as mere investment in share of any other company i.e. dividend, bonus shares.

Therefore, in both the above cases, investment of parent company in the share of its subsidiary company is treated as investment according to AS 13.

Exclusion of subsidiary company will be only for any of the above reasons but a company cannot be treated as outside the group just because the main business of the subsidiary company is not in line with the business of parent company.

### 21.6 CONTROL EXISTS WHEN PARENT COMPANY HAS EITHER:

- a. The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise.

For example, A Ltd. holds 75% shares in B Ltd., then B Ltd. is subsidiary of A Ltd., in other words A Ltd. is the parent company.

If A Ltd. is holding 25% shares in C Ltd., then there is no holding-subsidiary relationship between them. But if along with A Ltd., B Ltd. also holds 30% shares in C Ltd., then A Ltd. holding in C Ltd. is 55%, though indirectly, and A Ltd. is parent company of both B Ltd. and C Ltd.

- b. Or control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from subsidiary company's activities.

Point to be noted here is that, the control over composition of board or governing body is for economic benefit. If any company is controlling the composition of governing body of gratuity trust, provident fund trust etc., since the objective is not the economic benefit and therefore it will not be included in consolidated financial statement.

An enterprise is considered to control the composition of the board of directors or governing body of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company or members of the body. An enterprise is deemed to have the power to appoint a director/member, if any of the following conditions is satisfied:

- (i) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid; or
- (ii) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise; or
- (iii) The director/member is nominated by that enterprise or a subsidiary thereof.

If A Ltd. is proved to be a subsidiary company of B Ltd. by virtue of point (a) and also a subsidiary of C Ltd. as per point (b), then the problem arises that which company is liable to prepare Consolidated Financial Statement taking A Ltd. as its subsidiary. For this purpose **ASI – 24** explains that both B Ltd. and C Ltd. will prepare such Consolidated Financial Statement, group being constituted of themselves and A Ltd.

In addition to the above points, one should also consider the following points:

Determination of control in any company or organization, does not depend only on the share in capital, many a times even when the share in capital is less than 50% but still we consider the parent-subsidiary relationship as the voting power granted under special circumstances is more than 50%.

For example, ICICI Bank advanced loan of 40 crores to A Ltd., whose share capital is Rs. 10 crores only. As per the loan agreement, in case company defaults to repay the principal or to pay the interest on due date three times, ICICI Bank will have right to participate in the decision making of the company and this right will come to an end with the repayment of the loan amount with all its interest. On happening of the event, ICICI Bank got the voting right in the company meetings (Board and AGM) and as its advances to company is 80% of shares plus advances, bank carry 80% voting right and we can say that there exists a parent-subsidiary relationship, where A Ltd. is subsidiary of ICICI Bank.

Control is said to come into existence from the date when the conditions of such control are satisfied. If company does have control over the function of another company but consolidated financial statement is not prepared for the reason that there is restriction of impairing the resources then later, on removal of such restriction control will be said to come into existence but not from the date of such removal but from the date when such investments led to control.

## 21.7 CONSOLIDATION PROCEDURES

In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line-by-line basis by adding together like items of assets, liabilities, income and expenses.

## 21.8 COST OF CONTROL

- ◆ The cost of investment of the parent in each of its subsidiaries and the parent's share in equity of each subsidiary should be eliminated. For the purpose equity and investment as on the date of each investment is taken.
- ◆ On the date of investment if the cost of investment to the parent is more than share of equity in that particular subsidiary, the difference is taken as Goodwill in the consolidated statement.

## 1.208 Financial Reporting

- ◆ On the date of investment if the cost of investment to the parent is less than share of equity in that particular subsidiary, the difference is taken as Capital Reserve in the consolidated statement.

### 21.9 ILLUSTRATIONS

#### Illustration 1

A Ltd. acquired 60% shares of B Ltd. @ Rs. 20 per share. Following are the extract of Balance Sheet of B Ltd.:

|                                        | Rs.         |
|----------------------------------------|-------------|
| 10,00,000 Equity Shares of Rs. 10 each | 1,00,00,000 |
| 10% Debentures                         | 10,00,000   |
| Creditors                              | 5,00,000    |
| Fixed Assets                           | 70,00,000   |
| Investments                            | 45,00,000   |
| Current Assets                         | 68,00,000   |
| Loans & Advances                       | 22,00,000   |

On the same day B Ltd. declared dividend at 20% and as agreed between both the companies fixed assets were to be depreciated @ 10% and investment to be taken at market value of Rs. 60,00,000. Calculate the Goodwill or Capital Reserve to be recorded in Consolidated Financial Statement.

#### Solution

##### Calculation of Goodwill/Capital Reserve

| Particulars                                     | Rs.          | Rs.          |
|-------------------------------------------------|--------------|--------------|
| Fixed Assets                                    | 7,00,00,000  |              |
| Less: Value written off (70,00,000 x 10%)       | 700,000      | 6,30,00,000  |
| Investments at Market value                     |              | 6,00,00,000  |
| Current Assets                                  |              | 6,80,00,000  |
| Loans & Advances                                |              | 2,20,00,000  |
| Total Assets                                    |              | 21,30,00,000 |
| Less: Total Liabilities: Creditors              | 5,50,00,000  |              |
| 10% Debentures                                  | 1,00,00,000  | 6,50,00,000  |
| Equity                                          |              | 14,80,00,000 |
| Majority Share in Equity (1,48,00,000 x 60%)    |              | 8,88,00,000  |
| Less: Cost of Investment (10,00,000 x 60%) x 20 | 12,00,00,000 |              |
| Less: Dividend Received (6,00,000 x 2)          | 1,20,00,000  | 10,80,00,000 |
| Goodwill                                        |              | 1,92,00,000  |

- ◆ Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.
- ◆ Goodwill and capital reserve of different subsidiaries can be adjusted to a net figure by the parent in consolidated financial statement.
- ◆ Goodwill of consolidated financial statement need not be written off to consolidated profit and loss account but test of impairment (Refer to AS – 28) is made each time a consolidated financial statement is prepared.
- ◆ When share application money and allotment money is paid separately on different dates, then as per AS – 21, date on which investment led to acquisition to control of subsidiary should be taken as date of investment, i.e., date of allotment.
- ◆ On the basis of above discussion, if control is gained in the subsidiary by a series of investments, then the date of the investment which led to holding-subsidiary relationship is taken into consideration and step by step calculations are made for each following investments.

### Illustration 2

A Ltd. purchased 40% stake of B Ltd. for Rs. 12 per share. After two years A Ltd. decided to purchase another 40% share in B Ltd. B Ltd. has 1,00,00,000 equity shares of Rs. 10 each as fully paid up shares. The purchase deal was finalised on the following terms:

- Purchase price per share to be calculated on the basis of average profit of last three years capitalised at 7.5%. Profits for last three years are Rs. 35 lacs, Rs. 65 lacs and Rs. 89 lacs.
- Total assets of B Ltd. of Rs. 11,50,00,000. Assets to be appreciated by Rs. 40,00,000.
- Of the External Creditors for Rs. 2,50,00,000 one creditor to whom Rs. 10,00,000 was due has expired and nothing is to be paid to settle this liability.
- B Ltd. will declare dividend @ 15%.

Calculate the Goodwill or Capital Reserve for A Ltd. in Consolidated Financial Statement.

### Solution

#### Calculation of Purchase Consideration

| <i>Particulars</i>              | <i>Rs.</i> |
|---------------------------------|------------|
| Profits for Last 3 years: First | 8,900,000  |
| Second                          | 6,500,000  |
| Third                           | 3,500,000  |
| Total profits for last 3 years  | 18,900,000 |

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|                                                  |            |
|--------------------------------------------------|------------|
| Average Profits (1,89,00,000/3)                  | 6,300,000  |
| Total value of B Ltd. (63,00,000/7.5%)           | 84,000,000 |
| Number of Shares in B Ltd.                       | 10,000,000 |
| Value per Share                                  | 8.40       |
| Purchase Consideration (1,00,00,000 x 40%) x 8.4 | 33,600,000 |

#### Calculation of Goodwill/Capital Reserve

| <i>Particulars</i>                                 | <i>Rs.</i>        | <i>Rs.</i>            |
|----------------------------------------------------|-------------------|-----------------------|
| Fixed Assets                                       | 115,000,000       |                       |
| Add: Appreciation in value of the asset            | <u>4,000,000</u>  | 119,000,000           |
| Less: Creditors                                    | 25,000,000        |                       |
| Less: Amount to be written off                     | <u>1,000,000</u>  | <u>24,000,000</u>     |
| Net Asset                                          |                   | 95,000,000            |
| Share in Net Asset (9,50,00,000 x 80%)             |                   | <u>76,000,000</u>     |
| Less: Cost of Investment: Purchase Consideration   | 33,600,000        |                       |
| Less: Dividend Received (10,00,00,000 x 40% x 15%) | <u>6,000,000</u>  |                       |
|                                                    | 27,600,000        |                       |
| Add: Investment (1,00,00,000 x 40% x 12)           | <u>48,000,000</u> | <u>75,600,000</u>     |
| Capital Reserve                                    |                   | <u><u>400,000</u></u> |

### 21.10 MINORITY INTEREST

- ◆ From the net income of the subsidiary, amount proportionate to minority interest is calculated and adjusted with the group income i.e. it is deducted from the profit & loss account balance and added to minority interest, so that the income of the group belonging to the parent is identified separately.
- ◆ Care should be taken to adjust for the cumulative preference dividend and profits belonging to the preference shares (if any) in the minority interest for the preference shares not held by the consolidated group. This adjustment should be made irrespective of whether or not dividends have been declared.
- ◆ Minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the net assets consist of:
  - (i) The amount of equity attributable to minorities at the date on which investment in a subsidiary is made and



- (ii) The minorities' share of movements in equity since the date the parent-subsidary relationship came in existence.
- ◆ If carrying amount and cost of investment are different, carrying amount is considered for the purpose.

**Illustration 3**

Following are the Balance Sheet of A Ltd. and B Ltd.:

| <i>Liabilities</i>    | <i>All Fig, in '000</i> |               | <i>Assets</i>    | <i>All Fig, in '000</i> |               |
|-----------------------|-------------------------|---------------|------------------|-------------------------|---------------|
|                       | <i>A Ltd.</i>           | <i>B Ltd.</i> |                  | <i>A Ltd.</i>           | <i>B Ltd.</i> |
| Equity Shares         | 6,000                   | 5,000         | Goodwill         | 100                     | 20            |
| 6% Preference shares  | -                       | 1,000         | Fixed Assets     | 3,850                   | 2,750         |
| General Reserve       | 1,200                   | 800           | Investment       | 1,620                   | 1,100         |
| Profit & Loss Account | 1,020                   | 1,790         | Stock            | 1,900                   | 4,150         |
| Bills Payable         | 1,100                   | 1,540         | Debtors          | 2,450                   | 3,080         |
| Creditors             | 2,750                   | 1,870         | Bills Receivable | 2,150                   | 1,000         |
| Proposed Dividend     | 600                     | 500           | Cash & Bank      | 600                     | 400           |
|                       | <u>12,670</u>           | <u>12,500</u> |                  | <u>12,670</u>           | <u>12,500</u> |

A Ltd. purchased 3/4<sup>th</sup> interest in B Ltd. at the beginning of the year at the premium of 25%. Following are the other information available:

- Profit & Loss Account of B Ltd. includes Rs. 1000 thousands brought forward from the previous year.
- The directors of both the companies have proposed a dividend of 10% on equity share capital for the previous and current year.

From the above information calculate Pre and Post Acquisition Profits, Minority Interest and Cost of Control.

**Solution****Calculation of Pre and Post Acquisition Profits**

| <i>Particulars</i>               | <i>Pre Acquisition Profits</i> | <i>Post Acquisition Profits</i> |
|----------------------------------|--------------------------------|---------------------------------|
| Profit & Loss Account            | 1,000,000                      | 790,000                         |
| General Reserve                  | 800,000                        | -                               |
|                                  | <u>1,800,000</u>               | <u>790,000</u>                  |
| Less: Minority Interest (1800/4) | 450,000                        |                                 |
| (790/4)                          |                                | 197,500                         |
| Consolidated Balance Sheet       | <u>1,350,000</u>               | <u>592,500</u>                  |

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### Calculation of Minority Interest

| <i>Particulars</i>                         | <i>Rs.</i>       |
|--------------------------------------------|------------------|
| Paid up Equity Share Capital (50,00,000/4) | 1,250,000        |
| Paid up Preference Share Capital           | 1,000,000        |
| Pre Acquisition Profits                    | 450,000          |
| Post Acquisition Profits                   | 197,500          |
| Minority Interest                          | <u>2,897,500</u> |

### Calculation of Goodwill/Capital Reserve

| <i>Particulars</i>                                        | <i>Rs.</i>       | <i>Rs.</i>     |
|-----------------------------------------------------------|------------------|----------------|
| Cost of Investment in Subsidiary (50,00,000 x 75% x 125%) | 4,687,500        |                |
| Less: Dividend Received (50,00,000 x 75% x 10%)           | <u>375,000</u>   | 4,312,5000     |
| Less: Paid up Capital                                     | 3,750,000        |                |
| Pre Acquisition Profits                                   | <u>1,350,000</u> | 5,100,000      |
| Capital Reserve                                           |                  | <u>787,500</u> |

- ♦ The losses applicable to the minority are deducted from the minority interest unless minority interest is nil. Any further loss is adjusted with the consolidated group interest except to the extent that the minority has a binding obligation to, and is able to, make the losses good. Subsequently, when the particular subsidiary makes profits, minority share in profits is added to majority share to the extent minority interest losses were absorbed by majority share.

For example, 25% minority interest has the share in net equity Rs. 40 lacs and company made cumulative losses since the date of investment Rs. 200 lacs. 25% of Rs. 200 lacs, Rs. 50 lacs are minority share in losses. Losses upto Rs. 40 lacs will be adjusted with the minority interest and further loss of Rs. 10 lacs will be adjusted with the majority interest. Hence in the Consolidated Balance Sheet for the relevant year, minority interest on the liabilities side will be NIL.

In the next year, if subsidiary company makes a profit say, Rs. 60 lacs. Minority interest comes to Rs. 15 lacs, out of these 15 lacs, first Rs. 10 lacs will be added to majority interest as recovery of losses absorbed in past and balance Rs. 5 lacs will appear in Consolidated Balance Sheet as part of the Minority Interest.

## 21.11 OTHER POINTS

- ♦ **Inter Group Transactions:** The effect of any unrealised profits from inter group transactions should be eliminated from consolidated financial statement. Effect of losses from inter group transactions need not be eliminated only when the cost is not recoverable.

For example, A Ltd. sold goods for Rs. 1,25,000 to B Ltd., another subsidiary under same group at the gross profit of 20% on sales. On the date of consolidated balance sheet, B Ltd. has goods worth Rs. 25,000 as stock from the same consignment. The unrealised

profits of Rs. 5,000 ( $25,0000 \times 20\%$ ) will be deducted from the closing stock and it will be valued as Rs. 20,000 i.e. at cost to A Ltd. for the purpose of Consolidated Financial Statement.

- ◆ **Reporting Date:** As far as possible the reporting date of the financial statements should be same for parent company and all subsidiary companies. If practically it is not possible to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn up to reporting dates different from the reporting date of the parent, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months.
- ◆ **Accounting Policies:** Accounting policies followed in the preparation of the financial statements of the parent, subsidiaries and consolidated financial statement should be uniform for like transactions and other events in similar circumstances.

If accounting policies followed by different companies in the group are not uniform, then adjustments should be made in the items of the subsidiaries to bring them in line with the accounting policy of the parent. Here we will not disturb the figures or policies in respective books, but while including the items in consolidated financial statement, adequate adjustments will be made.

For example, parent company A Ltd. is valuing the stock on weighted average basis and its stock is valued as Rs. 100 lacs but its subsidiary B Ltd. is following FIFO method and its stock is valued at Rs. 20 Lacs. Stock of B Ltd. will be valued under weighted average method say, Rs. 25 lacs. Now for the purpose of consolidated financial statement, stock of B Ltd. will taken as Rs. 25 lacs and the stock disclosed in consolidated trading account on credit side and in consolidated balance sheet assets side will be Rs. 125 lacs. Hence adequate adjustments are made for this Rs. 5 lac in consolidated financial statement.

If it is not practical to make such adjustments for uniform accounting policies in preparing the consolidated financial statements, then the fact should be disclosed together with the amounts of the each items in the consolidated financial statement to which the different accounting policies have been applied.

Let us take above example, incase it is not possible practically to adjust Rs. 5 lacs in the stock of B Ltd. for the purpose of consolidated financial statement, then item will be disclosed in Consolidated Trading Account (Credit Side) and Consolidated Balance Sheet (Asset Side) as follow:

|                                                   |                |          |
|---------------------------------------------------|----------------|----------|
| Closing Stock of A Ltd. (Weighted Average Method) | 100 lacs       |          |
| Closing Stock of B Ltd. (FIFO Method)             | <u>25 lacs</u> | 125 lacs |

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### 21.12 DISPOSAL OF HOLDING

The results of operations of a subsidiary are included in the consolidated financial statement as from the date on which parent-subsidiary relationship comes into existence and are included in the consolidated statement of profit and loss until the date of cessation of the relationship. On disposal of the investment, consolidated profit and loss account will include the transactions till the date the parent-subsidiary relationship ceases to exist. The difference between the proceeds from the disposal of investment and the parent's share in the net asset of the subsidiary on the basis of the carrying amount, on the date of disposal is recorded in the consolidated profit and loss account. While calculating the share of parent in the net asset of the subsidiary on the date of disposal, adjustment is made for the minority interest calculated as above.

In order to ensure the comparability of the financial statements from one accounting period to the next, supplementary information is often provided about the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date and the results for the reporting period and on the corresponding amounts for the preceding period. The carrying amount of the investment at the date that it ceases to be a subsidiary is regarded as cost thereafter.

Investment in the subsidiary, in the separate financial statement of the parent is recorded according to the provisions of AS – 13.

#### Illustration 4

A Ltd. had acquired 80% share in the B Ltd. for Rs. 25 lacs. The net assets of B Ltd. on the day are Rs. 22 lacs. During the year A Ltd. sold the investment for Rs. 30 lacs and net assets of B Ltd. on the date of disposal was Rs. 35 lacs. Calculate the profit or loss on disposal of this investment to be recognised in consolidated financial statement.

#### Solution

##### Calculation of Profit/Loss on disposal of investment in subsidiary

| Particulars                                                   | Rs.       | Rs.       |
|---------------------------------------------------------------|-----------|-----------|
| Net Assets of B Ltd. on the date of disposal                  |           | 3,500,000 |
| Less: Minority Interest (35 lacs x 20%)                       |           | 700,000   |
| A Ltd.'s Share in Net Assets                                  |           | 2,800,000 |
| Proceeds from the sale of Investment                          |           | 3,000,000 |
| Less: A Ltd.'s share in net assets                            |           | 2,800,000 |
|                                                               |           | 200,000   |
| Less: Goodwill in the Consolidated Financial Statement        |           |           |
| Cost of investment                                            | 2,500,000 |           |
| Less: A Ltd.'s Share in net asset on the date (22 lacs x 80%) | 1,760,000 | 740,000   |
| Loss on sale of investment                                    |           | 540,000   |

**Illustration 5**

A Ltd. had acquired 80% share in the B Ltd. for Rs. 15 lacs. The net assets of B Ltd. on the day are Rs. 22 lacs. During the year A Ltd. sold the investment for Rs. 30 lacs and net assets of B Ltd. on the date of disposal was Rs. 35 lacs. Calculate the profit or loss on disposal of this investment to be recognised in consolidated financial statement.

**Solution*****Calculation of Profit/Loss on disposal of investment in subsidiary***

| <i>Particulars</i>                                            | <i>Rs.</i> | <i>Rs.</i> |
|---------------------------------------------------------------|------------|------------|
| Net Assets of B Ltd. on the date of disposal                  |            | 3,500,000  |
| Less: Minority Interest (35 lacs x 20%)                       |            | 700,000    |
| A Ltd.'s Share in Net Assets                                  |            | 2,800,000  |
| Proceeds from the sale of Investment                          |            | 3,000,000  |
| Less: A Ltd.'s share in net assets                            |            | 2,800,000  |
|                                                               |            | 200,000    |
| Less: Capital Reserve in the Consolidated Financial Statement |            |            |
| A Ltd.'s Share in net asset on the date (22 lacs x 80%)       | 1,760,000  |            |
| Less: Cost of investment                                      | 1,500,000  | 260,000    |
| Profit on sale of investment                                  |            | 460,000    |

**21.13 DISCLOSURE**

In addition to disclosures required by paragraph 11 and 20, following disclosures should be made:

- a. In the consolidated financial statements a list of all subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;
- b. In consolidated financial statements, where applicable:
  - (i) The nature of the relationship between the parent and a subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than one-half of the voting power of the subsidiary;
  - (ii) The effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period; and
  - (iii) The names of the subsidiary(ies) of which reporting date(s) is/are different from that of the parent and the difference in reporting dates.

**21.14 TRANSITIONAL PROVISIONS**

On the first occasion that consolidated financial statements are presented, comparative figures for the previous period need not be presented. In all subsequent years full comparative figures for the

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previous period should be presented in the consolidated financial statements.

### **21.15 ASI – 26: ACCOUNTING FOR TAXES ON INCOME IN THE CONSOLIDATED FINANCIAL STATEMENTS**

While preparing consolidated financial statements, the tax expense to be shown in the consolidated financial statements should be the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries.

The amounts of tax expense appearing in the separate financial statements of a parent and its subsidiaries do not require any adjustment for the purpose of consolidated financial statements. In view of this, while preparing consolidated financial statements, the tax expense to be shown in the consolidated financial statements is the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries.

#### **Self-examination Questions**

1. Define the following terms in the context of AS 21.
  - (a) Group.
  - (b) Parent.
  - (c) Subsidiary.
  - (d) Control.
2. X Ltd has less than majority voting rights in Y Ltd., but the other shareholders of Y Ltd. are passive (i.e., they do not exercise voting rights). Can it be said that Y Ltd. is a subsidiary of X Ltd.
3. What constitutes “control” over a partnership firm? Where a company is a partner in a firm, should it consider the partnership firm as a subsidiary and consolidate the partnership firm?
4. Explain the purpose of preparing consolidated financial statements.
5. Explain the treatment for cost of investment and parent’s portion of equity in the course of consolidation.
6. Describe the treatment of intra group transactions and balances in the course of consolidation procedures.
7. How should transactions between a parent and a subsidiary on sale of goods be eliminated in the CFS?
8. Explain the principles under AS 21 when investments in a subsidiary are made at different points of time.
9. Can the parent and subsidiary have different dates of reporting? Explain in brief.

10. A and B Ltd. are subsidiaries of Z Ltd. As on the date of consolidated financial statements, goodwill arising from holding in A Ltd is Rs.36 lakhs whereas capital reserve in case of B Ltd. is Rs.24 lakhs. Can these amounts be mutually netted off in the consolidated balance sheet?

## UNIT 22

### AS 22: ACCOUNTING FOR TAXES ON INCOME

*Reference:* The students are advised to refer the full text of AS 22 "Accounting for Taxes on Income " (issued 2001) given in Appendix I at the end of the Study Material (Volume-II).

#### 22.1 INTRODUCTION

AS 22 was issued in 2001 and is mandatory in nature for:

- a. All the accounting periods commencing on or after 01.04.2001, in respect of the following:
  - (i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.
  - (ii) All the enterprises of a group, if the parent presents consolidated financial statements and the Accounting Standard is mandatory in nature in respect of any of the enterprises of that group in terms of (i) above.
- b. All the accounting periods commencing on or after 01.04.2002, in respect of companies not covered by (a) above.
- c. All the accounting periods commencing on or after 01.04.2003, in respect of all other enterprises.

This standard prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period. The concept of matching is more peculiar in cases of income taxes since in a number of cases, the taxable income may be significantly different from the income reported in the financial statements due to the difference in treatment of certain items under taxation laws and the way it is reflected in accounts.

#### 22.2 NEED

Matching of such taxes against revenue for a period poses special problems arising from the fact that in a number of cases, taxable income may be significantly different from the accounting income. This divergence between taxable income and accounting income arises due to two main reasons. Firstly, there are differences between items of revenue and expenses as appearing in the statement of profit and loss and the items which are considered as revenue, expenses or deductions for tax purposes, known as Permanent Difference. Secondly, there are differences between the amount in respect of a particular item of revenue or expense as recognised in the statement of profit and loss and the corresponding amount which is recognised for the computation of taxable income, known as Time Difference.



## 22.3 DEFINITIONS

**Tax expense (tax saving)** is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

**Current tax** is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.

**Deferred tax** is the tax effect of timing differences.

The differences between taxable income and accounting income can be classified into permanent differences and timing differences.

**Timing differences** are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.

**Permanent differences** are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently.

## 22.4 RECOGNITION

Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period. Permanent differences do not result in deferred tax assets or deferred tax liabilities. Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets or as deferred tax liabilities, in the balance sheet. While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation. This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised 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 assets can be realised.

## 22.5 RE-ASSESSMENT OF UNRECOGNISED DEFERRED TAX ASSETS

At each balance sheet date, an enterprise re-assesses unrecognised deferred tax assets. The enterprise recognises previously unrecognised deferred tax assets to the extent that it has become reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which such deferred tax assets can be realised.

## 22.6 MEASUREMENT

Current tax should be measured at the amount expected to be paid to (recovered from) the

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taxation authorities, using the applicable tax rates and tax laws. Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws. Deferred tax assets and liabilities should not be discounted to their present value.

### **22.7 REVIEW OF DEFERRED TAX ASSETS**

The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available.

### **22.8 DISCLOSURE**

An enterprise should offset assets and liabilities representing current tax if the enterprise:

- a. Has a legally enforceable right to set off the recognised amounts and
- b. Intends to settle the asset and the liability on a net basis.

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.

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. 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. 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.

### **22.9 TRANSITIONAL PROVISION**

On the first occasion that the taxes on income are accounted for in accordance with this Statement, the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this Statement as deferred tax asset/liability with a corresponding credit/charge to the revenue reserves, subject to the consideration of prudence in case of deferred tax assets (see paragraphs 15-18). The amount so credited/charged to the

revenue reserves should be the same as that which would have resulted if this Statement had been in effect from the beginning.

## **22.10 RELEVANT ACCOUNTING STANDARDS INTERPRETATIONS**

### **Accounting Standards Interpretation (ASI) 3 (Revised)**

The deferred tax in respect of timing differences which reverse during the tax holiday period should not be recognised to the extent the enterprise's gross total income is subject to the deduction during the tax holiday period as per the requirements of the Act. Deferred tax in respect of timing differences which reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22.

For the above purposes, the timing differences which originate first should be considered to reverse first.

### **Accounting Standards Interpretation (ASI) 5**

The deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22.

For the above purposes, the timing differences which originate first should be considered to reverse first.

### **Accounting Standards Interpretation (ASI) 6**

The payment of tax under section 115JB of the Act is a current tax for the period. In a period in which a company pays tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act. In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the current period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act.

### **Accounting Standards Interpretation (ASI) 7**

In case of a company, deferred tax assets should be disclosed on the face of the balance sheet separately after the head 'Investments' and deferred tax liabilities should be disclosed on the face of the balance sheet separately after the head 'Unsecured Loans'.

## **1.222 Financial Reporting**

### **Accounting Standards Interpretation (ASI) 9**

Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement and will have to be evaluated on a case to case basis. Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Virtual certainty is not a matter of perception and it should be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc., submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence.

### **Accounting Standards Interpretation (ASI) 11**

In an amalgamation in the nature of purchase, where the consideration for the amalgamation is allocated to the individual identifiable assets/liabilities on the basis of their fair values at the date of amalgamation as per AS 14, 'Accounting for Amalgamations', and the carrying amounts thereof for tax purposes continue to be the same as that for the transferor enterprise, deferred tax on the difference between the values of the assets/liabilities, arrived at for accounting purposes on the basis of their fair values, and the carrying amounts thereof for tax purposes should not be recognised as this constitutes a permanent difference. The consequent differences between the amounts of depreciation for accounting purposes and tax purposes in respect of such assets in subsequent years would also be permanent differences. In a situation where any deferred tax asset, including in respect of unabsorbed depreciation and carry forward of losses, was not recognised by the transferor enterprise, because the conditions relating to prudence laid down in AS 22, were not satisfied, the transferee enterprise can recognise the same if the conditions relating to prudence as per AS 22 are satisfied. In such a case, the accounting treatment, as described below, depends on the nature of amalgamation as well as the accounting treatment adopted for amalgamation in accordance with AS 14. Where the amalgamation is in the nature of purchase and the consideration for the amalgamation is allocated to individual identifiable assets/liabilities on the basis of their fair values at the date of amalgamation as permitted in AS 14, the deferred tax assets should be recognised by the transferee enterprise at the time of amalgamation itself considering these as identifiable assets. These deferred tax assets can be recognised at the time of amalgamation only if the conditions relating to prudence laid down in AS 22, are satisfied from the point of view of the transferee enterprise at the time of amalgamation. The recognition of deferred tax assets will automatically affect the amount of the goodwill/capital reserve arising on amalgamation.

In a case where the conditions for recognition of deferred tax assets as per AS 22 are not satisfied at the time of the amalgamation, but are satisfied by the first annual balance sheet date following the amalgamation, the deferred tax assets are recognised in accordance with AS 22. The

corresponding adjustment should be made to the goodwill/capital reserve arising on the amalgamation. If, however, the conditions for recognition of deferred tax assets are not satisfied even by the first annual balance sheet date following the amalgamation, the corresponding effect of any subsequent recognition of the deferred tax asset on the satisfaction of the conditions should be given in the statement of profit and loss of the year in which the conditions are satisfied and not in the goodwill/capital reserve.

Where the amalgamation is in the nature of purchase and the transferee enterprise incorporates the assets/liabilities of the transferor enterprise at their existing carrying amounts as permitted in AS 14, the deferred tax assets should not be recognised at the time of amalgamation. However, if, by the first annual balance sheet date subsequent to amalgamation, the unrecognised deferred tax assets are recognised pursuant to the provisions of AS 22 relating to re-assessment of unrecognised deferred tax assets, the corresponding adjustment should be made to goodwill/capital reserve arising on the amalgamation. In a case where the conditions for recognition of deferred tax assets as per AS 22 are not satisfied by the first annual balance sheet date following the amalgamation, the corresponding effect of any subsequent recognition of the deferred tax asset on the satisfaction of the conditions should be given in the statement of profit and loss of the year in which the conditions are satisfied and not in the goodwill/capital reserve.

Where the amalgamation is in the nature of merger, the deferred tax assets should not be recognised at the time of amalgamation. However, if, by the first annual balance sheet date subsequent to the amalgamation, the unrecognised deferred tax assets are recognised pursuant to the provisions of AS 22 relating to re-assessment of unrecognised deferred tax assets, the corresponding adjustment should be made to the revenue reserves. In a case where the conditions for recognition of deferred tax assets as per AS 22 are not satisfied by the first annual balance sheet date following the amalgamation, the corresponding effect of any subsequent recognition of the deferred tax asset on the satisfaction of the conditions should be given in the statement of profit and loss of the year in which the conditions are satisfied and not in the revenue reserves.

## 22.11 MISCELLANEOUS ILLUSTRATIONS

### Illustration 1

From the following details of A Ltd. for the year ended 31-03-2006, calculate the deferred tax asset/liability as per AS-22

| <i>Particulars</i>           | <i>Rs.</i> |
|------------------------------|------------|
| Accounting Profit            | 6,00,000   |
| Book Profit as per MAT       | 3,50,000   |
| Profit as per Income Tax Act | 60,000     |
| Tax rate                     | 20%        |
| MAT rate                     | 7.50%      |

## 1.224 Financial Reporting

### Solution

Tax as per accounting profit  $6,00,000 \times 20\% = 1,20,000$

Tax as per Income-tax Profit  $60,000 \times 20\% = 12,000$

Tax as per MAT  $3,50,000 \times 7.50\% = 26,250$

Tax expense = Current Tax + Deferred Tax

$1,50,000 = 15,000 + \text{Deferred tax}$

Therefore, Deferred Tax liability as on 31-03-2004

$$= 1,20,000 - 12,000 = 1,08,000$$

Amount of tax to be debited in Profit and Loss account for the year 31-03-2006

Current Tax + Deferred Tax liability + Excess of MAT over current tax

$$= 12,000 + 1,08,000 + 14,250$$

$$= 1,34,250$$

### Illustration 2

Ultra Ltd. has provided the following information.

Depreciation as per accounting records = Rs. 2,00,000

Depreciation as per tax records = Rs. 5,00,000

Unamortised preliminary expenses as per tax record = Rs. 30,000

There is adequate evidence of future profit sufficiency. How much deferred tax asset/liability should be recognized as transition adjustment. Tax rate 50%.

### Solution

Calculation of difference between taxable income and accounting income

| <i>Particulars</i>                                   | <i>Amount (Rs.)</i> |
|------------------------------------------------------|---------------------|
| Excess depreciation as per tax (5,00,000 – 2,00,000) | 3,00,000            |
| Less: Expenses provided in taxable income            | <u>30,000</u>       |
| Timing difference                                    | <u>2,70,000</u>     |

Tax expense is more than the current tax due to timing difference.

Therefore deferred tax liability =  $50\% \times 2,70,000 = \text{Rs. } 1,35,000$

**Illustration 3**

XYZ is an export oriented unit and was enjoying tax holiday upto 31.3.2002. No provision for deferred tax liability was made in accounts for the year ended 31.3.2002. While finalising the accounts for the year ended 31.3.2003, the Accountant says that the entire deferred tax liability upto 31.3.2002 and current year deferred tax liability should be routed through Profit and Loss Account as the relevant Accounting Standard has already become mandatory from 1.4.2001. Do you agree?

**Solution**

Paragraph 33 of AS 22 on "Accounting For Taxes on Income" relates to the transitional provisions. It says, "On the first occasion that the taxes on income are accounted for in accordance with this statement, the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this statement as deferred tax asset/liability with a corresponding credit/charge to the revenue reserves, subject to the consideration of prudence in case of deferred tax assets.

Further Paragraph 34 lays down, "For the purpose of determining accumulated deferred tax in the period in which this statement is applied for the first time, the opening balances of assets and liabilities for accounting purposes and for tax purposes are compared and the differences, if any, are determined. The tax effects of these differences, if any, should be recognised as deferred tax assets or liabilities, if these differences are timing differences."

Therefore, in the case of XYZ, even though AS 22 has come into effect from 1.4.2001, the transitional provisions permit adjustment of deferred tax liability/asset upto the previous year to be adjusted from opening reserve. In other words, the deferred taxes not provided for alone can be adjusted against opening reserves.

Provision for deferred tax asset/liability for the current year should be routed through profit and loss account like normal provision.

**Illustration 4**

PQR Ltd.'s accounting year ends on 31st March. The company made a loss of Rs. 2,00,000 for the year ending 31.3.2001. For the years ending 31.3.2002 and 31.3.2003, it made profits of Rs. 1,00,000 and Rs. 1,20,000 respectively. It is assumed that the loss of a year can be carried forward for eight years and tax rate is 40%. By the end of 31.3.2001, the company feels that there will be sufficient taxable income in the future years against which carry forward loss can be set off. There is no difference between taxable income and accounting income except that the carry forward loss is allowed in the years ending 2002 and 2003 for tax purposes. Prepare a statement of Profit and Loss for the years ending 2001, 2002 and 2003.

## 1.226 Financial Reporting

### Solution

#### Statement of Profit and Loss

|                                                                    | 31.3.2001         | 31.3.2002     | 31.3.2003     |
|--------------------------------------------------------------------|-------------------|---------------|---------------|
|                                                                    | Rs.               | Rs.           | Rs.           |
| Profit (Loss)                                                      | (2,00,000)        | 1,00,000      | 1,20,000      |
| Less: Current tax                                                  |                   |               | (8,000)       |
| <b>Deferred tax:</b>                                               |                   |               |               |
| Tax effect of timing differences originating during the year       | 80,000            |               |               |
| Tax effect of timing differences reversed/adjusted during the year |                   | (40,000)      | (40,000)      |
| <b>PROFIT (LOSS) AFTER TAX EFFECT</b>                              | <u>(1,20,000)</u> | <u>60,000</u> | <u>72,000</u> |

### Illustration 5

The following particulars are stated in the Balance Sheet of M/s Exe Ltd. as on 31.03.2003:

|                              | (Rs. in Lakhs) |
|------------------------------|----------------|
| Deferred Tax Liability (Cr.) | 20.00          |
| Deferred Tax Assets (Dr.)    | 10.00          |

The following transactions were reported during the year 2003-04:

|       |                                                                                                                                                                                           |       |
|-------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|
| (i)   | Tax Rate                                                                                                                                                                                  | 50%   |
| (ii)  | Depreciation – As per Books                                                                                                                                                               | 50.00 |
|       | Depreciation – for Tax purposes                                                                                                                                                           | 30.00 |
|       | There were no addition to Fixed Assets during the year.                                                                                                                                   |       |
| (iii) | Items disallowed in 2002-03 and allowed for Tax purposes in 2003-04                                                                                                                       | 10.00 |
| (iv)  | Interest to Financial Institutions accounted in the Books on accrual basis, but actual payment was made on 30.09.2004                                                                     | 20.00 |
| (v)   | Donations to Private Trusts made in 2003-04                                                                                                                                               | 10.00 |
| (vi)  | Share issue expenses allowed under 35(D) of the I.T. Act, 1961 for the year 2003-04 (1/10th of Rs. 50.00 lakhs incurred in 1999-2000)                                                     | 5.00  |
| (vii) | Repairs to Plant and Machinery Rs. 100.00 lakhs was spread over the period 2003-04 and 2004-05 equally in the books. However, the entire expenditure was allowed for Income-tax purposes. |       |

Indicate clearly the impact of above items in terms of Deferred Tax liability/Deferred Tax Assets and the balances of Deferred Tax Liability/Deferred Tax Asset as on 31.03.2004.



**Solution****Impact of various items in terms of deferred tax liability/deferred tax asset.**

| <i>Transactions</i>                            | <i>Analysis</i>                                                                                                                                                                            | <i>Nature of difference</i>   | <i>Effect</i>   | <i>Amount</i>                        |
|------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------|-----------------|--------------------------------------|
| Difference in depreciation                     | Generally, written down value method of depreciation is adopted under IT Act which leads to higher depreciation in earlier years of useful life of the asset in comparison to later years. | Responding timing difference  | Reversal of DTL | Rs. 20 lakhs<br>× 50% = Rs. 10 lakhs |
| Disallowances, as per IT Act, of earlier years | Tax payable for the earlier year was higher on this account.                                                                                                                               | Responding timing difference  | Reversal of DTA | Rs. 10 lakhs<br>× 50% = Rs. 5 lakhs  |
| Interest to financial institutions             | It is allowed as deduction under section 43B of the IT Act, if the payment is made before the due date of filing the return of income (i.e. 31st October, 2004).                           | No timing difference          | Not applicable  | Not applicable                       |
| Donation to private trusts                     | Not an allowable expenditure under IT Act.                                                                                                                                                 | Permanent difference          | Not applicable  | Not applicable                       |
| Share issue expenses                           | Due to disallowance of full expenditure under IT Act, tax payable in the earlier years was higher.                                                                                         | Responding timing difference  | Reversal of DTA | Rs. 5 lakhs × 50% = Rs. 2.5 lakhs    |
| Repairs to plant and machinery                 | Due to allowance of full expenditure under IT Act, tax payable of the current year will be less.                                                                                           | Originating timing difference | Increase in DTL | Rs. 50 lakhs<br>× 50% = Rs. 25 lakhs |

## 1.228 Financial Reporting

### Deferred Tax Liability Account

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3. Z Ltd. presents the following information for the year ending 31.03.2006 and 31.03.2007 from which you are required to calculate the Deferred Tax Asset/Liability assuming tax rate of 30% and state how the same should be dealt with as per relevant accounting standard.

|                                                                   | 31.03.2006  | 31.03.2007  |
|-------------------------------------------------------------------|-------------|-------------|
|                                                                   | Rs. (lakhs) | Rs. (lakhs) |
| Depreciation as per books                                         | 4,010.10    | 4,023.54    |
| Unabsorbed carry forward business loss and depreciation allowance | 2,016.60    | 4,110.00    |
| Disallowance under Section 43B of Income tax Act, 1961            | 518.35      | 611.45      |
| Deferred Revenue Expenses                                         | 4.88        | —           |
| Provision for Doubtful Debts                                      | 282.51      | 294.35      |

Z Ltd. had incurred a loss of Rs. 504 lakhs for the year ending 31.03.2007 before providing for Current Tax of Rs. 26.00 lakhs.

4. Milton Ltd. is a full tax free enterprise for the first 10 years of its existence and is in the second year of its operations. Depreciation timing difference resulting in a deferred tax liability in years 1 and 2 is Rs.200 lakhs and 400 lakhs respectively. From the 3<sup>rd</sup> year onwards, it is expected that the timing difference would reverse each year by Rs.10 lakhs. Assuming tax rate @35%, find out the deferred tax liability at the end of the second year and any charge to the profit and loss account.
5. Under the Income Tax Act, depreciation is allowed to the extent of 100% of the cost of asset on WDV basis. However, under the Companies Act, 1956, a company has the option to provide depreciation for such an amount as is arrived at by dividing 95% of the original cost of the asset by the specified period. Is the difference of 5% a permanent difference?
6. Compute the DTA/DTL with the following information if Tax Rate 40%-
- |                                         |   |                      |
|-----------------------------------------|---|----------------------|
| Profit before tax as per books          | = | Rs.100 lakhs         |
| Add back: Goodwill written off in books | = | Rs. 10 lakhs         |
| Depreciation as per books               | = | Rs. 60 lakhs         |
| Less: Depreciation under Income Tax Act | = | <u>Rs.(30) lakhs</u> |
| Taxable income as per Income Tax Act    | = | <u>Rs.140 lakhs</u>  |
7. What are the applicable tax rates for computing current tax and deferred tax?

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8. Explain the procedure for re-assessment of unrecognized DTA.
9. Can DTA and DTL be recognised at their discounted present values?
10. Explain the applicability of AS 22 in case of tax holiday u/s 10A and 10B of the income-tax Act, 1961.

## UNIT 23

### AS 23: ACCOUNTING FOR INVESTMENTS IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS

Reference: The students are advised to refer the full text of AS 23 "Accounting for Investments in Associates in Consolidated Financial Statements" (issued 2001) given in Appendix I at the end of the Study Material (Volume-II).

#### 23.1 INTRODUCTION

AS 23, comes into effect in respect of accounting periods commencing on or after 1-4-2002. AS 23 describes the principles and procedures for recognizing investments in associates (in which the investor has significant influence, but not a subsidiary or joint venture of investor) in the consolidated financial statements of the investor. An investor which presents consolidated financial statements should account for investments in associates as per equity method in accordance with this standard but in its separate financial statements, AS 13 will be applicable.

#### 23.2 OBJECTIVE

The objective of this Statement is to lay down principles and procedures for recognizing the investments in associates and its effect on the financial operations of the group in the consolidated financial statement. Reference to AS 23 is compulsory for the companies following AS 21 and preparing consolidated financial statement for their group. For disclosing investment in associates in the separate financial statement of the investor itself, one should follow AS 13.

#### 23.3 DEFINITIONS OF THE TERMS USED IN THE ACCOUNTING STANDARD

A **subsidiary** is an enterprise that is controlled by another enterprise (known as the parent). A **parent** is an enterprise that has one or more subsidiaries.

A **group** is a parent and all its subsidiaries.

**Equity** is the residual interest in the assets of an enterprise after deducting all its liabilities.

**Consolidated financial statements** are the financial statements of a group presented as those of a single enterprise.

An **associate** is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

**Significant influence** is the power to participate in the financial and/or operating policy decisions of the investee but not control over those policies. This definition excludes the subsidiaries or joint venture from the scope of an associate but apart from these any other enterprises, which are significantly influenced by the investor is an associate for the purpose of this standard. Any enterprise having 20% or more control over voting power or any interest directly or indirectly in any

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other enterprise will be assumed to have significantly influencing the other enterprise unless proved otherwise. Similarly any enterprise that does not have 20% or more control then it is assumed not having significant influence on the enterprise unless proved otherwise.

An enterprise can influence the significant economic decision making by many ways like:

- ◆ Having some voting power.
- ◆ Representation on the board of directors or governing body of the investee.
- ◆ Participation in policy-making processes.
- ◆ Interchange of managerial personnel.
- ◆ Provision of essential technical information.
- ◆ Influencing inter company transactions i.e. sale of goods and services, sharing technical knowledge etc.

**Control exists when parent company has either:**

- a. The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise.
- b. Or control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from subsidiary company's activities.

If any company is controlling the composition of governing body of gratuity trust, provident fund trust etc., since the objective is not the economic benefit and therefore it will not be included in consolidated financial statement.

An enterprise is considered to control the composition of the board of directors or governing body of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company or members of the body. An enterprise is deemed to have the power to appoint a director/member, if any of the following conditions is satisfied:

- (i) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid; or
- (ii) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise; or
- (iii) The director/member is nominated by that enterprise or a subsidiary thereof.

To understand the above definitions let us take few examples:

Example1: A Ltd. has 70% holding in C Ltd. and B Ltd. also has 28% holding in the same company. So, A Ltd. with the majority holding i.e. more than 50% is the parent company and C Ltd. with more than 20% share though minor but a business associate.

Example 2: A Ltd. holding 90% share in B Ltd. and 10% in C Ltd., and also B Ltd. holding 11% shares in C Ltd. In this case, A Ltd. is parent of B Ltd. but due to total of direct and indirect holding of (10 + 11) 21% in C Ltd., C Ltd. is an associate of A Ltd. Though for consolidated financial statement purpose, these holding will be 19.9% (10% + 90% of 11%), as rest 1.1% belongs to minority interest.

**23.4 The equity method** is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee.

From the definition, following broad conclusions can be drawn:

- a. In CFS, investment is to be recorded at cost.
- b. Any surplus or deficit in cost and net asset to be recorded as goodwill or capital reserve.
- c. Distributions received from an investee reduce the carrying amount of the investment.
- d. Any subsequent change in share in net asset is adjusted in cost of investment and goodwill/capital reserve.
- e. Consolidated Profit & Loss shows the investor's share in the results of operations of the investee.

#### Illustration 1

A Ltd. acquire 45% of B Ltd. shares on April 01, 2005, the price paid was Rs. 15,00,000. Following are the extract of balance sheet of B Ltd.:

|                              |               |
|------------------------------|---------------|
| Paid up Equity Share Capital | Rs. 10,00,000 |
| Securities Premium           | Rs. 1,00,000  |
| Reserve & Surplus            | Rs. 5,00,000  |

B Ltd. has reported net profits of Rs. 3,00,000 and paid dividends of Rs. 1,00,000. Calculate the amount at which the investment in B Ltd. should be shown in the consolidated balance sheet of A Ltd. as on March 31, 2006.

#### Solution

##### Calculation of the carrying amount of Investment as per equity method

| <i>Particulars</i> | <i>Rs.</i> | <i>Rs.</i> |
|--------------------|------------|------------|
| Equity Shares      | 1,00,000   |            |
| Security Premium   | 100,000    |            |
| Reserves & Surplus | 500,000    |            |

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|                                  |           |           |
|----------------------------------|-----------|-----------|
| Net Assets                       | 1,600,000 |           |
| 45% of Net Asset                 | 720,000   |           |
| Add: 45% of Profits for the year | 135,000   |           |
|                                  | 855,000   |           |
| Less: Dividend Received          | 45,000    | 810,000   |
| Less: Cost of Investment         |           | 1,500,000 |
| Goodwill                         |           | 690,000   |

#### Consolidated Balance Sheet (Extract)

| Assets               | Rs.     | Rs.       |
|----------------------|---------|-----------|
| Investment in B Ltd. | 810,000 |           |
| Add: Goodwill        | 690,000 | 1,500,000 |

### 23.5 CIRCUMSTANCES UNDER WHICH EQUITY METHOD IS FOLLOWED

Equity method of accounting is to be followed by all the enterprises having significant influence on their associates except in the following cases:

- Control is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.
- The term 'Near Future' is expressed in ASI – 8, explained above with AS – 21.

Or it operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the investor.

In both the above cases, investment of investor in the share of the investee is treated as investment according to AS – 13.

An investor should discontinue the use of the equity method from the date that:

- It ceases to have significant influence in an associate but retains, either in whole or in part, its investment.
- The use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with AS – 13, Accounting for Investments. For this purpose, the carrying amount of the investment at that date should be regarded as cost thereafter.



**23.6 APPLICATION OF THE EQUITY METHOD**

- ◆ Many of the rules followed under equity method for an associate is similar to consolidated financial statement rules as in case of subsidiary i.e. AS – 21.
- ◆ Investment in an associate should be recorded as equity from the date when such relation comes in effect.
- ◆ Investment in the associate is recorded at cost and any difference in the cost and investor's share in equity on the date of acquisition is shown as goodwill or capital reserve.

**Case 1:** A Ltd. holds 22% share of B Ltd. on 1<sup>st</sup> April of the year and following are the relevant information as available on the date are Cost of Investment Rs. 33,000 and Total Equity on the date of acquisition Rs. 2,00,000.

|                                           |                   |
|-------------------------------------------|-------------------|
| A Ltd.'s share in equity (2,00,000 x 22%) | Rs. 44,000        |
| Less: Cost of Investment                  | <u>Rs. 33,000</u> |
| Capital Reserve                           | <u>Rs. 11,000</u> |

**Extract of Balance Sheet**

| Assets               | Rs.           | Rs.    |
|----------------------|---------------|--------|
| Investment in B Ltd. | 44,000        |        |
| Less: Goodwill       | <u>11,000</u> | 33,000 |

**Case 2:** A Ltd. holds 22% share of B Ltd. on 1<sup>st</sup> April of the year and following are the relevant information as available on the date are Cost of Investment Rs. 55,000 and Total Equity on the date of acquisition Rs. 2,00,000.

|                                                 |                   |
|-------------------------------------------------|-------------------|
| Cost of Investment                              | Rs. 55,000        |
| Less: A Ltd.'s share in equity (2,00,000 x 22%) | <u>Rs. 44,000</u> |
| Goodwill                                        | <u>Rs. 11,000</u> |

**Extract of Balance Sheet**

| Assets               | Rs.           | Rs.    |
|----------------------|---------------|--------|
| Investment in B Ltd. | 44,000        |        |
| Add: Goodwill        | <u>11,000</u> | 55,000 |

- ◆ An enterprise having share of profits of more than 50% in other company, they are classified as Parent-Subsidiary relationship. Share in profits less than 51% but more than 20% then this relationship is termed as associate relationship. This stake of 20% can be acquired either in one go or in more than one transaction. This share of stake can be

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increased further say from 25% to 30%. Adjustment should be made with each transaction.

**Case 1:** A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 during the same year. Other information is as follow:

Cost of Investment for 10% Rs. 1,00,000 and for 15% Rs. 1,45,000

Net asset on April 01<sup>st</sup> Rs. 8,50,000 and on October 01<sup>st</sup> Rs. 10,00,000.

Calculations for April 01:

|                        |                   |
|------------------------|-------------------|
| Cost of investment     | Rs. 1,00,000      |
| 10% share in net asset | <u>Rs. 85,000</u> |
| Goodwill               | <u>Rs. 15,000</u> |

Calculations for October 01:

|                                 |                     |
|---------------------------------|---------------------|
| 15% share in net asset          | Rs. 1,50,000        |
| Cost of investment              | <u>Rs. 1,45,000</u> |
| Capital Reserve                 | <u>Rs. 5,000</u>    |
| Total goodwill (15,000 – 5,000) | Rs. 10,000          |

**Case 2:** A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 of the same year. Other information is as follow:

Cost of Investment for 10% Rs. 1,00,000 and for 15% Rs. 1,55,000

Net asset on April 01<sup>st</sup> Rs. 8,50,000 and on October 01<sup>st</sup> Rs. 10,00,000.

Calculations for April 01:

|                        |                   |
|------------------------|-------------------|
| Cost of investment     | Rs. 1,00,000      |
| 10% share in net asset | <u>Rs. 85,000</u> |
| Goodwill               | <u>Rs. 15,000</u> |

Calculations for October 01:

|                                 |                     |
|---------------------------------|---------------------|
| Cost of investment              | Rs. 1,55,000        |
| 15% share in net asset          | <u>Rs. 1,50,000</u> |
| Goodwill                        | <u>Rs. 5,000</u>    |
| Total goodwill (15,000 + 5,000) | Rs. 20,000          |

**Case 3:** A Ltd. acquired 25% stake of B Ltd. on April 01 and further 5% on October 01 of the same year. Other information is as follow:

Cost of Investment for 25% Rs. 1,50,000 and for 5% Rs. 20,000

Net asset on April 01<sup>st</sup> Rs. 5,00,000.

Profit for the year Rs. 90,000 earned in the ratio 2:1 respectively.

Calculations for April 01:

|                        |                     |
|------------------------|---------------------|
| Cost of investment     | Rs. 1,50,000        |
| 25% share in net asset | <u>Rs. 1,25,000</u> |
| Goodwill               | <u>Rs. 25,000</u>   |

Calculations for October 01:

|                                                                       |                     |
|-----------------------------------------------------------------------|---------------------|
| Profits for the first half $(90,000/3) \times 2$                      | Rs. 60,000          |
| Additional share of A Ltd.                                            | 5%                  |
| Pre-acquisition profits i.e. capital reserve $(60,000 \times 5\%)$    | Rs. 3,000           |
| 5% share in net asset                                                 | Rs. 25,000          |
| Cost of investment                                                    | <u>Rs. 20,000</u>   |
| Capital Reserve                                                       | <u>Rs. 5,000</u>    |
| Cost of Investment on April 01 <sup>st</sup>                          | Rs. 1,50,000        |
| Less: Goodwill                                                        | <u>Rs. 25,000</u>   |
| Carrying Amount on April 01 <sup>st</sup>                             | Rs. 1,25,000        |
| Add: Additional Share in Net Asset on October 01 <sup>st</sup>        | Rs. 25,000          |
| Add: Capital share of Profits for first half                          | Rs. 3,000           |
| Add: Revenue shares of Profits for first half $(60,000 \times 25\%)$  | Rs. 15,000          |
| Add: Revenue shares of Profits for second half $(30,000 \times 30\%)$ | <u>Rs. 9,000</u>    |
| Total Carrying Amount on March 31 <sup>st</sup>                       | <u>Rs. 1,77,000</u> |

- ◆ If there is any transaction between the Investor Company and investee concern then the unrealised profits on such goods to the extent of investor's share should be eliminated from consolidated financial statement. As in the above example, the profits calculated on the goods lying with the buyer on the date of statement, will be eliminated to the extent of investor's share i.e. 22%.
- ◆ Any loss on such transactions are not eliminated to the extent that such loss is not recoverable. Otherwise such losses are written off from consolidated financial statement fully.

## Illustration 2

A Ltd. acquired 40% share in B Ltd. on April 01, 2003 for Rs. 10 lacs. On that date B Ltd. had 1,00,000 equity shares of Rs. 10 each fully paid and accumulated profits of Rs. 2,00,000. During

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the year 2003-04 B Ltd. suffered a loss of Rs. 10,00,000; during 2004-05 loss of Rs. 12,50,000 and during 2005-06 again a loss of Rs. 5,00,000. Show the extract of consolidated balance sheet of A Ltd. on all the four dates recording the above events.

#### Solution

##### Calculation of Goodwill/Capital Reserve under Equity Method

| Particulars              | Rs.       |
|--------------------------|-----------|
| Equity Shares            | 1,000,000 |
| Reserves & Surplus       | 200,000   |
| Net Assets               | 1,200,000 |
| 40% of Net Asset         | 480,000   |
| Less: Cost of Investment | 1,000,000 |
| Goodwill                 | 520,000   |

##### Consolidated Balance Sheet (Extract) as on April 01, 2003

| Assets               | Rs.     | Rs.       |
|----------------------|---------|-----------|
| Investment in B Ltd. | 480,000 |           |
| Add: Goodwill        | 520,000 | 1,000,000 |

##### Calculation of Goodwill/Capital Reserve under Equity Method

| Particulars                               | Rs.       |
|-------------------------------------------|-----------|
| Investment in B Ltd.                      | 480,000   |
| Add: Goodwill                             | 520,000   |
| Cost of Investment                        | 1,000,000 |
| Less: Loss for the year (10,00,000 x 40%) | 400,000   |
| Carrying Amount of Investment             | 600,000   |

##### Consolidated Balance Sheet (Extract) as on March 31, 2004

| Assets               | Rs.     | Rs.     |
|----------------------|---------|---------|
| Investment in B Ltd. | 80,000  |         |
| Add: Goodwill        | 520,000 | 600,000 |

**Calculation of Goodwill/Capital Reserve under Equity Method**

| <i>Particulars</i>                        | <i>Rs.</i>     |
|-------------------------------------------|----------------|
| Carrying Amount of Investment             | 600,000        |
| Less: Loss for the year (12,50,000 x 40%) | 500,000        |
| Carrying Amount of Investment             | <u>100,000</u> |

**Consolidated Balance Sheet (Extract) as on March 31, 2005**

| <i>Assets</i>        | <i>Rs.</i>     | <i>Rs.</i> |
|----------------------|----------------|------------|
| Investment in B Ltd. | -              |            |
| Add: Goodwill        | <u>100,000</u> | 100,000    |

**Calculation of Goodwill/Capital Reserve under Equity Method**

| <i>Particulars</i>                       | <i>Rs.</i>       |
|------------------------------------------|------------------|
| Carrying Amount of Investment            | 100,000          |
| Less: Loss for the year (5,00,000 x 40%) | 200,000          |
| Carrying Amount of Investment            | <u>(100,000)</u> |

**Consolidated Balance Sheet (Extract) as on March 31, 2006**

| <i>Assets</i>        | <i>Rs.</i> | <i>Rs.</i> |
|----------------------|------------|------------|
| Investment in B Ltd. |            | -          |

- ◆ As far as possible the reporting date of the financial statements should be same for consolidated financial statement. If practically it is not possible to draw up the financial statements of one or more enterprise to such date and, accordingly, those financial statements are drawn up to reporting dates different from the reporting date of the investor, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the consolidated financial statements. In any case, the difference between reporting dates of the concern and consolidated financial statement should not be more than six months.
- ◆ Accounting policies followed in the preparation of the financial statements of the investor, investee and consolidated financial statement should be uniform for like transactions and other events in similar circumstances.

If accounting policies followed by different enterprises in the group are not uniform, then adjustments should be made in the items of the individual financial statements to bring it in line with the accounting policy of the consolidated statement.

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The carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment, such reduction being determined and made for each investment individually.

### **23.7 CONTINGENCIES**

In accordance with AS – 4, the investor discloses in the consolidated financial statements:

- a. Its share of the contingencies and capital commitments of an associate for which it is also contingently liable; and
- b. Those contingencies that arise because the investor is severally liable for the liabilities of the associate.

### **23.8 DISCLOSURE**

- ◆ In addition to the disclosures required above, an appropriate listing and description of associates including the proportion of ownership interest and, if different, the proportion of voting power held should be disclosed in the consolidated financial statements.
- ◆ Investments in associates accounted for using the equity method should be classified as long-term investments and disclosed separately in the consolidated balance sheet. The investor's share of the profits or losses of such investments should be disclosed separately in the consolidated statement of profit and loss. The investor's share of any extraordinary or prior period items should also be separately disclosed.
- ◆ The name(s) of the associate(s) of which reporting date(s) is/are different from that of the financial statements of an investor and the differences in reporting dates should be disclosed in the consolidated financial statements.
- ◆ In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances and it is not practicable to make appropriate adjustments to the associate's financial statements, the fact should be disclosed along with a brief description of the differences in the accounting policies.

### **23.9 TRANSITIONAL PROVISIONS**

On the first occasion when investment in an associate is accounted for in consolidated financial statements in accordance with this Statement, the carrying amount of investment in the associate should be brought to the amount that would have resulted had the equity method of accounting been followed as per this Statement since the acquisition of the associate. The corresponding adjustment in this regard should be made in the retained earnings in the consolidated financial statements.

**23.10 RELEVANT ACCOUNTING STANDARDS INTERPRETATIONS****ASI – 16: Treatment of Proposed Dividend in Associates in Consolidated Financial Statements:**

In case an associate has made a provision for proposed dividend in its financial statements, the investor's share of the results of operations of the associate should be computed without taking into consideration the proposed dividend.

**ASI – 18: Consideration of Potential Equity Shares for Determining whether an Investee is an Associate, Accounting for Investments in Associates in Consolidated Financial Statements:**

The potential equity shares of the investee held by the investor should not be taken into account for determining the voting power of the investor.

**Illustration 3**

On April 01, 2003 A Ltd. acquired 25% shares of C Ltd. for Rs. 5,00,000 and subscribed for 100% shares of a new company B Ltd. promoted by the management of A Ltd. Following are the balance sheet of all the three companies:

**Balance Sheet as on April 01, 2003 (Fig. in '000)**

| <i>Liabilities</i>           | <i>A Ltd.</i> | <i>B Ltd.</i> | <i>C Ltd.</i> | <i>Assets</i>  | <i>A Ltd.</i> | <i>B Ltd.</i> | <i>C Ltd.</i> |
|------------------------------|---------------|---------------|---------------|----------------|---------------|---------------|---------------|
|                              | <i>Rs.</i>    | <i>Rs.</i>    | <i>Rs.</i>    |                | <i>Rs.</i>    | <i>Rs.</i>    | <i>Rs.</i>    |
| Equity Shares of Rs. 10 each | 5,000         | 1,000         | 1,000         | Fixed Assets   | 7,000         | -             | 2,500         |
| Profit & Loss A/c.           | 6,500         | -             | 2,300         | Investment     | 1,500         | -             | 2,000         |
| Current Liabilities          | 2,500         | -             | 3,700         | Current Assets | 5,500         | 1,000         | 2,500         |
|                              | 14,000        | 1,000         | 7,000         |                | 14,000        | 1,000         | 7,000         |

On March 31, 2004 A Ltd. purchased another 50% share of C Ltd. from the open market for Rs. 40,00,000

| <i>Liabilities</i>           | <i>A Ltd.</i> | <i>B Ltd.</i> | <i>C Ltd.</i> | <i>Assets</i> | <i>A Ltd.</i> | <i>B Ltd.</i> |
|------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|
|                              | <i>Rs.</i>    | <i>Rs.</i>    | <i>Rs.</i>    |               | <i>Rs.</i>    | <i>Rs.</i>    |
| Equity Shares of Rs. 10 each |               |               |               | Investment    | 5,500         | 1,000         |
| Profit & Loss A/c.           | 7,900         | 500           | 4,500         |               |               |               |
| Current Liabilities          | 15,000        | 3,000         | 10,000        |               | 15,000        | 3,000         |

**Balance Sheet as on March 31, 2005 (Fig. in '000)**

| <i>Liabilities</i>           | <i>A Ltd.</i> | <i>B Ltd.</i> | <i>C Ltd.</i> | <i>Assets</i>  | <i>A Ltd.</i> | <i>B Ltd.</i> | <i>C Ltd.</i> |
|------------------------------|---------------|---------------|---------------|----------------|---------------|---------------|---------------|
|                              | <i>Rs.</i>    | <i>Rs.</i>    | <i>Rs.</i>    |                | <i>Rs.</i>    | <i>Rs.</i>    | <i>Rs.</i>    |
| Equity Shares of Rs. 10 each | 5,000         | 1,000         | 1,000         | Fixed Assets   | 5,700         | 900           | 2,100         |
| Profit & Loss A/c.           | 9,000         | 1,500         | 5,100         | Investment     | 2,800         | 2,000         | 3,500         |
| Current Liabilities          | 3,000         | 2,500         | 3,900         | Current Assets | 8,500         | 2,100         | 4,400         |
|                              | 17,000        | 5,000         | 10,000        |                | 17,000        | 5,000         | 10,000        |

## 1.242 Financial Reporting

You are required to prepare Consolidated Profit & Loss Account for the year ended on 31/03/2004 and 31/03/2005, also prepare Consolidated Balance Sheet as on 01/04/2003, 31/03/2004 and 31/03/2005.

### Solution

#### Calculation of Goodwill/Capital Reserve

| <i>Particulars</i>             | <i>Rs.</i> |
|--------------------------------|------------|
| Equity Share Capital of C Ltd. | 1,000,000  |
| Profit & Loss Account          | 2,300,000  |
| Net Assets                     | 3,300,000  |
| 25% of Net Asset               | 825,000    |
| Less: Cost of Investment       | 500,000    |
| Capital Reserve                | 325,000    |

#### Consolidated Balance Sheet as on April 01, 2003

| <i>Liabilities</i>  | <i>Rs.</i> | <i>Rs.</i> | <i>Assets</i>            | <i>Rs.</i> | <i>Rs.</i> |
|---------------------|------------|------------|--------------------------|------------|------------|
| Equity Shares       | 5,000,000  |            | Fixed Assets             |            | 7,000,000  |
| Consolidated P&L    | 6,500,000  |            | Investment in Associates | 825,000    |            |
| Current Liabilities | 2,500,000  |            | Less: Capital Reserve    | 325,000    | 500,000    |
|                     |            |            | Current Assets           |            | 6,500,000  |
|                     | 14,000,000 |            |                          |            | 14,000,000 |

#### Calculation of Goodwill/Capital Reserve

| <i>Particulars</i>             | <i>Rs.</i> |
|--------------------------------|------------|
| Equity Share Capital of C Ltd. | 1,000,000  |
| Profit & Loss Account          | 4,500,000  |
| Net Assets                     | 5,500,000  |
| 75% of Net Asset               | 4,125,000  |
| Less: Cost of Investment       | 4,500,000  |
| Goodwill                       | 375,000    |

#### Consolidated Profit & Loss for the year ended on March 31, 2004

| <i>Particulars</i> | <i>Rs.</i> | <i>Particulars</i> | <i>Rs.</i> | <i>Rs.</i> |
|--------------------|------------|--------------------|------------|------------|
|                    |            | Balance b/d.       |            | 6,500,000  |
|                    |            | Profits of A Ltd.  | 1,400,000  |            |
| Balance c/d.       | 8,400,000  | Profits of B Ltd.  | 500,000    | 1,900,000  |
|                    | 8,400,000  |                    |            | 8,400,000  |



**Consolidated Balance Sheet as on March 31, 2004**

| <i>Liabilities</i>  | <i>Rs.</i>        | <i>Assets</i>             | <i>Rs.</i>        |
|---------------------|-------------------|---------------------------|-------------------|
| Equity Shares       | 5,000,000         | Goodwill on Consolidation | 375,000           |
| Consolidated P&L    | 8,400,000         | Fixed Assets              | 9,550,000         |
| Current Liabilities | 8,100,000         | Investment                | 6,000,000         |
| Minority Interest   | 1,375,000         | Current Assets            | 6,950,000         |
|                     | <u>22,875,000</u> |                           | <u>22,875,000</u> |

**Calculation of Profit/Loss on Disposal**

| <i>Particulars</i>              | <i>Rs.</i>       |
|---------------------------------|------------------|
| Equity Share Capital of C Ltd.  | 1,000,000        |
| Profit & Loss Account           | 4,500,000        |
| Net Assets                      | <u>5,500,000</u> |
| 45% of Net Asset                | 2,475,000        |
| Less: Proceeds from Disposal    | <u>3,000,000</u> |
| Profits                         | 525,000          |
| Less: Goodwill (3,75,000/75)x45 | <u>225,000</u>   |
| Profit on Sales of Investment   | <u>300,000</u>   |

**Calculation of Goodwill/Capital Reserve**

| <i>Particulars</i>                              | <i>Rs.</i>       |
|-------------------------------------------------|------------------|
| Equity Share Capital of C Ltd.                  | 1,000,000        |
| Profit & Loss Account                           | 4,500,000        |
| Net Assets                                      | <u>5,500,000</u> |
| 30% of Net Asset                                | 1,650,000        |
| Less: Cost of investmnet (18,00,000 + 1,80,000) | <u>1,980,000</u> |
| Goodwill                                        | <u>330,000</u>   |

**Consolidated Profit & Loss for the year ended on March 31, 2005**

| <i>Particulars</i> | <i>Rs.</i>        | <i>Particulars</i>                       | <i>Rs.</i>       | <i>Rs.</i>        |
|--------------------|-------------------|------------------------------------------|------------------|-------------------|
|                    |                   | Balance b/d.                             |                  | 8,400,000         |
|                    |                   | Profits of A Ltd. (11,00,000 – 3,00,000) | 800,000          |                   |
|                    |                   | Profits of B Ltd.                        | <u>1,000,000</u> | 1,800,000         |
|                    |                   | Profits from Business Associates         |                  | 180,000           |
| Balance c/d.       | 10,680,000        | Profits from sale of Investment          |                  | 300,000           |
|                    | <u>10,680,000</u> |                                          |                  | <u>10,680,000</u> |

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### Consolidated Balance Sheet as on March 31, 2005

| <i>Liabilities</i>  | <i>Rs.</i>        | <i>Assets</i>        | <i>Rs.</i>     | <i>Rs.</i>        |
|---------------------|-------------------|----------------------|----------------|-------------------|
| Equity Shares       | 5,000,000         | Fixed Assets         |                | 6,600,000         |
| Consolidated P&L    | 10,680,000        | Investment in C Ltd. | 1,650,000      |                   |
| Current Liabilities | 5,500,000         | Add: Goodwill        | <u>330,000</u> | 1,980,000         |
|                     |                   | Investment           |                | 2,000,000         |
|                     |                   | Current Assets       |                | 10,600,000        |
|                     | <u>21,180,000</u> |                      |                | <u>21,180,000</u> |

### **Self-examination Questions**

1. Define the following terms in the context of AS 23:
  - (a) Associate.
  - (b) Investor.
  - (c) Significant influence.
  - (d) Equity method.
  - (e) Consolidated financial statements.
2. Explain the major principles used in application of the equity method?
3. Explain the disclosure requirement for contingent liabilities under AS 23.
4. Can the associate and investor have different reporting dates?
5. X Ltd. (Associate) has revalued its fixed assets from Rs.100 lakhs to Rs.360 lakhs. This revaluation amount has not been included in its profit and loss account. Y Ltd. (Investor) holds 25% stake in the associates. Explain how this should be reflected in Y Ltd. consolidated financial statements.
6. X Ltd. has invested to the extent of 25% in Y & Co., during the end of the financial year, for the purpose of reporting, X Ltd., the investor company values its investment in the associate. It finds that its share of losses of the associate exceeds the amount at which the investment is carried. Further in the current year, the associate reports loss. Should X Ltd. recognise the loss for the current year?

## UNIT 24

### AS 24: DISCONTINUING OPERATIONS

*Reference:* The students are advised to refer the full text of AS 24 "Discontinuing Operations" (issued 2002) given in Appendix I at the end of the Study Material (Volume-II).

#### 24.1 INTRODUCTION

AS 24, is mandatory in nature in respect of accounting periods commencing on or after 1-4-2004 for the following:

- (i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.
- (b) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, the Accounting Standard would be mandatory in nature in respect of accounting periods commencing on or after 1-4-2005. Earlier application of the accounting standard would be encouraged.

This standard is applicable to all discontinuing operations, representing separate major line of business or geographical area of operations of an enterprise.

#### 24.2 OBJECTIVE

The objective of this Statement is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.

#### 24.3 DISCONTINUING OPERATION

A discontinuing operation is a component of an enterprise:

- a. That the enterprise, pursuant to a single plan, is:
  - (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or
  - (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or

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- (iii) Terminating through abandonment and
  - b. That represents a separate major line of business or geographical area of operations.
  - c. That can be distinguished operationally and for financial reporting purposes.

The sales of assets and settlements of liabilities may occur over a period of months or perhaps even longer. Thus, disposal of a component may be in progress at the end of a financial reporting period. To qualify as a discontinuing operation, the disposal must be pursuant to a single co-ordinated plan.

An enterprise may terminate an operation by abandonment without substantial sales of assets. An abandoned operation would be a discontinuing operation if it satisfies the criteria in the definition. However, changing the scope of an operation or the manner in which it is conducted is not an abandonment because that operation, although changed, is continuing.

Examples of activities that do not necessarily satisfy criterion of the definition, but that might do so in combination with other circumstances, include:

- a. Gradual or evolutionary phasing out of a product line or class of service.
- b. Discontinuing, even if relatively abruptly, several products within an ongoing line of business.
- c. Shifting of some production or marketing activities for a particular line of business from one location to another and
- d. Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation - if all the following conditions are met:

- a. The operating assets and liabilities of the component can be directly attributed to it.
- b. Its revenue can be directly attributed to it.
- c. At least a majority of its operating expenses can be directly attributed to it.

Assets, liabilities, revenue, and expenses are directly attributable to a component if they would be eliminated when the component is sold, abandoned or otherwise disposed of. If debt is attributable to a component, the related interest and other financing costs are similarly attributed to it. Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations.

## **24.4 INITIAL DISCLOSURE EVENT**

With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

- a. The enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation or
- b. The enterprise's board of directors or similar governing body has both (i) approved a detailed, formal plan for the discontinuance and (ii) made an announcement of the plan.

#### **24.5 RECOGNITION AND MEASUREMENT**

For recognizing and measuring the effect of discontinuing operations, this AS does provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.

#### **24.6 PRESENTATION AND DISCLOSURE**

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

- a. A description of the discontinuing operation(s).
- b. The business or geographical segment(s) in which it is reported as per AS 17.
- c. The date and nature of the initial disclosure event.
- d. The date or period in which the discontinuance is expected to be completed if known or determinable.
- e. The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled.
- f. The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period.
- g. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto and
- h. The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.

When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur:

- a. For any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss and
- b. The net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale

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agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

In addition to these disclosures, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes. The disclosures should continue in financial statements for periods up to and including the period in which the discontinuance is completed. A discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received. If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefore and its effect should be disclosed. Any disclosures required by this Statement should be presented separately for each discontinuing operation.

The disclosures should be presented in the notes to the financial statements except the following which should be shown on the face of the statement of profit and loss:

- a. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto and
- b. The amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.

Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that mentioned above.

Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 25, Interim Financial Reporting, including:

- a. Any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation and
- b. Any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled.

### Self Examination Questions

1. What is meant by discontinuing operation?
2. Give examples of activities that do not necessarily result in a discontinuing operation.
3. K Ltd. produces four products. One of the products is identified as a discontinuing operation. Does this affect the going concern assumption in its financial statements?
4. Are there any specific principles for recognition and measurement prescribed by AS 24.

5. Explain the disclosure requirements on the occurrence of an initial disclosure event.
6. Write short notes on updating the disclosures in respect of discontinuing operations.
7. What is the disclosure requirement when an enterprise abandons or withdraws from a discontinuing operation?

## UNIT 25

### AS 25: INTERIM FINANCIAL REPORTING

Reference: The students are advised to refer the full text of AS 25 "Interim Financial Reporting" (issued 2002) given in Appendix I at the end of the Study Material (Volume-II).

#### 25.1 INTRODUCTION

AS 25 does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Statement. The standard prescribes the minimum contents of an interim financial report and requires that an enterprise which elects to prepare and present an interim financial report, should comply with this standard. It also lays down the principles for recognition and measurement in a complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors and others to understand an enterprise's capacity to generate earnings and cash flows, its financial condition and liquidity.

A statute governing an enterprise or a regulator may also require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Statement. In such a case, the recognition and measurement principles as laid down in this Statement are applied in respect of such information, unless otherwise specified in the statute or by the regulator.

#### 25.2 DEFINITIONS OF THE TERMS USED UNDER THE ACCOUNTING STANDARD

**Interim period** is a financial reporting period shorter than a full financial year.

**Interim financial report** means a financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period.

#### 25.3 CONTENT OF AN INTERIM FINANCIAL REPORT

A complete set of financial statements normally includes Balance sheet, statement of Profit & Loss, Cash flow statement and Notes including those relating to accounting policies and other statements and explanatory material that are an integral part of the financial statements. The benefit of timeliness of presentation may be partially offset by a reduction in detail in the information provided. Therefore, this Statement requires preparation and presentation of an interim financial report containing, as a minimum, a set of condensed financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported. AS 25 does not prohibit or discourage an enterprise from presenting a complete set of financial statements in its interim financial report, rather than a set of condensed financial statements. The recognition and measurement principles set out in this Statement apply also to



complete financial statements for an interim period, and such statements would include all disclosures required by this Statement as well as those required by other Accounting Standards. Minimum Components of an Interim Financial Report includes condensed Financial Statement.

#### **25.4 FORM AND CONTENT OF INTERIM FINANCIAL STATEMENTS**

If an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements. If an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes as required by this Statement. Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading. If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with AS 20.

#### **25.5 SELECTED EXPLANATORY NOTES**

An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

- a. A statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change.
- b. Explanatory comments about the seasonality of interim operations.
- c. The nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence as per AS 5.
- d. The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period.
- e. Issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares.
- f. Dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares.
- g. Segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms of AS 17, Segment Reporting, to disclose segment information in its annual financial statements).

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- h. The effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations and
- i. Material changes in contingent liabilities since the last annual balance sheet date.

The above information should normally be reported on a financial year-to-date basis. However, the enterprise should also disclose any events or transactions that are material to an understanding of the current interim period.

### **25.6 PERIODS FOR WHICH INTERIM FINANCIAL STATEMENTS ARE REQUIRED TO BE PRESENTED**

Interim financial statement should be prepared in comparative form, with the current period figures for the same period previous year should also be disclosed.

For an enterprise whose business is highly seasonal, financial information for the twelve months ending on the interim reporting date and comparative information for the prior twelve-month period may be useful.

### **25.7 MATERIALITY**

In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. In making assessments of materiality, it should be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data. For reasons of understandability of the interim figures, materiality for making recognition and disclosure decision is assessed in relation to the interim period financial data. Thus, for example, unusual or extraordinary items, changes in accounting policies or estimates, and prior period items are recognised and disclosed based on materiality in relation to interim period data.

#### **Illustration 1**

Sincere Corporation is dealing in seasonal product sales pattern of the product, quarter wise is as follows:

|                                                    |     |
|----------------------------------------------------|-----|
| 1 <sup>st</sup> quarter 30 <sup>th</sup> June      | 10% |
| 2 <sup>nd</sup> quarter 30 <sup>th</sup> September | 10% |
| 3 <sup>rd</sup> quarter 31 <sup>st</sup> December  | 60% |
| 4 <sup>th</sup> quarter 31 <sup>st</sup> March     | 20% |

Information regarding the 1<sup>st</sup> quarter ending on 30<sup>th</sup> June, 2006 is as follows:

|                           |           |
|---------------------------|-----------|
| Sales                     | 80 crores |
| Salary and other expenses | 60 crores |

Advertisement expenses (routine) 4 crores

Administrative and selling expenses 8 crores

While preparing interim financial report for first quarter Sincere Corporation wants to defer Rs. 10 crores expenditure to third quarter on the argument that third quarter is having more sales therefore third quarter should be debited by more expenditure. Considering the seasonal nature of business and the expenditures are uniform throughout all quarters, calculate the result of the first quarter as per AS-25. Also give a comment on the company's view.

### Solution

| Particulars                                                | (Rs. In crores) |
|------------------------------------------------------------|-----------------|
| Result of first quarter ending 30 <sup>th</sup> June, 2006 |                 |
| Turnover                                                   | 80              |
| Other Income                                               | <u>Nil</u>      |
| Total (a)                                                  | <u>80</u>       |
| Less: Changes in inventories                               | Nil             |
| Salaries and other cost                                    | 60              |
| Administrative and selling Expenses (4+8)                  | <u>12</u>       |
| Total (b)                                                  | <u>72</u>       |
| Profit (a)-(b)                                             | 8               |

According to AS-25 the Income and Expense should be recognized when they are earned and incurred respectively. Therefore seasonal incomes will be recognized when they occur. Thus the company's view is not as per AS-25.

### Illustration 2

The accounting year of X Ltd. ends on 30<sup>th</sup> September, 2006 and it makes its reports quarterly. However for the purpose of tax, year ends on 31<sup>st</sup> March every year. For the Accounting year beginning on 1-10-2005 and ends on 30-9-2006, the quarterly income is as under:-

|                                              |                |
|----------------------------------------------|----------------|
| 1 <sup>st</sup> quarter ending on 31-12-2005 | Rs. 200 crores |
| 2 <sup>nd</sup> quarter ending on 31-3-2006  | Rs. 200 crores |
| 3 <sup>rd</sup> quarter ending on 30-6-2006  | Rs. 200 crores |
| 4 <sup>th</sup> quarter ending on 30-9-2006  | Rs. 200 crores |
| Total                                        | Rs. 800 crores |

Average actual tax rate for the financial year ending on 31-3-2006 is 20% and for financial year ending 31-3-2007 is 30%. Calculate tax expense for each quarter.

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### Solution

Calculation of tax expense

|                                              |         |              |
|----------------------------------------------|---------|--------------|
| 1 <sup>st</sup> quarter ending on 31-12-2005 | 200×20% | Rs. 40 lakhs |
| 2 <sup>nd</sup> quarter ending on 31-3-2006  | 200×20% | Rs. 40 lakhs |
| 3 <sup>rd</sup> quarter ending on 30-6-2006  | 200×30% | Rs. 60 lakhs |
| 4 <sup>th</sup> quarter ending on 30-9-2006  | 200×30% | Rs. 60 lakhs |

## 25.8 DISCLOSURE IN ANNUAL FINANCIAL STATEMENTS

AS 5, requires disclosure, in financial statements, of the nature and (if practicable) the amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods. Similarly, if an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

## 25.9 ACCOUNTING POLICIES

An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

To illustrate:

- a. The principles for recognising and measuring losses from inventory write-downs, restructurings, or impairments in an interim period are the same as those that an enterprise would follow if it prepared only annual financial statements. However, if such items are recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognised amount;
- b. A cost that does not meet the definition of an asset at the end of an interim period is not deferred on the balance sheet date either to await future information as to whether it has met the definition of an asset or to smooth earnings over interim periods within a financial year; and
- c. Income tax expense is recognised in each interim period based on the best estimate of the weighted average annual effective income tax rate expected for the full financial year.

Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual effective income tax rate changes.

Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. The recognition of items in the balance sheet which do not meet the definition of assets or liabilities is not allowed.

An enterprise that reports more frequently than half-yearly, measures income and expenses on a year-to-date basis for each interim period using information available when each set of financial statements is being prepared. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. Paragraphs 16(d) and 25 require, however, that the nature and amount of any significant changes in estimates be disclosed.

#### **25.10 REVENUES RECEIVED SEASONALLY OR OCCASIONALLY**

Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year.

#### **25.11 COSTS INCURRED UNEVENLY DURING THE FINANCIAL YEAR**

Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

#### **25.12 USE OF ESTIMATES**

The measurement procedures to be followed in an interim financial report should be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the enterprise is appropriately disclosed.

#### **25.13 RESTATEMENT OF PREVIOUSLY REPORTED INTERIM PERIODS**

One objective of the preceding principle is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. The effect of the principle requires that within the current financial year any change in accounting policy be applied retrospectively to the beginning of the financial year.

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### **25.14 TRANSITIONAL PROVISION**

On the first occasion that an interim financial report is presented in accordance with this Statement, the following need not be presented in respect of all the interim periods of the current financial year:

- a. Comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year; and
- b. Comparative cash flow statement for the comparable year-to-date period of the immediately preceding financial year.

### **25.15 ACCOUNTING STANDARDS INTERPRETATION (ASI 27): APPLICABILITY OF AS 25 TO INTERIM FINANCIAL RESULTS, ACCOUNTING STANDARD (AS) 25, INTERIM FINANCIAL REPORTING**

The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

### **25.16 MISCELLANEOUS ILLUSTRATIONS**

#### **Illustration 1**

Accountants of Poornima Ltd. show a net profit of Rs.7,20,000 for the third quarter of 2005 after incorporating the following:

- (i) Bad debts of Rs.40,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.
- (ii) Extra ordinary loss of Rs.35,000 incurred during the quarter has been fully recognized in this quarter.
- (iii) Additional depreciation of Rs.45,000 resulting from the change in the method of charge of depreciation.

Ascertain the correct quarterly income.

#### **Solution**

In the above case, the quarterly income has not been correctly stated. As per AS 25 "Interim Financial Reporting", the quarterly income should be adjusted and restated as follows:

Bad debts of Rs. 40,000 have been incurred during current quarter. Out of this, the company has deferred 50% (i.e.) Rs. 20,000 to the next quarter. Therefore, Rs. 20,000 should be deducted from Rs. 7,20,000. The treatment of extra-ordinary loss of Rs. 35,000/- being recognized in the same quarter is correct.

Recognising additional depreciation of Rs. 45,000 in the same quarter is in tune with AS 25. Hence, no adjustments are required for these two items.

Poornima Ltd should report quarterly income as Rs. 7,00,000 (Rs. 7,20,000–Rs. 20,000).

### Illustration 2

Intelligent Corporation (I–Corp.) is dealing in seasonal products. The quarterly sales pattern of the product is given below:

| Quarter I         | II        | III            | IV            |
|-------------------|-----------|----------------|---------------|
| Ending 31st March | 30th June | 30th September | 31st December |
| 15%-              | 15%-      | 50%-           | -25%          |

For the First quarter ending 31st March, 2005, I–Corp. gives you the following information:

|                                     | Rs. crores |
|-------------------------------------|------------|
| Sales                               | 50         |
| Salary and other expenses           | 30         |
| Advertisement expenses (routine)    | 02         |
| Administrative and selling expenses | 08         |

While preparing interim financial report for the first quarter 'I–Corp.' wants to defer Rs. 21 crores expenditure to third quarter on the argument that third quarter is having more sales, therefore third quarter should be debited by higher expenditure, considering the seasonal nature of business. The expenditures are uniform throughout all quarters.

Calculate the result of first quarter as per AS 25 and comment on the company's view.

### Solution

#### Result of the first quarter ended 31st March, 2005

|                                             |           | (Rs. in crores) |
|---------------------------------------------|-----------|-----------------|
| Turnover                                    |           | 50              |
| Add: Other Income                           |           | <u>Nil</u>      |
| Total                                       |           | 50              |
| Less: Change in inventories                 | Nil       |                 |
| Salaries and other cost                     | 30        |                 |
| Administrative and selling expenses (8 + 2) | <u>10</u> | <u>40</u>       |
| Profit                                      |           | <u>10</u>       |

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As per AS 25 on Interim Financial Reporting, the income and expense should be recognised when they are earned and incurred respectively. As per para 38 of AS 25, the costs should be anticipated or deferred only when

- (i) it is appropriate to anticipate that type of cost at the end of the financial year, and
- (ii) costs are incurred unevenly during the financial year of an enterprise.

Therefore, the argument given by I-Corp relating to deferment of Rs. 21 crores is not tenable as expenditures are uniform through out all quarters.

#### Self-examination Questions

1. Define interim period and interim financial reports.
2. Explain the purposes of an interim financial report.
3. What are the minimum contents of an interim financial reports?
4. Discuss the concept of materiality in relation to AS 25.
5. What are the periods for which interim financial statements should be presented?
6. Explain the recognition principles for the following items in interim financial statements:
  - (a) Assets.
  - (b) Expense.
  - (c) Losses.
  - (d) Income-tax
7. What is the treatment for costs incurred unevenly during a financial year?
8. Describe the use of estimates in interim financial reporting.
9. In view of the provisions of Accounting Standard 25 on Interim Financial Reporting, on what basis will you calculate, for an interim period, the provision in respect of defined benefit schemes like pension, gratuity etc. for the employees?
10. Rahul Ltd. experienced Rs. 50,000 decline in the market value of its inventory in the first quarter of its financial year. Rahul Ltd. had expected this decline to reverse in the third quarter, and in fact, the third quarter recovery exceeded the previous decline by Rs. 10,000. Rahul Ltd.'s inventory did not experience any other declines in market value during the financial year. What amount of loss and/or gain should Rahul Ltd. report in its interim financial statements for the first and third quarters?



## UNIT 26

### AS 26: INTANGIBLE ASSETS

Reference: The students are advised to refer the full text of AS 26 "Intangible Assets" (issued 2002) given in Appendix I at the end of the Study Material (Volume-II).

#### 26.1 INTRODUCTION

AS 26, comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date for the following:

- (i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.
- (ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. From the date of this Standard becoming mandatory for the concerned enterprises, AS 8; AS 6 & AS 10 stand withdrawn for the aspects relating to Intangible Assets.

The standard prescribes the accounting treatment for intangible assets that are not dealt with specifically under other accounting standards, and requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The standard specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

#### 26.2 SCOPE

This standard should be applied by all enterprises in accounting intangible assets, except (a) intangible assets that are covered by another AS, (b) financial assets, (c) rights and expenditure on the exploration for or development of minerals, oil, natural gas and similar non-regenerative resources, (d) intangible assets arising in insurance enterprise from contracts with policy holders, (e) expenditure in respect of termination benefits. Exclusions from the scope of an Accounting Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. However, this Statement applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises. This Statement also applies to rights under licensing agreements for items such as motion picture films, video recordings,

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plays, manuscripts, patents and copyrights. These items are excluded from the scope of AS 19.

### 26.3 DEFINITIONS

**An asset** is a resource:

- a. Controlled by an enterprise as a result of past events and
- b. From which future economic benefits are expected to flow to the enterprise.

**Monetary assets** are money held and assets to be received in fixed or determinable amounts of money.

**Amortisation** is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

**An active market** is a market where all the following conditions exist:

- a. The items traded within the market are homogeneous.
- b. Willing buyers and sellers can normally be found at any time and
- c. Prices are available to the public.

**An impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

**A financial asset** is any asset that is:

- a. Cash,
- b. A contractual right to receive cash or another financial asset from another enterprise,
- c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable or
- d. An ownership interest in another enterprise.

### 26.4 INTANGIBLE ASSETS

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks. Not all the items described above will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Statement does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. In some cases, an asset may incorporate both intangible and tangible

elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. If use of physical assets is possible only with the intangible part of it, we treat them as Fixed Assets like Operating system for computers. If physical element is just to support intangible part of it, we treat them as intangible assets.

### **26.5 IDENTIFIABILITY**

The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity. Though Separability is not a necessary condition for identifiability. If an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

### **26.6 CONTROL**

An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement or by a legal duty on employees to maintain confidentiality. Future economic benefit is also flown from the skill of labour and customer loyalty but usually this flow of benefits cannot be controlled by the enterprise. As employees may quite the concern anytime or even loyal customers may decide to purchase goods and services from other suppliers. Moreover these items don't even qualify as intangible asset as per the definition given in this AS.

### **26.7 FUTURE ECONOMIC BENEFITS**

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise.

### **26.8 RECOGNITION AND INITIAL MEASUREMENT OF AN INTANGIBLE ASSET**

The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the definition of an intangible asset and recognition criteria set out as below:

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- a. It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise. An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence and
- b. The cost of the asset can be measured reliably.

An intangible asset should be measured initially at cost.

### **26.9 SEPARATE ACQUISITION**

If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

### **26.10 ACQUISITION AS PART OF AN AMALGAMATION**

An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with AS 14. In accordance with this Statement:

- a. A transferee recognises an intangible asset that meets the recognition criteria, even if that intangible asset had not been recognised in the financial statements of the transferor and
- b. If the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill.

Hence, judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. The cost initially recognised for the intangible asset in this case is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation. Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc.) or discounting estimated future net

cash flows from the asset.

### 26.11 ACQUISITION BY WAY OF A GOVERNMENT GRANT

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. AS 12, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

### 26.12 INTERNALLY GENERATED INTANGIBLE ASSETS

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into **Research Phase & Development Phase**. If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

*Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.*

### 26.13 RESEARCH PHASE

**Research** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. No intangible asset arising from research or from the research phase should be recognised. Expenditure on research or on the research phase should be recognised as an expense when it is incurred.

Examples of research activities are:

- a. Activities aimed at obtaining new knowledge.
- b. The search for, evaluation and final selection of, applications of research findings or other knowledge.
- c. The search for alternatives for materials, devices, products, processes, systems or services;
- d. The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

### 26.14 DEVELOPMENT PHASE

**Development** is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

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An intangible asset arising from development or from the development phase should be recognised if, and only if, an enterprise can demonstrate all of the following:

- 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.

Examples of development activities are:

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

An enterprise assesses the future economic benefits to be received from the asset using the principles in Accounting Standard on Impairment of Assets.

An enterprise's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

This Statement takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

### **26.15 COST OF AN INTERNALLY GENERATED INTANGIBLE ASSET**

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use from the time when the intangible asset first meets the

recognition criteria. The cost includes, if applicable:

- a. Expenditure on materials and services used or consumed in generating the intangible asset.
- b. The salaries, wages and other employment related costs of personnel directly engaged in generating the asset.
- c. Any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset and
- d. Overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset. Allocations of overheads are made on bases similar to those discussed in AS 2 & AS 16.

The following are not components of the cost of an internally generated intangible asset:

- a. Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use.
- b. Clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance and
- c. Expenditure on training the staff to operate the asset.

#### **26.16 RECOGNITION OF AN EXPENSE**

Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

- a. It forms part of the cost of an intangible asset that meets the recognition criteria or
- b. The item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. It forms part of the amount attributed to goodwill (capital reserve) at the date of acquisition.

It does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Expenses recognized as expenses cannot be reclassified as cost of Intangible Asset in later years.

#### **26.17 SUBSEQUENT EXPENDITURE**

Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

- a. It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and
- b. The expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the

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intangible asset.

Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance is always recognised as an expense to avoid the recognition of internally generated goodwill. After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

### **26.18 AMORTISATION PERIOD**

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Statement adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

- a. Amortises the intangible asset over the best estimate of its useful life.
- b. Estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss and
- c. Discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset.

If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless the legal rights are renewable and renewal is virtually certain. There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

### **26.19 AMORTISATION METHOD**

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.

The amortisation charge for each period should be recognised as an expense unless another



Accounting Standard permits or requires it to be included in the carrying amount of another asset.

#### **26.20 RESIDUAL VALUE**

The residual value of an intangible asset should be assumed to be zero unless:

- a. There is a commitment by a third party to purchase the asset at the end of its useful life or
- b. There is an active market for the asset and:
  - (i) Residual value can be determined by reference to that market and
  - (ii) It is probable that such a market will exist at the end of the asset's useful life.

#### **26.21 REVIEW OF AMORTISATION PERIOD AND AMORTISATION METHOD**

During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. Over time, the pattern of future economic benefits expected to flow to an enterprise from an intangible asset may change. Therefore, the amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5.

#### **26.22 RECOVERABILITY OF THE CARRYING AMOUNT-IMPAIRMENT LOSSES**

Impairment losses of intangible assets are calculated on the basis of AS 28, which will be discussed in the later units of this chapter. If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognised under AS 28 and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition. In addition to the requirements of AS 28, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

- a. An intangible asset that is not yet available for use and
- b. An intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

The recoverable amount should be determined under AS 28 and impairment losses recognised accordingly.

If the useful life of an intangible asset was estimated to be less than ten years at initial recognition,

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but the useful life is extended by subsequent expenditure to exceed ten years from when the asset became available for use, an enterprise performs the required impairment test and makes the disclosure required.

### **26.23 RETIREMENTS AND DISPOSALS**

An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

### **26.24 DISCLOSURE**

The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

- a. The useful lives or the amortisation rates used.
- b. The amortisation methods used.
- c. The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.
- d. A reconciliation of the carrying amount at the beginning and end of the period showing:
  - i. Additions, indicating separately those from internal development and through amalgamation.
  - ii. Retirements and disposals.
  - iii. Impairment losses recognised in the statement of profit and loss during the period.
  - iv. Impairment losses reversed in the statement of profit and loss during the period.
  - v. Amortisation recognised during the period and
  - vi. Other changes in the carrying amount during the period.

The financial statements should also disclose:

- a. If an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset.
- b. A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole.

- c. The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and
- d. The amount of commitments for the acquisition of intangible assets.

The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

## 26.25 TRANSITIONAL PROVISIONS

Where, on the date of this Statement coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under this Statement and the period determined has expired on the date of this Statement coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period determined has not expired on the date of this Statement coming into effect and:

- a. If the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period.
- b. If the remaining period as per the accounting policy followed by the enterprise:
  - (i) Is shorter as compared to the balance of the period determined, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,
  - (ii) Is longer as compared to the balance of the period determined, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period.

## 26.26 ILLUSTRATIONS

### Illustration 1

Dell International Ltd. is developing a new production process. During the financial Year 31<sup>st</sup> March, 2006, the total expenditure incurred on this process was Rs. 40 lakhs. The production process met the criteria for recognition as an intangible asset on 1<sup>st</sup> 2005. Expenditure incurred till this date was Rs. 16 lakhs.

Further expenditure incurred on the process for the financial year ending 31<sup>st</sup> March 2007, was Rs.

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70 lakhs. As at 31-3-2007, the recoverable amount of know-how embodied in the process is estimated to be Rs. 62 lakhs. This includes estimates of future cash outflows as well as inflows.

You are required to work out:

- (a) What is the expenditure to be charged to the profit and loss account for the financial year ended 31<sup>st</sup> March 2006? (Ignore depreciation for this purpose)
- (b) What is the carrying amount of the intangible asset as at 31<sup>st</sup> March 2006?
- (c) What is the expenditure to be charged to the profit and loss account for the financial year ended 31<sup>st</sup> March 2007? (Ignore depreciation for this purpose)
- (d) What is the carrying amount of the intangible asset as at 31<sup>st</sup> March 2007?

#### Solution

- (a) Rs. 22 lakhs
- (b) Carrying amount as on 31-3-2006 will be expenditure incurred after 1-12-2005= Rs. 24 lakhs
- (c) Book cost of intangible asset as on 31-3-2007 is as follows  
Total Book cost = Rs.(70 + 24) lakhs = Rs. 94 lakhs  
Recoverable amount as estimated = Rs. 62 lakhs  
Difference to be charged to Profit and Loss account = Rs. 32 lakhs
- (d) Rs. 62 lakhs

#### Illustration 2

A Pharma Company spent Rs. 33 lakhs during the accounting year ended 31st March, 2006 on a research project to develop a drug to treat "AIDS". Experts are of the view that it may take four years to establish whether the drug will be effective or not and even if found effective it may take two to three more years to produce the medicine, which can be marketed. The company wants to treat the expenditure as deferred revenue expenditure. Comment.

#### Solution

As per para 41 of AS 26 'Intangible Assets', no intangible asset arising from research (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred. Thus the company cannot treat the expenditure as deferred revenue expenditure. The entire amount of Rs. 33 lakhs spent on research project should be charged as an expense in the year ended 31st March, 2006.

#### Illustration 3

Swift Ltd. acquired a patent at a cost of Rs.80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalized the cost and started amortizing the asset at

Rs.10,00,000 per annum. After two years it was found that the product life-cycle may continue for another 5 years from then. The net cash flows from the product during these 5 years were expected to be Rs.36,00,000, Rs.46,00,000, Rs.44,00,000, Rs.40,00,000 and Rs.34,00,000. Find out the amortization cost of the patent for each of the years.

### Solution

Swift Limited amortised Rs.10,00,000 per annum for the first two years i.e. Rs.20,00,000. The remaining carrying cost can be amortized during next 5 years on the basis of net cash flows arising from the sale of the product. The amortisation may be found as follows:

| Year  | Net cash flows<br>Rs | Amortization Ratio | Amortization Amount<br>Rs. |
|-------|----------------------|--------------------|----------------------------|
| I     | -                    | 0.125              | 10,00,000 <sup>1</sup>     |
| II    | -                    | <u>0.125</u>       | 10,00,000                  |
| III   | 36,00,000            | 0.180              | 10,80,000                  |
| IV    | 46,00,000            | 0.230              | 13,80,000                  |
| V     | 44,00,000            | 0.220              | 13,20,000                  |
| VI    | 40,00,000            | 0.200              | 12,00,000                  |
| VII   | <u>34,00,000</u>     | <u>0.170</u>       | <u>10,20,000</u>           |
| Total | <u>2,00,00,000</u>   | <u>1.000</u>       | <u>80,00,000</u>           |

It may be seen from above that from third year onwards, the balance of carrying amount i.e., Rs.60,00,000 has been amortized in the ratio of net cash flows arising from the product of Swift Ltd.

**Note:** The answer has been given on the basis that the patent is renewable and Swift Ltd. got it renewed after expiry of five years.

### Illustration 4

During 2004, an enterprise incurred costs to develop and produce a routine, low risk computer software product, as follows:

|                                                                                             | Amount<br>(Rs). |
|---------------------------------------------------------------------------------------------|-----------------|
| Completion of detailed programme and design                                                 | 25,000          |
| Coding and Testing                                                                          | 20,000          |
| Other coding costs                                                                          | 42,000          |
| Testing costs                                                                               | 12,000          |
| Product masters for training materials                                                      | 13,000          |
| Duplication of computer software and training materials, from product masters (2,000 units) | 40,000          |
| Packing the product (1,000 units)                                                           | 11,000          |

<sup>1</sup> It has been assumed that the company had amortized the patent at Rs. 10,00,000 per annum in the first two years on the basis of economic benefits derived from the product manufactured under the patent.

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What amount should be capitalized as software costs in the books of the company, on Balance Sheet date?

### Solution

As per para 44 of AS-26, costs incurred in creating a computer software product should be charged to research and development expense when incurred until technological feasibility/asset recognition criteria has been established for the product. Technological feasibility/asset recognition criteria has been established upon completion of detailed programme design or working model. In this case, Rs. 45,000 would be recorded as an expense (Rs. 25,000 for completion of detailed program design and Rs. 20,000 for coding and testing to establish technological feasibility/asset recognition criteria). Cost incurred from the point of technological feasibility/asset recognition criteria until the time when products costs are incurred are capitalized as software cost (Rs. 42,000 + Rs. 12,000 + Rs.13,000) Rs. 67,000.

### Self-examination Questions

1. How is an intangible asset measured on initial recognition?
2. How will you measure the cost of an acquired intangible asset?
3. Write short note on internally generated intangible assets.
4. V Ltd. had spent Rs.50 lakhs for publicity and research expenses on one of its new consumer product which was marketed in the accounting year but proved to be a failure. How will you treat this expenditure?
5. List the principles involved in amortisation of intangible assets.
6. What is the treatment for residual value of an intangible asset.
7. How are retirement and disposal of intangible asset treated?
8. Explain the disclosure requirements of AS 26.
9. A Company had deferred research and development cost of Rs. 150 lakhs. Sales expected in the subsequent years are as under:

| <i>Years</i> | <i>Sales<br/>(Rs. in lakhs)</i> |
|--------------|---------------------------------|
| 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?

## UNIT 27

### AS 27: FINANCIAL REPORTING OF INTERESTS IN JOINT VENTURES

*Reference:* The students are advised to refer the full text of AS 27 "Financial Reporting of Interests in Joint Ventures" (issued 2002) given in Appendix I at the end of the Study Material (Volume-II).

#### 27.1 INTRODUCTION

AS 27, comes into effect in respect of accounting periods commencing on or after 01.04.2002. This standard set out principles and procedures for accounting of interests in joint venture and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors regardless of the structures or forms under which the joint venture activities take place. The standard deals with three broad types of joint ventures – jointly controlled operations, jointly controlled assets and jointly controlled entities. The requirements relating to accounting for joint ventures in consolidated financial statements according to proportionate consolidation method, as contained in AS 27, apply only when consolidated financial statements are prepared by venturer. Otherwise, AS 13 will be applicable in venturer's separate financial statements. An investor in joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with AS 13, AS 21 and AS 23.

#### 27.2 SCOPE

This Statement should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place. The provisions of this AS need to be referred to for consolidated financial statement only when CFS is prepared and presented by the venturer.

#### 27.3 DEFINITIONS

**A joint venture** is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

From the above definition we conclude that the essential conditions for any business relation to qualify as joint venture are:

- ◆ **Two or more parties coming together:** Parties can be an individual or any form of business organization say, BOI, AOP, Company, firm.
- ◆ **Venturers undertake some economic activity:** Economic activity means activities with the profit-making motive. Joint venture is separate from the regular identity of the venturers, it may be in the form of independent and separate legal organization other than regular concern of the venturer engaged in the economic activity.

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- ◆ **Venturers have joint control on the economic activity:** The operating and financial decisions are influenced by the venturers and they also share the results of the economic activity.
- ◆ **There exists a contractual agreement:** The relationship between venturers is governed by the contractual agreement. This agreement can be in the form of written and signed agreement or as minutes of venturer meeting or in any other written form.

**Joint control** is the contractually agreed sharing of control over an economic activity.

**Control** is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

A **venturer** is a party to a joint venture and has joint control over that joint venture.

An **investor** in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

### 27.4 CONTRACTUAL ARRANGEMENT

The joint venture covered under this statement is governed on the basis of contractual agreement. Non-existence of contractual agreement will disqualify an organization to be covered in AS – 27. Joint ventures with contractual agreement will be excluded from the scope of AS – 23 only if the investment qualifies as subsidiary under AS – 21, in this case, it will be covered by AS – 21. Contractual agreement can be in the form of written contract, minutes of discussion between parties (venturers), articles of the concern or by-laws of the relevant joint venture.

Irrespective of the form of the contract, the content of the contract ideally should include the following points:

- ◆ The activity, duration and reporting obligations of the joint venture.
- ◆ The appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers.
- ◆ Capital contributions by the venturers.
- ◆ The sharing by the venturers of the output, income, expenses or results of the joint venture.

The main object of contractual agreement is to distribute the economic control among the venturers, it ensures that no venturer should have unilateral control. If contractual agreement is signed by a party to safeguard its right, such agreement will not make the party a venturer. For example, IDBI gave loan to the joint venture entity of L&T and Tania Construction, they signed an agreement according to which IDBI will be informed for all important decisions of the joint venture entity. This agreement is to protect the right of the IDBI, hence just signing the contractual agreement will not make investor a venturer. Similarly, just because contractual agreement has assigned the role of a manager to any of the venturer will not disqualify him as venturer. For



example, Mr. A, M/s. B & Co. and C Ltd. entered into a joint venture, where according to the agreement, all the policies making decisions on financial and operating activities will be taken in a regular meeting attended by them or their representatives. Implementation and execution of these policies will be the responsibility of Mr. A. Here Mr. A is acting as venturer as well as manager of the concern.

## 27.5 FORMS OF JOINT VENTURES

Joint ventures may take many forms and structures, this Statement identifies them in three broad types - **Jointly Controlled Operations (JCO)**, **Jointly Controlled Assets (JCA)** and **Jointly Controlled Entities (JCE)**. Any structure which satisfies the following characteristics can be classified as joint ventures: (a) Two or more venturers are bound by a contractual arrangement and (b) The contractual arrangement establishes joint control.

**27.6 Jointly Controlled Operations (JCO):** Under this set up, venturers do not create a separate entity for their joint venture business but they use their own resources for the purpose. They raise any funds required for joint venture on their own, they incur any expenses and sales are also realised individually. They use same set of fixed and employees for joint venture business and their own business. Since there is no separate legal entity and venturers don't recognize the transactions separately, they do not maintain a separate set of books for joint venture. All the transactions of joint venture are recorded in their books only. Following are the key features of JCO:

- a. Each venturer has his own separate business.
- b. There is no separate entity for joint venture business.
- c. All venturers are creating their own assets and maintain them.
- d. Each venturer record only his own transactions without any separately set of books maintained for the joint venture business.
- e. There is a common agreement between all of them.
- f. Venturers use their assets for the joint venture business.
- g. Venturers met the liabilities created by them for the joint venture business.
- h. Venturers met the expenses of the joint venture business from their funds.
- i. Any revenue generated or income earned from the joint venture is shared by the venturers as per the contract.

Mr. A (dealer in tiles and marbles), Mr. B (dealer in various building materials) and Mr. C (Promoter) enters into a joint venture business, where any contract for construction received will be completed jointly, say, Mr. A will supply all tiles and marbles, Mr. B will supply other materials from his godown and Mr. C will look after the completion of construction. As per the contractual agreement, they will share any profit/loss in a predetermined ratio. None of them are using

## 1.276 Financial Reporting

separate staff or other resources for the joint venture business and neither do they maintain a separate account. Every thing is recorded in their personal business only. Venturer doesn't maintain a separate set of books but they record only their own transactions of the joint venture business in their books. Any transaction of joint venture recorded separately is only for internal reporting purpose. Once all transactions recorded in venturer financial statement, they don't need to be adjusted for in consolidated financial adjustment.

### Illustration 1

Mr. A, Mr. B and Mr. C entered into a joint venture to Purchase a land, Construct and Sell Flats. Mr. A purchased a land for Rs. 60,00,000 on 01.01.2004 and for the purpose he took loan from a bank for Rs. 50,00,000 @ 8% interest p.a. He also paid registering fees Rs. 60,000 on the same day. Mr. B supplied the materials for Rs. 4,50,000 from his godown and further he purchased the materials for Rs. 5,00,000 for the joint venture. Mr. C met all other expenses of advertising, labour and other incidental expenses which turnout to be Rs. 9,00,000. On 31.06.2004 each of the venturer agreed to take away one flat each to be valued at Rs. 10,00,000 each flat and rest were sold by them as follow: Mr. A for Rs. 40,00,000; Mr. B for Rs. 20,00,000 and Mr. C for Rs. 10,00,000. Loan was repaid on the same day by Mr. A alongwith the interest and net proceeds were shared by the partners equally.

You are required to prepare the Consolidated Profit & Loss Account and Joint Venture Account in the books of each venturer.

### Solution

| <b>Consolidated Profit &amp; Loss Account</b> |            |                   |                              |            |                   |
|-----------------------------------------------|------------|-------------------|------------------------------|------------|-------------------|
| <i>Particulars</i>                            | <i>Rs.</i> | <i>Rs.</i>        | <i>Particulars</i>           | <i>Rs.</i> | <i>Rs.</i>        |
| To Purchase of Land:                          |            |                   | By Sale of Flats:            |            |                   |
| Mr. A                                         |            | 6,000,000         | Mr. A                        | 4,000,000  |                   |
| To Registration Fees:                         |            |                   | Mr. B                        | 2,000,000  |                   |
| Mr. A                                         |            | 60,000            | Mr. C                        | 1,000,000  | 7,000,000         |
| To Materials:                                 |            |                   | By Flats taken by Venturers: |            |                   |
| Mr. B                                         |            | 950,000           | Mr. A                        | 1,000,000  |                   |
| To Other Expenses:                            |            |                   | Mr. B                        | 1,000,000  |                   |
| Mr. C                                         |            | 900,000           | Mr. C                        | 1,000,000  | 3,000,000         |
| To Bank Interest:                             |            |                   |                              |            |                   |
| Mr. A                                         |            | 200,000           |                              |            |                   |
| To Profits:                                   |            |                   |                              |            |                   |
| Mr. A                                         | 630,000    |                   |                              |            |                   |
| Mr. B                                         | 630,000    |                   |                              |            |                   |
| Mr. C                                         | 630,000    | 1,890,000         |                              |            |                   |
|                                               |            | <u>10,000,000</u> |                              |            | <u>10,000,000</u> |

**In the Books of Mr. A****Joint Venture Account**

| <i>Particulars</i>              | <i>Rs.</i> | <i>Rs.</i>       | <i>Particulars</i>      | <i>Rs.</i> | <i>Rs.</i>       |
|---------------------------------|------------|------------------|-------------------------|------------|------------------|
| To Bank Loan (Purchase of Land) |            | 5,000,000        | By Bank (Sale of Flats) |            | 4,000,000        |
| To Bank:(Purchase of Land)      |            | 1,000,000        | By Land & Buidling      |            | 1,000,000        |
| To Bank (Registration Fees)     |            | 60,000           | By Bank (Paid to Mr. B) |            | 1,420,000        |
| To Bank (Bank Interest)         |            | 200,000          | By Bank (Paid to Mr.C)  |            | 470,000          |
| To Profit on JV                 |            | 630,000          |                         |            |                  |
|                                 |            | <u>6,890,000</u> |                         |            | <u>6,890,000</u> |

**In the Books of Mr. B****Joint Venture Account**

| <i>Particulars</i>               | <i>Rs.</i> | <i>Rs.</i>       | <i>Particulars</i>      | <i>Rs.</i> | <i>Rs.</i>       |
|----------------------------------|------------|------------------|-------------------------|------------|------------------|
| To Purchases (Material Supplied) |            | 450,000          | By Bank (Sale of Flats) |            | 2,000,000        |
| To Bank (Materials)              |            | 500,000          | By Land & Buidling      |            | 1,000,000        |
| To Profit on JV                  |            | 630,000          |                         |            |                  |
| To Bank (Received from Mr. A)    |            | 1,420,000        |                         |            |                  |
|                                  |            | <u>3,000,000</u> |                         |            | <u>3,000,000</u> |

**In the Books of Mr. C****Joint Venture Account**

| <i>Particulars</i>            | <i>Rs.</i> | <i>Rs.</i>       | <i>Particulars</i>      | <i>Rs.</i> | <i>Rs.</i>       |
|-------------------------------|------------|------------------|-------------------------|------------|------------------|
| To Bank (Misc. Expenses)      |            | 900,000          | By Bank (Sale of Flats) |            | 1,000,000        |
| To Profit on JV               |            | 630,000          | By Land & Buidling      |            | 1,000,000        |
| To Bank (Received from Mr. A) |            | 470,000          |                         |            |                  |
|                               |            | <u>2,000,000</u> |                         |            | <u>2,000,000</u> |

**27.7 JOINTLY CONTROLLED ASSETS (JCA)**

Separate legal entity is not created in this form of joint venture but venturer owns the assets jointly, which are used by them for the purpose of generating economic benefit to each of them. They take up any expenses and liabilities related to the joint assets as per the contract. We can conclude the following points:

- ◆ There is no separate legal identity.
- ◆ There is a common control over the joint assets.

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- ◆ Venturers use this asset to derive some economic benefit to themselves.
- ◆ Each venturer incurs separate expenses for their transactions.
- ◆ Expenses on jointly held assets are shared by the venturers as per the contract.
- ◆ In their financial statement, venturer shows only their share of the asset and total income earned by them along with total expenses incurred by them.
- ◆ Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.
- ◆ Financial statements may not be prepared for the joint venture, although the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

For example, ABC Ltd., BP Ltd. and HP Ltd. having the same point of oil refinery and same place of customers agreed to spread a pipeline from their unit to customers place jointly. They agreed to share the expenditure on the pipeline construction and maintenance in the ratio 3:3:4 respectively and the time allotted to use the pipeline was in the ratio 4:3:3 respectively.

For the joint venture, each venturer will record his share of joint assets as per AS – 10, Accounting for Fixed Assets, and any expenditure incurred or revenue generated will be recorded with other items similar to JCO. Following are the few differences between JCO and JCA for better understanding:

- ◆ In JCO venturers use their own assets for joint venture business but in JCA they jointly own the assets to be used in joint venture.
- ◆ JCO is an agreement to joint carry on the operations to earn income whereas, JCA is an agreement to jointly construct and maintain an asset to generate revenue to each venturer.
- ◆ Under JCO all expenses and revenues are shared at an agreed ratio, in JCA only expenses on joint assets are shared at the agreed ratio.

### Illustration 2

A Ltd., B Ltd. and C Ltd. decided to jointly construct a pipeline to transport the gas from one place to another, that was manufactured by them. For the purpose following expenditure was incurred by them: Buildings Rs. 12,00,000 to be depreciated @ 5% p.a., Pipeline for Rs. 60,00,000 to be depreciated @ 15% p.a., computers and other electronics for Rs. 3,00,000 to be depreciated @ 40% p.a. and various vehicles of Rs. 9,00,000 to be depreciated @ 20% p.a.

They also decided to equally bear the total expenditure incurred on the maintenance of the pipeline that comes to Rs. 6,00,000 each year.

You are required to show the consolidated financial balance sheet and the extract of Profit & Loss Account and Balance Sheet for each venturer.

**Solution**

| <b><u>Consolidated Balance Sheet</u></b> |                  |                  |                    |                  |                  |
|------------------------------------------|------------------|------------------|--------------------|------------------|------------------|
| <i>Liabilities</i>                       | <i>Rs.</i>       | <i>Rs.</i>       | <i>Assets</i>      | <i>Rs.</i>       | <i>Rs.</i>       |
| Capital of Venturers:                    |                  |                  | Land & Building:   |                  |                  |
| A Ltd.                                   | 2,580,000        |                  | A Ltd.             | 380,000          |                  |
| B Ltd.                                   | 2,580,000        |                  | B Ltd.             | 380,000          |                  |
| C Ltd.                                   | <u>2,580,000</u> | 7,740,000        | C Ltd.             | <u>380,000</u>   | 1,140,000        |
|                                          |                  |                  | Plant & Machinery: |                  |                  |
|                                          |                  |                  | A Ltd.             | 1,900,000        |                  |
|                                          |                  |                  | B Ltd.             | 1,900,000        |                  |
|                                          |                  |                  | C Ltd.             | <u>1,900,000</u> | 5,700,000        |
|                                          |                  |                  | Computers:         |                  |                  |
|                                          |                  |                  | A Ltd.             | 60,000           |                  |
|                                          |                  |                  | B Ltd.             | 60,000           |                  |
|                                          |                  |                  | C Ltd.             | <u>60,000</u>    | 180,000          |
|                                          |                  |                  | Vehicles:          |                  |                  |
|                                          |                  |                  | A Ltd.             | 240,000          |                  |
|                                          |                  |                  | B Ltd.             | 240,000          |                  |
|                                          |                  |                  | C Ltd.             | <u>240,000</u>   | 720,000          |
|                                          |                  | <u>7,740,000</u> |                    |                  | <u>7,740,000</u> |

**In the Books of A Ltd.**

| <b><u>Extract of Profit &amp; Loss Account</u></b> |               |            |                    |            |            |
|----------------------------------------------------|---------------|------------|--------------------|------------|------------|
| <i>Particulars</i>                                 | <i>Rs.</i>    | <i>Rs.</i> | <i>Particulars</i> | <i>Rs.</i> | <i>Rs.</i> |
| To Depreciation:                                   |               |            |                    |            |            |
| Land & Building                                    | 20,000        |            |                    |            |            |
| Plant & Machinery                                  | 300,000       |            |                    |            |            |
| Computers                                          | 40,000        |            |                    |            |            |
| Vehicles                                           | <u>60,000</u> | 420,000    |                    |            |            |
| To Pipeline Expenses                               |               | 200,000    |                    |            |            |

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### Extract of Balance Sheet

| <i>Liabilities</i> | <i>Rs.</i> | <i>Rs.</i> | <i>Assets</i>      | <i>Rs.</i> | <i>Rs.</i> |
|--------------------|------------|------------|--------------------|------------|------------|
|                    |            |            | Land & Building    | 400,000    |            |
|                    |            |            | Less: Depreciation | 20,000     | 380,000    |
|                    |            |            | Plant & Machinery  | 2,000,000  |            |
|                    |            |            | Less: Depreciation | 300,000    | 1,700,000  |
|                    |            |            | Computers          | 100,000    |            |
|                    |            |            | Less: Depreciation | 40,000     | 60,000     |
|                    |            |            | Vehicles           | 300,000    |            |
|                    |            |            | Less: Depreciation | 60,000     | 240,000    |

### **In the Books of B Ltd.**

### Extract of Profit & Loss Account

| <i>Particulars</i>   | <i>Rs.</i> | <i>Rs.</i> | <i>Particulars</i> | <i>Rs.</i> | <i>Rs.</i> |
|----------------------|------------|------------|--------------------|------------|------------|
| To Depreciation:     |            |            |                    |            |            |
| Land & Building      | 20,000     |            |                    |            |            |
| Plant & Machinery    | 300,000    |            |                    |            |            |
| Computers            | 40,000     |            |                    |            |            |
| Vehicles             | 60,000     | 420,000    |                    |            |            |
| To Pipeline Expenses |            | 200,000    |                    |            |            |

### Extract of Balance Sheet

| <i>Liabilities</i> | <i>Rs.</i> | <i>Rs.</i> | <i>Assets</i>      | <i>Rs.</i> | <i>Rs.</i> |
|--------------------|------------|------------|--------------------|------------|------------|
|                    |            |            | Land & Building    | 400,000    |            |
|                    |            |            | Less: Depreciation | 20,000     | 380,000    |
|                    |            |            | Plant & Machinery  | 2,000,000  |            |
|                    |            |            | Less: Depreciation | 300,000    | 1,700,000  |
|                    |            |            | Computers          | 100,000    |            |
|                    |            |            | Less: Depreciation | 40,000     | 60,000     |
|                    |            |            | Vehicles           | 300,000    |            |
|                    |            |            | Less: Depreciation | 60,000     | 240,000    |

## In the Books of C Ltd.

Extract of Profit & Loss Account

| <i>Particulars</i>   | <i>Rs.</i> | <i>Rs.</i> | <i>Particulars</i> | <i>Rs.</i> | <i>Rs.</i> |
|----------------------|------------|------------|--------------------|------------|------------|
| To Depreciation:     |            |            |                    |            |            |
| Land & Building      | 20,000     |            |                    |            |            |
| Plant & Machinery    | 300,000    |            |                    |            |            |
| Computers            | 40,000     |            |                    |            |            |
| Vehicles             | 60,000     | 420,000    |                    |            |            |
| To Pipeline Expenses |            | 200,000    |                    |            |            |

Extract of Balance Sheet

| <i>Liabilities</i> | <i>Rs.</i> | <i>Rs.</i> | <i>Assets</i>      | <i>Rs.</i> | <i>Rs.</i> |
|--------------------|------------|------------|--------------------|------------|------------|
|                    |            |            | Land & Building    | 400,000    |            |
|                    |            |            | Less: Depreciation | 20,000     | 380,000    |
|                    |            |            | Plant & Machinery  | 2,000,000  |            |
|                    |            |            | Less: Depreciation | 300,000    | 1,700,000  |
|                    |            |            | Computers          | 100,000    |            |
|                    |            |            | Less: Depreciation | 40,000     | 60,000     |
|                    |            |            | Vehicles           | 300,000    |            |
|                    |            |            | Less: Depreciation | 60,000     | 240,000    |

**27.8 JOINTLY CONTROLLED ENTITIES (JCE)**

This is the format where venturer creates a new entity for their joint venture business. All the venturers pool their resources under new banner and this entity purchases its own assets, create its own liabilities, expenses are incurred by the entity itself and sales are also made by this entity. The net result of the entity is shared by the venturers in the ratio agreed upon in the contractual agreement. This contractual agreement also determines the joint control of the venturer. Being a separate entity, separate set of books is maintained for the joint venture and in the individual books of venturers the investment in joint venture is recorded as investment (AS – 13). Joint venture can be a foreign company operating in India through an Indian concern say Gremo Insurance of Germany contributes 49% of the assets in joint venture in India with Indo Bank Ltd. of India. They agreed to share the net results in 1:1 ratio. The main objective of the joint venture is to exploits the technical expertise of Gremo Insurance and Goodwill of Indo Bank Ltd. It can also be two or more local concerns opening an organization or firm or company contributing their assets to this new joint venture concern and share the profits of the operation in the agreed ratio.

## 1.282 Financial Reporting

### Illustration 3

A Ltd. a UK based company entered into a joint venture with B Ltd. in India, wherein B Ltd. will sell import the goods manufactured by A Ltd. on account of joint venture and sell them in India. A Ltd. and B Ltd. agreed to share the expenses & revenues in the ratio of 5:4 respectively whereas profits are distributed equally. A Ltd. invested 49% of total capital but has equal share in all the assets and is equally liable for all the liabilities of the joint venture. Following is the trail balance of the joint venture at the end of the first year:

| <i>Particulars</i>  | <i>Dr. (Rs.)</i> | <i>Cr.(Rs.)</i> |
|---------------------|------------------|-----------------|
| Purchases           | 9,00,000         |                 |
| Other Expenses      | 3,06,000         |                 |
| Sales               |                  | 13,05,000       |
| Fixed Assets        | 6,00,000         |                 |
| Current Assets      | 2,00,000         |                 |
| Unsecured Loans     |                  | 2,00,000        |
| Current Liabilities |                  | 1,00,000        |
| Capital             |                  | 4,01,000        |

Closing stock was valued at Rs. 1,00,000.

You are required to prepare the Consolidated Financial Statement.

### Solution

| <b>Consolidated Profit &amp; Loss Account</b> |                |                  |                    |                |                  |
|-----------------------------------------------|----------------|------------------|--------------------|----------------|------------------|
| <i>Particulars</i>                            | <i>Rs.</i>     | <i>Rs.</i>       | <i>Particulars</i> | <i>Rs.</i>     | <i>Rs.</i>       |
| To Purchases:                                 |                |                  | By Sales:          |                |                  |
| A Ltd.                                        | 500,000        |                  | A Ltd.             | 725,000        |                  |
| B Ltd.                                        | <u>400,000</u> | 900,000          | B Ltd.             | <u>580,000</u> | 1,305,000        |
| To Expenses:                                  |                |                  | By Closing Stock:  |                |                  |
|                                               |                |                  | A Ltd.             | 50,000         |                  |
|                                               |                |                  | B Ltd.             | <u>50,000</u>  | 100,000          |
| To Net Profits:                               |                |                  |                    |                |                  |
| A Ltd.                                        | 99,500         |                  |                    |                |                  |
| B Ltd.                                        | <u>99,500</u>  | 199,000          |                    |                |                  |
|                                               |                | <u>1,099,000</u> |                    |                | <u>1,405,000</u> |



| Consolidated Balance Sheet |                |                |                       |                |                |
|----------------------------|----------------|----------------|-----------------------|----------------|----------------|
| <i>Liabilities</i>         | <i>Rs.</i>     | <i>Rs.</i>     | <i>Assets</i>         | <i>Rs.</i>     | <i>Rs.</i>     |
| Capital:                   |                |                | Fixed Assets:         |                |                |
| A Ltd.                     | 196,490        |                | A Ltd.                | 300,000        |                |
| B Ltd.                     | <u>204,510</u> | 401,000        | B Ltd.                | <u>300,000</u> | 600,000        |
| Profit & Loss Account:     |                |                | Closing Stock:        |                |                |
| A Ltd.                     | 99,500         |                | A Ltd.                | 50,000         |                |
| B Ltd.                     | <u>99,500</u>  | 199,000        | B Ltd.                | <u>50,000</u>  | 100,000        |
| Unsecured Loans:           |                |                | Other Current Assets: |                |                |
| A Ltd.                     | 100,000        |                | A Ltd.                | 100,000        |                |
| B Ltd.                     | <u>100,000</u> | 200,000        | B Ltd.                | <u>100,000</u> | 200,000        |
| Current Liabilities:       |                |                |                       |                |                |
| A Ltd.                     | 50,000         |                |                       |                |                |
| B Ltd.                     | <u>50,000</u>  | 100,000        |                       |                |                |
|                            |                | <u>900,000</u> |                       |                | <u>900,000</u> |

## 27.9 CONSOLIDATED FINANCIAL STATEMENTS OF A VENTURER

**Proportionate consolidation** is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

Proportionate consolidation method of accounting is to be followed except in the following cases:

- Investment is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.
- The term 'Near Future' is expressed in ASI – 8, explained above with AS – 21.

Or joint venture operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the venturers.

In both the above cases, investment of venturer in the share of the investee is treated as investment according to AS – 13.

A venturer should discontinue the use of the proportionate consolidation method from the date that:

- It ceases to have joint control in the joint venture but retains, either in whole or in part, its investment.
- The use of the proportionate consolidation method is no longer appropriate because the joint venture operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturers.

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From the date of discontinuing the use of the proportionate consolidation method,

- a. If interest in entity is more than 50%, investments in such joint ventures should be accounted for in accordance with AS – 21, Consolidated Financial Statement.
- b. Joint ventures where interest is 20% or more but less than 51%, investments are to be accounted for in accordance with AS – 23, Accounting for Investment in Associates in Consolidated Financial Statement.
- c. For all other cases investment in joint venture is treated as per AS – 13, Accounting for Investment.
- d. For this purpose, the carrying amount of the investment at the date on which joint venture relationship ceases to exist should be regarded as cost thereafter.

Following are the features of Proportionate Consolidation Method:

- a. Stress is given on substance over form i.e., more importance is given to the share of venturers in the profit or loss of the venture from the share of assets and liabilities rather than the nature and form of the joint venture.
- b. Venturer's share of joint assets, liabilities, expenses and income are shown on the separate lines in the consolidated financial statement.

For example, Mr. A enters into a joint venture with Mr. B and has contributed 33% of the total fixed assets and has share of 40% in current assets and current liabilities. Its share in net result is 50%. Consolidated Balance Sheet will be prepared by Mr. A as follow:

| <b>Consolidated Balance Sheet</b> |               |                 |                        |               |                 |
|-----------------------------------|---------------|-----------------|------------------------|---------------|-----------------|
| Liabilities                       | Rs.           | Rs.             | Assets                 | Rs.           | Rs.             |
| <u>Capital:</u>                   |               |                 | <u>Fixed Assets:</u>   |               |                 |
| Mr. A's Share                     | 33,000        |                 | Mr. A's Share          | 25,000        |                 |
| Mr. B's Share                     | <u>67,000</u> | 1,00,000        | Mr. B's Share          | <u>50,000</u> | 75,000          |
| <u>Current Liabilities:</u>       |               |                 | <u>Current Assets:</u> |               |                 |
| Mr. A's Share                     | 20,000        |                 | Mr. A's Share          | 30,000        |                 |
| Mr. B's Share                     | <u>30,000</u> | <u>50,000</u>   | Mr. B's Share          | <u>45,000</u> | <u>75,000</u>   |
|                                   |               | <u>1,50,000</u> |                        |               | <u>1,50,000</u> |

Similar to above all the items of expenses and income will also be classified line by line for each item. The whole basis of this provision is to bring transparency in the books of account. If there is any special clause for sharing of expenses, income or any other item that should be clearly disclosed in the consolidated financial statement.

- c. Most of the provisions of Proportionate Consolidation Method are similar to the provisions of AS – 21.

- d. As far as possible the reporting date of the financial statements of jointly controlled entity and venturers should be same. If practically it is not possible to draw up the financial statements to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made in joint venturer's books for the effects of significant transactions or other events that occur between the jointly controlled entity's date and the date of the venturer's financial statements. In any case, the difference between reporting dates should not be more than six months.
- e. Accounting policies followed in the preparation of the financial statements of the jointly controlled entity and venturer should be uniform for like transactions and other events in similar circumstances.

If accounting policies followed by venturer and jointly controlled entity are not uniform, then adjustments should be made in the items of the venturer to bring it in line with the accounting policy of the joint venture.

- f. Any asset or liability should not be adjusted by another liability or asset. Similarly any income or expense cannot be adjusted with another expense or income. Such adjustment can be made only when legally it is allowed to adjust them and such items does lead to settlement of obligation or writing off of assets.

For example, bills receivable cannot be adjusted with bills payable but if debtors includes Rs. 5,000 from Mr. A and creditors also have Rs. 3,000 to Mr. A, then Rs. 3,000 can be adjusted or deducted from both items i.e. debtors and creditors.

- g. On the date when interest in joint entity is acquired, if the interest of venturer in net assets of the entity is less than the cost of investment in joint entity, the difference will be recognized as goodwill in the consolidated financial statement and if net asset is more than cost of investment, then the difference is recognized as capital reserve.

In case the carrying amount of investment is different then cost of investment, we take carrying amount for the purpose of the above calculation.

- h. An investor who don't have joint control in the entity is like associate as discussed in AS – 23, therefore the treatment of losses will be similar to AS – 23. If investor's share in loss of the joint entity is in excess of his interest in net asset, this excess loss will be recognized by the venturers. In future when entity starts reporting profits, investor's share of profits will be provided to venturer till total amount is equivalent to absorbed losses.

#### Illustration 4

A Ltd. entered into a joint venture with B Ltd. on 1:1 basis and a new company C Ltd. was formed for the same purpose and following is the balance sheet of all the three companies:

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| <i>Particulars</i>  | <i>A Ltd.</i> | <i>B Ltd.</i> | <i>C Ltd.</i> |
|---------------------|---------------|---------------|---------------|
| Share Capital       | 1,000,000     | 750,000       | 500,000       |
| Reserve & Surplus   | 1,800,000     | 1,600,000     | 1,200,000     |
| Loans               | 300,000       | 400,000       | 200,000       |
| Current Liabilities | 400,000       | 250,000       | 100,000       |
| Fixed Assets        | 3,050,000     | 2,625,000     | 1,950,000     |
| Investment in JV    | 250,000       | 250,000       | -             |
| Current Assets      | 200,000       | 125,000       | 50,000        |

Prepare the balance sheet of A Ltd., B Ltd. and C Ltd. under proportionate consolidation method.

### Solution

#### Balance Sheet of A Ltd.

| <i>Liabilities</i>   | <i>Rs.</i>     | <i>Rs.</i>     | <i>Assets</i>   | <i>Rs.</i>     | <i>Rs.</i>     |
|----------------------|----------------|----------------|-----------------|----------------|----------------|
| Share Capital:       |                | 1,000,000      | Fixed Assets:   |                |                |
| Reserve & Surplus:   |                |                | A Ltd.          | 3,050,000      |                |
| A Ltd.               | 1,800,000      |                | C Ltd.          | <u>975,000</u> | 4,025,000      |
| C Ltd.               | <u>600,000</u> | 2,400,000      |                 |                |                |
| Loans:               |                |                | Current Assets: |                |                |
| A Ltd.               | 300,000        |                | A Ltd.          | 200,000        |                |
| C Ltd.               | <u>100,000</u> | 400,000        | C Ltd.          | <u>25,000</u>  | 225,000        |
| Current Liabilities: |                |                |                 |                |                |
| A Ltd.               | 400,000        |                |                 |                |                |
| C Ltd.               | <u>50,000</u>  | 450,000        |                 |                |                |
|                      |                | <u>4250000</u> |                 |                | <u>4250000</u> |

#### Balance Sheet of B Ltd.

| <i>Liabilities</i>   | <i>Rs.</i>     | <i>Rs.</i>     | <i>Assets</i>   | <i>Rs.</i>     | <i>Rs.</i>     |
|----------------------|----------------|----------------|-----------------|----------------|----------------|
| Share Capital:       |                | 750,000        | Fixed Assets:   |                |                |
| Reserve & Surplus:   |                |                | B Ltd.          | 2,625,000      |                |
| B Ltd.               | 1,600,000      |                | C Ltd.          | <u>975,000</u> | 3,600,000      |
| C Ltd.               | <u>600,000</u> | 2,200,000      |                 |                |                |
| Loans:               |                |                | Current Assets: |                |                |
| B Ltd.               | 400,000        |                | B Ltd.          | 125,000        |                |
| C Ltd.               | <u>100,000</u> | 500,000        | C Ltd.          | <u>25,000</u>  | 150,000        |
| Current Liabilities: |                |                |                 |                |                |
| B Ltd.               | 250,000        |                |                 |                |                |
| C Ltd.               | <u>50,000</u>  | 300,000        |                 |                |                |
|                      |                | <u>3750000</u> |                 |                | <u>3750000</u> |

**27.10 TRANSACTIONS BETWEEN A VENTURER AND JOINT VENTURE**

When venturer transfers or sells assets to Joint Venture, the venturer should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers. The venturer should recognise the full amount of any loss only when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss. When the venturer from the joint venture purchases the assets, venturer will not recognized his share of profits in the joint venture of such transaction unless he disposes off the assets. A venturer should recognise his share of the losses resulting from these transactions in the same way as profits except that losses will be recognised in full immediately only when they represent a reduction in the net realisable value of current assets or an impairment loss. In case the joint venture is in the form of separate entity then provisions of above the Para will be followed only for consolidated financial statement and not for venturer's own financial statement. In the books of venturer, profit or loss from such transactions are recognised in full.

**27.11 REPORTING INTERESTS IN JOINT VENTURES IN THE FINANCIAL STATEMENTS OF AN INVESTOR**

The investors who don't have joint control over the entity recognized his share of net results and his investments in joint venture as per AS – 13. In the consolidated financial statement it is recognized as per AS – 13, AS – 21 or AS – 23 as appropriate.

**27.12 OPERATORS OF JOINT VENTURES**

Payment to operators is recognized as expense in CFS and in the books of the operators as per AS – 9, Revenue Recognition. The operator may any of the venturer, in this case any amount received by him, as management fees for the service will be recognized as stated above in this Para.

**27.13 DISCLOSURE**

A venturer should disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

- a. Any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;
- b. Its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and
- c. Those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

A venturer should disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

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- a. Any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and
- b. Its share of the capital commitments of the joint ventures themselves.

A venturer should disclose a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence. A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

#### **Self-Examination Questions**

1. Define the following terms in the context of AS 27:
  - (a) Joint venture.
  - (b) Venturer.
  - (c) Investor.
  - (d) Joint control.
  - (e) Jointly controlled operation.
2. Explain the meaning and features of jointly controlled entity form of a joint venture.
3. How will you compute goodwill or capital reserve while applying proportionate consolidation method?
4. Explain proportionate consolidation method with the help of an example.
5. How are transactions between a joint venturer and joint venture recognised?

## UNIT 28

### AS 28: IMPAIRMENT OF ASSETS

Reference: The students are advised to refer the full text of AS 28 "Impairment of Assets" (issued 2002) given in Appendix I at the end of the Study Material (Volume-II).

#### 28.1 INTRODUCTION

AS 28 comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date for the following:

- (i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.
- (ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of accounting periods commencing on or after 1-4-2005 and is mandatory in nature from that date.

This standard prescribes the procedures to be applied to ensure that the assets of an enterprise are carried at an amount not exceeding their recoverable amount (amount to be recovered through use or sale of the asset). The standard also lays down principles for reversal of impairment losses and prescribes certain disclosures in respect of impaired assets. An enterprise is required to assess at each balance sheet date whether there is an indication that an enterprise may be impaired. If such an indication exists, the enterprise is required to estimate the recoverable amount and the impairment loss, if any, should be recognised in the profit and loss account.

#### 28.2 SCOPE

The standard should be applied in accounting for impairment of all assets except inventories (AS 2), assets arising under construction contracts (AS 7), financial assets including investments covered under AS 13, and deferred tax assets (AS 22). There are chances that the provision on account of impairment losses may increase sickness of companies and potentially sick companies may actually become sick.

#### 28.3 ASSESSMENT

An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset. An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. In assessing whether there is any indication that an asset may be

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impaired, an enterprise should consider, as a minimum, the following indications:

### *External sources of information*

- a. During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.
- b. Significant changes with an adverse effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated.
- c. Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.
- d. The carrying amount of the net assets of the reporting enterprise is more than its market capitalization.

### *Internal sources of information*

- a. Evidence is available of obsolescence or physical damage of an asset.
- b. Significant changes with an adverse effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs or to dispose of an asset before the previously expected date and
- c. Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

The concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated. If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation method or the residual value for the asset need to be reviewed and adjusted under the Accounting Standard 6, even if no impairment loss is recognised for the asset.

## 28.4 MEASUREMENT OF RECOVERABLE AMOUNT

**Recoverable Amount** is the higher of an asset's net selling price and its value in use.

Recoverable amount for an asset is defined by the statement as the higher of net selling price or value of use whichever is higher. If there is no reason to believe that an asset's value in use materially exceeds its net selling price, the asset's recoverable amount may be taken to be its net selling price. This will often be the case for an asset that is held for disposal. Otherwise, if it is not possible to determine the selling price we take value in use of assets as it's recoverable amount.



Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs, unless either:

- a. The asset's net selling price is higher than its carrying amount; or
- b. The asset's value in use can be estimated to be close to its net selling price and net selling price can be determined.

**Net selling price** is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

**Costs of disposal** are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

The best evidence for net selling price is a price in the bidding sales agreement for the disposal of the assets or similar assets. In the absence of this net selling price is estimated from the transactions for the assets in active market, if the asset has the active market. If there is no binding sale agreement or active market for an asset, net selling price is based on the best information available to reflect the amount that an enterprise could obtain, at the balance sheet date, for the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal.

**Value in Use** is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Estimating the value in use of an asset involves the following steps:

- a. Estimating the future cash inflows and outflows arising from continuing use of the asset and from its ultimate disposal; and
- b. Applying the appropriate discount rate to these future cash flows.

## 28.5 BASIS FOR ESTIMATES OF FUTURE CASH FLOWS

Cash flow projections should be based on the most recent budgets/forecasts for a maximum of five years. Financial budgets/forecasts over a period longer than five years may be used if management is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years. This rate is steady or declining. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used, unless a higher rate can be justified.

Cash flow projections should be based on reasonable and supportable assumptions that represent

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management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence.

### 28.6 COMPOSITION OF ESTIMATES OF FUTURE CASH FLOWS

Estimates of future cash flows should include (i) Projections of net cash inflows from the continuing use of the asset and (ii) Net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

Care should be taken for the following points:

- a. When the carrying amount of an asset does not yet include all the cash outflows to be incurred before it is ready for use or sale, estimate of any further cash outflow that is expected to be incurred before the asset is ready for use or sale should be included.
- b. Cash inflows from assets that generate cash inflows from continuing use that are largely independent of the cash inflows from the asset under review should not be included.
- c. Cash outflows that relate to obligations that have already been recognised as liabilities to be excluded.
- d. Future cash outflows or inflows expected to arise because of restructuring of the organization should be not considered.
- e. Any future capital expenditure enhancing the capacity of the assets should be excluded.
- f. Any increase in expected cash inflow from the above expenditure should also be excluded.
- g. Estimates of future cash flows should not include cash inflows or outflows from financing activities and also income tax receipts or payments.

*Foreign Currency Future Cash Flows* are estimated in the currency it will be generated and after they are discounted for the time value of money, we convert them in the reporting currency on the basis of AS 11.

#### *Discount Rate*

The discount rate(s) should be a pre tax rate(s) that reflect(s) current market assessments of the time value of money and the risks specific to the asset. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the enterprise expects to derive from the asset.

### 28.7 RECOGNITION AND MEASUREMENT OF AN IMPAIRMENT LOSS

If recoverable amount of assets more than carrying amount, we ignore the difference and asset is

carried on at the same book value. But when this recoverable amount is less than the carrying amount, this difference termed as Impairment Loss should be written off immediately as expenses to Profit & Loss Account. If assets are carried out at revalued figures then the impairment loss equivalent to revalued surplus is adjusted with it and the balance (if any) is charged to Profit & Loss Account. Depreciation for the coming years on the assets are recalculated on the basis new carrying amount, residual value and remaining useful life of the asset, according to AS 6.

A *cash generating unit* is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

#### **28.8 IDENTIFICATION OF THE CASH-GENERATING UNIT TO WHICH AN ASSET BELONGS**

If there is any indication that an asset may be impaired, the recoverable amount should be estimated for the individual asset, if it is not possible to estimate the recoverable amount of the individual asset because the value in use of the asset cannot be determined and it is probably different from scrap value. Therefore, the enterprise estimates the recoverable amount of the cash-generating unit to which the asset belongs.

If recoverable amount cannot be determined for an individual asset, an enterprise identifies the lowest aggregation of assets that generate largely independent cash inflows from continuing use. Even if part or all of the output produced by an asset or a group of assets is used by other units of the reporting enterprise, this asset or group of assets forms a separate cash-generating unit if the enterprise could sell this output in an active market. This is because this asset or group of assets could generate cash inflows from continuing use that would be largely independent of the cash inflows from other assets or groups of assets. In using information based on financial budgets/forecasts that relates to such a cash-generating unit, an enterprise adjusts this information if internal transfer prices do not reflect management's best estimate of future market prices for the cash-generating unit's output. Cash-generating units should be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

#### **28.9 RECOVERABLE AMOUNT AND CARRYING AMOUNT OF A CASH-GENERATING UNIT**

The carrying amount of a cash-generating unit should be determined consistently with the way the recoverable amount of the cash-generating unit is determined i.e. carrying amount is the summation of the carrying amount of all the assets grouped under one cash-generating unit. This also includes the liability only if that liability is necessary to be considered to determine the recovery amount. This may occur if the disposal of a cash-generating unit would require the buyer to take over a liability. In this case, the net selling price of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. In order to perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in

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determining both the cash-generating unit's value in use and its carrying amount. For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit or liabilities that have already been recognised in the financial statements. In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

### **28.10 GOODWILL**

Goodwill does not generate cash flows independently from other assets or groups of assets and, therefore, the recoverable amount of goodwill as an individual asset cannot be determined. As a consequence, if there is an indication that goodwill may be impaired, recoverable amount is determined for the cash-generating unit to which goodwill belongs. This amount is then compared to the carrying amount of this cash-generating unit and any impairment loss is recognized. If goodwill can be allocated on a reasonable and consistent basis, an enterprise applies the 'bottom-up' test only. If it is not possible to allocate goodwill on a reasonable and consistent basis, an enterprise applies both the 'bottom-up' test and 'top-down' test

### **28.11 CORPORATE ASSETS**

Key characteristics of corporate assets are that they do not generate cash inflows independently from other assets or groups of assets and their carrying amount cannot be fully attributed to the cash-generating unit under review.

In testing a cash-generating unit for impairment, an enterprise should identify all the corporate assets that relate to the cash-generating unit under review. For each identified corporate asset:

- a. If the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply the 'bottom-up' test only; and
- b. If the carrying amount of the corporate asset cannot be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply both the 'bottom-up' and 'top-down' tests.

### **28.12 IMPAIRMENT LOSS FOR A CASH-GENERATING UNIT**

The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:

- a. First, to goodwill allocated to the cash-generating unit (if any); and
- b. Then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

These reductions in carrying amounts should be treated as impairment losses on individual assets

The carrying amount of an asset should not be reduced below the highest of:

- a. Its net selling price (if determinable);
- b. Its value in use (if determinable); and
- c. Zero.

The amount of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

### **28.13 REVERSAL OF AN IMPAIRMENT LOSS**

An enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset. An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the estimates of cash inflows, cash outflows or discount rates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss. Indications of a potential decrease in an impairment loss are mainly mirror the indications of a potential impairment loss discussed above as external and internal indicators. The concept of materiality applies in identifying whether an impairment loss recognised for an asset in prior accounting periods may need to be reversed and the recoverable amount of the asset determined.

### **28.14 REVERSAL OF AN IMPAIRMENT LOSS FOR AN INDIVIDUAL ASSET**

If impairment loss was written off to profit and loss account, then the reversal of impairment loss should be recognized as income in the financial statement immediately. If impairment loss was adjusted with the Revaluation Reserve as per AS 10; then reversal of impairment loss will be written back to the reserve account to the extent it was adjusted, any surplus will be recognised as revenue. But in any case the increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods. This is mainly because any further increase in value of asset is revaluation, which is governed by AS 10.

After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

### **28.15 REVERSAL OF AN IMPAIRMENT LOSS FOR A CASH-GENERATING UNIT**

A reversal of an impairment loss for a cash-generating unit should be allocated to increase the carrying amount of the assets of the unit in the following order:

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- a. First, assets other than goodwill on a pro-rata basis based on the carrying amount of each asset in the unit; and
- b. Then, to goodwill allocated to the cash-generating unit (if any),

### **28.16 REVERSAL OF AN IMPAIRMENT LOSS FOR GOODWILL**

This Statement does not permit an impairment loss to be reversed for goodwill because of a change in estimates, an impairment loss recognised for goodwill should not be reversed in a subsequent period unless:

- a. The impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and
- b. Subsequent external events have occurred that reverse the effect of that event.

### **28.17 IMPAIRMENT IN CASE OF DISCONTINUING OPERATIONS**

In applying this Statement to a discontinuing operation, an enterprise determines whether the recoverable amount of an asset of a discontinuing operation is assessed for the individual asset or for the asset's cash-generating unit. For example:

- a. If the enterprise sells the discontinuing operation substantially in its entirety, none of the assets of the discontinuing operation generate cash inflows independently from other assets within the discontinuing operation. Therefore, recoverable amount is determined for the discontinuing operation as a whole and an impairment loss, if any, is allocated among the assets of the discontinuing operation in accordance with this Statement;
- b. If the enterprise disposes of the discontinuing operation in other ways such as piecemeal sales, the recoverable amount is determined for individual assets, unless the assets are sold in groups; and
- c. If the enterprise abandons the discontinuing operation, the recoverable amount is determined for individual assets as set out in this Statement.

### **28.18 DISCLOSURE**

For each class of assets, the financial statements should disclose:

- a. The amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;
- b. The amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;
- c. The amount of impairment losses recognised directly against revaluation surplus during the period; and

- d. The amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

An enterprise that applies AS 17, Segment Reporting, should disclose the following for each reportable segment based on an enterprise's primary format (as defined in AS 17):

- a. The amount of impairment losses recognised in the statement of profit and loss and directly against revaluation surplus during the period; and
- b. The amount of reversals of impairment losses recognised in the statement of profit and loss and directly in revaluation surplus during the period.

If an impairment loss for an individual asset or a cash-generating unit is recognised or reversed during the period and is material to the financial statements of the reporting enterprise as a whole, an enterprise should disclose:

- a. The events and circumstances that led to the recognition or reversal of the impairment loss;
- b. The amount of the impairment loss recognised or reversed;
- c. For an individual asset:
  - (i) The nature of the asset; and
  - (ii) The reportable segment to which the asset belongs, based on the enterprise's primary format (as defined in AS 17, Segment Reporting);
- d. For a cash-generating unit:
  - (i) A description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, a reportable segment as defined in AS 17 or other);
  - (ii) The amount of the impairment loss recognised or reversed by class of assets and by reportable segment based on the enterprise's primary format (as defined in AS 17); and
  - (iii) If the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), the enterprise should describe the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified;
- e. Whether the recoverable amount of the asset (cash-generating unit) is its net selling price or its value in use;
- f. If recoverable amount is net selling price, the basis used to determine net selling price (such as whether selling price was determined by reference to an active market or in some other way); and

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- g. If recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

If impairment losses recognised (reversed) during the period are material in aggregate to the financial statements of the reporting enterprise as a whole, an enterprise should disclose a brief description of the following:

- a. The main classes of assets affected by impairment losses (reversals of impairment losses);
- b. The main events and circumstances that led to the recognition (reversal) of these impairment losses.

### 28.19 TRANSITIONAL PROVISIONS

On the date of this Statement becoming mandatory, an enterprise should assess whether there is any indication that an asset may be impaired (see paragraphs 5-13). If any such indication exists, the enterprise should determine impairment loss, if any, in accordance with this Statement. The impairment loss, so determined, should be adjusted against opening balance of revenue reserves being the accumulated impairment loss relating to periods prior to this Statement becoming mandatory unless the impairment loss is on a revalued asset. An impairment loss on a revalued asset should be recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset. If the impairment loss exceeds the amount held in the revaluation surplus for that same asset, the excess should be adjusted against opening balance of revenue reserves. Any impairment loss arising after the date of this Statement becoming mandatory should be recognised in accordance with this Statement (i.e., in the statement of profit and loss unless an asset is carried at revalued amount. An impairment loss on a revalued asset should be treated as a revaluation decrease).

### 28.20 ILLUSTRATIONS

#### Illustration 1

Ergo Industries Ltd. gives the following estimates of cash flows relating to fixed asset on 31-12-2005. The discount is 15%.

| <u>Year</u>                       |   | <u>Cash Flow (Rs. In lakhs)</u> |
|-----------------------------------|---|---------------------------------|
| 2006                              |   | 4000                            |
| 2007                              |   | 6000                            |
| 2008                              |   | 6000                            |
| 2009                              |   | 8000                            |
| 2010                              |   | 4000                            |
| Residual value at the end of 2010 | = | Rs. 1000 lakhs                  |
| Fixed Asset purchased on 1-1-2003 | = | Rs. 40,000 lakhs                |



Useful life = 8 years

Net selling price on 31-12-2010 = Rs. 20,000 lakhs

Calculate on 31-12-2005:

- (a) Carrying amount at the end of 2005
- (b) Value in use on 31-12-2005
- (c) Recoverable amount on 31-12-2005
- (d) Impairment loss to be recognized for the year ended 31-12-2005
- (e) Revised carrying amount
- (f) Depreciation charge for 2006

### Solution

#### Calculation of value in use

| Year | Cash Flow | Discount as per 15% | Discounted cash flow |
|------|-----------|---------------------|----------------------|
| 2006 | 4000      | 0.870               | 3480                 |
| 2007 | 6000      | 0.756               | 4536                 |
| 2008 | 6000      | 0.658               | 3948                 |
| 2009 | 8000      | 0.572               | 4576                 |
| 2010 | 4000      | 0.497               | 1988                 |

Value in use = Rs. 18528 lakhs

Calculation of carrying amount:

Original cost = Rs. 20,000 lakhs

Depreciation for 3 years =  $[(40,000 - 1000) \times 3/8] = \text{Rs. } 14,625$

Carrying amount on 31-12-2005 =  $[40,000 - 14,625] = \text{Rs. } 25,375$

Recoverable amount = Rs. 20,000 lakhs

Impairment Loss =  $\text{Rs. } (25,375 - 20,000) = \text{Rs. } 5,375$  lakhs

Revised carrying amount =  $\text{Rs. } (25,375 - 5,375) = \text{Rs. } 20,000$  lakhs

Depreciation Charge for 2006 =  $(20,000 - 1000)/5 = \text{Rs. } 3,800$

### Illustration 2

X Ltd. is having a plant (asset) carrying amount of which is Rs. 100 lakhs on 31.3.2004. Its balance useful life is 5 years and residual value at the end of 5 years is Rs. 5 lakhs. Estimated future cash flow from using the plant in next 5 years are:-

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| <i>For the year ended on</i> | <i>Estimated cash flow (Rs. in lakhs)</i> |
|------------------------------|-------------------------------------------|
| 31.3.2005                    | 50                                        |
| 31.3.2006                    | 30                                        |
| 31.3.2007                    | 30                                        |
| 31.3.2008                    | 20                                        |
| 31.3.2009                    | 20                                        |

Calculate "value in use" for plant if the discount rate is 10% and also calculate the recoverable amount if net selling price of plant on 31.3.2004 is Rs. 60 lakhs.

#### Solution

| <b>Present value of future cash flow</b>                                                                    |                         |                                |                                 |
|-------------------------------------------------------------------------------------------------------------|-------------------------|--------------------------------|---------------------------------|
| <i>Year ended</i>                                                                                           | <i>Future Cash Flow</i> | <i>Discount @ 10%<br/>Rate</i> | <i>Discounted cash<br/>flow</i> |
| 31.3.2005                                                                                                   | 50                      | 0.909                          | 45.45                           |
| 31.3.2006                                                                                                   | 30                      | 0.826                          | 24.78                           |
| 31.3.2007                                                                                                   | 30                      | 0.751                          | 22.53                           |
| 31.3.2008                                                                                                   | 20                      | 0.683                          | 13.66                           |
| 31.3.2009                                                                                                   | 20                      | 0.620                          | <u>12.40</u>                    |
|                                                                                                             |                         |                                | 118.82                          |
| Present value of residual price on 31.3.2009 = $5 \times 0.620$                                             |                         |                                | <u>3.10</u>                     |
| Present value of estimated cash flow by use of an asset and residual value, which is called "value in use". |                         |                                | <u>121.92</u>                   |

If net selling price of plant on 31.3.2004 is Rs. 60 lakhs, the recoverable amount will be higher of Rs. 121.92 lakhs (value in use) and Rs.60 lakhs (net selling price), hence recoverable amount is Rs.121.92 lakhs

#### Self-Examination Questions

1. Define the following terms:
  - (i) Cash generating unit.
  - (ii) Corporate assets.
  - (iii) Active market.
  - (iv) Depreciable amount.
  - (v) Impairment loss.

- (vi) Carrying amount.
- (vii) Recoverable amount.
- 2. When should an enterprise make an assessment for ascertaining impairment?
- 3. Under what circumstances an enterprise is not required to make a formal estimate of an asset's recoverable amount?
- 4. List the various items that are considered in estimating the future cash flows to determine the value in use of an asset.
- 5. Venus Ltd. has an asset, which is carried in the Balance Sheet on 31.3.2005 at Rs. 500 lakhs. As at that date the value in use is Rs. 400 lakhs and the net selling price is Rs. 375 lakhs.

From the above data:

- (i) Calculate impairment loss.
- (ii) Prepare journal entries for adjustment of impairment loss.
- (iii) Show, how impairment loss will be shown in the Balance Sheet.

## UNIT 29

### AS 29 : PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Reference: The students are advised to refer the full text of AS 29 "Provisions, Contingent Liabilities and Contingent Assets" (issued 2003) given in Appendix I at the end of the Study Material (Volume-II).

#### 29.1 INTRODUCTION

As 29 comes into effect in respect of accounting periods commencing on or after 1-4-2004. The objective of AS 29 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. This standard applies in accounting for provisions and contingent liabilities and contingent assets resulting from financial instruments (not carried at fair value) and insurance enterprises (other than those arising from contracts with policyholders). The standard will not apply to provisions/liabilities resulting from executing controls and those covered under any other accounting standard.

This Standard is mandatory in nature from that date:

- a. In its entirety, for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:
  - i. Enterprises whose equity or debt securities are listed whether in India or outside India.
  - ii. Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.
  - iii. Banks including co-operative banks.
  - iv. Financial institutions.
  - v. Enterprises carrying on insurance business.
  - vi. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.
  - vii. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.
  - viii. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

- b. In its entirety, except paragraph 67, for the enterprises which do not fall in any of the categories in (a) above but fall in any one or more of the following categories:
  - i. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 40 lakhs but does not exceed Rs. 50 crore. Turnover does not include 'other income'.
  - ii. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 1 crore but not in excess of Rs. 10 crore at any time during the accounting period.
  - iii. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.
- c. In its entirety, except paragraphs 66 and 67, for the enterprises, which do not fall in any of the categories in (a) and (b) above.

Where an enterprise has been covered in any one or more of the categories in (a) above and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from paragraph 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) above for two consecutive years.

Where an enterprise has been covered in any one or more of the categories in (a) or (b) above and subsequently, ceases to be covered in any of the categories in (a) and (b) above, the enterprise will not qualify for exemption from paragraphs 66 and 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) and (b) above for two consecutive years.

Where an enterprise has previously qualified for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, but no longer qualifies for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, in the current accounting period, this Standard becomes applicable, in its entirety or, in its entirety except paragraph 67, as the case may be, from the current period. However, the relevant corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not disclose the information required by paragraph 67 or paragraphs 66 and 67, as the case may be, should disclose the fact.

## 29.2 SCOPE

This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:

- a. Those resulting from financial instruments that are carried at fair value;
- b. Those resulting from executory contracts;
- c. Those arising in insurance enterprises from contracts with policy-holders; and

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d. Those covered by another Accounting Standard.

Where another Accounting Standard like 7; 9; 15; 19; 22 & 24 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Statement instead of this Statement.

### 29.3 DEFINITIONS

**Executory contracts** are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

A **Provision** is a liability which can be measured only by using a substantial degree of estimation.

A **Liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An **Obligating event** is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A Contingent liability is:

- (a) A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
- (b) A present obligation that arises from past events but is not recognised because:
  - (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  - (ii) A reliable estimate of the amount of the obligation cannot be made.

A **Contingent asset** is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

**Present obligation** - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

**Possible obligation** - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

A **Restructuring** is a programme that is planned and controlled by management, and materially changes either:

- (a) The scope of a business undertaken by an enterprise; or
- (b) The manner in which that business is conducted.

## 29.4 PROVISIONS

### A provision should be recognised when:

- (a) An enterprise has a present obligation as a result of a past event;
- (b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- (c) A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

## 29.5 PRESENT OBLIGATION

An enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence. On the basis of such evidence:

- (a) Where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and
- (b) Where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

## 29.6 PAST EVENT

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

## 29.7 PROBABLE OUTFLOW OF RESOURCES EMBODYING ECONOMIC BENEFITS

For a liability to qualify for recognition there must be not only a present obligation but also the

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probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Statement, an outflow of resources or other event is regarded as probable if the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

### **29.8 RELIABLE ESTIMATE OF THE OBLIGATION**

In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability.

### **29.10 CONTINGENT LIABILITIES**

An enterprise should not recognise a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

### **29.11 CONTINGENT ASSETS**

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An enterprise should not recognise a contingent asset, since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority.

### **29.12 MEASUREMENT -BEST ESTIMATE**

The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The amount of a provision should not be discounted to its present value. The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22. The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

### **29.13 FUTURE EVENTS**

Expected future events may be particularly important in measuring provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by



future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

#### **29.14 EXPECTED DISPOSAL OF ASSETS**

Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

#### **29.15 REIMBURSEMENTS**

In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

#### **29.16 CHANGES IN PROVISIONS**

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

#### **29.17 USE OF PROVISIONS**

Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

#### **29.18 APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES**

##### *Future Operating Losses*

Future operating losses do not meet the definition of a liability and the general recognition criteria, therefore provisions should not be recognised for future operating losses.

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#### *Restructuring*

The following are examples of events that may fall under the definition of restructuring:

- (a) Sale or termination of a line of business;
- (b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another;
- (c) Changes in management structure, for example, eliminating a layer of management; and
- (d) Fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

A provision for restructuring costs is recognised only when the recognition criteria for provisions. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms.

A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

- (a) Necessarily entailed by the restructuring; and
- (b) Not associated with the ongoing activities of the enterprise.

A restructuring provision does not include such costs as:

- (a) Retraining or relocating continuing staff;
- (b) Marketing; or
- (c) Investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

Identifiable future operating losses up to the date of a restructuring are not included in a provision.

As required by paragraph 44, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

### **29.19 DISCLOSURE**

For each class of provision, an enterprise should disclose:

- (a) The carrying amount at the beginning and end of the period;

- (b) Additional provisions made in the period, including increases to existing provisions;
- (c) Amounts used (i.e. incurred and charged against the provision) during the period; and
- (d) Unused amounts reversed during the period.

An enterprise should disclose the following for each class of provision:

- (a) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
- (b) An indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, and
- (c) The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

- (a) An estimate of its financial effect,
- (b) An indication of the uncertainties relating to any outflow; and
- (c) The possibility of any reimbursement.

## 29.19 MISCELLANEOUS ILLUSTRATIONS

### Illustration 1

At the end of the financial year ending on 31st December, 2006, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

|                                | Probability | Loss (Rs.) |
|--------------------------------|-------------|------------|
| In respect of five cases (Win) | 100%        | —          |
| Next ten cases (Win)           | 60%         | —          |
| Lose (Low damages)             | 30%         | 1,20,000   |
| Lose (High damages)            | 10%         | 2,00,000   |
| Remaining five cases           |             |            |
| Win                            | 50%         | —          |
| Lose (Low damages)             | 30%         | 1,00,000   |
| Lose (High damages)            | 20%         | 2,10,000   |

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss

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and the accounting treatment in respect thereof.

#### Solution

(a) According to AS 29 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

- (i) There is a present obligation arising out of past events but not recognized as provision.
- (ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
- (iii) The possibility of an outflow of resources embodying economic benefits is also remote.
- (iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 60% and for remaining five cases is 50%. As per AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

$$\begin{aligned}\text{Expected loss in next ten cases} &= 30\% \text{ of Rs. } 1,20,000 + 10\% \text{ of Rs. } 2,00,000 \\ &= \text{Rs. } 36,000 + \text{Rs. } 20,000 \\ &= \text{Rs. } 56,000\end{aligned}$$

$$\begin{aligned}\text{Expected loss in remaining five cases} &= 30\% \text{ of Rs. } 1,00,000 + 20\% \text{ of Rs. } 2,10,000 \\ &= \text{Rs. } 30,000 + \text{Rs. } 42,000 \\ &= \text{Rs. } 72,000\end{aligned}$$

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of Rs. 9,20,000 ( $\text{Rs. } 56,000 \times 10 + \text{Rs. } 72,000 \times 5$ ) as contingent liability.

#### Self-examination Questions

1. What are the conditions to be satisfied for recognition of provisions?
2. Explain the procedure for identification and quantifying the amount of provision.
3. What are the aspects to be considered in measurement of a provision?

4. Explain the disclosure requirements of AS 29 in respect of provisions.

## **UNIT 30**

### **GUIDANCE NOTES**

Reference: *The students are advised to refer the full text of relevant Guidance Notes given in Appendix III at the end of the Study Material (Volume-2).*

#### **30.1 INTRODUCTION**

Guidance Notes are primarily designed to provide guidance to members of ICAI on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. In recent years several Guidance Notes on accounting aspects have been issued promptly responding to the need for accounting guidance on contemporary issues, which arise due to amendments in laws and other developments related to economic reforms in the country. These Guidance Notes are issued by the Council of the ICAI from time to time.

Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

#### **30.2 STATUS OF GUIDANCE NOTES**

In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard.

Similarly, in a situation where certain matters are covered by a recommendatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the recommendatory Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard coming into effect, unless otherwise specified in the new Accounting Standard.

In a situation where certain matters are covered by a mandatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the earlier Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard becoming mandatory, unless otherwise specified in the new Accounting Standard.

**30.3 GUIDANCE NOTES ON ACCOUNTING ASPECTS**

The council of the Institute of Chartered Accountants of India has, so far issued 23\* Guidance Notes till

July 1, 2006. 2 Guidance Notes are under the process of revision. The following is the list of various guidance notes on accounting aspects:

1. GN(A) 2 (Revised 1976)Guarantees & Counter-Guarantees Given by Companies
2. GN(A) 3 (Issued 1982) Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets
3. GN(A) 4 (Issued 1982)Guidance Note on Accounting for Changing Prices
4. GN(A) 6 (Issued 1988)Guidance Note on Accrual Basis of Accounting
5. Guidance Note on Treatment of Expenditure during Construction Period (under revision)
6. GN(A) 7 (Issued 1989) Guidance Note on Accounting for Depreciation in Companies
7. GN(A) 9 (Issued 1994) Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares
8. GN(A) 11 (Issued 1997) Guidance Note on Accounting for Corporate Dividend Tax
9. GN(A) 12 (Revised 2000) Guidance Note on Accounting Treatment for Excise Duty
10. Guidance Note on Accounting Treatment for MODVAT/ CENVAT(under revision)
11. GN(A) 13 (Issued 2000) Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds
12. GN(A) 16 (Issued 2003) Guidance Note on Accounting for Securitisation
13. GN(A) 17 (Issued 2003) Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options
15. GN(A) 18 (Issued 2005)Guidance Note on Accounting for Employee Share-base Payments
16. GN(A) 20 (Issued 2005) Guidance Note on Accounting for-Fringe Benefits Tax
17. GN(A) 22 (Issued 2006) Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax under the Income-tax Act, 1961

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\* The students are advised to refer the July, 2006 edition of “Compendium of Guidance Notes–Accounting” which contains all guidance notes on accounting that have been issued upto July 1, 2006 are in force as on that date.

### **30.4 AN OVERVIEW OF GUIDANCE NOTES**

#### **30.4.1 GN(A) 2 (Revised 1976) Guarantees & Counter-Guarantees Given by Companies**

This Guidance Note provides guidance relating to the treatment and disclosure of guarantees and counter-guarantees in published accounts. Companies are often required to furnish guarantees, warranties or indemnities (hereinafter collectively called guarantees) to parties. While normally these guarantees are furnished directly by the company, often they are furnished by other parties like banks, directors, etc. on behalf of the company. In such cases, the company issues counter-guarantees to the persons who furnish the guarantee. As there appears to be considerable divergence of practice in the treatment given to guarantees in published accounts of companies, this Note is issued to offer guidance in this matter. The Guidance Note also explains treatment of the guarantees given by a company on behalf of others and disclosure of guarantees in the accounts of a company receiving a guarantee.

#### **.30.4.2 GN(A) 3 (Issued 1982) Guidance Note on Treatment of Reserve Created on Revaluation\* of Fixed Assets**

The Guidance Note provides detailed consideration of various aspects regarding treatment of reserve created on revaluation of fixed assets. Companies normally revalue fixed assets in order to bring into books the replacement cost of such assets. The Guidance Note states that it will be prudent not to charge the additional depreciation against revaluation reserve, though this may result in reduction of distributable profits and will not give a realistic appraisal of the company's operations in inflationary conditions.

#### **30.4.3 GN(A) 4 (Issued 1982) Guidance Note on Accounting for Changing Prices**

In the recent decades when a high rate of annual inflation has become a way of life in many countries including India, it has been felt that the historical cost information should be supplemented by adequate information reflecting the effects of inflation on an enterprise. Considerable efforts have been made by the accountants all over the world, for developing suitable methods to measure the impact of changing prices.

The Guidance Note on Accounting for Changing Prices deals with the most intricate and controversial issue in accounting. The very need for a method of accounting to take cognisance of changing prices has often been questioned; its policy implications have been widely debated; and each of the numerous methods has been discussed in this guidance note. Various methods have been developed – two of them, current purchasing power accounting (CPPA) method and current cost accounting (CCA) method have gained wide exposure. The CPPA method, while retaining the historical costs as the basis of income measurement and asset valuation, seeks to eliminate the mathematical inconsistency of conventional accounting by expressing all revenues, expenses, assets and liabilities in terms of units of uniform purchasing power. The CCA method, on the other

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\* For accounting treatment of revaluation reserves in amalgamations, the students are advised to refer AS 14 “Accounting for Amalgamations”.



hand, substitutes historical costs by current costs.

#### **30.4.4 GN(A) 6 (Issued 1988) Guidance Note on Accrual Basis of Accounting**

This guidance note is issued by the Research Committee of the ICAI providing guidance in respect of maintenance of accounts on the accrual basis of accounting. The Guidance Note explains the concept of accrual as a basis of accounting, particularly, in comparison with the cash basis of accounting. It also deals generally with the matters of recognition of revenue and expenses, assets and liabilities. A section of the Guidance Note is devoted to the concept of materiality vis-a-vis accrual basis of accounting. It also provides guidance to the auditor in case a company has not maintained its accounts on accrual basis. Illustrations highlighting application of the principles explained in the Guidance Note to certain important commercial situations have also been given in the Guidance Note.

Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. "Accrual" is one of the fundamental accounting assumptions. Para 27 of the Accounting Standard on Disclosure of Accounting Policies (AS-1), issued by the Institute of Chartered Accountants of India (ICAI), provides that if fundamental accounting assumptions, viz., going concern, consistency and accrual are not followed, the fact should be disclosed.

#### **30.4.5 Guidance Note on Treatment of Expenditure during Construction Period (under revision)**

The Guidance Note on Treatment of Expenditure during Construction Period contains modifications in respect of treatment of income earned during construction period and some others pertaining to preparation of profit and loss account by a company during construction period. This subject has always been of great importance and it has assumed even greater importance in recent times because of rapid industrialization involving the setting up of huge and complicated plants, often with foreign collaboration. The problem is not merely one of accounting for the income and expenditure which may arise during the construction period. There is also the problem involved in regard to the tax treatment of such income and expenditure during this period and in regard to the method of disclosing such income and expenditure in the financial statements of a company, prepared in accordance with the provisions of the Companies Act. Since there is a certain amount of confused thinking in regard to these matters, the Guidance Note provides detailed discussion on the treatment of income and expenditure arising during the construction period.

#### **30.4.6 GN(A) 7 (Issued 1989) Guidance Note on Accounting for Depreciation in Companies**

The subject of accounting for depreciation has always been a matter of crucial importance for the purpose of true and fair determination of the operating results of an entity and the depiction of its financial position through its profit and loss account and the balance sheet, respectively. With a view to provide an authoritative position of the Institute on the issues arising out of the said amendments in this regard and to consolidate and revise the existing pronouncements on the

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subject of accounting for depreciation, in particular reference to the companies, issued by the Institute and its various Committees, the Research Committee of the Institute has brought out this Guidance Note on Accounting for Depreciation in Companies. This Guidance Note on Accounting for Depreciation in Companies, accordingly, comprehensively deals with various aspects of accounting for depreciation, such as, methods of charging depreciation (including change in the method of providing depreciation), relevant rates of depreciation for the purpose of preparation of accounts of a company with particular reference to Schedule XIV, pro-rata computation of depreciation, depreciation on low value items, charge of depreciation in case of revaluation of assets and other matters arising on account of amendments in the Companies Act, 1956

### **30.4.7 GN(A) 9 (Issued 1994) Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares**

This Guidance Note discusses the nature of revaluation reserve and in this context examines the question whether such reserves can be utilised for issue of bonus shares. Revaluation of fixed assets is one of the issues dealt with in Accounting Standard (AS) 10 on 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India. According to this Guidance Note, bonus shares cannot be issued by capitalisation of revaluation reserve. If any company (including a private or a closely held public company) utilises revaluation reserve for issue of bonus shares, the statutory auditor of the company should qualify his audit report.

### **30.4.8 GN(A) 11 (Issued 1997) Guidance Note on Accounting for Corporate Dividend Tax**

Corporate Dividend Tax (CDT) is in addition to the income-tax chargeable in respect of the total income of a domestic company and was introduced under The Finance Act, 1997. The Guidance Note on Accounting for Corporate Dividend Tax explains the salient features of Corporate Dividend tax (CDT). As per the Guidance Note, CDT on dividend, being directly linked to the amount of the dividend concerned, should also be reflected in the accounts of the same financial year even though the actual tax liability in respect thereof may arise in a different year. The liability in respect of CDT arises only if the profits are distributed as dividends whereas the normal income-tax liability arises on the earning of the taxable profits. Since the CDT liability relates to distribution of profits as dividends which are disclosed 'below the line', it is appropriate that the liability in respect of CDT should also be disclosed 'below the line' as a separate item. It is felt that such a disclosure would give a proper picture regarding payments involved with reference to dividends.

### **30.4.9 GN(A) 12 (Revised 2000) Guidance Note on Accounting Treatment for Excise Duty**

Excise duty is a duty on manufacture or production of excisable goods in India. Section 3 of the Central Excise Act, 1944, deals with charge of Excise Duty. This Section provides that a duty of excise on excisable goods which are produced or manufactured in India shall be levied and collected in such manner as may be prescribed. The subject of accounting of excise duty has, so far, beset with certain controversies, yet, the ICAI with the issuance of this Guidance Note, has recommended practices which are broadly in accordance with the generally accepted accounting principles would be well established. Subsequent to the issuance of that Guidance Note, the nature

of excise duty has been further clarified by some Supreme Court decisions. Further, the principles to be followed for the valuation of inventories have been explained in the Accounting Standard (AS) 2 on 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India. This Guidance Note recommends accounting treatment for Excise Duty in respect of excisable goods produced or manufactured by an enterprise. A separate Guidance Note on Accounting Treatment for MODVAT sets out principles for accounting for MODVAT (now renamed as 'CENVAT'). In considering the appropriate treatment of excise duty for the purpose of determination of cost for inventory valuation, it is necessary to consider whether excise duty should be considered differently from other expenses. As per the recommendations given in the Guidance Note, Excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation. Where excise duty is paid on excisable goods and such goods are subsequently utilised in the manufacturing process, the duty paid on such goods, if the same is not recoverable from taxing authorities, becomes a manufacturing cost and must be included in the valuation of work-in-progress or finished goods arising from the subsequent processing of such goods. Where the liability for excise duty has been incurred but its collection is deferred, provision for the unpaid liability should be made. Excise duty cannot be treated as a period cost and if the method of accounting for excise duty is not in accordance with the principles explained in this Guidance Note, the auditor should qualify his report.

#### **30.4.10 Guidance Note on Accounting Treatment for MODVAT/CENVAT (under revision)**

The objective of this Guidance Note is to provide guidance in respect of accounting for MODVAT/CENVAT credit. Salient features of MODVAT and CENVAT are also explained in the guidance note. This Guidance Note on "Accounting Treatment for MODVAT/CENVAT" is, currently under revision.

#### **30.4.11 GN(A) 13 (Issued 2000) Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds**

Mutual Funds have assumed greater significance in recent years as major players in the capital market of the country. In order that the Mutual Funds play their role in a more effective manner, it is important that they are managed efficiently so that the common investor of the Mutual Funds is not affected adversely. In this context, the Securities and Exchange Board of India – the principal regulator of the capital market in the country – has laid down various regulations to regulate Mutual Funds for investor's protection. Regulations, however, prescribe that till necessary Guidance Note is issued by the Institute, investments may continue to be valued at cost with the market value being shown separately. Pursuant to this, the Institute has issued this Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds. This Guidance Note deals with issues related to forms of investments and cost of investments and provides guidance on the accounting treatment of depreciation and appreciation when investments are marked to market and accounting for disposal of investments.

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### **30.4.12 GN(A) 16 (Issued 2003) Guidance Note on Accounting for Securitisation**

Securitisation is a process of pooling and re-packaging the homogenous illiquid financial assets into marketable securities. The process involves the three primary parties, viz., Originator, who is the owner of the financial assets, Special Purpose Entity (SPE) who buys the asset from the Originator and issues securities and Investors who subscribe to the securities issued by the SPE. While the accounting for securities in the books of investors would generally be governed by the principles of Accounting Standard (AS) 13 on 'Accounting for Investments', no accounting guidance was available in India for accounting for securitization transactions in the books of the Originator and the SPE. A need was, therefore, felt to lay down appropriate accounting principles for such transactions particularly in the books of the Originator and the SPE. Keeping this in view, the ICAI has formulated this Guidance Note on Accounting for Securitisation. This Guidance Note recommends accounting for securitization transactions in the books of the Originator, specially addressing issues such as when to derecognise, fully or partly, the securitised assets; treatment of securitisation of future receivables; measurement of consideration received in the form of securities; etc. The Guidance Note also recommends accounting for securitisation transactions in the books of SPEs and deals with certain issues relating to accounting in the books of Investors.

### **30.4.13 GN(A) 17 (Issued 2003) Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options**

The objective of this Guidance Note is to explain the accounting treatment of the Equity Derivative Instruments (meaning equity index futures, equity stock futures, equity index options and equity stock options) irrespective of the motive (speculation, hedging or arbitrage) behind their trading. Derivatives are financial instruments whose values change with the change in specified interest rates, security prices, commodity prices, index of prices or rates or other similar variables e.g. futures and forward contracts, swaps and option contracts. Trading of Equity Derivative Instruments, in India, is done in some major stock exchanges like the National Stock Exchange of India Ltd. (NSE) and The Stock Exchange, Mumbai (BSE).

The Guidance Note discusses accounting treatment in the books of client of an Equity Derivative Instruments in India, accounting for Equity Index Futures and Equity Stock Futures, accounting for Equity Index Options and Equity Stock Options and the required disclosures in the financial statements.

#### ***Terms Used in the Guidance Note***

**Option:** A contract, which gives the buyer/holder the right, but not the obligation, to buy or sell a specified underlying asset at a predetermined price, on or before the specified future date.

**Option Buyer/Holder:** Person who buys a Call or a Put Option.

**Option Seller/Writer:** Person who sells a Call or a Put Option.

**Call Option:** The buyer/holder gets the right to purchase the underlying asset whereas the seller/writer has an obligation to sell the underlying asset.

*Put Option:* The buyer/holder gets the right to sell the underlying asset whereas the seller/writer has an obligation to buy the underlying asset.

*At the money:* Current market value of the underlying asset is the same as the Exercise Price.

*In the Money:*

*Call Option:* Current Market value of the underlying asset is above the Exercise Price of the Option.

*Put Option:* Current market value of the underlying asset is below the Exercise price of the Option.

*Out of the Money:*

*Call Option:* Current market value of the underlying asset is below the Exercise price of the Option.

*Put Option:* Current market value of the underlying asset is above the Exercise Price of the Option.

*Option Premium:* Price paid by the Option Buyer/Holder to the Option Seller/Writer to acquire the right in the Option.

*Strike/Exercise Price:* Price specified in the option contract at which the underlying asset may be purchased or sold by the buyer/holder.

*Exercise Date:* Date on which the buying/selling right in the Option is actually exercised by the Option Buyer/Holder.

*Expiry Date:* Last date on or upto which the Option can be exercised.

*Clearing Corporation/House:* Clearing Corporation/House approved by SEBI for clearing and settlement of trades on the Derivatives Exchange/Segment.

*Clearing Member:* All categories of members of Clearing House admitted as clearing members by the Clearing House to the Derivatives Segment.

Derivatives: Include,

- (a) a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;
- (b) a contract which derives its value from the prices, or index of prices, of underlying securities.

*Derivative Exchange:* Exchange approved by SEBI as such.

*Derivative Segment:* Segment of an existing Exchange approved by SEBI as such.

*Trading Member:* Member of Derivatives Exchange/Segment and registered with SEBI.

*Client:* A person on whose instructions and, on whose account the Trading Member enters into any contract for the purchase or sale of any contract or does any act in relation thereto.

*Forward Contract:* An agreement between two parties whereby one party agrees to buy from or sell to the other party an asset at a future time for an agreed contract price. At maturity, a forward

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contract is settled by delivery of asset by seller to buyer in return for payment of contract price.

*Futures Contract:* An agreement between two parties to buy or sell an asset at a certain time in future for an agreed price. Normally trading is done on an exchange.

*Equity Index Futures Contract:* A contract to buy or sell equity index at an agreed amount on a specified future date. (underlying asset is an equity index).

*Equity Stock Futures Contract:* A contract to buy or sell a security at an agreed amount on a specified future date. (underlying asset is a security).

*Equity Index Options:* Type of derivative instruments whereby a person gets the right to buy or sell an agreed number of units of equity index on a specified future date.

*Equity Stock Options:* A type of derivative instruments whereby a person gets the right to buy or sell an agreed number of units of a security on or before a specified future date.

*Contract Month:* In relation to a futures contract, means the month in which the exchange/Clearing Corporation rules require a contract to be finally settled, and in relation to an options contract means the month in which the Expiry Date falls.

*Daily Settlement Price:* Closing price of the equity index/stock futures contract for the day or such other price as may be decided by the Clearing House from time to time.

*Final Settlement Price:* Closing price of the Equity Derivative Instruments contract on the last trading day of the contract or such other price as may be specified by the Clearing Corporation, from time to time.

*Long Position and Short Position:* Outstanding purchase and sell obligations, respectively in respect of equity index/stock futures contracts at any point of time.

*Open Interest:* The total number of Equity Derivative Instruments Contracts that have not yet been offset and closed by an opposite contract non-fulfilled either by delivery of cash or by actual delivery of underlying security.

*Settlement Date:* Date on which the outstanding obligations in an equity index/stock futures contract are required to be settled as provided in the bye-laws of the Derivatives Exchange/Segment.

#### Trading in Equity Derivative Instruments in India

- ◆ Traded in Derivatives Segment, only through a Trading Member or a Clearing Member acting as a Trading Member.
- ◆ Clearing House acts as a legal counter party to all deals or provides an unconditional guarantee assuring the fulfillment of obligations of the parties to the contract in case of default.
- ◆ Process of trading similar to screen-based trading in securities.

- ◆ Exchanges permitting Equity Derivative Instruments trading introduce standardized contracts providing the contract specifications and specifying the Settlement/Expiry Date, as the case may be e.g. Settlement/Expiry Date adopted by BSE and NSE is last thursday of the contract month.
- ◆ Clients can enter into contracts with different contract/strike prices and different premiums.
- ◆ Trading can be done only in multiples of the market lot, decided beforehand for each individual stock.
- ◆ Clearing/Trading Members required to collect margin money from the clients and pay to clearing House as prescribed by them to cover risk of default.
- ◆ Margin money may be paid in cash or bank guarantee or deposit receipts or securities or other mode as per terms and conditions specified by clearing house.

Accounting Treatment in the books of the Client

*Initial Margin:* Margin required to be paid by a client while entering into an Equity Derivative Instruments contract.

- ◆ Is calculated by using a software called SPAN (Standard Portfolio Analysis of Risk), on a daily basis.
- ◆ Deficit/Excess margin is paid/received by the client to/from the Trading/Clearing Member daily.
- ◆ Accounting is common for all types of Equity Derivatives Instruments contract.
- ◆ Debit the amount paid/payable to an appropriate account (e.g. Initial Margin – Equity Derivative Instruments Account).
- ◆ Debit/Credit subsequent payments/receipts to the same account.
- ◆ Show the account with the balance separately under “Current Assets” in the balance sheet.
- ◆ Show separately the excess amount if any, paid, as deposit under Current Assets.
- ◆ Disclose separately in notes to financial statements, the outstanding Equity Derivative Instruments contracts at the year end in case payment is made otherwise than in cash.
- ◆ In case of lump sum deposits instead of payments/receipts on daily basis, debit the amount to an appropriate account (e.g. Deposit for Margin Money Account).
- ◆ Debit/credit the above account with the amount of initial margin received into/paid from it, crediting/debiting the ‘Initial Margin – Equity Derivative Instruments Account.’

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- ◆ Show the balance at the year end as a deposit under “Current Assets” in the balance sheet.

#### *Accounting for Equity Index Futures and Equity Stock Futures*

##### *Payment/Receipt of Mark-to-Market Margin:*

- ◆ Both parties to equity index/stock futures contract pay daily, mark-to-market margin in addition to initial margin.
- ◆ Clearing Member to pay to/collect from the Clearing House, the difference between the price at which the contract was bought or sold and the Daily Settlement price of that day, or the Settlement Price of the previous trading day and the Settlement Price of the contract at the end of the trading day, as the case may be.
- ◆ Paid only in cash.
- ◆ Credit/debit such payments/receipts of the client to the bank account, debiting/crediting the same to Mark-to-Market Margin – Equity Index Futures or Equity Stock Futures Account.
- ◆ Debit/Credit the Deposit for Margin Money Account and credit/debit the Mark-to-Market Margin Equity Index Futures/Equity Stock Futures Account, in case of lump sum deposits.

##### **Open Interests in Futures Contracts on balance sheet date**

- ◆ In the balance sheet show the debit balance in Mark-to-Market Margin Equity/Index Stock Futures Account as a current asset and a credit balance as a current liability.
- ◆ Maintain the above account Index-wise/Scripwise to determine the net amount paid/received on account of Mark-to-Market Margin on open futures contract on the balance sheet date.
- ◆ For a debit balance create a provision of anticipated loss for the same amount and ignore credit balance, if any, as per the ‘prudence’ principle.
- ◆ Credit the above provision to Provision for Loss on Equity Index/Stock Futures Account adjusting any opening balances and debit/credit the profit and loss account with the balance provision required to be made/excess provision written back.
- ◆ Show the above provision accounts as a deduction from Mark-to-Market Margin – Equity Index/Stock Futures Account, if it is shown as a current asset or else show the above provision accounts as provision on the liabilities side of the balance sheet.

##### *Final Settlement/Squaring – Up*

- ◆ Recognise profit/loss on the final settlement of the contracts in the series of equity index/stock futures, in the profit and loss account debiting/crediting the Mark-to-Market



Margin Equity Index/Stock Futures Account, being the amount of difference between the Final Settlement Price and contract prices of all the contracts in the series.

- ◆ Any party to an equity index/stock futures contract can at any time of the contract, square up its future obligations under the contract by entering into a reverse contract. The purchase and sale contracts offset each other.
- ◆ Follow the same accounting treatment for squared up contracts as in case of final settlement.
- ◆ Use weighted average method to calculate contract price in case of more than one contracts outstanding at the time of squaring up.

*Delivery settled stock futures contracts*

- ◆ At time of final settlement, securities are transferred in consideration for cash at the contract price and reflected in the books at original contract price.
- ◆ Debit/credit securities account for Long and Short futures contract (by contract price), crediting/debiting the Mark-to-Market Margin Equity Stock Futures Account and Cash/Bank Account.

*Default by the Client in Payment of Mark to Market Margin.*

- ◆ Contract is closed out and the amount not paid is adjusted against initial margin.
- ◆ Debit the Mark-to-Market Margin Equity Index/Stock Futures account with the amount so adjusted and credit the 'Initial Margin-Equity Derivative Instruments Account'.
- ◆ Where the initial margin falls short of unpaid mark-to market margin, create and show as a liability, the difference, under 'Current Liabilities and Provisions', if it continues to exist on the balance sheet date.
- ◆ Calculate and recognise any profit/loss on closed out contract as per methods for calculating profit/loss in case of final settlement and squared-up contracts.

*Accounting for Equity Index Options and Equity Stock Options*

*Payment/receipt of premium*

- ◆ Option buyer/holder required to pay Option Premium to Option Seller/Writer to acquire the right in options.
- ◆ Debit the amount to the Equity Index/Stock Option Premium Account in the books of the buyer/holder.
- ◆ Credit the amount to the Equity Index/Stock Option Premium Account in the books of the seller/writer.

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#### *Open Interests in Options Contracts on balance sheet date*

- ◆ Show the balance of the above Premium account under the head 'Current Assets' or 'Current Liabilities', in balance sheet.
- ◆ Follow same entries in case of multiple options and debit/credit the same for all options and also show the balance of this composite account similarly in the balance sheet.
- ◆ Create a provision in the books of buyer/holder for, premium paid for option less premium prevailing on balance sheet date. Ignore recognition of any negative difference.
- ◆ Credit the provision to 'Provision for Loss on Equity Index/Stock Option Account'.
- ◆ In the balance sheet show the provision as a deduction from the balance of Equity Index/Stock Option Premium account.
- ◆ Create a provision in the books of the seller/writer for premium prevailing on the balance sheet date less the premium received for the option, ignoring any negative difference.
- ◆ Credit the provision to Provision for Loss on Equity Index/Stock Option Account, debiting profit and loss account.
- ◆ In the balance sheet show the above Provision Account and Equity Stock Option Account under the head "Current Liabilities and Provisions".
- ◆ In case of multiple open options, at the year end, credit the Provision for Loss on Equity Index/Stock Options Account with composite amount of index-wise/scrip-wise provision required for all open options of any Strike Price and any Expiry Date under that index/scrip.
- ◆ Adjust any opening balance in the Provision for Loss on Equity Index/Stock Options Account with the current year provision and debit/credit profit and loss account with balance provision required/excess provision written back.
- ◆ For multiple open options, in the balance sheet show the Provision for Loss on Equity Index/Stock Options Account as a deduction from Equity Index/Stock Options Premium Account disclosed under the head 'Current Assets' or as a provision under the head 'Current Liabilities and Provisions', if the above Premium Account is disclosed as a current liability due to credit balance.

#### *Accounting at the time of final settlement*

##### *Index options and cash-settled stock option contracts*

##### *(a) In the books of the buyer/holder*

- ◆ Recognise premium as expense on exercising option.
- ◆ Debit profit and loss account and credit 'Equity Index/Stock Options Premium Account'.

- ◆ Recognise as income, the receipt of favourable difference (if any) between Final Settlement Price on Exercise/Expiry Date and Strike Price.

*(b) In the books of the seller/writer*

- ◆ Recognise premium as income on exercising option.
- ◆ Credit profit and loss account and debit 'Equity Index/Stock Option Premium Account.
- ◆ Recognise as loss, the payment of adverse difference (if any) between the Final Settlement Price as on the Exercise/Expiry Date and Strike Price.

*Delivery –settled stock options contracts*

- ◆ Accounting treatment for options expiring unexercised will be same as for cash-settled options. In case options are exercised, securities are transferred in consideration for cash at Strike Price. Accounting treatment shall be as follows:-

*(a) In the books of buyer/holder*

- ◆ Call option: debit relevant security account and credit cash/bank account for receiving security for which call option entered.
- ◆ Put Option: debit cash/bank account and credit relevant security account for delivery of security for which put option entered.
- ◆ Pass the same accounting entries for premium paid as in case of cash settled options.

*(b) In the books of seller/writer*

- ◆ Call Option: credit relevant security account and debit cash/bank account for delivery of security for which call option entered.
- ◆ Put Option: credit cash/bank account and debit the relevant security account for receiving security for which put option entered.
- ◆ Pass same accounting entries for premium received as in case of cash settled options.

*Accounting at the time of squaring-up of an option contract*

- ◆ Transfer the difference between the premium paid and premium received after adjusting the brokerage charged (on squared-up transaction), to the profit and loss account.

**Determination of profit/loss in multiple options**

- ◆ In case of outstanding multiple options of same scrip/index with same Strike Price and same Expiry Date, follow weighted average method on squaring up of transactions.

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- ◆ In case of multiple equity stock options of same scrip with same Strike Price and Same Expiry Date, follow weighted average method where such option(s) is/are exercised before the Expiry Date.

#### **Disclosure**

Apart from the disclosures already mentioned, the following other disclosures are required to be made under the guidance note:

- ◆ Enterprise to disclose the accounting policies and methods adopted, recognition criteria and basis of measurement applied for various Equity Derivative Instruments.
- ◆ Disclose amount of bank guarantee/book value and market-value of securities in respect of outstanding Equity Derivative Instruments contracts at the year end, separately for each type of instrument, where initial margin is not paid in cash.
- ◆ Enterprise to give details of futures contracts outstanding at the year end (open interests) for each Equity Index/Stock Futures.
- ◆ Buyer/holder and the seller/writer of the option to give details for outstanding option contracts at the year end for each Equity Index/Stock Option.

(All open index/stock futures interests/options should be added together irrespective of the contract price and series/Strike Price and Expiry Date for each equity index/stock for disclosure).

#### **30.4.14 GN(A) 18 (Issued 2005)Guidance Note on Accounting for Employee Share-based Payments**

Recognising the need for establishing uniform sound accounting principles and practices for all types of share-based payments, the Accounting Standards Board of the Institute is developing an Accounting Standard covering various types of share-based payments including employee share-based payments. However, as the formulation of the Standard is likely to take some time, the Institute has decided to bring out this Guidance Note. Once the Accounting Standard dealing with Share-based Payments comes into force, this Guidance Note will automatically stand withdrawn.

This Guidance Note establishes financial accounting and reporting principles for employee share-based payment plans, viz., employee stock option plans, employee stock purchase plans and stock appreciation rights. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

For accounting purposes, employee share-based payment plans are classified into the following categories:

- ◆ Equity-settled: Under these plans, the employees receive shares.
- ◆ Cash-settled: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.

- ◆ Employee share-based payment plans with cash alternatives: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

An employee share-based payment plan falling in the above categories can be accounted for by adopting the fair value method or the intrinsic value method. The accounting treatment recommended here in below is based on the fair value method.

An enterprise should recognise as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in this Guidance Note. If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognise services received in full with a corresponding credit to the equity account. If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.

An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted (subject to the requirements of paragraphs 9 to 11). If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognised for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognised for employee services received if the shares or stock

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options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied.

To apply the requirements of the Guidance Note, the enterprise should recognise an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest. Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, should be taken into account when estimating the fair value of the shares or stock options granted. On exercise of the right to obtain shares or stock options, the enterprise issues shares on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.

For cash-settled employee share-based payment plans, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognised in profit or loss for the period.

For employee share-based payment plans in which the terms of the arrangement provide either the enterprise or the employee with a choice of whether the enterprise settles the transaction in cash or by issuing shares, the enterprise is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment plan if, and to the extent that, the enterprise has incurred a liability to settle in cash (or other assets), or as an equity-settled share-based payment plan if, and to the extent that, no such liability has been incurred.

Accounting for employee share-based payment plans is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share-based payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, *mutatis mutandis*, in place of the fair value as described in paragraphs 5 to 14.

Apart from the above, the Guidance Note also deals with various other significant aspects of the employee share-based payment plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, reload feature, graded vesting, earnings-per-share implications, accounting for employee share-based payments

administered through a trust, etc. The Guidance Note also recommends detailed disclosure requirements. The appendices to the Guidance Note provide detailed guidance on measurement of fair value of shares and stock options, including determination of various inputs to the option-pricing models and examples to illustrate application of various principles recommended in the Guidance Note.

#### **30.4.15 GN(A) 20 (Issued 2005) Guidance Note on Accounting for-Fringe Benefits Tax**

Tax-revenue is the most important instrument for ensuring social justice, both in equitably distributing the burden of development, as also in reducing inequalities of incomes. Compared to other sources such as borrowing and deficit financing, it is preferable because, unlike borrowing, it involves no interest burden, and unlike deficit financing, it does not result in rise in prices. In the recent years the Government has undertaken major reforms of the tax-system of the country. As another step in this direction, the Finance Act, 2005, has introduced Chapter XII-H on 'Income-tax on Fringe Benefits' in the Income-tax Act, 1961. With the introduction of Fringe Benefits Tax, the profession of Chartered Accountants is placed with the responsibility of ensuring proper financial reporting of the tax. Since the Fringe Benefits Tax has raised issues of accounting, I am happy that the Research Committee of the Institute has formulated this Guidance Note on Accounting for Fringe Benefits Tax which has been issued under the authority of the Council of the ICAI. The Fringe Benefits Tax is an additional tax to be paid by an employer in addition to the income-tax payable for every assessment year starting from the assessment year 2006-07. The tax is to be paid in respect of the fringe benefits provided or deemed to have been provided by an employer to his employees. Fringe Benefits Tax is a new law and as is the case with any new law, many issues arise not only in respect of its interpretation and application but also with regard to accounting for the tax for the purpose of preparation of financial statements. The Guidance Note deals with accounting for Fringe Benefits Tax, particularly with regard to the recognition and presentation of the Fringe Benefits Tax in the financial statements. An employer becomes liable to pay Fringe Benefits Tax as soon as it incurs an expense which is considered to be a fringe benefit as per the requirements of Chapter XII-H of the Income-tax Act, 1961, even though the actual payment of the tax and/or assessment of the tax takes place on a later date. Accordingly, the employer should recognise, in the financial statements for the period, expense for the Fringe Benefits Tax paid/payable in respect of all expenses giving rise to such tax incurred during that period. The employer should, therefore, measure the amount of the Fringe Benefits Tax keeping in view the aforesaid provisions of the Act. Since the Fringe Benefits Tax is an additional tax for the employer, it should be included in the determination of net profit or loss for the period, i.e., the Fringe Benefits Tax, should be charged to the profit and loss account. In the context of presentation of the Fringe Benefits Tax in the profit and loss account of companies, the Fringe Benefits Tax should be disclosed as a separate item after determining profit before tax on the face of the profit and loss account for the period in which the related fringe benefits are recognised. The amount of the Fringe Benefits Tax (net of the advance tax thereon), outstanding if any, at the year-end, should be disclosed as a provision in the balance sheet.

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#### **30.4.16 GN(A) 22 (Issued 2006) Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax under the Income-tax Act, 1961**

The Finance Act, 2005, inserted sub-section (1A) to section 115JAA, to grant tax credit in respect of MAT paid under section 115JB of the Act with effect from assessment year 2006-07. This Guidance Note deals with various aspects of accounting and presentation of MAT paid and the credit available in this regard. The Guidance Note describes the salient features of MAT credit and its accounting treatment. MAT credit should be recognised as an asset only when and to the extent there is convincing evidence that the company will pay normal income tax during the specified period. MAT credit is a deferred tax asset for the purposes of AS 22. A company should write down the carrying amount of the MAT credit asset to the extent there is no longer a convincing evidence to the effect that the company will pay normal income tax during the specified period. Where a company recognises MAT credit as an asset on the basis of the considerations specified in the guidance note, the same should be presented under the head 'Loans and Advances' since, there being a convincing evidence of realisation of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'. In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph the guidance note. According to paragraph 6 of Accounting Standards Interpretation (ASI)6, 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognised as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein.

### **30.5 MISCELLANEOUS ILLUSTRATIONS**

#### **Illustration 1**

While executing a new project, the company had to pay Rs. 50 lakhs to the State Government as part of the cost of roads built by the State Government in the vicinity of the project for the purpose of carrying machinery and materials to the project site. The road so built is the property of the State Government. Advise the company on the following item while from the view point of finalisation of accounts.

#### **Solution**

In this case, the capital expenditure incurred by the company would not be represented by any actual assets, since the roads would remain the property of the relevant State authorities even though a part of their cost has been defrayed by the company in order to facilitate its business.



Having regard to the nature of the expenditure and the purpose for which it is incurred, it is suggested in para 10 of Guidance Note on Treatment of Expenditure During Construction Period that it would be more appropriate and realistic to classify such expenditure in the balance sheet under the heading of "Capital Expenditure" rather than either, write-off the expenditure to revenue or classify the expenditure under the heading of "Miscellaneous Expenditure" or "Deferred Revenue Expenditure" subject to two conditions. In the first place, the description of the specific item on the balance sheet should be such as to indicate quite clearly that the capital expenditure is not represented by any assets owned by the company. In the second place, the capital expenditure should be written off over the approximate period of its utility or over a relatively brief period not exceeding five years, whichever is less.

### Illustration 2

HSL Ltd. is manufacturing goods for local sale and exports. As on 31st March, 2005, it has the following finished stocks in the factory warehouse:

- (i) Goods meant for local sale Rs. 100 lakhs (cost Rs. 75 lakhs).
- (ii) Goods meant for exports Rs. 50 lakhs (cost Rs. 20 lakhs).

Excise duty is payable at the rate of 16%. The company's Managing Director says that excise duty is payable only on clearance of goods and hence is not a cost. Please advise HSL using guidance note, if any issued on this, including valuation of stock.

### Solution

Guidance Note on Accounting Treatment for Excise Duty says that excise duty is a duty on manufacture or production of excisable goods in India.

According to Central Excise Rules, 2002, excise duty should be collected at the time of removal of goods from factory premises or factory warehouse. The levy of excise duty is upon the manufacture or production, the collection part of it is shifted to the stage of removal.

Further, paragraph 23(i) of the Guidance Note makes it clear that excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation.

Therefore, in the given case of HSL Ltd., the Managing Director's contention that "excise duty is payable only on clearance of goods and hence is not a cost is incorrect. Excise duty on the goods meant for local sales should be provided for at the rate of 16% on the selling price, that is, Rs. 100 lakhs for valuation of stock.

Excise duty on goods meant for exports, should be provided for, since the liability for excise duty arises when the manufacture of the goods is completed. However, if it is assumed that all the conditions specified in Rule 19 of the Central Excise Rules, 2002 regarding export of excisable goods without payment of duty are fulfilled by HSL Ltd., excise duty may not be provided for.

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#### **Illustration 3**

SFL Ltd. is a mutual fund. The fund values the investment on “mark to market basis”. The Accountant argues since investment are valued on the above basis there is no necessity to disclose depreciation separately in the financial statements. Do you agree?

#### **Solution**

The Guidance Note on Accounting for Investments in the Financial statements of Mutual Funds provides that the investments should be marked to market on the balance sheet date. The provision for depreciation in the value of investments should be made in the books by debiting the Revenue Account. The provision so created should be shown as a deduction from the value of investments in the balance sheet. Clause 2(i) of the Eleventh Schedule provides that “where the financial statements are prepared on a mark to market basis, there need not be a separate provision for depreciation.” However keeping in view, ‘prudence’ as a factor for preparation of financial statements and correct disclosure of the amount of depreciation on investments, the guidance note recommends that the gross value of depreciation on investments should be reflected in the Revenue Account rather than the same being netted off with the appreciation in the value of other investments. In other words, depreciation/appreciation on investments should be worked out on an individual investment basis or by category of investment basis, but not on an overall basis or by category of investment.

In the given case of SFL Ltd., depreciation should be separately disclosed in the financial statements.

#### **Illustration 4**

A company has given counter guarantees of Rs. 2.25 crores to various banks in respect of the guarantees given by the said banks in favour of Government authorities. Outstanding counter guarantees as at the end of financial year 2003-2004 were Rs. 1.95 crores. How should this information be shown in the Financial Statements of the Company.

#### **Solution**

The counter guarantee given by the company is, infact, an undertaking to perform what is, in any event, the obligation of the company itself. In any case, this is a matter which is in the control of the company itself and the mere possibility of a default by the company in the future cannot be said to involve the existence of a contingent liability on the balance sheet date.

Thus, as per ‘Guidance Note on Guarantees and Counter-Guarantees given by Companies’, no separate disclosure is required in respect of counter guarantees.

#### **Illustration 5**

A factory went into commercial production on 1st April, 2006. It uses as its raw materials product X on which excise duty of Rs. 30 per Kg. is paid and product Y on which excise duty of Rs. 20 per kg. is paid. On 31st March, 2006 it had stock of 20,000 kgs. of X and 15,000 kgs. of Y which it had

purchased at an all inclusive price of Rs. 150 per kg. for X and Rs. 120 per kg. for Y. The suppliers of X and Y are to receive payment on 15th May, 2006.

During April 2006, the factory manufactured 40,000 units of the end product for which the consumption of material X was 60,000 kgs. and material Y was 45,000 kgs. The excise duty on the end product is Rs. 60 per unit. 30,000 units of the end product were dispatched, 8,000 units were kept in warehouse and balance 2,000 kgs. were kept in finished goods godown.

During the month the factory purchased 50,000 kgs. of X at Rs. 145 per kg. (inclusive of excise duty of Rs. 30 per kg.) on credit of 60 days and 50,000 kgs. of Y at Rs. 110 per kg. (inclusive of excise duty of Rs. 20 per kg.) on credit of 45 days.

The cost of "converting" the raw materials into finished product amounts to Rs. 150 per unit of end product of which Rs. 100 is "cash cost" paid immediately and Rs. 50 represents non-cash charge for depreciation. There is no work in process.

Sales are effected at Rs. 750 per unit in respect of credit transactions and at Rs. 700 per unit in respect of cash transactions. 20% of despatches were in respect of cash transactions while the balance 80% were in respect of credit transactions (one month credit).

You are required to:

- (a) (i) Calculate modvat credit available, modvat credit availed of and balance in modvat credit as on 30th April, 2006.
- (ii) Show the necessary ledger accounts in respect of modvat. (3 + 2 = 5 marks)
- (b) Value the inventory of:
  - (i) raw material
  - (ii) finished goods in warehouse
  - (iii) finished goods in finished goods godown on "first in first out" principle.
- (c) Show the ledger accounts of customers, suppliers and bank, assuming that the necessary bank balance is available at the start of the month to meet "cash" expenses of that month.
- (d) Calculate the working capital as on 30th April, 2006.
- (e) State the impact of 'modvat' on working capital requirement of the factory as on 30th April, 2006.

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#### Solution

(a) (i) Excise duty paid on raw materials:

|                           |        | X   |                  |        | Y   |                  | Total            |
|---------------------------|--------|-----|------------------|--------|-----|------------------|------------------|
|                           | Kgs.   | @   | Amount           | Kgs.   | @   | Amount           | Amount           |
|                           |        | Rs. | Rs.              |        | Rs. | Rs.              | Rs.              |
| Stock on 31st March, 1997 | 20,000 | 30  | 6,00,000         | 15,000 | 20  | 3,00,000         | 9,00,000         |
| Purchases                 | 50,000 | 30  | <u>15,00,000</u> | 50,000 | 20  | <u>10,00,000</u> | <u>25,00,000</u> |
|                           |        |     | <u>21,00,000</u> |        |     | <u>13,00,000</u> | <u>34,00,000</u> |

Modvat credit available:

$$\text{Rs. } 21,00,000 + 13,00,000 = \text{Rs. } 34,00,000$$

Modvat credit available of:

$$\text{Production} = 40,000 \text{ units}$$

$$\text{Excise duty on the end product} = \text{Rs. } 60 \text{ per unit}$$

$$\text{Modvat credit availed of} = 40,000 \times 60 = \text{Rs. } 24,00,000$$

$$\text{Balance in Modvat credit } 34,00,000 - 24,00,000 = \text{Rs. } 10,00,000$$

**Note:** Normally goods are removed from factory on payment of excise duty. However, in respect of certain goods, provision has been made to store the goods in warehouses without payment of duty (Rule 20 of Central Excise Rules, 2002). These provisions are also applicable to goods transferred to customs warehouse.

It is to be noted that as per para 33 of The Guidance Note on Accounting Treatment for Excise Duty, it is necessary that a provision for liability in respect of unpaid excise duty should be made in the accounts in respect of stocks lying in the factory or warehouse since the liability for excise duty arises when the manufacture of the goods is completed.

#### (ii) Modvat Credit Receivable Account

|         |    |             |                 |          |          |                 |             |
|---------|----|-------------|-----------------|----------|----------|-----------------|-------------|
| Dr.     |    |             |                 | Cr.      |          |                 |             |
| 2006    |    |             |                 | 2006     |          |                 |             |
|         |    |             |                 |          |          |                 |             |
| April 1 | To | Balance b/d |                 | April    | By       | Excise Duty A/c | 24,00,000   |
|         |    | X           | 6,00,000        |          |          |                 |             |
|         |    | Y           | <u>3,00,000</u> |          |          |                 |             |
|         |    |             |                 | 9,00,000 | April 31 | By              | Balance c/d |
|         |    |             |                 |          |          |                 | 10,00,000   |

|       |    |               |                  |                  |
|-------|----|---------------|------------------|------------------|
| April | To | Suppliers A/c |                  |                  |
|       |    | X             | 15,00,000        |                  |
|       |    | Y             | <u>10,00,000</u> |                  |
|       |    |               | <u>25,00,000</u> |                  |
|       |    |               | <u>34,00,000</u> | <u>34,00,000</u> |

**PURCHASES ACCOUNT**

|            |    |                                 |                    |          |    |                    |
|------------|----|---------------------------------|--------------------|----------|----|--------------------|
| <i>Dr.</i> |    |                                 |                    |          |    | <i>Cr.</i>         |
| 2006       |    |                                 |                    | 2006     |    |                    |
| April      | To | Suppliers A/c                   |                    | April 31 | By | Balance c/d        |
|            |    | X: $[50,000 \times (145 - 30)]$ | 57,50,000          |          |    | 1,02,50,000        |
|            |    | Y: $[50,000 \times (110 - 20)]$ | <u>45,00,000</u>   |          |    |                    |
|            |    |                                 | <u>1,02,50,000</u> |          |    | <u>1,02,50,000</u> |

**(b) Valuation of Inventory****(i) Raw material:**

|                                | X             | Y                |
|--------------------------------|---------------|------------------|
|                                | (Kgs.)        | (Kgs.)           |
| Opening stock                  | 20,000        | 15,000           |
| Purchases                      | <u>50,000</u> | <u>50,000</u>    |
|                                | 70,000        | 65,000           |
| Consumption                    | <u>60,000</u> | <u>45,000</u>    |
| Closing stock                  | <u>10,000</u> | <u>20,000</u>    |
| Inventory:                     |               | Rs.              |
| X : $10,000 \times (145 - 30)$ |               | 11,50,000        |
| Y : $20,000 \times (110 - 20)$ |               | <u>18,00,000</u> |
|                                |               | <u>29,50,000</u> |

**(ii) Finished goods in warehouse**

|                                             |                 | Rs.       |
|---------------------------------------------|-----------------|-----------|
| Raw material cost of 80,000 units of output |                 |           |
| X : $12,000^* \times (145 - 30)$            | 13,80,000       |           |
| Y : $9,000^* \times (110 - 20)$             | <u>8,10,000</u> | 21,90,000 |
| Conversion cost                             |                 |           |

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|                                            |                 |                  |
|--------------------------------------------|-----------------|------------------|
| Cash cost : $8,000 \times \text{Rs. } 100$ | 8,00,000        |                  |
| Non-cash : $8,000 \times \text{Rs. } 50$   | <u>4,00,000</u> | 12,00,000        |
| Excise duty                                |                 |                  |
| $8,000 \times \text{Rs. } 60$              |                 | <u>4,80,000</u>  |
|                                            |                 | <u>38,70,000</u> |

\* For 40,000 units of output,

input of X = 60,000 Kgs.

input of Y = 45,000 Kgs.

Therefore, for 8,000 units of finished goods in warehouse:

$$\text{Input of X} = \frac{60,000}{40,000} \times 8,000 = 12,000 \text{ Kgs.}$$

$$\text{Input of Y} = \frac{45,000}{40,000} \times 8,000 = 9,000 \text{ Kgs.}$$

(iii) Finished goods in finished goods godown

|                                                                |           |
|----------------------------------------------------------------|-----------|
|                                                                | Rs.       |
| Cost of 8,000 units of finished goods in warehouse             | 38,70,000 |
| Cost of 2,000 units of finished goods in finished goods godown |           |
| $= \frac{38,70,000}{8,000} \times 2,000 =$                     | 9,67,500  |

(c)

#### Customers Account

| Dr. |                                                                    | Rs.                |    | Cr.                |
|-----|--------------------------------------------------------------------|--------------------|----|--------------------|
|     |                                                                    |                    |    | Rs.                |
| To  | Sales A/c $\left( \frac{80}{100} \times 30,000 \times 750 \right)$ | 1,80,00,000        | By | Balance c/d        |
|     |                                                                    | <u>1,80,00,000</u> |    | <u>1,80,00,000</u> |

#### Suppliers Account

|    |             | Rs.         |    | Rs.                                                         |
|----|-------------|-------------|----|-------------------------------------------------------------|
| To | Balance c/d | 1,75,50,000 | By | Balance b/d                                                 |
|    |             |             |    | X : $20,000 \times \text{Rs. } 150 = 30,00,000$             |
|    |             |             |    | Y : $15,000 \times \text{Rs. } 120 = \underline{18,00,000}$ |
|    |             |             |    | 48,00,000                                                   |
|    |             |             | By | Purchases A/c                                               |
|    |             |             | By | Modvat Credit Receivable A/c                                |
|    |             |             |    | 1,02,50,000                                                 |

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$$X : 50,000 \times 30 = 15,00,000$$

$$Y : 50,000 \times 20 = \underline{10,00,000}$$

|                    |                    |
|--------------------|--------------------|
|                    | <u>25,00,000</u>   |
| <u>1,75,50,000</u> | <u>1,75,50,000</u> |

*Bank Account*

|                                                                                                   | Rs.              |                                 | Rs.              |
|---------------------------------------------------------------------------------------------------|------------------|---------------------------------|------------------|
| To Balance b/d                                                                                    | 40,00,000        | By Cash Expenses (40,000 × 100) | 40,00,000        |
| To Sales (cash sales) A/c<br>$\left( \frac{20}{100} \times 30,000 \times \text{Rs. } 700 \right)$ | 42,00,000        | By Balance c/d                  | 42,00,000        |
|                                                                                                   | <u>82,00,000</u> |                                 | <u>82,00,000</u> |

**(d) Working Capital as on 30th April, 2006**

Current Assets:

Inventory

|                                  |                  |                    |
|----------------------------------|------------------|--------------------|
| (i) Raw materials                |                  |                    |
| X                                | 11,50,000        |                    |
| Y                                | <u>18,00,000</u> | 29,50,000          |
| (ii) Finished goods in warehouse | 38,70,000        |                    |
| in finished goods godown         | <u>9,67,500</u>  | 48,37,500          |
| Customers                        |                  | 1,80,00,000        |
| Bank balance                     |                  | 42,00,000          |
| Modvat credit receivable         |                  | <u>10,00,000</u>   |
|                                  |                  | 3,09,87,500        |
| Less: Current Liabilities        |                  |                    |
| Sundry creditors                 |                  | <u>1,75,50,000</u> |
|                                  |                  | <u>1,34,37,500</u> |

**(e) Impact of Modvat on Working Capital Requirement**

Modvat has enabled

- (i) dispatch on sale of 30,000 units of finished product,
- (ii) removal of 10,000 units of finished product,

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without payment of a single rupee in cash. Cash outlay so saved at Rs. 60 per unit is Rs. 24,00,000.

It has also ensured creation of a current asset worth Rs. 10,00,000 in Modvat Credit Receivable Account.

Thus MODVAT reduces the pressure on working capital.

#### Illustration 6

On 24<sup>th</sup> January, 2006 Chinnaswamy of Chennai sold goods to Watson of Washington, U.S.A. for an invoice price of \$40,000 when the spot market rate was Rs.44.20 per US \$. Payment was to be received after three months on 24<sup>th</sup> April, 2006. To mitigate the risk of loss from decline in the exchange-rate on the date of receipt of payment, Chinnaswamy immediately acquired a forward contract to sell on 24<sup>th</sup> April, 2006 US \$ 40,000 @ Rs.43.70. Chinnaswamy closed his books of account on 31<sup>st</sup> March, 2006 when the spot rate was Rs.43.20 per US \$. On 24<sup>th</sup> April, 2006, the date of receipt of money by Chinnaswamy, the spot rate was Rs.42.70 per US \$.

Pass journal entries in the books of Chinnaswamy to record the effect of all the above mentioned effects.

#### Solution

| (c)      |                                                                                                                       | Journal Entries in the books of Chinnaswamy |           |     |           |
|----------|-----------------------------------------------------------------------------------------------------------------------|---------------------------------------------|-----------|-----|-----------|
| 2006     |                                                                                                                       |                                             |           | Rs. | Rs.       |
| Jan. 24  | Watson                                                                                                                | Dr.                                         | 17,68,000 |     |           |
|          | To Sales Account                                                                                                      |                                             |           |     | 17,68,000 |
|          | (Credit sales made to Watson of Washington, USA for \$40,000 recorded at spot market rate of Rs.44.20 per US \$)      |                                             |           |     |           |
| " "      | Forward (Rs.) Contract Receivable Account                                                                             | Dr.                                         | 17,48,000 |     |           |
|          | Deferred Discount Account                                                                                             | Dr.                                         | 20,000    |     |           |
|          | To Forward (\$) Contract Payable                                                                                      |                                             |           |     | 17,68,000 |
|          | (Forward contract acquired to sell on 24 <sup>th</sup> April, 2006 US \$40,000 @ Rs.43.70)                            |                                             |           |     |           |
| March 31 | Exchange Loss Account                                                                                                 | Dr.                                         | 40,000    |     |           |
|          | To Watson                                                                                                             |                                             |           |     | 40,000    |
|          | (Record of exchange loss @ Re.1 per \$ due to market rate becoming Rs.43.20 per US \$ rather than Rs.44.20 per US \$) |                                             |           |     |           |



|          |   |                                                                                                     |     |           |           |
|----------|---|-----------------------------------------------------------------------------------------------------|-----|-----------|-----------|
| "        | " | Forward (\$) Contract Payable                                                                       | Dr. | 40,000    |           |
|          |   | To Exchange Gain Account                                                                            |     |           | 40,000    |
|          |   | (Decrease in liability on forward contract due to fall in exchange rate)                            |     |           |           |
| "        | " | Discount Account                                                                                    | Dr. | 14,667    |           |
|          |   | To Deferred Discount Account                                                                        |     |           | 14,667    |
|          |   | (Record of proportionate discount expense for 66 days out of 90 days)                               |     |           |           |
| April 24 |   | Bank Account                                                                                        | Dr. | 17,08,000 |           |
|          |   | Exchange Loss Account                                                                               | Dr. | 20,000    |           |
|          |   | To Watson                                                                                           |     |           | 17,28,000 |
|          |   | (Receipt of \$40,000 from Watson, USA customer @ Rs.42.70 per US \$; exchange loss being Rs.20,000) |     |           |           |
| "        | " | Forward (\$) Contract Payable Account                                                               | Dr. | 17,28,000 |           |
|          |   | To Exchange Gain Account                                                                            |     |           | 20,000    |
|          |   | To Bank Account                                                                                     |     |           | 17,08,000 |
|          |   | (Settlement of forward contract by payment of \$40,000)                                             |     |           |           |
| "        | " | Bank Account                                                                                        | Dr. | 17,48,000 |           |
| "        | " | To Forward (Rs.) Contract Receivable                                                                |     |           | 17,48,000 |
|          |   | (Receipt of cash in settlement of forward contract receivable)                                      |     |           |           |
| "        | " | Discount Account                                                                                    | Dr. | 5,333     |           |
|          |   | To Deferred Discount Account                                                                        |     |           | 5,333     |
|          |   | (Recording of discount expense for 24 days:                                                         |     |           |           |
|          |   | $\text{Rs.20,000} \times \frac{24 \text{ days}}{90 \text{ days}} = \text{Rs.5,333}$ )               |     |           |           |

**Illustration 7**

A Company has its share capital divided into shares of Rs. 10 each. On 1st April, 2004 it granted 10,000 employees' stock options at Rs. 40, when the market price was Rs. 130. The options were to be exercised between 16th December, 2004 and 15th March, 2005. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year.

Show Journal Entries.

### 1.340 Financial Reporting

#### Solution

| Journal Entries         |                                                                                                                                                  |     |            |            |
|-------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------|-----|------------|------------|
|                         | Particulars                                                                                                                                      |     | Dr.<br>Rs. | Cr.<br>Rs. |
| 2004                    |                                                                                                                                                  |     |            |            |
| April 1                 | Employee Compensation Expense                                                                                                                    | Dr. | 9,00,000   |            |
|                         | To Employee Stock Options Outstanding                                                                                                            |     |            | 9,00,000   |
|                         | (Being grant of 10,000 stock options to employees at Rs. 40 when market price is Rs. 130)                                                        |     |            |            |
| 2005                    |                                                                                                                                                  |     |            |            |
| 16th Dec. to 15th March | Bank                                                                                                                                             | Dr. | 3,80,000   |            |
|                         | Employee stock options outstanding                                                                                                               | Dr. | 8,55,000   |            |
|                         | To Equity share capital                                                                                                                          |     |            | 95,000     |
|                         | To Securities premium                                                                                                                            |     |            | 11,40,000  |
|                         | (Being allotment to employees of 9,500 equity shares of Rs. 10 each at a premium of Rs. 120 per share in exercise of stock options by employees) |     |            |            |
| March 16                | Employee stock options outstanding                                                                                                               | Dr. | 45,000     |            |
|                         | To Employee compensation expense                                                                                                                 |     |            | 45,000     |
|                         | (Being entry for lapse of stock options for 500 shares)                                                                                          |     |            |            |
| March 31                | Profit and Loss A/c                                                                                                                              | Dr. | 8,55,000   |            |
|                         | To Employee compensation expense                                                                                                                 |     |            | 8,55,000   |
|                         | (Being transfer of employee compensation expense to profit and loss account)                                                                     |     |            |            |

#### Illustration 8

Mr. Investor buys a stock option of ABC Co. Ltd. in July, 2006 with a strike price Rs. 250 to be expired on 30<sup>th</sup> August, 2006. The premium is Rs. 20 per unit and the market lot is 100. The

margin to be paid is Rs. 120 per unit.

Show the accounting treatment in the books of Buyer when:

- (i) the option is settled by delivery of the asset, and
- (ii) the option is settled in cash and the Index price is Rs. 260 per unit.

### Solution

Accounting entries in the books of buyer

|              |                                                         |     |        |        |
|--------------|---------------------------------------------------------|-----|--------|--------|
| July, 2006   | Equity stock option premium Account                     | Dr. | 2,000  |        |
|              | To Bank Account                                         |     |        | 2,000  |
|              | <u>(Being premium paid to acquire stock option)</u>     |     |        |        |
|              | Equity Stock Option Margin Account                      | Dr. | 12,000 |        |
|              | To Bank Account                                         |     |        | 12,000 |
|              | <u>(Being initial margin paid on option)</u>            |     |        |        |
|              | <u>(i) Option is settled by delivery of assets</u>      |     |        |        |
| August, 2006 | Equity shares of ABC Ltd. Account                       | Dr. | 25,000 |        |
|              | To Equity Stock Option Margin Account                   |     |        | 12,000 |
|              | To Bank Account                                         |     |        | 13,000 |
|              | <u>(Being option exercised and shares acquired.</u>     |     |        |        |
|              | <u>Margin adjusted and the balance amount was paid)</u> |     |        |        |
|              | Profit and loss Account                                 | Dr. | 2,000  |        |
|              | To Equity Stock Option Premium Account                  |     |        | 2,000  |
|              | <u>(Being the premium transferred to profit and</u>     |     |        |        |
|              | <u>loss account on exercise of option)</u>              |     |        |        |
|              | Bank Account                                            | Dr. | 12,000 |        |
|              | To Equity Stock Option Margin Account                   |     |        | 12,000 |
|              | <u>( Being margin on equity stock option</u>            |     |        |        |
|              | <u>received back on exercise /expiry of option)</u>     |     |        |        |

### Self-examination Questions

1. Summarise the recommendations of the Institute of Chartered Accountants of India regarding accounting treatment of excise duty.

### 1.342 Financial Reporting

2. Write a short note on accounting of income during construction period.
3. Explain the methods of accounting for changing prices in brief.
4. What is corporate dividend tax (CDT)? Explain the disclosure and presentation requirements of CDT.
5. What is meant by Securitisation? Explain the following terms :
  - (i) Call option.
  - (ii) Interest scrip.
  - (iii) Servicing asset.
6. Explain the accounting for equity index futures and equity stock futures.
7. Describe the procedure of accounting at the time of exercise or expiry of the vested options.
8. Explain the concept of fringe benefits tax. Describe the presentation of fringe benefits tax in the financial statements in brief.
9. A Ltd. took a forward cover against USD 5 lakhs to be paid at the end of the January, 2005 as on October, 2004 when the spot rate was Rs. 46.40 and forward rate was Rs. 46.90. What is the treatment of additional money spent on forward cover, if the company closes its books on 31<sup>st</sup> March of every year?
10. How is the difference between forward rate and exchange rate recognized on the date of transaction in a forward contract?
11. Can bonus shares be issued by capitalization of reserves?
12. How would guarantee be disclosed in the accounts of a company receiving guarantee?
13. On the basis of the following information related to trading in Options, you are required to pass relevant Journal Entries (at the time of inception and at the time of final settlement) in the books of Mr. Ramaswami (Buyer) and Mrs. Sharda (Seller). Assume that the price on expiry is Rs.950/- and both Mr. Ramaswami and Mrs. Sharda follow the calendar year as an accounting year.

| <i>Date of Purchase</i> | <i>Option type</i> | <i>Expiry Date</i> | <i>Premium per Unit</i> | <i>Contract Multiplier</i> | <i>Strike Price</i> |
|-------------------------|--------------------|--------------------|-------------------------|----------------------------|---------------------|
| 29.3.2006               | Equity Index, Call | 31.5.2006          | Rs.10                   | 200                        | Rs.850              |

# **INTERNATIONAL ACCOUNTING STANDARDS, INTERNATIONAL FINANCIAL REPORTING STANDARDS, THEIR INTERPRETATIONS AND US GAAPs - AN OVERVIEW**

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## **1. INTRODUCTION**

In today's complex economic environment, the measurement and presentation of financial information is critical as far as allocation of economic resources is concerned. Accounting was created as a mean of measuring and reporting upon such economic activity. Throughout the world, various accounting bodies are engaged in the task of formulating and implementing accounting policies and practices to show true and fair view of the financial statements, which are the basis of decision-making.

Accounting as a language of business communicates the financial results of an enterprise to various interested parties by means of financial statements exhibiting true and fair view of its state of affairs as also of the working results. Like any other language, accounting has its own set of rules, which have been developed by accounting bodies. These rules cannot be absolutely rigid like those of the physical sciences. These rules, accordingly, do provide a reasonable degree of flexibility in line with the economic environment, social needs, legal requirements and technological developments. This however, does not imply that accounting principles and practices can be applied arbitrarily. Accounting principles have to operate within the bounds of rationality. This could, perhaps, be considered as a genesis for setting the accounting standards.

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance. The Accounting Standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby

## **2.2 Financial Reporting**

ensuring comparability of financial statements of different enterprises. The Accounting Standards deal with the issues of (i) recognition of events and transactions in the financial statements, (ii) measurement of these transactions and events, (iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader, and (iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

Accounting Standards standardize diverse accounting policies with a view to eliminate, to the maximum possible extent, (i) the non-comparability of financial statements and thereby improving the reliability of financial statements, and (ii) to provide a set of standard accounting policies, valuation norms and disclosure requirements.

The last decade has witnessed a sea change in the global economic scenario. The emergence of transnational corporations in search of money, not only for fuelling growth, but to sustain on going activities has necessitated raising of capital from all parts of the world, cutting across frontiers. Each country has its own set of rules and regulations for accounting and financial reporting. Therefore, when an enterprise decides to raise capital from the markets other than the country in which it is located, the rules and regulations of that other country will apply and this in turn will require that the enterprise is in a position to understand the differences between the rules governing financial reporting in the foreign country as compared to its own country of origin. Therefore translation and re-instatements are of utmost importance in a world that is rapidly globalising in all ways. In themselves also, the accounting standards and principle need to be robust so that the larger society develops degree of confidence in the financial statements, which are put forward by organizations.

## **2. INTERNATIONAL ACCOUNTING STANDARD BOARD**

With a view of achieving these objectives, the London based group namely the International Accounting Standards Committee (IASC), responsible for developing International Accounting Standards, was established in June, 1973. It is presently known as International Accounting Standards Board, The IASC comprises the professional accountancy bodies of over 75 countries (including the Institute of Chartered Accountants of India). Primarily, the IASC was established, in the public interest, to formulate and publish, International Accounting Standards to be followed in the presentation of audited financial statements. International Accounting Standards were issued to promote acceptance and observance of International Accounting Standards worldwide. The members of IASC have undertaken a responsibility to support the standards promulgated by IASC and to propagate those standards in their respective countries.

Between 1973 and 2001, the International Accounting Standards Committee (IASC) released International Accounting Standards. Between 1997 and 1999, the IASC restructured their

organisation, which resulted in formation of International Accounting Standards Board (IASB). These changes came into effect on 1st April, 2001. Subsequently, IASB issued statements about current and future standards: IASB publishes its Standards in a series of pronouncements called **International Financial, Reporting Standards (IFRS)**. However, IASB has not rejected the standards issued by the ISAC. Those pronouncements continue to be designated as "International Accounting Standards" (IAS). The IASB approved IASB Resolution on IASC Standards at their meeting in April, 2001, in which it confirmed the status of all IASC Standards and SIC Interpretations in effect as on 1st April, 2001.

### **3. OVERVIEW OF INTERNATIONAL ACCOUNTING STANDARDS**

#### **3.1 IAS 1 (REVISED): PRESENTATION OF FINANCIAL STATEMENTS**

IAS 1 on "Presentation of Financial Statements" was issued in December 2003 and is applicable for annual periods beginning on or after 1 January 2005.

IAS 1 set down the basis for presentation of general purpose financial statements, to ensure dual comparability both with the entity's financial statements of previous or earlier periods along with the financial statements of other entities of same industry.

IAS 1 does not apply to interim financial statements prepared in accordance with IAS 34 on "Interim Financial Reporting".

#### **SUMMARY**

As per IAS 1, general purpose financial statement includes a balance sheet; an income statement; a statement of changes in equity; a cash flow statement; and notes comprising a summary of important accounting policies and other explanatory notes.

Financial statements helps in presenting fairly the financial position, financial performance and cash flows of an organisation. Financial Statements are fairly presented by giving faithful representation of the transactions, events and conditions and their effects, in accordance with the definitions and recognition criteria of assets, liabilities, income and expenses established in the *Framework for the Preparation and Presentation of Financial Statements*. The application of IFRSs and IFRIs, with additional disclosure as and when necessary, is supposed to result in financial statements that give a fair presentation. An entity should make an explicit and unreserved statement complying with IFRSs in the notes to the financial statements. Such a statement is only made on compliance with all the requirement of IFRSs. A departure from IFRSs in financial statements is acceptable only in the extremely rare circumstances where information useful to users in making economic decisions conflicts the compliance with IFRSs. In case of departure from a requirement of an IFRS, IAS 1 specifies the disclosures required by an entity.

IAS 1 specifies the following important points to be remembered at the time of preparation and presentation of financial statements:

- ◆ Unless management intends to liquidate the entity or to cease trading, financial

## 2.4 Financial Reporting

statements are prepared on a going concern basis.

- ◆ Financial statements are prepared using the accrual basis of accounting, except for cash flow information
- ◆ The classification and presentation of items in the financial statements are usually retained and followed from one period to the next.
- ◆ Similar material items are grouped and presented separately. Dissimilar material items are presented separately. Omissions or misstatements of items will be termed as material if they can, collectively or individually, influence financial decisions of users taken on the basis of financial statement.
- ◆ Unless required or permitted by an IFRS, assets and liabilities, and income and expenses, are not offset.
- ◆ For all amounts reported in the financial statements, comparative information is disclosed unless an IFRS requires or permits otherwise.
- ◆ Once in a year at least financial statements should be presented.

IAS 1 specifies the disclosures of minimum line item on the face of the balance sheet, the income statement, the statement of changes in equity or in the notes. Classification of assets and liabilities into current and non-current items are made and presented on the face of the balance sheet.

IAS 1 specifies disclosures regarding information to be presented in the financial statements, including decisions, basis of estimation of uncertainty, and accounting policies.

### 3.2 IAS 2 (REVISED): INVENTORIES

IAS 2 (revised) on "Inventories" was issued in December 2003 and is applicable to annual periods beginning on or after 1 January 2005.

This Standard deals with all inventories of assets that are:

- ◆ Held for sale in the ordinary course of business.
- ◆ In the process of production for sale.
- ◆ In the form of materials or supplies to be consumed in the production process.
- ◆ In the rendering of services.

In the case of a service provider, inventories include the costs of the service for which the related revenue has not yet been recognized (for instance: the work in progress of auditors, lawyers and architects)

IAS 2 prescribes the accounting treatment for inventories, except:

- (a) Work in progress arising under construction contracts (IAS 11 *Construction Contracts*);



- (b) Financial instruments (IAS 39 *Financial Instruments*); and
- (c) Biological assets related to agricultural activity and agricultural produce at the time of harvest (IAS 41 *Agriculture*).

### **SUMMARY**

Inventories are measured at the lower of cost and net realisable value. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Inventories are usually written down to Net Realisable Value based on the following principles:

- ◆ Items are treated on an item-by-item basis.
- ◆ Similar items are normally grouped together.
- ◆ Each service is treated as a separate item.

Cost includes all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

First-in, first-out (FIFO) or weighted average cost formula is used to assign the cost of inventories, other than those for which specific identification of costs are appropriate.

Cost of inventories comprises:

- ◆ Purchase costs, such as the purchase price and import charges;
- ◆ Cost of conversion such as direct labour, production overheads, both variable and fixed, allocated at normal production capacity; and
- ◆ Other costs such as design and borrowing costs.

The period in which inventories are sold and revenue is recognised, the carrying amount of those sold inventories is also recognised as an expense in the same period.

If inventories are recognized on net realisable value then the difference of carrying amount and net realisable value should be write-down as an expense in the period the write-down or loss takes place.

IAS 2 also prescribes disclosures about inventories.

### **Illustration**

Omega Corp. purchased inventory on January 1, 20X5, for \$60,000. On December 31, 20X5, the inventory had an NRV of \$55,000. During 20X6, Omega Corp. sold the inventory for \$62,000. Based on the above information calculate the profit or loss in relation to inventory as on 31 December 20X5

## 2.6 Financial Reporting

### Solution

For the year ending December 31, 20X5, Omega Corp. recognized a \$5,000 loss on its income statement. Because IFRS requires the lower of cost or NRV reporting on inventory, the company must recognize a \$5,000 loss (\$55,000-\$60,000) on the income statement for 20X5. When the inventory is sold in 20X6, a profit of \$7,000 (\$62,000 - \$55,000) is recognized on the income statement.

### Illustration

The following information applies to the Corn Company for the current year:

|                                      |          |
|--------------------------------------|----------|
| Purchases of merchandise for resale  | \$30,000 |
| Merchandise returned to vendor       | 300      |
| Interest on notes payable to vendors | 600      |
| Freight-in on merchandise            | 750      |

Calculate the Corn's inventory costs for the year

### Solution

Value of Corn's inventory in the year end will be:

|                 |                 |
|-----------------|-----------------|
| Purchase        | \$30,000        |
| Add: Freight-in | \$750           |
| Less: Returns   | <u>\$(300)</u>  |
|                 | <u>\$30,450</u> |

**Note:** Interest costs on financing are not part of inventory cost (exceptions are in IAS 23).

## 3.3 IAS 7: CASH FLOW STATEMENTS

IAS 7 on "Cash Flow Statements" is applicable for periods beginning on or after 1 January 1994.

IAS 7 lay down the principles of preparing and presenting a cash flow statement, which is an essential part of the financial statements.

### SUMMARY

A cash flow statement provides information related to changes in cash and cash equivalents during a financial reporting period. Cash comprises cash in hand and at bank (net of bank overdrafts repayable on demand). Cash equivalents are short-term, highly liquid investments, which are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value.

A cash flow statement reports cash flows during the reporting period classified into operating, investing and financing activities.

Operating activities are the principal revenue-producing activities of the entity. It also include activities that are not financing or investing activities. Cash flows from operating activities are reported using either:

- ◆ the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed (for example, sales, cost of sales, purchases and employee benefits); or
- ◆ the indirect method, whereby profit or loss for the period is adjusted for non-cash items, and items of income or expense related to investing and financing activities.

IAS 7 lays more emphasis on the use of the direct method.

Financing activities are activities which result in changes in the size and composition of the borrowings and equity of the entity (eg. cash proceeds from issuing shares; cash proceeds from issuing debt instruments; cash payments to repay amounts borrowed).

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents (eg. cash advances and loans given to other parties; cash payments and receipts to acquire and dispose of property, plant and equipment; cash payments and receipts to acquire and dispose of equity and debt investments including subsidiaries and other business units).

In the cash flow statement, cash flows are generally reported on gross basis. Cash flows from interest and dividends should be treated consistently and are disclosed separately as either operating, investing or financing activities depending on the nature of the entity. Cash flows from taxes on income are also disclosed separately within operating activities.

Foreign exchange transaction is recorded in the functional currency using the exchange rate at the date of the cash flow. Foreign operations' cash flows are translated at exchange rates on dates of cash flows.

When entities are equity or cost accounted, only actual cash flows from them (for instance dividends received) are shown in the cash flow statement. Cash flows from joint ventures are proportionately included in the cash flow statement.

IAS 7 states disclosures for cash and cash equivalents and also for certain non-cash transactions.

### **Illustration**

During the year ending 20X6, XYZ Company entered into the following transactions:

1. Purchased a new machine for \$1.3 million.
2. Paid cash dividends totaling \$0.8 million.
3. Purchased Treasury stock (own shares) totalling \$4.5 million.

## 2.8 Financial Reporting

4. Spent \$2.7 million on operating expenses, of which \$1.0 million was paid in cash and the remainder put on credit.

Which of the following correctly classifies each of the above transaction items as the operating, investing, and financing activities on the cash flows statement?

|       | Transaction 1     | Transaction 2     | Transaction 3     | Transaction 4                      |
|-------|-------------------|-------------------|-------------------|------------------------------------|
| (i)   | Investing inflow  | Operating outflow | Financing outflow | All expenses – Operating outflow   |
| (ii)  | Financing outflow | Financing outflow | Investing outflow | Cash paid (only)-operating outflow |
| (iii) | Investing outflow | Financing outflow | Financing outflow | Cash paid (only)-operating outflow |
| (iv)  | Financing inflow  | Operating outflow | Investing inflow  | Cash paid (only)-operating outflow |

### Solution

Choice c. is correct. Each transaction had both the proper statement of cash flow activity and the correct cash inflow or outflow direction.

Choice a. is incorrect. This choice incorrectly classifies the cash flow activities for transactions 1, 2 and 4.

Choice b. is incorrect. This choice incorrectly classifies the cash flow activities for transactions 1 and 3.

Choice d. is incorrect. This choice incorrectly classifies the cash flow activities for transactions 1, 2 and 3.

### Illustration

Ribbon Inc. had the following financial data for the year ended December 31, 2006:

|                                 | \$ in millions |
|---------------------------------|----------------|
| Capital expenditure             | 7.5            |
| Dividends declared              | 0.12           |
| Net income                      | 1.7            |
| Common stock issued             | 3.3            |
| Increase in accounts receivable | 1.2            |
| Depreciation and amortization   | 0.35           |
| Proceeds from sale of assets    | 0.6            |
| Gain on sale of assets          | 0.05           |

Based on the above, what is the ending cash balance at December 31, 2006, assuming an opening cash balance of \$4.7 million?

**Solution**

The ending cash balance at December 31, 2006 will be

|                                      | \$ in million |
|--------------------------------------|---------------|
| Operating cash flow                  |               |
| Net income                           | 1.7           |
| Depreciation and amortization        | 0.35          |
| Gain on sale of assets               | (0.05)        |
| Increase in accounts receivable      | (1.2)         |
| Operating cash flow                  | 0.8           |
| Investing cash flow                  |               |
| Capital expenditures                 | (7.5)         |
| Proceeds from sale of assets         | <u>0.6</u>    |
| Investing cash outflow               | <u>6.9</u>    |
| Financing cash flow                  |               |
| Common stock issued                  | <u>3.3</u>    |
| Financing cash inflow                | <u>3.3</u>    |
| Net change in cash (0.8 – 6.9 + 3.3) | (2.8)         |
| Beginning cash                       | <u>4.7</u>    |
| Ending cash                          | <u>1.9</u>    |

**Note:** Dividends had only been declared, not paid.

**3.4 IAS 8 (REVISED): ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS**

IAS 8 (revised) on “Accounting Policies, Change in Accounting Estimates and Errors” has been issued on 18th December 2003 and is applicable for periods beginning on or after 1st January 2005.

**SUMMARY**

**Accounting Policies**

Taking into consideration the applicability of the requirements and guidance in IASB standards and interpretations dealing with similar and related issues; and the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework, management must use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable, if the Standard or an Interpretation does not mention any specific accounting policy applying to a transaction, other event or condition.

## **2.10 Financial Reporting**

Selected accounting policy should be applied consistently for similar transactions, other events and conditions. An entity can change any of its accounting policy only if the change:

- ◆ is required by a standard or interpretation; or
- ◆ results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance, or cash flows.

Applying an accounting policy to a kind of transaction or event that did not exist in the past. Do not constitute as changes in accounting policies.

If a change in accounting policy is required by any IASB Standards or its interpretation, then change is accounted for as required by that new pronouncement or, if the new pronouncement does not include specific transition provisions, then the change in accounting policy is applied retrospectively i.e., adjusting the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

However, if it is impracticable to determine either the period-specific effects or the cumulative effect of the change for one or more prior periods presented, the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and shall make a corresponding adjustment to the opening balance of each affected component of equity for that period.

IAS 8 prescribes disclosures relating to changes in accounting policy for the current period and each prior period presented, to the extent practicable, the amount of the adjustment for each financial statement line item affected.

### **Accounting Estimate**

The effect of a change in an accounting estimate shall be recognised prospectively by including it in profit or loss of the year of change or also in the future periods, if the change affects both.

However, to the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it is recognised by adjusting the carrying amount of the related asset, liability, or equity item in the period of the change.

IAS 8 has prescribed certain disclosures for changes in accounting estimate.

### **Errors**

The general principle of IAS 8 is that an entity must correct all material prior period errors retrospectively as soon as they are discovered i.e., in the first set of financial statements authorised for issue after their discovery by:

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- ◆ restating the comparative amounts for the prior period(s) presented in which the error occurred; or
- ◆ if the error occurred before the earliest prior period presented, restate the opening balances of assets, liabilities and equity for the earliest prior period presented.

IAS 8 specifies certain disclosures relating to prior period errors.

Financial statements of subsequent periods need not repeat these disclosures.

### Illustration

Which of the following items is not included in an IFRS income statement for the current period?

- (i) The effects of corrections of prior period errors
- (ii) Income and gains or losses from discontinued operations
- (iii) Adjustments resulting from changes in accounting policies.

### Solution

**(i) Incorrect:** An entity should correct material prior period errors retrospectively in the first set of financial statements authorized for issue after their discovery by

- ◆ restating the comparative amounts for the prior period or periods presented in which the error occurred, or
- ◆ restating the opening balances of assets, liabilities, and equity for the earliest prior period presented.

**(ii) Correct:** Income and losses from discontinued operations (net of taxes) is shown on a separate line of the income statement, called Income (Loss) from Discontinued Operations (see IFRS 5).

**(iii) Incorrect:** The items are included in the income statement but they are not shown as extraordinary items. (Extraordinary items are not separately classified under IAS 1.)

**(iv) Incorrect:** Adjustment from changes in accounting policies should be applied retrospectively as if though the new policy had always applied. Opening balances are adjusted at the earliest period where feasible, when amounts prior to that period cannot be restated.

### 3.5 IAS 10 (REVISED): EVENTS AFTER THE BALANCE SHEET DATE

IAS 10 (revised) on "Events after the Balance Sheet Date" was issued in December 2003 and is applicable for annual periods beginning on or after 1 January 2005.

## **2.12 Financial Reporting**

IAS 10 prescribes the accounting for, and disclosure of, events after the balance sheet date. Events after the balance sheet date are those events that occur between the balance sheet date and the date when the financial statements are authorised for issue.

### **SUMMARY**

An entity adjusts the amounts recognised in the financial statements to reflect adjusting events after the balance sheet date. Events that provide evidence of conditions that existed at the balance sheet date are known as Adjusting events (eg. the settlement of a court case after the balance sheet date that confirms that the entity had a present obligation at the balance sheet date; the bankruptcy of a customer that occurs after the balance sheet date usually confirms that a loss existed at the balance sheet date on a receivable).

An entity does not adjust the amounts recognised in the financial statements to reflect non-adjusting events after the balance sheet date. Events that are indicative of conditions that arose after the balance sheet date are known as Non-adjusting events (eg. a decline in the market value of investments between the balance sheet date and the date when the financial statements are authorised for issue). For each material category of non-adjusting event after the balance sheet date, an entity discloses the nature of the event and an estimate of its financial effect.

At the balance sheet date, dividends declared after the balance sheet date are not recognised as a liability.

If management determines after the balance sheet date either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so then financial statements are not prepared on a going concern basis.

The financial statements disclose the date when the financial statements were authorised for issue, and who gave that authorisation.

### **Illustration**

Richard Corporation with a balance sheet date of December 31 has a foreign long-term liability that is not covered by a foreign exchange contract. The foreign currency amount was converted at the closing rate on December 31, 20X5, and is shown in the accounting records at the local currency (LC) 2.0 million.

The local currency dropped significantly against the U.S. dollar on February 27, 20X6. On this date, management decided to hedge further exposure by taking out a foreign currency forward-exchange contract, which limited the eventual liability to LC 6.0 million. If this situation were to apply at the balance sheet date, it would result in the corporation's liabilities exceeding the fair value of its assets.



### **Explanation**

The situation under discussion falls within the definition of post balance sheet events and specifically those events that refer to conditions arising after the balance sheet date.

The loss of LC 4.0 million that arises in 20X6 must be recognized in the 20X6 income statement. No provision in respect of the loss can be made in the financial statements for the year ending December 31, 20X5.

However, consideration should be given to whether it would be appropriate to apply the going concern concept in the preparation of the financial statements. The date and frequency of repayment of the liability will have to be considered.

The following information should be disclosed in a note to the financial statements for the year ending December 31, 20X5:

- ◆ The nature of the events.
- ◆ An estimate of the financial effect, in this case LC 4.0 million.

### **3.6 IAS 11: CONSTRUCTION CONTRACTS**

IAS 11 on "Construction Contracts" is applicable for periods beginning on or after 1 January 1995. It prescribes the accounting treatment of revenue and costs associated with construction contracts. Contracts in this Standard include those construction contracts for which the dates of contracting and of completion typically fall in different accounting periods.

#### **SUMMARY**

Contract revenue and contract costs are recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity ("percentage of completion method") only when the outcome of a construction contract can be estimated reliably. The outcome can be estimated reliably when the contract revenue, contract costs to date and to completion, and the stage of completion can be measured reliably.

Here, contract revenue comprise

- ◆ the initial agreed contract amount, and
- ◆ variations, claims and incentive payments to the extent that they will probably realize and are capable of being reliably measured.

Contract costs comprise

- ◆ direct contract costs (for instance: materials
- ◆ general contract costs (for instance: insurance); and
- ◆ costs specifically chargeable to the customer in terms of the contract (for instance: administrative costs)

## 2.14 Financial Reporting

When the outcome of a construction contract cannot be estimated reliably, revenue is recognised only to the extent of contract costs incurred, i.e., probable are recoverable. Contract costs are recognised as expenses when incurred. The percentage of completion method is used for recognition of revenue and expenses, if the outcome of the contract subsequently can be estimated reliably,

Immediately recognize any expected loss on a construction contract as an expense.

The principles of IAS 11 are normally applied separately to each contract specifically negotiated for the construction of:

- ◆ An asset
- ◆ A combination of assets that are closely interrelated or interdependent in terms of their design, technology, function, or use.
- ◆ A group of contracts should be treated as a single construction contract if it was negotiated as a single package.

IAS 11 specifies certain disclosures for construction contracts.

### Illustration

When comparing the use of the percentage of completion method with the completed contract method during a long-term project's life, the percentage-of-completion method will result in:

- (i) earlier recognition of cash flows,
- (ii) a higher return on assets,
- (iii) a lower debt-to-equity ratio, and
- (iv) a higher asset turnover.

### Solution

- (i) No: The choice of accounting method has no effect on cash flow.
- (ii) Yes: Because the periodic earnings will be higher under the percentage-of-completion method, the return on assets ratio will be higher.
- (iii) Yes: Because the percentage-of-completion method reports lower liabilities and higher net worth, the debt-to-equity ratio will be lower.
- (iv) Yes: The asset turnover ratio is higher under the percentage-of-completion method because sales are reported during the life of the project.

## 3.7 IAS 12: INCOME TAXES

IAS 12 on "Income Taxes" is applicable for periods beginning on or after 1 January 1998. It prescribes the accounting treatment for income taxes.

### **SUMMARY**

Current tax is defined as the amount of income tax payable (recoverable) in respect of taxable profit (tax loss) for the period. Income taxes payable for current and prior periods are recognised as a liability. Income tax recoverable or overpaid for current and prior periods is recognised as an asset.

A difference between the carrying amount of assets and liabilities in the balance sheet, and the tax base of assets and liabilities is termed as Temporary Difference. Temporary difference can be either

- ◆ Taxable temporary differences, which are temporary differences that will resulting taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled, or
- ◆ Deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount o the asset or liability is recovered or settled.

A deferred tax asset or liability arises if recovery (settlement) of assets (liabilities) affects the amount of future tax payments.

IAS 12 mandates the entity to recognise deferred tax liability in full.

### **Exceptions:**

1. A deferred tax liability (asset) is not recognised for a taxable (deductible) temporary difference arising from initial recognition of an asset or liability in transaction which:
  - ◆ at the time of the transaction, affects neither the accounting profit nor taxable profit (eg. an asset whose depreciation is not deductible for tax purposes; the entity intends to use that asset throughout its useful life); and
  - ◆ is not a business combination.
2. A deferred tax liability is not recognised out of any taxable temporary difference arising from initial recognition of goodwill, or from the goodwill for which amortisation is not deductible for tax purpose.
3. Deferred tax is not recognised on temporary difference arising on investments in subsidiaries, branches, associates and joint ventures if the entity is able to control the timing of the reversal of the difference, and it is probable that the temporary difference will not reverse in the future.

A deferred tax asset is recognised only to the extent it is probable that a tax benefit will be realised in the future. If it is probable that tax benefits will be realised, a deferred tax asset is recognised on unused tax losses and unused tax credits.

## **2.16 Financial Reporting**

Deferred tax is measured at tax rates expected to apply when the deferred tax asset / liability is realised or settled. The tax rates used must have been enacted or substantially enacted by the balance sheet date. A deferred tax assets or liabilities are not discounted.

The tax consequence of transactions and events is recognised in the same financial statement as the transaction or event – i.e., current and deferred taxes is:

- ◆ recognised as identifiable assets or liabilities at the acquisition date, if they arise as part of a business combination in accordance with IFRS 3 *Business Combinations*;
- ◆ recognised in equity, if the items to which they relate are credited or charged directly to equity;
- ◆ otherwise, recognised as tax income or expense.

IAS 12 specifies certain disclosures about income taxes.

### **3.8 IAS 14: SEGMENT REPORTING**

On 30<sup>th</sup> November 2006, IAS 14 has been replaced by IFRS 8 'Operating Segments'. IFRS 8 will be applicable for annual periods beginning on or after 1<sup>st</sup> January 2009.

### **3.9 IAS 15 INFORMATION REFLECTING THE EFFECTS OF CHANGING PRICES**

IAS 15 has been withdrawn with effect from 1 January 2005.

### **3.10 IAS 16 (REVISED): PROPERTY, PLANT AND EQUIPMENT**

IAS 16 (revised) on "Property, Plant and Equipment" was issued in December 2003 and is applicable to annual accounting periods beginning on or after 1 January 2005.

IAS 16 prescribes the accounting treatment for property, plant and equipment, unless another standard requires or permits a different accounting treatment. For example, IFRS 5 on "Non-current assets Held for Sale and Discontinued Operations" applies to property, plant and equipment classified as held for sale.

#### **SUMMARY**

Property, plant and equipment is initially recognised at historical cost. Subsequent to initial recognition, property, plant and equipments are carried either at:

- ◆ Cost less accumulated depreciation and any accumulated impairment loss, or
- ◆ Revalued amount less subsequent accumulated depreciation and any accumulated impairment loss. The revalued amount is the fair value at the date of revaluation.

The choice of measurement is applied consistently to an entire class of property, plant and equipment. Any revaluation increase in such assets is credited directly to the revaluation surplus in equity, unless it reverses a revaluation decrease previously recognised in profit or loss. Any revaluation decrease is recognised in profit or loss. However, the subsequent

revaluation decrease is debited directly to the revaluation surplus in equity to the extent of the credit balance in revaluation surplus in respect of that asset.

Depreciation is applied on component basis. That is to say, each part of an item of property, plant and equipment with a significant cost in relation to the total cost of the item is depreciated separately. The depreciable amount of an asset is allocated on a systematic basis over the useful life of the asset. Impairment is recognised in accordance with IAS 36 on "Impairment of Assets".

The gain or loss on derecognition of an item of property, plant and equipment is the difference between the net disposal proceeds, if any, and the carrying amount of the item. It is included in profit or loss.

IAS 16 specifies certain disclosures about property, plant and equipment.

### **3.11 IAS 17: LEASES**

IAS 17 (revised) on "Leases" was issued in December 2003 and is applicable to annual periods beginning on or after 1 January 2005.

IAS 17 prescribes, for lessors and lessees, the accounting policies and disclosure to apply to leases.

#### **SUMMARY**

A lease is classified as a finance lease or an operating lease at its inception (i.e. when the agreement or commitment is made). Finance leases are those that transfer substantially all the risks and rewards incident to ownership to the lessee. All other leases are operating leases.

Minimum lease payments are the payments over the lease term that the lessee is required to make to a third party. Certain contingent and other items are excluded. However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

#### ***Accounting by lessees***

At inception of the lease, a finance lease is recognised as an asset and a liability in the lessee's balance sheet at the lower of:

- ◆ The fair value of the leased asset, and
- ◆ The present value of the minimum lease payments.

Any initial direct costs of the lessee are added to the amount recognised as an asset. The minimum lease payments are apportioned between the finance charge and reduction of the

## 2.18 Financial Reporting

outstanding liability. The finance charge signifies a constant periodic rate of interest on the outstanding liability. The leased asset is depreciated in accordance with IAS 16 on "Property, Plant and Equipment". The asset is fully depreciated over the shorter of the lease term and the asset's useful life, if there is no reasonable certainty of eventual ownership.

Operating lease payments are recognized, over the lease term, as an expense on a straight-line basis.

### ***Accounting by lessors***

At inception of the lease, a finance lease is recorded as a receivable at an amount equal to the net investment in the lease. The net investment in the lease is the present value of:

- ◆ The minimum lease payments, and
- ◆ Any unguaranteed residual value accruing to the lessor.

Finance lease receivable includes any initial direct costs incurred by lessors other than manufacturer or dealer lessors. Finance income is recognised to produce a constant periodic rate of return on the lessor's net investment in the lease. In accordance with their policy for outright sales, manufacturer or dealer lessors recognise selling profit or loss.

Operating lease income is recognised on a straight-line basis over the lease term.

IAS 17 specifies the accounting treatment for sale and leaseback transactions, which depends upon the classification of the leaseback as either finance or operating.

IAS 17 specifies certain disclosures about leases, which are in addition to disclosures required by other standards.

## **3.12 IAS 18: REVENUE**

IAS 18 on "Revenue" is applicable for periods beginning on or after 1 January 1995.

IAS 18 prescribes accounting treatment for revenue arising from:

- ◆ the sale of goods;
- ◆ the rendering of services; and
- ◆ the use by others of entity assets yielding interest, royalties and dividends.

It excludes the treatment of revenue arising from transactions covered by other Standards (e.g. revenue arising from lease agreements dealt with in IAS 17 on "Leases") or amounts collected on behalf of third parties (eg. VAT).

### **SUMMARY**

Revenue is measured at the fair value of the consideration received or receivable. The consideration is usually cash. If the inflow of cash is significantly deferred, and there is a below-market rate of interest or no interest, the fair value of the consideration is determined by

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discounting expected future receipts. If dissimilar goods or services are exchanged (as in barter transactions), revenue is the fair value of the goods or services received or, if this is not reliably measurable, the fair value of the goods or services given up.

Revenue should be measured at the fair value of the consideration received:

- ◆ Trade discounts and volume rebates are deducted to determine fair value. However, payment discounts are non-deductible.
- ◆ When the inflow of cash is deferred (for example, the provision of interest-free credit), it effectively constitutes a financing transaction. The imputed rate of interest should be determined and the present value of the inflows calculated. The difference between the fair value and nominal amount of the consideration is separately recognized and disclosed as interest.
- ◆ When goods or services are exchanged for that of a similar nature and value, no revenue recognition occurs (commercial substance of the transaction should govern).

Revenue from the sale of goods is recognised when:

- ◆ the amount of revenue can be measured reliably;
- ◆ the costs of the transaction (including future costs) can be measured reliably;
- ◆ significant risks and rewards of ownership are transferred to the buyer;
- ◆ the seller has no continuing managerial involvement or control over the goods;
- ◆ it is probable that economic benefits will flow to the seller; and

Revenue from rendering services is recognised by reference to the stage of completion if the following conditions are satisfied:

- ◆ the amount of revenue can be measured reliably;
- ◆ the stage of completion of the transaction can be measured reliably;
- ◆ it is probable that economic benefits will flow to the service provider; and
- ◆ the costs of the transaction (including future costs) can be measured reliably.

If the outcome cannot be measured reliably, revenue should be recognised only to the extent of the expenses recognised that are recoverable.

*Financial service fees are recognized as follows:*

- ◆ Financial service fees that are an integral part of the effective yield on a financial instrument (such as an equity investment) carried at fair value are recognized immediately as revenue.

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- ◆ Financial service fees that are an integral part of the effective yield on a financial instrument carried at amortized cost (for example a loan) are recognized as revenue over the life of the asset as part of the application of the effective interest rate method.
- ◆ Origination fees on creation or acquisition of financial instruments carried at amortized cost, such as a loan, are deferred and recognized as adjustments to the effective interest rate.
- ◆ Most commitment fees to originate loans are deferred and recognized as adjustments to the effective interest rate or recognized as revenue on earlier expiry of commitment.

Interest revenue should be recognised on a time-proportion basis using the effective interest method. Royalties should be recognised on an accruals basis in accordance with the substance of the relevant agreement. Dividend revenue should be recognised when the shareholder's right to receive the dividend is established.

Repurchase agreements arise when an entity sells goods and immediately conclude an agreement to repurchase them at a later date; the substantive effect of the transaction is negated and the two transactions are dealt with as one.

Sales plus service refers to when the selling price of a product includes an amount for subsequent servicing, and the service revenue portion is deferred over the period that the service is performed.

Revenue cannot be recognized when the expenses cannot be measured reliably. Consideration already received for the sale is deferred as a liability until revenue recognition can take place.

IAS 18 specifies certain disclosures about revenue.

### *Revenue Recognition in respect of Initial Fees received by a Fund Manager*

IFRIC agreed :

- (1) that the customer only receives the benefit of upfront brokerage, set up, and initiation services over the life of the investment. Since the benefit of these services is not received by the investor upfront, the revenue should not all be recognised upfront;
- (2) that in situations where an investor pays an upfront fee for investment advice regardless of whether they invest in the recommended product, the investor does receive a valuable service and as such revenue should be recognised;
- (3) that in situations where an investor only pays for investment advice if they act upon the advice, there is no objective evidence that investors receive a valuable service separate from the ongoing service and so this advice does not trigger the recognition of revenue.

### **Illustration**

Symphony Tech., a high-tech company, is having a very poor year due to weak demand in the technology markets. The entity's controller, Mr. Samson, has determined that much of the



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inventory on hand is worth far less than the value recorded on the entity's books. He decides to write off this excess amount, which totals \$10 million. Furthermore, he is worried that the inventory will fall in value next year and decides to take a further write down of \$5 million. Both of these write-offs occur in the current year.

What is the technique adopted by the company?

### **Solution**

The company has engaged in a technique that shifts future expenses into the current period. The company has overstated the amount of the current charge by \$5 million. This expected decline in value should not be charged off until it occurs. It is conceivable that the market for Symphony Tech., products will rebound and that the charge-off was not needed. Effectively, the company has brought forward a potential future expense to the current period. The \$10 million charge-off is, however, appropriate.

### **Illustration**

A generous benefactor donates raw materials to an entity for use in its production process. The materials had cost the benefactor \$2,000 and had a market value of \$3,000 at the time of donation. The materials are still on hand at the balance sheet date. No entry has been made in the books of the entity. The question is whether the donation should be recognized as revenue in the books of the entity.

### **Solution**

The proper accounting treatment of the above matter is as follows:

- ◆ The accounting Standard that deals with inventories, IAS 2, provides no guidance on the treatment of inventory acquired by donation. However, donations received meet the definition of revenue in IAS 18 (that is, the gross inflow of economic benefits during the period arising in the course of ordinary activities when those inflows result in increases in equity, other than increases relating to contributions from equity participants). It could be argued that receiving a donation is not part of the ordinary course of activities. In such a case the donation would be regarded as a capital gain. For purposes of this case study, the donation is regarded as revenue.
- ◆ The donations should be recorded as revenue measured at its fair value (\$3,000) of the raw materials received (because that is the economic benefit).
- ◆ The raw materials received clearly meet the Framework's definition of an asset, because the raw materials (resource) are now owned (controlled) by the corporation as a result of the donation (past event) from which a profit can be made in the future (future economic benefits). The recognition criteria of the Framework, namely those of measurability and probability, are also satisfied.
- ◆ Because the raw materials donated relate to trading items, they should be disclosed as inventory, with the fair value of \$3,000 at the acquisition date being treated as the cost thereof.

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### **3.13 IAS 19: EMPLOYEE BENEFITS**

IAS 19 on "Employee Benefits" is applicable for periods beginning on or after 1 January 1999.

IAS 19 lays down the accounting for, and disclosure of employee benefits by employers, except to which IFRS 2 on "Share-based Payment" applies. IAS 19 does not deal with reporting by employee benefit plans because of IAS 26 on "Accounting and Reporting by Retirement Benefit Plans".

#### **SUMMARY**

Employee benefits are all forms of considerations given by an entity in exchange for services rendered by employees. These include:

- ◆ short-term benefits: falling due within twelve months of the rendering of service (eg. salaries, bonuses, holiday pay, sick pay);
- ◆ post-employment benefits: payable after completion of employment (eg. pensions, life insurance, medical care);
- ◆ other long-term benefits (such as long-service leave, and other benefits) not payable within twelve months; and
- ◆ termination benefits: payable when an employee's contract is terminated either voluntarily or involuntarily (eg. early retirement, redundancy pay).

#### **Short-term benefits**

Short-term benefits are recognised as expenses in the period of rendering services by an employee to the entity. The expected cost of compensated absences is recognised:

- ◆ when the absences occur for non-accumulating compensated absences, and
- ◆ when the service is rendered increasing the employee's entitlement to benefits for accumulating compensated absences.

Profit-sharing and bonus payments are recognised when the entity has a present legal or constructive obligation as a result of past events and a reliable estimate can be made of the obligation. A liability is recognised for unpaid short-term benefits.

#### **Post-employment benefits**

Post-employment benefits are classified into either defined contribution plans or defined benefit plans. Defined contribution plans are those plans where an employer pays fixed contributions to a separate entity and will have no legal or constructive obligations to pay further contributions. All other post-employment benefits will fall under the category of defined benefit plans.

Contributions payable to a defined contribution plan should be recognised as an expense as the employee renders its services to the entity.

For a defined benefit plan, an entity recognizes, at the balance sheet date, a net defined benefit asset or liability constituting the present value of the defined benefit obligations, based on actuarial assumptions, net of the fair value of any plan assets at the balance sheet date. IAS 19 promotes the involvement of a qualified actuary in measuring the defined benefit obligations, which are valued using the projected unit credit method. There is a limit or restriction on the recognition of a net defined benefit asset.

Actuarial gains and losses (comprising experience adjustments and the effects of changes in actuarial assumptions) are recognised as income or expense to the extent that they exceed 10% of the defined benefit obligation or 10% of the fair value of plan assets. The actuarial gains and losses are recognised over the average remaining working lives of employees participating in the plan. An entity can elect to recognise all actuarial gains and losses immediately.

Past service cost is recognised as an expense on a straight-line basis over the average period until the benefits become vested. The increase in the defined benefit obligation for employee service in prior periods, resulting in the current period from the introduction of, or change to, a defined benefit plan is termed as past service cost.

Movements in the amount of the net defined benefit pension asset or liability are recognised in profit or loss as a net pension expense or income. The effects of a curtailment or settlement of a plan on the defined benefit obligation and plan assets are recognised when the curtailment or settlement occurs.

#### **Other long-term benefits**

An entity recognises a liability for other long-term benefits equal to the present value of the defined benefit obligation, minus the fair value of any plan assets at the balance sheet date. Recognise immediately, any actuarial gains and losses, or past service costs as income or expense.

#### **Termination benefits**

An entity recognises a liability and an expense for termination benefits when it is demonstrably committed to either:

- ◆ provide termination benefits as a result of an offer made in order to encourage voluntary redundancy; or
- ◆ terminate the employment of employee(s) before the normal retirement date.

An entity is demonstrably committed when it has a detailed formal plan for the termination and is without realistic possibility of withdrawal.

IAS 19 specifies certain disclosures about employee benefits.

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### Illustration

On December 31, 20X0, an entity's balance sheet includes a pension liability of \$1.2 million. Management has made the decision to adopt IAS 19 as of January 1, 20X1, for the purpose of accounting for employee benefits. At that date, the present value of the obligation under IAS 19 is calculated at \$14.6 million and the fair value of plan assets is determined at \$11.0 million. On January 1, 19X6, the entity had improved pension benefits (cost for nonvested benefits amounted to \$1.6 million, and the average remaining period at that date, until vesting, was 8 years).

### Solution

The transitional liability is calculated as follows:

|                                                                          |         |
|--------------------------------------------------------------------------|---------|
|                                                                          | \$'00   |
| Present value of the obligation                                          | 146000  |
| Fair value of plan assets                                                | (11000) |
| Past service cost to be recognized in later periods ( $1.6 \times 3/8$ ) | (600)   |
| Transitional liability                                                   | 3000    |
| Liability already recognized                                             | 1200    |
| Increase in liability                                                    | 1800    |
|                                                                          | =====   |

The entity might (in terms of the transitional provisions of IAS 19) choose to recognize the transitional liability of \$1.8 million either immediately or recognize it as an expense on a straight-line basis upto 5 years. The choice is irrevocable. In future such transitional arrangements are dealt with by IFRS 1.

## 3.14 IAS 20 ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

IAS 20 on "Accounting for Government Grants and Disclosure of Government Assistance" was issued in April 1983 and was reformatted in the year 1994. It came into effect for annual periods beginning on or after 1 January 1984.

The objective of IAS 20 is to prescribe the accounting for, and disclosure of, government grants and other forms of government assistance. However, IAS 20 does not cover government assistance that is provided in the form of benefits helpful in determining taxable income.

### SUMMARY

A government grant is recognised only when enterprise will comply with any conditions attached to the grant received. The grant is recognised as income, over the period, to match them with the related costs, for which they are intended to compensate, on a systematic basis, and should not to be credited directly to equity.

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Non-monetary grants are usually accounted for at fair value (eg. land or other resources) although recording both the asset and the grant at a nominal amount is also permitted.

Except the requirement to operate in certain regions or industry sectors, grants should not be credited to equity even if there are no conditions attached to the assistance specifically relating to the operating activities of the enterprise

A grant receivable as compensation for costs already incurred or for immediate financial support, with no future related costs, should be recognised as income in the period in which it is receivable.

A grant relating to assets may be presented as deferred income or by deducting the grant from the asset's carrying amount. A grant relating to income may be reported separately as 'other income' or deducted from the related expense.

If a grant becomes repayable, it should be treated as a change in estimate. Where the original grant related to income, the repayment should be applied first against any related unamortised deferred credit, and any excess should be dealt with as an expense. Where the original grant related to an asset, the repayment should be treated as increasing the carrying amount of the asset or reducing the deferred income balance. The cumulative depreciation which would have been charged had the grant not been received should be charged as an expense.

Government grants do not include government assistance whose value cannot be reasonably measured, such as technical or marketing advice.

IAS 20 specifies certain presentation and disclosures for Government Grants.

**Illustration**

Workland Inc. obtained a grant of \$1.0 million from a government agency for an investment project to construct a manufacturing plant of at least \$8.8 million. The principal term is that the grant payments relate to the level of capital expenditure. The secondary intention of the grant is to safeguard 50 jobs. The grant will have to be repaid prorata if there is an underspending on capital. Twenty percent of the grant will have to be repaid if the jobs are not safeguarded until 18 months after the date of the last asset purchase.

The plant was completed on January 1, 20X4, at a total cost of \$9.0 million. The plant has an expected useful life of 20 years and is depreciated on a straight-line basis with no residual value.

**Solution**

The grant should be recognized as income on a systematic basis over the periods that will match it with related costs that it is intended to compensate.

Difficulties can arise where the terms of the grant do not specify precisely the expenditure to which it is intended to contribute. Grants might be received to cover costs comprising both

## 2.26 Financial Reporting

capital and revenue expenditure. This would require a detailed analysis of the terms of the grant.

The employment condition should be seen as an additional condition to prevent replacement of labor by capital, rather than as the reason for the grant. This grant should therefore be regarded as an asset-related grant. IAS 20 allows two acceptable methods of presentation of such grants. The application of each method is demonstrated for the first 3 years of operation:

### (1) Setting grant up as deferred income

The plant would be reflected as follows in the balance sheets at December 31, of the years as indicated:

|                          | 20X6<br>\$'000 | 20X5<br>\$'000 | 20X4<br>\$'000 |
|--------------------------|----------------|----------------|----------------|
| Plant                    |                |                |                |
| Historical cost          | 9000           | 9000           | 9000           |
| Accumulated depreciation | <u>(1350)</u>  | <u>(900)</u>   | <u>(450)</u>   |
| Carrying value           | 7650           | 8100           | 8550           |
| Deferred income          | 1000           | 1000           | 1000           |
|                          | 50             | 100            | 150            |

The following amounts would be recognized in the income statements of the respective years:

|                                              | 20X6<br>\$'000 | 20X5<br>\$'000 | 20X4<br>\$'000 |
|----------------------------------------------|----------------|----------------|----------------|
| Depreciation (expense)<br>(9000 ÷ 20)        | 450            | 450            | 450            |
| Government grant (income)<br>(1000,000 ÷ 20) | (50)           | (50)           | (50)           |

The above amounts are treated as separate income statement items and should not be offset under this method of presentation.

### (2) Deducting grant in arriving at carrying amount of asset

The adjusted historical cost of the plant would be \$8.0 million, which is the total cost of \$9.0 million less the \$1.0 million grant.

The plant would be reflected as follows in the respective balance sheets:

|                          | 20X6          | 20X5         | 20X4         |
|--------------------------|---------------|--------------|--------------|
|                          | \$'000        | \$'000       | \$'000       |
| Plant                    |               |              |              |
| Historical cost          | 8000          | 8000         | 8000         |
| Accumulated depreciation | <u>(1200)</u> | <u>(800)</u> | <u>(400)</u> |
|                          | <u>6800</u>   | <u>7200</u>  | <u>7600</u>  |

The income statements would reflect an annual depreciation charge of \$1.4 million (\$8000,000 ÷ 20). This charge agrees with the net result of the annual amounts recognized in the income statement under the first alternative.

### **3.15 IAS 21 (REVISED): THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES**

IAS 21 (revised) on "The Effects of Changes in Foreign Exchange Rates" was issued in December 2003 and is applicable for annual periods beginning on or after 1 January 2005.

IAS 21 prescribes how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency. IAS 21 does not apply to foreign currency derivatives and hedge accounting of foreign currency items covered by IAS 39 on "Financial Instruments: Recognition and Measurement".

#### **SUMMARY**

**Determine for each entity whether it is**

- ◆ A stand alone entity;
- ◆ An entity with foreign operations (parent); or
- ◆ A foreign operation (subsidiary, branch).

#### **Foreign Currency Transactions**

A foreign currency transaction is recorded initially in the functional currency, by applying to the foreign currency amount, the spot exchange rate between the functional currency and the foreign currency at the date of the transaction. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used (eg. an average weekly or monthly rate). Functional currency is the currency of the primary economic environment in which the entity operates.

At each balance sheet date:

- ◆ Foreign currency monetary items are translated using the closing rate;

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- ◆ Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Approximate or average rates may be more appropriate for inventories; and
- ◆ Non-monetary items that are measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

Income statement items may be translated using an average rate.

Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at initial recognition are recognised in profit or loss with one exception. Exchange differences arising on a monetary item that forms part of an entity's net investment in a foreign operation are recognised as a separate component of equity in the financial statements that include the foreign operation and the reporting entity (eg financial statements in which the foreign operation is consolidated, proportionately consolidated or accounted for using the equity method). Such exchange differences are recognised in profit or loss on disposal of the net investment.

### Foreign Operations

When translating a foreign operation for inclusion in the reporting entity's financial statements (i.e. translation to a presentation currency), assets and liabilities are translated at the closing rate, and income and expenses are translated at exchange rates at the dates of the transactions (approximate or average rates may be used for practical reasons). All resulting exchange differences are recognised as a separate component of equity.

On disposal of the foreign operation, all exchange differences deferred in the separate component of equity relating to that operation, are recognised in profit or loss.

Goodwill and fair value adjustments arising on the acquisition of a foreign operation should be treated as assets and liabilities of the foreign operation and are expressed in the functional currency of the foreign operation. Translation of goodwill and fair value adjustments is therefore at the closing rate.

When the functional currency of a foreign operation is the currency of a hyperinflationary economy:

- ◆ The financial statements are restated for price changes in accordance with IAS 29
- ◆ The restated amounts for both the balance sheet and the income statements are translated into the presentation currency using closing rates.

IAS 21 specifies disclosures about the functional currency of an entity, and exchange differences arising during the period.



### Illustration

Dark Inc. (whose functional currency is the US\$) purchased manufacturing equipment from the UK. The transaction was financed by means of a loan from a commercial bank in England.

Equipment that costs £40,000 was purchased on January 2, 20X7, and the amount was paid over by the bank to the supplier on that same day. The loan must be repaid on December 31, 20X8, and interest is payable at 10% biannually in arrears. The balance sheet date is December 31.

The following exchange rates apply:

|                   | £1 = \$ |
|-------------------|---------|
| January 2, 20X7   | 1.67    |
| June 30, 20X7     | 1.71    |
| December 31, 20X7 | 1.75    |
| June 30, 20X8     | 1.73    |
| December 31, 20X8 | 1.70    |

### Solution

The interest payments would be recorded at the spot rates applicable on the dates of payment in the following manner:

|                                   | \$          |
|-----------------------------------|-------------|
| June 20 20X7 (£2,000 × 1.71)      | 3420        |
| December 31, 20X7 (£2,000 × 1.75) | <u>3500</u> |
| Total interest for 20X7           | <u>6920</u> |
| June 30, 20X8 (£2,000 × 1.73)     | 3460        |
| December 31, 20X8 (£2,000 × 1.70) | <u>3400</u> |
| Total interest for 20X8           | <u>6860</u> |

The loan is initially recorded on January 2, 20X7, and restated at spot rate on December 31, 20X7, as well as December 31, 20X8, after which it is repaid at spot rate. The movements in the balance of the loan are reflected as follows:

|                                                       | \$            |
|-------------------------------------------------------|---------------|
| Recorded at January 2, 20X7 (£40,000 × 1.67)          | 66,800        |
| Foreign currency loss on restatement of loan          | <u>3200</u>   |
| Restate at December 31, 20X7 (£40,000 × 1.75)         | 70000         |
| Foreign currency profit on restatement of loan        | <u>(2000)</u> |
| Restate and pay at December 31, 20X8 (£40,000 × 1.70) | <u>68000</u>  |

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The loan will be stated at an amount of \$70000 in the balance sheet on December 31, 20X7. The manufacturing equipment remains at its historical spot rate of \$66800.

The following amounts will be recognized in the income statements:

|                                | 20X8   | 20X7 |
|--------------------------------|--------|------|
|                                | \$     | \$   |
| Interest                       | 6860   | 6920 |
| Foreign currency loss (profit) | (2000) | 3200 |

## 3.16 IAS 22 BUSINESS COMBINATIONS

IFRS 3 on "Business Combinations" supersedes IAS 22. IFRS 3 is effective from 1st January 2005.

## 3.17 IAS 23 (REVISED 1993) BORROWING COSTS

IAS 23 on "Borrowing Costs" was issued in March 1984 and was revised in December 1993 and is applicable for annual periods beginning on or after 1 January 1995.

IAS 23 prescribes the accounting treatment for borrowing costs, which are defined as interest and other costs incurred by an entity in connection with the borrowing of funds. IAS 23 allows two method of accounting for borrowing costs:

- ◆ Borrowing costs should be recognized as an expense in the period in which they are incurred; or
- ◆ Borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset can be capitalized when
  - it is probable that they will result in future economic benefits to the entity; and
  - the costs can be measured reliably (by reference to the effective interest rate method as per IAS 39).

## SUMMARY

Borrowing costs include interest on bank overdrafts and borrowings, amortisation of discounts or premiums on borrowings, amortisation of ancillary costs incurred in the arrangement of borrowings, finance charges on finance leases and exchange differences on foreign currency borrowings where they are regarded as an adjustment to interest costs.

Borrowing cost is interest and other costs incurred by an enterprise in connection with the borrowing of funds. Interest includes amortisation of discount/premium on debt. Other costs include amortisation of debt issue costs and certain foreign exchange differences that are regarded as an adjustment of interest cost. Borrowing cost does not include actual or imputed cost of equity capital, including any preferred capital not classified as a liability pursuant to IAS 32.

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A qualifying asset is an asset that takes a substantial period of time to get ready for its intended use. It can be property, plant, and equipment and investment property during the construction period, intangible assets during the development period, or "made-to-order" inventories.

All borrowing costs should be expensed in the period in which they are incurred. Borrowing costs in relation to the acquisition, construction and production of a qualifying asset should be treated as part of the cost of the relevant asset. Where the allowed alternative is adopted, that treatment should be applied consistently to all borrowing costs incurred for the acquisition, construction and production of qualifying assets.

Where funds are borrowed specifically, costs eligible for capitalisation are the actual costs incurred less any income earned on the temporary investment of such borrowings. Where funds are part of a general pool, the eligible amount is determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate will be the weighted average of the borrowing costs applicable to the general pool.

Where the alternative treatment is followed, capitalisation should commence when expenditures are being incurred, borrowing costs are being incurred and activities that are necessary to prepare the asset for its intended use or sale are in progress (may include some activities prior to commencement of physical production). Capitalisation should be suspended during periods in which active development is interrupted. Capitalisation should cease when substantially all of the activities necessary to prepare the asset for its intended use or sale are complete. If only minor modifications are outstanding, this indicates that substantially all of the activities are complete.

Where construction is completed in stages, which can be used while construction of the other parts continues, capitalisation of attributable borrowing costs should cease when substantially all of the activities necessary to prepare that part for its intended use or sale are complete.

IAS 23 specifies certain disclosures for borrowing cost.

**Illustration**

A company has a building under construction that is being financed with \$8 million of debt, \$6 million of which is a construction loan directly on the building. The rest is financed out of the general debt of the company. The company will use the building when it is completed. The debt structure of the firm is as follows:

|                                         |        |
|-----------------------------------------|--------|
|                                         | \$'000 |
| Construction loan @ 11%                 | 6,000  |
| Long-term debentures @ 9%               | 9,000  |
| Long-term subordinated debentures @ 10% | 3,000  |

The debentures and subordinated debentures were issued at the same time.

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### Calculate:

- (i) The interest payable during the year.
- (ii) The capitalized interest cost to be recorded as an asset on the balance sheet.
- (iii) Amount of interest expense to be reported on the income statement.

### Solution

- (i) The interest payable during the year will be:
- (ii) The capitalized interest cost to be recorded as an asset on the balance sheet will be:

$$0.11(\$6,000,000) + .09(\$9,000,000) + .10(\$3,000,000) = \$1,770,000$$

Effective interest rate on the construction loan is 11 percent.

Effective average interest rate on the company's other debt is:

$$\frac{9,000,000}{12,000,000} \times 9\% + \frac{3,000,000}{12,000,000} \times 10\% = 9.25\%$$

These two rates are used to calculate the capitalized interest:

$$\begin{aligned} \text{Capitalized Interest} &= \$6,000,000 (.11) + 2,000,000 (.925) \\ &= \$660,000 + 185,000 = \$845,000 \end{aligned}$$

- (iii) Amount of interest expense to be reported on the income statement will be:  
 $\$1,770,000 - \$845,000 = \$925,000$

## 3.18 IAS 24 (REVISED): RELATED PARTY DISCLOSURES

IAS 24 (revised) on "Related Party Disclosures" was issued in December 2003 and is applicable for annual periods beginning on or after 1 January 2005.

IAS 24 specifies the disclosures necessary to draw attention to the possibilities that the financial position and financial performance of an entity may have been affected by the existence of related party and by transactions and outstanding balances with such related parties.

### SUMMARY

A party is related to an entity if it:

- ◆ has joint control over the entity;
- ◆ has significant influence over the entity;
- ◆ directly or indirectly, controls, is controlled by, or is under common control with, the entity;

- ◆ is a close member of the family of any individual who controls, or has significant influence or joint control over, the entity;
- ◆ is a member of the key management personnel of the entity or its parent;
- ◆ is a joint venture in which the entity is a venturer;
- ◆ is an associate of the entity;
- ◆ is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, any of the key management personnel or their close family members;
- ◆ is a close member of the family of any of the aforementioned key management personnel;
- ◆ is a post-employment benefit plan for the benefit of employees of the entity, or of any of its related parties.

A related party transaction is a transfer of resources, services or obligations between related parties, regardless of whether price is charged.

IAS 24 requires the following related party disclosures:

- ◆ Nature of relationships between parents and subsidiaries, even if there were no transactions between those related parties;
- ◆ The name of the entity's parent and, if different, the ultimate controlling party;
- ◆ Compensation of key management personnel;
- ◆ If there have been transactions between related parties, the nature of the relationship and information about the transactions and outstanding balances with related parties.

Such disclosures are made separately for each of the following categories: the parent; entities with joint control or significant influence over the entity; subsidiaries; associates; joint ventures in which the entity is a venturer; key management personnel; and other related parties.

**Examples of the kinds of transactions that are disclosed if they are with a Related Party**

- ◆ Purchases or sales of goods.
- ◆ Rendering or receiving of services.
- ◆ Purchases or sales of property and other assets.
- ◆ Leases.
- ◆ Transfers under license agreements.
- ◆ Transfers of research and development.

## **2.34 Financial Reporting**

- ◆ Transfers under finance arrangements (including loans and equity contributions in cash or in kind).
- ◆ Settlement of liabilities on behalf of the entity or by the entity on behalf of another party.
- ◆ Provision of guarantees or collateral.

### **3.19 IAS 26: ACCOUNTING AND REPORTING BY RETIREMENT BENEFIT PLANS**

IAS 26 on "Accounting and Reporting by Retirement Benefit Plans" is applicable for periods beginning on or after 1 January 1988.

IAS 26 applies to the financial statements of retirement benefit plans. Retirement benefit plans are arrangements whereby an entity provides benefits to employees on or after termination of service when such benefits, or the contributions towards them, can be determined or estimated in advance of retirement from the provisions of a document or from the entity's practices.

#### **SUMMARY**

Retirement benefit plans are either defined contribution plans or defined benefit plans.

Defined contribution plans are retirement benefits plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon. An employer's obligation is usually discharged by its contributions.

Defined benefit plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula which is usually based on employee's earnings or year of service or both.

The financial statements of defined contribution plan comprise a statement of net assets available for benefits and a description of the funding policy.

The following principles apply to the valuation of assets owned by the plan:

- ◆ Investments should be carried at fair value.
- ◆ If carried at other than fair value, the investments' fair value should be disclosed.

The financial statements of a defined benefit plan contain either:

A statement that shows:

- ◆ the actuarial present value of promised retirement benefits, distinguishing between vested and non-vested benefits;
- ◆ the net assets available for benefits; and
- ◆ the resulting excess or deficit; or

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A statement of net assets available for benefits including either:

- ◆ a reference to this information in an accompanying actuarial report; or
- ◆ a note disclosing the actuarial present value of promised retirement benefits, distinguishing between vested and non-vested benefits.

The actuarial present values of promised retirement benefits are based on the benefits promised under the terms of the plan on services rendered to date using either current salary levels or projected salary levels. Retirement benefit plan investments are carried at fair value.

IAS 26 specifies certain disclosures in the financial statements for retirement benefit plans.

**Illustration**

The financial statements of a retirement benefit plan should inter alia contain a statement of changes in net assets available for benefits.

**Solution**

*The following extract was taken from the World Bank Group: Staff Retirement Plan- 2004 Annual Report. It contains statements that comply with the IAS 26 requirements in all material respects.*

Statements of Changes in Net Assets Available for Benefits (in thousands)

|                                                          | <i>Year Ended December 31</i> |                  |
|----------------------------------------------------------|-------------------------------|------------------|
|                                                          | <i>2004</i>                   | <i>2003</i>      |
| <b>Investment income (loss)</b>                          |                               |                  |
| Net appreciation in fair value of Investments (Note F)   | 881,325                       | 1,348,382        |
| Interest and dividends                                   | 262,406                       | 265,212          |
| Less: Investment management fees                         | <u>(45,193)</u>               | <u>(43,618)</u>  |
| Net investment income                                    | <u>1,098,538</u>              | <u>1,569,976</u> |
| <b>Contributions (Note C)</b>                            |                               |                  |
| Contributions by participants                            | 77,224                        | 76,280           |
| Contributions by employer                                | <u>184,228</u>                | <u>85,027</u>    |
| Total contributions                                      | <u>261,452</u>                | <u>161,307</u>   |
| Total additions                                          | <u>1,359,990</u>              | <u>1,731,283</u> |
| <b>Benefit payments</b>                                  |                               |                  |
| Pensions                                                 | (293,908)                     | (271,399)        |
| Commutation payments                                     | (41,218)                      | (32,099)         |
| Contributions, withdrawal benefits, and interest paid to |                               |                  |

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|                                          |                   |                   |
|------------------------------------------|-------------------|-------------------|
| former participants on withdrawal        | (28,312)          | (23,586)          |
| Lump sum death benefits                  | (622)             | (1,671)           |
| Termination grants                       | <u>(2,375)</u>    | <u>(3,048)</u>    |
| Total benefit payments                   | <u>(366,435)</u>  | <u>(331,803)</u>  |
| <b>Administrative expenses</b>           |                   |                   |
| Custody and consulting fees              | (4,516)           | (4,985)           |
| Others                                   | <u>(8,083)</u>    | <u>(5,902)</u>    |
| Total administrative expenses            | <u>(12,599)</u>   | <u>(10,887)</u>   |
| Net increase                             | <u>980,956</u>    | <u>1,388,593</u>  |
| <b>Net assets available for benefits</b> |                   |                   |
| Beginning-of-year                        | <u>10,276,705</u> | <u>8,888,112</u>  |
| End-of-year                              | <u>11,257,661</u> | <u>10,276,705</u> |

## 3.20 IAS 27 (REVISED): CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

IAS 27 (revised) on "Consolidated and Separate Financial Statements" was issued in December 2003 and is applicable to annual periods beginning on or after 1 January 2005.

IAS 27 is applicable to the preparation and presentation of consolidated financial statements for a group under the control of a parent. It also deals with the accounting for investments in subsidiaries, jointly controlled entities and associates in the separate financial statements of a parent.

### SUMMARY

Unless certain conditions are met allowing it not to prepare consolidated financial statements, a parent has to present consolidated financial statements in which it consolidates its investment in subsidiaries (those entities which are controlled by it either because of parent owning 50% of the voting power or right or due to financial or operating policies of the entity or influence over the board of directors). The consolidated financial statements are prepared using uniform accounting policies. A parent should present consolidated financial statements as if the group were a single entity. The difference of the reporting dates of the parent and its subsidiaries shall not be more than 3 months.

The preparation of consolidated financial statements involves the combination of the financial statements of the parent and its subsidiaries on a line-by-line basis by adding together like items of assets, liabilities, equity, income, and expenses. Other basic procedures include the following:

- ◆ The carrying amount of the parent's investment and its portion of equity of each subsidiary are eliminated in accordance with the procedures of IFRS 3.



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- ◆ Minority interests in the net assets of consolidated subsidiaries are identified and presented separately as part of equity.
- ◆ Intragroup balances and intragroup transactions are eliminated in full.
- ◆ Minority interests in the profit or loss of subsidiaries for the period are identified but are not deducted from profit for the period.
- ◆ Consolidated profits are adjusted for the subsidiary's cumulative preferred dividends, whether or not dividends have been declared.
- ◆ An investment is accounted for in terms of IAS 39 from the date that it ceases to be a subsidiary and does not subsequently become an associate.
- ◆ The losses applicable to the minority interest might exceed the minority investor's interest in the equity of the subsidiary. The excess is charged against the majority interest except to the extent that the minority has a binding obligation to, and is able to, make good on the losses.

When separate financial statements are prepared, investment in subsidiaries, jointly controlled entities and associates should be accounted for either at cost or in accordance with IAS 39. The same accounting should be applied for each category of investments.

IAS 27 specifies certain disclosures to be made in consolidated and separate financial statements.

Consolidated financial statements need not be presented in the case of a wholly owned subsidiary or virtually wholly owned subsidiary (with unanimous approval of minority shareholders) if

- ◆ Debt or equity instruments are not traded in a public market;
- ◆ It did not file – or is not filing - financial statements with securities commission; and
- ◆ Its ultimate parent publishes IFRS – consolidated financial statements.

**Illustration**

The following amounts of profit after tax relate to the ABCDE group of entities:

|        |        |
|--------|--------|
|        | \$     |
| A Inc. | 15,000 |
| B Inc. | 4,000  |
| C Inc. | 2,500  |
| D Inc. | 6,000  |
| E Inc. | 8,000  |

## 2.38 Financial Reporting

A Inc. owns 75 percent of the voting power in B Inc. and 30 percent of the voting power in C Inc.

B Inc. also owns 30 percent of the voting power in C Inc. and 25 percent of the voting power in E Inc.

C Inc. owns 40 percent of the voting power in D Inc.

### Issues

What is the status of each entity in the group and how is the minority share in the group profit after tax calculated?

### Solution

B Inc. and C Inc. are both subsidiaries of A Inc., which owns, directly or indirectly through a subsidiary, more than 50 percent of the voting power in the entities.

C Inc. and E Inc. are deemed to be associates of B Inc., whereas D Inc. is deemed to be an associate of C Inc. unless it can be demonstrated that significant influence does not exist.

The minority interest in the group profit after tax is calculated as follows:

|                                | \$           | \$             |
|--------------------------------|--------------|----------------|
| Profit after tax of C Inc. Own | 2,500        |                |
| Equity accounted:              |              |                |
| D Inc. (40% x 6,000)           | <u>2,400</u> |                |
|                                | <u>4,900</u> |                |
| Minority interest of 40%       |              | 1,960          |
| Profit after tax of B Inc.     |              |                |
| Own                            | 4,000        |                |
| Equity accounted:              |              |                |
| C Inc. (30% x 4,000)           | 1,470        |                |
| C Inc. (25% x 8,000)           | <u>2,000</u> |                |
|                                | <u>7,470</u> |                |
| Minority interest of 25%       |              | <u>1,867.5</u> |
|                                |              | <u>3,827.5</u> |

### Illustration

A Alpha Parent company, with subsidiaries in various countries, follows the accounting policy of FIFO costing for all inventories in the group. It has recently acquired a controlling interest in a foreign subsidiary that uses LIFO because of the tax benefits.

How is this aspect dealt with on consolidation?

### **Solution**

IAS 27 requires consolidated financial statements to be prepared using uniform accounting policies. However, it does not demand that an entity in the group change its method of accounting in its separate financial statements to that method which is adopted for the group.

Therefore, on consolidation appropriate adjustments must be made to the financial statements of the foreign subsidiary to convert the carrying amount of inventories to a FIFO-based amount.

### **3.21 IAS 28 (REVISED): INVESTMENT IN ASSOCIATES**

IAS 28 (revised) on "Investment in Associates" was issued in December 2003 and is applicable to annual periods beginning on or after 1 January 2005.

IAS 28 applies in accounting for investments in associates, except those held by:

- ◆ Mutual funds, unit trusts and similar entities including investment-linked insurance funds that upon initial recognition are designated at fair value through profit or loss or are classified as held for trading and accounted for in accordance with IAS 39 on "Financial Instruments: Recognition and Measurement"; or.
- ◆ Venture capital organizations.

### **SUMMARY**

An associate is an entity over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture. Significant influence is the power to participate in financial and operating policy decisions of the investee but cannot be termed as control or joint control over those policies. If the investor owns 20% or more of the voting power of the investee, such influence is presumed to exist.

An investment in the associates is accounted for using the equity method. The equity method is not used when:

- ◆ The investment is classified as held for sale in accordance with IFRS 5 on "Non-current Assets Held for Sale and Discontinued Operations"; or
- ◆ The investor is itself a subsidiary, its owners do not object to the equity method not being applied and its debt and equity securities are not publicly traded. In the given case, the investor's parent must present consolidated financial statements, which should comply with IFRSs.

The equity method is applied as follows:

- ◆ Initial measurement is applied at cost (excluding borrowing costs as per IAS 23).
- ◆ Subsequent measurement is adjusted for postacquisition change in the investor's share of

## 2.40 Financial Reporting

- The net assets of the associate share of profit or loss included in income statement; and
- The share of other change included in equity.

Many procedures for the equity method are similar to consolidation procedures, such as the following:

- ◆ Eliminating intragroup profits and losses arising from transactions between the investor and the investee.
- ◆ Identifying the goodwill portion of the purchase price
- ◆ Amortization of goodwill
- ◆ Adjustments for depreciation of depreciable assets, based on their fair values.
- ◆ Adjustments for the effect of cross holdings
- ◆ Using uniform accounting policies

The investor computes its share of profits or losses after adjusting for the cumulative preferred dividends, whether or not they have been declared. The investor recognizes losses of an associate until the investment is zero. Further losses are only provided for to the extent of guarantees given by the investor.

Uniform accounting policies for like transactions and events in similar circumstances must be used in the investor's financial statements. Difference between the reporting date of the investor and reporting date of associate must not be more than 3 months.

An investor discontinues the equity method from the date that it ceases to have significant influence over the associate. From that date it accounts for the investment in accordance with IAS 39, provided the associate does not become a subsidiary or a joint venture as defined in IAS 31.

IAS 28 specifies certain disclosures to be made in the investor's financial statements about associates.

### Illustration

Dasy Inc. acquired a 40 percent interest in the ordinary shares of Neel Inc. on the date of incorporation, January 1, 20X0, for an amount of \$22,000. This enabled Dolo Inc. to exercise significant influence over Neel Inc. On December 31, 20X3, the shareholders' equity of Neel Inc. was as follows:

|                               |        |
|-------------------------------|--------|
|                               | \$     |
| Ordinary issued share capital | 55,000 |
| Reserves                      | 18,000 |

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|                    |                |
|--------------------|----------------|
| Accumulated profit | <u>65,000</u>  |
|                    | <u>138,000</u> |

The following abstracts were taken from the financial statements of Neel Inc. for the year ending December 31, 20X4:

\$

**Income statement**

|                           |                |
|---------------------------|----------------|
| Profit after tax          | 22,800         |
| Extraordinary items       | <u>(1,200)</u> |
| Net profit for the period | <u>21,600</u>  |

**Statement of changes in equity**

|                                              |                |
|----------------------------------------------|----------------|
| Accumulated profits at beginning of the year | 65,000         |
| Net profit for the period                    | 21,600         |
| Dividends paid                               | <u>(8,000)</u> |
| Accumulated profits at end of the year       | <u>786,000</u> |

In November 20X4, Dasy Inc. sold inventories to Neel Inc. for the first time. The total sales amounted to \$5,000 and Dasy Inc. earned a profit of \$1,000 on the transaction. None of the inventories had been sold by Neel Inc. by December 31. The income tax rate is 30 percent.

**Solution**

The application of the equity method would result in the carrying amount of the investment in Neel Inc. being reflected as follows:

\$

|                                                                                           |                |
|-------------------------------------------------------------------------------------------|----------------|
| Original cost                                                                             | 22,000         |
| Post acquisition profits accounted for at beginning of the year [40% x (18,000 + 65,000)] | <u>33,200</u>  |
| Carrying amount on January 1, 20X4                                                        | 55,200         |
| Attributable portion of net profit for the period (Calculation 1)                         | 8,360          |
| Dividends received (40% x 8,000)                                                          | <u>(3,200)</u> |
|                                                                                           | <u>60,360</u>  |

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### Calculation 1

|                                                             |              |
|-------------------------------------------------------------|--------------|
| Attributable portion of net profit                          | \$           |
| Net profit (40% × 21,600)                                   | <u>8,640</u> |
| After-tax effect of unrealized profit [40% × (70% × 1,000)] | <u>(280)</u> |
| All                                                         | <u>8,360</u> |

### 3.22 IAS 29: FINANCIAL REPORTING IN HYPERINFLATIONARY ECONOMIES

IAS 29 on "Financial Reporting in Hyperinflationary Economies" is applicable for periods beginning on or after 1 January 1990.

IAS 29 is applicable to the financial statements, including the consolidated financial statements, of those entities whose functional currency is the currency of a hyperinflationary economy. Hyperinflation is indicated by the economic environment of a country, which include, amongst others, the cumulative inflation rate over three years is approaching, or exceeds, 100%.

#### SUMMARY

Restatement starts from the beginning of the period in which hyperinflation is identified.

When functional currency of an entity's is the currency of a hyperinflationary economy, the financial statements are stated in measuring unit current at the balance sheet date. Comparative amounts for prior periods should also be stated in the measuring unit current at the balance sheet date. The gain or loss on the net monetary position is charged to profit or loss account.

The restated financial statements replace the financial statements and do not serve as a supplement of the financial statements. Separate presentation of the non-adjusted financial statements is not permitted.

#### Restatement Of Historical Cost Financial Statements

Rules applicable to the restatement of the balance sheet are as follows:

- ◆ Monetary items are not restated.
- ◆ Index-linked assets and liabilities are restated in accordance with the agreement.
- ◆ Non-monetary items are restated in terms of the current measuring unit by applying the changes in the index or currency unit to the carrying values since the date of acquisition (or the first period of restatement) or fair values on dates of valuation.
- ◆ Non-monetary assets are not restated if they are shown at net realizable value, fair value, or recoverable amount at balance sheet date.

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- ◆ At the beginning of the first period in which the principles of IAS 29 are applied, components of owners' equity, except accumulated profits and any revaluation surplus are restated from the dates the components were contributed.
- ◆ At the end of the first period and subsequently all components of owners' equity are restated from the date of contribution.
- ◆ The movements in owners' equity are included in equity.

All items in the income statement are restated by applying the change in the general price index from the dates when the items were initially recorded.

A gain or loss on the net monetary position is included in net income. This amount can be estimated by applying the change in the general price index to the weighted average of net monetary assets or liabilities.

**Restatement Of Currency Cost Financial Statements**

Rules applicable to the restatement of the balance sheet are:

- ◆ Items shown at current cost are not restated.
- ◆ Other items are restated in terms of the rules above.

All amounts included in the income statement are restated into the measuring unit at balance sheet date by applying the general price index.

If a gain or loss on the net monetary position is calculated, such an adjustment forms part of the gain or loss on the net monetary position calculated in terms of IAS 29.

All cash flows are expressed in terms of the measuring unit at balance sheet date.

When a foreign subsidiary, associate, or joint venture of a parent company reports in a hyperinflationary economy, the financial statements of such entities should first be restated in accordance with IAS 29 and then translated at closing rate as if the entities were foreign entities per IAS 21.

As soon as an economy ceases to be hyperinflationary, an entity discontinues the preparation and presentation of financial statements in accordance with IAS 29. However, for the carrying amounts in its subsequent financial statements, the amounts expressed in the measuring unit current at the end of the previous reporting period are treated as the basis.

IAS 29 specifies certain disclosures about the effects of a hyperinflationary economy on an entity's financial statements.

## 2.44 Financial Reporting

### Illustration

Dolo Inc. was incorporated in January 1, 20X2 with an equity capital of \$4 million. The balance sheets of the entity at the beginning and end of the first financial year were as follows:

|                                | <b>Beginning</b> | <b>End</b>    |
|--------------------------------|------------------|---------------|
|                                | <b>\$'000</b>    | <b>\$'000</b> |
| Assets                         |                  |               |
| Property, Plant, and Equipment | 6,000            | 5,000         |
| Inventory                      | 3,000            | 4,000         |
| Receivables                    | <u>5,000</u>     | <u>6,000</u>  |
|                                | <u>14,000</u>    | <u>15,000</u> |
| Equity and Liabilities         |                  |               |
| Share Capital                  | 4,000            | 4,000         |
| Accumulated Profit             | -                | 1,000         |
| Borrowings                     | <u>10,000</u>    | <u>10,000</u> |
|                                | <u>14,000</u>    | <u>15,000</u> |

The income statement for the first year reflected the following amounts:

|                                     | <b>\$'000</b>  |
|-------------------------------------|----------------|
| Revenue                             | 80,000         |
| Operating Expenses                  | (75,000)       |
| Depreciation of Plant and Equipment | <u>(1,000)</u> |
| Operating Profit                    | 4,000          |
| Interest Paid                       | <u>(2,000)</u> |
| Profit before Tax                   | 2,000          |
| Income Tax Expense                  | <u>(1,000)</u> |
| Profit after Tax                    | 1,000          |

### Additional Information

1. The rate of inflation was 120 percent for the year.

The inventory represents 2 months' purchases, and all income statement items accrued evenly during the year.



**Solution**

The financial statements can be restated to the measuring unit at balance sheet date using a reliable price index, as follows:

| <b>Balance Sheet</b>               |                 |                 |                    |
|------------------------------------|-----------------|-----------------|--------------------|
|                                    | <b>Recorded</b> | <b>Restated</b> | <b>Calculation</b> |
|                                    | <b>\$'000</b>   | <b>\$'000</b>   |                    |
| <b>Assets</b>                      |                 |                 |                    |
| Property, Plant, and Equipment     | 5,000           | 11,000          | 2.20/1.00          |
| Inventory (Calculation a)          | 4,000           | 4,190.5         | 2.22/2.10          |
| Receivables                        | <u>6,000</u>    | <u>6,000</u>    |                    |
|                                    | <u>15,000</u>   | <u>21,190.5</u> |                    |
| <b>Equity and Liabilities</b>      |                 |                 |                    |
| Share Capital                      | 4,000           | 8,800           | 2.20/1.00          |
| Accumulated Profits                | 1,000           | 2,390.5         | Balancing          |
| Borrowings                         | <u>10,000</u>   | <u>10,000</u>   |                    |
|                                    | <u>15,000</u>   | <u>21,190.5</u> |                    |
| <b>Income Statement</b>            | <b>\$'000</b>   | <b>\$'000</b>   |                    |
| Revenue (Calculation b)            | 80,000          | 110,000         | 2.20/1.60          |
| Operating Expenses                 | (75,000)        | (103,125)       | 2.20/1.60          |
| Depreciation (Calculation c)       | (1,000)         | (2,200)         | 2.20/1.00          |
| Interest Paid                      | (2,000)         | (2,750)         | 2.20/1.60          |
| Income Tax Expense                 | <u>(1,000)</u>  | <u>(1,375)</u>  | 2.20/1.60          |
| Net Profit before Restatement Gain | <u>1,000</u>    | 550             |                    |
| Gain arising from                  |                 |                 | Balancing          |
| Inflationary Adjustment            |                 | <u>1,840.5</u>  | Figure             |
| Net Profit after Restatement Gain  |                 | <u>2,390.5</u>  |                    |

**Calcualtions**

**a. Index for inventory**

Inventory purchased on average at 30 November

Index at that date =  $1.00 + (1.20 \times 11/12) = 2.10$

## **2.46 Financial Reporting**

### **b. Index for income and expenses**

Average for the year =  $1.00 + (1.20 \div 2) = 1.60$

### **c. Index for depreciation**

Linked to the index of property, plant and equipment = 1.00

## **3.23 IAS 30: DISCLOSURES IN THE FINANCIAL STATEMENTS OF BANKS AND SIMILAR FINANCIAL INSTITUTIONS**

IAS 30 is superseded by IFRS 7 on "Financial Instruments: Disclosures" effective from 1st January 2007

## **3.24 IAS 31 (REVISED): INTEREST IN JOINT VENTURES**

IAS 31 (revised) on "Interest in Joint Ventures" was issued in December 2003 and is applicable to annual periods beginning on or after 1 January 2005.

Regardless of the structures or forms under which the joint venture activities take place, IAS 31 is applicable in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers.

IAS 31 does not apply to interests in jointly controlled entities held by:

- ◆ Mutual funds, unit trusts and similar entities including investment-linked insurance funds that upon initial recognition are designated as at fair value through profit or loss or are classified as held for trading and accounted for in accordance with IAS 39 on "Financial Instruments: Recognition and Measurement"; or
- ◆ Venture capital organizations.

## **SUMMARY**

Where two or more parties undertake an economic activity that is subject to joint control under a contractual arrangement is termed as a joint venture. These are of three types:

- ◆ Jointly controlled operations; or
- ◆ Jointly controlled assets; or
- ◆ Jointly controlled entities.

Joint control exists only when the strategic, financial and operating decisions relating to the economic activity require the undisputed consent of the parties sharing control.

A venturer recognises its interest in a jointly controlled operation by recognising in its financial statements the assets that it controls, the liabilities and expenses that it incurs, and its share of the income that it earns from the sale of goods or services by the joint venture.

A venturer recognises its interest in jointly controlled assets on a proportional basis.

It also recognises any liabilities or expenses it incurs, its share of liabilities or expenses incurred jointly, and any income from the sale or use of its share of the output of the joint venture.

A venturer recognises its interest in a jointly controlled entity using either the equity method in accordance with IAS 28 on "Investment in Associates" or proportionate consolidation. The use of proportionate consolidation or the equity method is not required when:

- ◆ The investment is classified as held for sale in accordance with IFRS 5 on "Non-current Assets Held for Sale and Discontinued Operations"; or
- ◆ The venturer is itself a subsidiary, its owners do not object to proportionate consolidation or the equity method not being applied, and its debt and equity securities are not publicly traded. In this case the venturer's parent must present consolidated financial statements that comply with IFRSs.

A venturer discontinues proportionate consolidation from the date that it ceases to have joint control over a jointly controlled entity. A venturer discontinues the equity method, from the date that it ceases to have joint control over, or significant influence in, a jointly controlled entity.

On transferring the assets to a joint venture, the venturer recognises only that portion of the profit or loss that is attributable to the interests of the other venturers.

On purchasing assets from a joint venture, the venturer does not recognise its share of the joint venture's profit or loss from the transaction until it resells that assets to an independent third party. A loss on transactions between a venturer and a joint venture may provide evidence of a reduction in the net realisable value of current assets or an impairment loss. In such cases the loss is recognized immediately.

The following general accounting considerations apply:

- ◆ Transactions between a venturer and a joint venture are treated as follows:
  - The venturer's share of unrealized profits on sales or contribution of assets to a joint venture is eliminated.
  - Full unrealized loss on sale or contribution of assets to a joint venture is eliminated.
  - The venturer's share of profits or losses on sales of assets by a joint venture to the venturer is eliminated.
- ◆ An investor in a joint venture that does not have joint control should report its interest in a joint venture in the consolidated financial statements in terms of ICAS 39 or, if it has significant influence, in terms of IAS 28.
- ◆ Operators or managers of a joint venture should account for any fees as revenue in terms of IAS 18.

IAS 31 specifies certain disclosures to be made in venturer's financial statements about joint ventures.

## **2.48 Financial Reporting**

### **3.25 IAS 32 (REVISED): FINANCIAL INSTRUMENTS: PRESENTATION**

IAS 32 (revised) on “Financial Instruments: Presentation” was issued in December 2003 and is applicable for annual periods beginning on or after 1 January 2005.

IAS 32 intends to enhance the understanding of the financial statement users’ about the significance of financial instruments to an entity’s financial position, financial performance and cash flows. It prescribes requirements for the presentation of financial instruments and identifies information that should be disclosed about them.

IAS 32 applies to all types of financial instruments both recognized and unrecognized and should be applied to contracts to buy or sell a non-financial item that can be settled net

- ◆ In cash;
- ◆ By another financial instrument; or
- ◆ By exchanging financial instruments, as if the contracts were financial instruments.

IAS 32 applies to all risks arising from all financial instruments, except:

- ◆ those interests in subsidiaries, associates and joint ventures that are consolidated, or are accounted for using the equity method or proportionate consolidation in accordance with IAS 27 on “Consolidated and Separate Financial Statements, IAS 28 Investment in Associates” or IAS 31 on “Interests in Joint Ventures”;
- ◆ employers’ rights and obligations under employee benefit plans (IAS 19 on “Employee Benefits”);
- ◆ contracts for contingent consideration in a business combination (IFRS 3 on “Business Combinations”);
- ◆ insurance contract as defined by IFRS 4 on “Insurance Contracts”;
- ◆ financial instruments that are within the scope of IFRS 4 on “Insurance Contracts” because they contain a discretionary participation feature; and
- ◆ financial instruments, contracts and obligations under share-based payment transactions (IFRS 2 on “Share Based Payment”).

#### **SUMMARY**

Financial instruments are classified, from the perspective of the issuer, as financial assets, financial liabilities and equity instruments. Compound financial instruments may contain both a liability and an equity component.

Interest, dividends, losses and gains relating to financial liabilities are recognised as income or expense in profit or loss. Distributions to holders of equity instruments are debited directly to equity, net of any related income tax benefit.

Financial assets and financial liabilities are offset when and only when there is a legally enforceable right to set off and the entity intends to settle on a net basis.

IAS 32 requires disclosure about factors that affect the amount, timing and certainty of an entity's future cash flows relating to financial instruments and the accounting policies applied to those instruments. It also requires disclosure about the nature and extent of an entity's use of financial instruments, the business purposes they serve, the risks associated with them, and management's policies for controlling those risks.

The principles in IAS 32 complement the principles for recognising and measuring financial assets and financial liabilities in IAS 39 *Financial Instruments: Recognition and Measurement*.

**Note:** Disclosure provisions of IAS 32 are replaced by IFRS 7 on "Financial Instruments: Disclosures" effective 1 January 2007. Title of IAS 32 therefore changed to *Financial Instruments: Presentation*

### **3.26 IAS 33 (REVISED): EARNINGS PER SHARE**

IAS 33 (revised) on "Earnings per Share" was issued in December 2003 and is applicable for annual periods beginning on or after 1 January 2005.

IAS 33 prescribes principles for the determination and presentation of earnings per share, so as to improve performance comparisons between different reporting entities in the same reporting period and between different reporting periods for the same entity.

IAS 33 is applied by entities whose ordinary shares or potential ordinary shares are publicly traded and by entities that are in the process of issuing ordinary shares or potential ordinary shares in public markets. If another entity chooses to disclose earnings per share information, such information is calculated and disclosed in accordance with IAS 33.

#### **SUMMARY**

An entity presents on the face of the income statement basic and diluted earnings per share for each class of ordinary shares that has a different right to share in profit for the period. An entity calculates basic and diluted earnings per share for profit or loss from continuing operations attributable to the ordinary equity holders of the parent entity. If an entity reports a discontinued operation, it also discloses basic and diluted earnings per share for the discontinued operation.

#### **Basic Earnings per Share**

Basic earnings per share is calculated by dividing profit or loss attributable to ordinary equity holders of the parent entity (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the period.

## 2.50 Financial Reporting

The profit or loss attributable to the parent entity is adjusted for the after-tax amounts of preference dividends, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as equity.

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The weighted average number of ordinary shares outstanding during the period and for all periods presented is adjusted for events, other than the conversion of potential ordinary shares that have changed the number of ordinary shares outstanding without a corresponding change in resources (eg. a bonus issue, a share split).

### Illustration

Winners reported net earnings of \$25,000 for the year ending 20X1. The company had 12,500 shares of \$1 par value common stock and 3,000 shares of \$40 par value convertible preference shares outstanding during the year. The dividend rate on the preference shares is \$2 per share. Each share of the convertible into two shares of Winners' Class A common shares. During the year no convertible preference shares were converted.

What is Winners' basic earnings per share?

### Solution

$$\text{Basic earnings} = \frac{\text{Net income} - \text{Preference dividends}}{\text{Weighted average common shares}}$$

$$\begin{aligned} &= \frac{(\$25,000 - (\$2 \times 3,000 \text{ shares}))}{12,500 \text{ shares}} \\ &= \frac{\$19,000}{12,500} \\ &= \$1.52 \text{ per share} \end{aligned}$$

### Diluted Earnings per Share

Diluted earnings per share is calculated by adjusting the profit or loss attributable to ordinary equity holders of the parent entity, and the weighted average number of ordinary shares outstanding, for the effects of all dilutive potential ordinary shares.

The profit or loss attributable to ordinary equity holders of the parent entity, as calculated for basic earnings per share, is adjusted for the after-tax effects of:

- ◆ any dividends or other items related to dilutive potential ordinary shares deducted in arriving at profit or loss attributable to ordinary equity holders;
- ◆ any interest recognised in the period related to dilutive potential ordinary shares; and

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- ◆ any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.

The number of ordinary shares is the weighted average number of ordinary shares outstanding, as calculated for basic earnings per share, plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. Potential ordinary shares are treated as dilutive when their conversion to ordinary shares would decrease earnings per share or increase loss per share from continuing operations (eg options and warrants, convertible instruments, contingently issuable shares).

**Illustration**

Winners reported net earnings of \$25,000 for the year ending 20X1. The company had 12,500 shares of \$1 par value common stock and 3,000 shares of \$40 par value convertible preference shares outstanding during the year. The dividend rate on the preference shares is \$2 per share. Each share of the convertible preference shares can be converted into two shares of Winners' Class A common shares. During the year no convertible preference shares were converted.

What is Winners' diluted earnings per share?

**Solution**

$$\text{Diluted earnings per share} = \frac{\text{Net income} - \text{preference dividends} + \text{Dividends on converted securities}}{\text{Shares outstanding} + \text{Additional shares if securities were converted}}$$

$$= \frac{\$25,000 - \$6,000 + \$6,000}{12,500 + (3,000 \times 2)}$$

Earnings per share amounts should be restated in the following circumstances:

- ◆ If the number of shares outstanding is affected as a result of a capitalization, bonus issue, share split or a reverse share split, the calculation of basic EPS and diluted EPS should be adjusted retrospectively.
- ◆ If these changes occur after balance sheet date but before issue of financial statements, the per share calculations are based on the new number of shares.

IAS 33 specifies disclosures about earnings per share information.

## 2.52 Financial Reporting

### 3.27 IAS 34: INTERIM FINANCIAL REPORTING

IAS 34 on "Interim Financial Reporting" is applicable for periods beginning on or after 1 January 1999.

IAS 34 prescribes the minimum content of an interim financial report and the principles for recognition and measurement in any interim financial statements (covering a period shorter than a full financial year for instance a quarter or half year).

IAS 34 does not specify which entities must publish interim financial reports, how frequently, or how soon after the end of an interim period. Those are matters that are usually specified by law or regulation. IAS 34 applies if an entity is required or elects to publish an interim financial report in accordance with International Financial Reporting Standards.

#### SUMMARY

IAS 34 defines the minimum content of an interim financial report as a condensed balance sheet, condensed income statement, condensed statement showing changes in equity, condensed cash flow statement, and selected explanatory notes.

Interim financial statements covers the following periods:

- ◆ A balance sheet at the end of the current interim period, and a comparative balance sheet as of the end of the most recent full financial year;
- ◆ Income statements for the current interim period and cumulatively for the current financial year to date, with comparative income statements for the comparable interim periods of the immediately preceding financial year;

An entity that publishes interim financial reports quarterly would, for example, prepare four income statements in its third quarter, i.e. one for the 9 months cumulatively since the beginning of the year, one for the third quarter only and comparative income settlements for the exact comparable periods of the prior financial year.

- ◆ A statement of changes in equity cumulatively for the current financial year to date, and a comparative statement for the comparable year-to-date period of the prior year; and
- ◆ A cash flow statement cumulatively for the current financial year to date, and a comparative statement for the comparable year-to-date period of the prior financial year.

The form and content of an interim financial report is prescribed as follows:

- ◆ Include at a minimum
  - Each of the headings and subtotals that were included in the most recent annual financial statements; and
  - Selected explanatory notes required by this IAS.



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- ◆ Basic and diluted earnings per share to be presented on the face of the income statement.
- ◆ A parent should prepare the report on a consolidated basis.

The notes to the interim financial statements are viewed primarily as an update since the last annual report. The notes required include disclosures about changes in accounting policies, seasonality or cyclicity, changes in estimates, changes in outstanding debt or equity, dividends, segment revenue and result, events occurring after balance sheet date, acquisition or disposal of subsidiaries and long-term investments, restructurings, discontinuing operations, and changes in contingent liabilities or contingent assets.

An entity applies the same accounting policies in its interim financial statements as in its latest annual financial statements. Measurements for interim reporting purposes are made on a year-to-date basis. The interim financial report includes a statement of compliance with IAS 34.

IAS 34 specifies disclosures required in interim financial statements.

**Illustration**

The following three basic recognition and measurement principles are stated in IAS 34:

- A. An entity should apply the same accounting policies in its interim financial statements as it applies in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an entity's reporting (annually, semiannually, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.
- B. Revenues that are received seasonally, cyclically, or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the entity's financial year.
- C. Costs that are incurred unevenly during an entity's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

## 2.54 Financial Reporting

### Solution

The following table illustrates the practical application of the above-mentioned recognition and measurement principles:

#### *Principles and Issues*

#### *Practical Application*

##### **A. Same accounting policies as for annual financial statements.**

A devaluation in the functional currency against other currencies occurred just before the end of the first quarter of the year. This necessitated the recognition of foreign exchange losses on the restatement of unhedged liabilities, which are repayable in foreign currencies.

Indications are that the functional currency will regain its position against the other currencies by the end of the second quarter of the year. Management is reluctant to recognize these losses as expenses in the interim financial report and wants to defer recognition, based on the expectation of the functional currency. They hope that the losses will be neutralized by the end of the next quarter, in order to smooth the earnings rather than recognizing losses in one quarter and profits in the next.

In the interim financial statements, these losses are recognized as expenses in the first quarter in accordance with IAS 21.

The losses are recognized as expenses on a year-to-date basis to achieve the objective of applying the same accounting policies for both the interim and annual financial statements.

##### **B. Deferral of revenues**

An ice cream manufacturing corporation recently had its shares listed on the local stock exchange. Management is worried about publishing the first quarter's interim results because the entity normally earns most of its profits in the third and fourth quarters (during the summer months).

Statistics show that the revenue pattern is more or less as follows:

First quarter = 10 percent of total annual revenue

Second quarter = 15 percent of total annual revenue

Third quarter = 40 percent of total annual revenue

Fourth quarter = 35 percent of total annual

It is a phenomenon in the business world that some entities consistently earn more revenues in certain interim periods of a financial year than in other interim periods, for example, seasonal revenues of retailers.

IAS 34 requires that such revenues are recognized when they occur, because anticipation or deferral would not be appropriate at the balance sheet date. Revenue of \$254,000 is therefore reported in the first quarter.

revenue

During the first quarter of the current year total revenue amounted to \$254,000. However, management plans to report  $\frac{1}{4}$  of the projected annual revenue in its interim financial report, calculated as follows:

$$\$254,000 \div 0,10 \times \frac{1}{4} = \$635,000$$

### **C. Deferral of expenses**

An entity that reports quarterly has an operating loss carryforward of \$10,000 for income tax purposes at the start of the current financial year, for which a deferred tax asset has not been recognized.

The entity earns \$10,000 in the first quarter of the current year and expects to earn \$10,000 in each of the three remaining quarters. Excluding the carryforward, the estimated average annual income tax rate is expected to be 40 per cent. Tax expense for the year would be calculated as follows:

$$40 \text{ percent} \times (40,000 - 10,000 \text{ tax loss}) = \$12,000$$

The effective tax rate based on the annual earnings would then be 30 percent ( $12,000 \div 40,000$ ).

The question is whether the tax charge for interim financial reporting should be based on actual or effective annual rates, which are illustrated below:

Income tax payable

| Quarter | Actual Rate     | Effective Rate  |
|---------|-----------------|-----------------|
| First   | Nil*            | 3,000           |
| Second  | 4,000           | 3,000           |
| Third   | 4,000           | 3,000           |
| Fourth  | <u>4,000</u>    | <u>3,000</u>    |
|         | <u>\$12,000</u> | <u>\$12,000</u> |

\* The full benefit of the tax loss carried forward is used in the first quarter.

According to IAS 34, §30(c), the interim period income tax expenses is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the weighted average annual effective income tax rate applied to the pretax income of the interim period.

This is consistent with the basic concept set out in IAS 34, §28 that is same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Interim period income tax expense is calculated by applying to an interim period's pretax income the tax rate that would be applicable to expected total annual earnings, that is, the weighted average annual effective income tax rate.

This rate would reflect a blend of the progressive tax rate structure expected to be applicable to the full year's earnings.

This particular issue is dealt with in IAS 34, Appendix B, para. 22.

## **2.56 Financial Reporting**

### **3.28 IAS 35 DISCONTINUING OPERATIONS**

IAS 35 is superseded by IFRS 5 effective 1 January 2005

### **3.29 IAS 36: IMPAIRMENT OF ASSETS**

IAS 36 on "Impairment of Assets" was issued in March 2004. It is applied to goodwill and intangible assets acquired in business combinations after 31st March 2004, and to all other assets for annual periods beginning on or after 31st March 2004.

IAS 36 prescribes the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. IAS 36 applies in accounting for impairment of all assets other than:

- ◆ inventories (IAS 2 on "Inventories");
- ◆ assets arising from construction contracts (IAS 11 on "Construction Contracts");
- ◆ deferred tax assets (IAS 12 on "Income Taxes");
- ◆ assets arising from employee benefits (IAS 19 on "Employee Benefits");
- ◆ financial assets within the scope of IAS 39 on "Financial Instruments: Recognition and Measurement";
- ◆ investment property measured at fair value (IAS 40 on "Investment Property");
- ◆ biological assets related to agricultural activity that are measured at fair value less estimated point-of-sale costs (IAS 41 on "Agriculture");
- ◆ deferred acquisition costs and intangible assets, arising from insurance contracts within the scope of IFRS 4 on "Insurance Contracts"; and
- ◆ non-current assets (or disposal groups) classified as held for sale in accordance with IFRS 5 on "Non-current Assets Held for Sale and Discontinued Operations".

### **SUMMARY**

The recoverable amount of an asset or a cash generating unit is measured whenever there is an indication that the asset may be impaired. At each reporting date, an entity assesses whether there is any indication that an asset may be impaired. In addition, the recoverable amount of the following assets is measured annually:

- ◆ an intangible asset with an indefinite useful life ;
- ◆ an intangible asset not yet available for use; and
- ◆ goodwill.

The recoverable amount of an asset or a cash generating unit is the higher of its fair value less costs to sell and its value in use. Fair value less costs to sell is the amount obtainable

from the sale of an asset or a cash generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. Value in use is the present value of the future cash flows expected to be derived from an asset or a cash generating unit.

Recoverable amount is determined for an individual asset. However, if the asset does not generate cash inflows that are largely independent of those from other assets, the recoverable amount is determined for the cash-generating unit to which the asset belongs. A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

For the purpose of impairment testing, goodwill acquired in a business combination is allocated to each of the cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the combination.

An impairment loss, being the carrying amount of an asset less its recoverable amount, is recognised immediately in profit or loss. If the asset is revalued in accordance with another Standard (e.g. an item of property, plant and equipment in accordance with IAS 16 on "Property, Plant and Equipment"), the impairment loss is treated as a revaluation decrease in accordance with that other standard. An impairment loss for a cash-generating unit is allocated to reduce the carrying amount of the assets of the unit in the following order:

1. reduce the carrying amount of any goodwill allocated to the cash-generating unit, and then,
2. reduce the other assets of the unit pro rata on the basis of the carrying amount of each asset.

An impairment loss recognised in prior periods is reversed if there is a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. In this case, the carrying amount of the asset is increased to its recoverable amount, but not exceeding the carrying amount of the asset that would have been determined had no impairment loss been recognised in prior years.

Goodwill impairment must not be reversed.

IAS 36 specifies disclosures about impairment of assets and cash-generating units, and the allocation of goodwill acquired in a business combination to cash-generating units.

## 2.58 Financial Reporting

### Illustration

The following information relates to individual equipment items of an entity at a balance sheet date:

|                   | <i>Carrying<br/>amount</i> | <i>Fair value<br/>less costs to<br/>sell</i> | <i>Value in<br/>use</i> |
|-------------------|----------------------------|----------------------------------------------|-------------------------|
|                   | \$                         | \$                                           | \$                      |
| Item #1           | 11,900                     | 12,100                                       | 11,400                  |
| Item #2 (note 1)  | 23,700                     | 20,700                                       | 20,500                  |
| Item #3 (note 1)  | 11,500                     | 11,700                                       | 12,300                  |
| Item #4           | 8,300                      | 7,500                                        | 7,900                   |
| Item # 5 (note 2) | 3,100                      | 2,600                                        |                         |

Further information:

1. Items #2 and #3 are carried at revalued amounts, and the cumulative revaluation surpluses included in equity for the items are \$1,200 and \$600 respectively. Both items are manufacturing equipment.
2. Item #5 is a bus used for transporting employees in the mornings and evenings. It is not possible to determine the value in use of the bus separately because the bus does not generate cash inflows from continuing use that are independent of the cash flows from other assets.

### Solution

The major issues related to the possible impairment of the above-mentioned items can be analyzed as follows:

#### Item #1

The recoverable amount is defined as the higher of an asset's net selling price and its value in use. No impairment loss is recognized because the recoverable amount of \$12,100 is higher than the carrying amount of \$11,900.

#### Items #2

Item #2 is impaired because its recoverable amount (\$20,700) is lower than its carrying amount (\$23,700) giving rise to an impairment loss of \$3,000. According to IAS 36 (Para 60), the loss should be treated as a revaluation decrease. Therefore, \$1,200 of the loss is debited to revaluation surplus in equity and the balance of the loss (\$1,800) is recognized in profit or loss.

**Item #3**

Item #3 is not impaired.

**Item #4**

Item #4 is impaired because its recoverable amount (\$7,900) is lower than its carrying amount (\$8,300), giving rise to an impairment loss of \$400 which is recognized as an expense in profit or loss.

**Item #5**

The recoverable amount of the bus cannot be determined because the asset's value in use cannot be estimated to be close to its net selling price and it does not generate cash inflows from continuing use that are largely independent of those from other assets. Therefore, management must determine the cash-generating unit to which the bus belongs and estimate the recoverable amount of this unit as a whole. If this unit consists of items #1 to #5, the carrying amount of the cash-generating unit (after recognizing the impairment losses on items #2 and #4) is \$55,100. the fair value less costs to sell of the cash-generating unit is \$54,600 (assuming that the assets could not be sold for more than the aggregate of their individual fair values). The value in use of the cash-generating unit is \$52,100 (assuming, again, that the assets do not collectively produce cash flows that are higher than those used in the determination of their individual values in use). Therefore, the recoverable amount of the cash-generating unit is \$54,600, giving rise to a further impairment loss of \$500. the loss should be allocated on a pro rata basis to items #1, #3, and #5 provided that the carrying amount of each item is not reduced below the highest of its fair value less costs to sell and value in use. This means in practice, that the whole of the loss is allocated to item #5, the bus.

**3.30 IAS 37: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS**

IAS 37 on "Provisions, Contingent Liabilities and Contingent Assets" was issued in July 1998 and is applicable for periods beginning on or after 1 July 1999.

IAS 37 prescribes the accounting and disclosure for provisions, contingent liabilities and contingent assets, other than:

- ◆ those resulting from executory contracts, except where the contract is onerous; and
- ◆ those covered by another Standard, including:
  - contingent liabilities assumed in a business combinations (IFRS 3 on "Business Combinations");
  - provisions with regard to
- ◆ construction contracts (IAS 11 on "Construction Contracts");
- ◆ income taxes (IAS 12 on "Income Taxes");

## 2.60 Financial Reporting

- ◆ leases (IAS 17 on “Leases”);
- ◆ employee benefits (IAS 19 on “Employee Benefits”); and
- ◆ insurance contracts (IFRS 4 on “Insurance Contracts”).

IAS 37 does not apply to financial instruments (including guarantees) within the scope of IAS 39 on “Financial instruments: Recognition and Measurement”.

### SUMMARY

A provision is a liability of uncertain timing or amount. Examples of provisions are: warranty obligations; legal or constructive obligations to clean up contaminated land or restore facilities; and a retailer’s policy to refund customers.

A provision is recognised when:

- ◆ an entity has a present obligation (legal or constructive) as a result of a past event;
- ◆ it is probable that an outflow of economic benefits will be required to settle the obligation; and
- ◆ a reliable estimate can be made of the amount of the obligation.

A constructive obligation arises from the entity’s actions, through which it has indicated to others that it will accept certain responsibilities, and as a result has created an expectation that it will discharge those responsibilities.

The amount recognised as a provision is the best estimate of the expenditure required to settle the obligation at the balance sheet date. Provisions are reviewed at each balance sheet date and adjusted to the current best estimate. A provision is used only for expenditures for which the provision was originally recognised.

Provisions are not recognised for future operating losses. If the entity has a contract that is onerous, the present obligation under the contract is recognised as a provision.

A constructive obligation to restructure arises only when an entity:

- ◆ has a detailed formal plan for the restructuring; and
- ◆ has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

A contingent liability is not recognised, but is disclosed unless the possibility of an outflow of resources is remote.

A contingent asset is not recognised, but is disclosed when an inflow of economic benefits is probable.

IAS 37 specifies disclosures about provisions, contingent liabilities and contingent assets.



### **3.31 IAS 38: INTANGIBLE ASSETS**

IAS 38 on "Intangible Assets" was issued in March 2004 and is applied to the accounting for intangible assets acquired in business combinations after 31st March 2004, and to all other intangible assets for annual periods beginning on or after 31st March 2004.

IAS 38 prescribes the accounting treatment for intangible assets, except:

- ◆ intangible assets that are within the scope of another Standard. For example, IAS 2 on "Inventories" applies to intangible assets (eg. computer software, licenses) held for sale in the ordinary course of business;
- ◆ mineral rights and expenditure on exploration for, or development and extraction of non-regenerative resources.

#### **SUMMARY**

An intangible asset is initially recognised at cost if all of the following criteria are met:

- ◆ the asset meets the definition of an intangible asset i.e. it is identifiable and controlled by the entity;
- ◆ it is probable that future economic benefits that are attributable to the asset will flow to the entity; and
- ◆ the cost of the asset can be measured reliably.

Internally generated goodwill, brands, mastheads, publishing titles, customer lists and similar items are not recognised as assets and are expensed. Expenditure on research is recognised as an expense. There is no recognition of an intangible asset arising from research. An intangible asset arising from development is recognised only if specified criteria are met.

If an intangible item does not meet the criteria for recognition as an asset, the expenditure is recognised as an expense when incurred. Expenditure that was initially recognised as an expense is not included in the cost of an intangible asset at a later date.

Subsequent to initial recognition, an intangible asset is carried at:

- ◆ cost less any accumulated amortisation and any accumulated impairment losses; or
- ◆ revalued amount less any subsequent accumulated amortisation and any accumulated impairment losses. The revalued amount is fair value at the date of revaluation and is determined by reference to an active market.

An intangible asset can only be carried at revalued amount if there is an active market for the asset. Any revaluation increase is credited directly to equity as revaluation surplus, unless it reverses a revaluation decrease of the same asset previously recognised in profit or loss. Any revaluation decrease is recognised in profit or loss.

## 2.62 Financial Reporting

However, the decrease is debited directly to the revaluation surplus in equity to the extent of any credit balance in revaluation surplus in respect of that asset.

For any internal project to create an intangible asset, the research phase and development phase should be distinguished from one another. Research expenditure is treated as an expense. Development expenditure is recognized as an intangible asset if all of the following can be demonstrated:

- ◆ The technical feasibility of completing the intangible asset so that it will be available for use or sale
- ◆ The availability of adequate technical, financial, and other resources to complete the development and to use or sell the intangible asset.
- ◆ The intention to complete the intangible asset and use or sell it.
- ◆ The ability to use or sell the intangible asset.
- ◆ How the intangible asset will generate probable future economic benefits.
- ◆ The ability to measure the expenditure.

An entity assesses whether the useful life of an intangible asset is finite or indefinite; the useful life is indefinite if there is no foreseeable limit to the period over which the asset is expected to generate net cash flows. The depreciable amount of an intangible asset with a finite life is amortised on a systematic basis over its useful life. An intangible asset with an indefinite useful life is not amortised, but is tested for impairment at least annually. Impairment of intangible assets is recognised in accordance with IAS 36 on "Impairment of Assets".

The gain or loss on derecognition of an intangible asset is the difference between the net disposal proceeds, if any, and the carrying amount of the item. The gain or loss is recognised in profit or loss.

IAS 38 specifies disclosures about intangible assets.

### Illustration

A Inc., a motor vehicle manufacturer, has a research division that worked on the following projects during the year:

#### Project 1

The design of a steering mechanism that does not operate like a conventional steering wheel, but reacts to the impulses from a driver's fingers.

#### Project 2

The design of a welding apparatus that is controlled electronically rather than mechanically.

The following is a summary of the expenses of the particular department:

**International Accounting Standards, International Financial Reporting Standards, 2.63  
their interpretations and US GAAPs- An Overview**

|                          | <b>General</b> | <b>Project 1</b> | <b>Project 2</b> |
|--------------------------|----------------|------------------|------------------|
|                          | <b>\$'000</b>  | <b>\$'000</b>    | <b>\$'000</b>    |
| Material and Services    | 12.8           | 93.5             | 62.0             |
| Labour                   |                |                  |                  |
| Direct Labour            | -              | 62.0             | 32.0             |
| Department Head Salary   | 40.0           | -                | -                |
| Administrative Personnel | 72.5           | -                | -                |
| Overhead                 |                |                  |                  |
| <b>Direct</b>            | -              | 34.0             | 41.0             |
| <b>Indirect</b>          | 27.0           | 11.0             | 6.0              |

The departmental head spent 15% of his time on Project 1 and 10% of his time on Project 2.

**Solution**

The capitalization of development costs for the year would be as follows:

|                                                                                             | <b>\$'000</b> |
|---------------------------------------------------------------------------------------------|---------------|
| Project 1. The activity is classified as research and all costs are recognized as expenses. | -             |
| Project 2. $(62.0 + 32.0 + 10\% \times 40.0 + 41.0 + 6.0)$                                  | <u>145.0</u>  |
|                                                                                             | <u>145.0</u>  |

**3.32 IAS 39: FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT**

IAS 39 on "Financial Instruments: Recognition and Measurement" was issued in December 2003 and is applicable for annual periods beginning on or after 1 January 2005.

IAS 39 prescribes principles for recognising and measuring all types of financial instruments except:

- ◆ those interests in subsidiaries, associates and joint ventures that are consolidated, or are accounted for using the equity method or proportionate consolidation in accordance with IAS 27 on "Consolidated and Separate Financial Statements", IAS 28 on "Investment in Associates" or IAS 31 on "Interests in Joint Ventures";
- ◆ rights and obligations under leases (IAS 17 on "Leases"). However:
  - lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of IAS 39;
  - finance lease payables recognised by a lessee are subject to the derecognition provisions of IAS 39; and

## 2.64 Financial Reporting

- derivatives that are embedded in leases are subject to the embedded derivatives provisions of IAS 39.
- ◆ employers' rights and obligations under employee benefit plans (IAS 19 on "Employee Benefits");
- ◆ financial instruments issued by the entity that meet the definition of an equity instrument in IAS 32 (including options and warrants).
- ◆ rights and obligations under an insurance contracts as defined by IFRS 4 on "Insurance Contracts", and under a contract that is within IFRS 4 because it contains a discretionary participation feature. However, IAS 39 applies to derivatives embedded in such a contract;
- ◆ contracts for contingent consideration in a business combination (IFRS 3 on "Business Combinations");
- ◆ contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date;
- ◆ loan commitments that cannot be settled net in cash or another financial instrument (except those that are designated as financial liabilities at fair value through profit or loss); and
- ◆ financial instruments, contracts and obligations under share-based payment transactions (IFRS 2 on "Share Based Payment"), except certain contracts to buy or sell a non-financial item as noted below.

IAS 39 applies to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments. However, IAS 39 does not apply to any such contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

### SUMMARY

#### Recognition and derecognition

A financial asset or liability is recognised when the entity becomes a party to the instrument contract. A financial liability is derecognised when the liability is extinguished. A financial asset is derecognised when, and only when:

- ◆ the contractual rights to the cash flows from the asset expire; or
- ◆ the entity transfers substantially all the risks and rewards of ownership of the asset; or

- ◆ the entity transfers the asset, while retaining some of the risks and rewards of ownership, but no longer has control of the asset (ie the transferee has the ability to sell the asset). The risks and rewards retained are recognised as an asset.

### **Measurement**

Financial assets and liabilities are initially recognised at fair value. Subsequent measurement depends on how the financial instrument is categorised:

#### **At amortised cost using the effective interest method**

- ◆ Held-to-maturity investments: non-derivative financial assets with fixed or determinable payments and maturity that the entity has the positive intention and ability to hold to maturity.
- ◆ Loans and receivables: non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.
- ◆ Financial liabilities that are not held for trading and not designated at fair value through profit or loss.

#### **At fair value**

- ◆ At fair value through profit or loss: Financial asset or liability that is classified as held for trading, is a derivative or has been designated by the entity at inception as at fair value through profit or loss.
- ◆ Available-for-sale financial assets: Non-derivative financial assets that do not fall within any of the other categories. The unrealised movements in fair value are recognised in equity until disposal or sale, at which time, those unrealized movements from prior periods are recognised in profit or loss.

If there is objective evidence that a financial asset is impaired, the carrying amount of the asset is reduced and an impairment loss is recognised. A financial asset carried at amortised cost is not carried at more than the present value of estimated future cash flows. An impairment loss on an available-for-sale asset that reduces the carrying amount below acquisition cost is recognised in profit or loss.

### **Hedge accounting**

IAS 39 provides for two kinds of hedge accounting, recognising that entities commonly hedge both the possibility of changes in cash flows (ie a cash flow hedge) and the possibility of changes in fair value (ie a fair value hedge). Strict conditions must be met before hedge accounting is applied:

- ◆ There is formal designation and documentation of a hedge at inception.

## 2.66 Financial Reporting

- ◆ The hedge is expected to be highly effective (ie the hedging instrument is expected to almost fully offset changes in fair value or cash flows of the hedged item that are attributable to the hedged risk).
- ◆ Any forecast transaction being hedged is highly probable.
- ◆ Hedge effectiveness is reliably measurable (ie the fair value or cash flows of the hedged item and the fair value of the hedging instrument can be reliably measured).
- ◆ The hedge must be assessed on an ongoing basis and be highly effective.

When a fair value hedge exists, the fair value movements on the hedging instrument and the corresponding fair value movements on the hedged item are recognised in profit or loss. When a cash flow hedge exists, the fair value movements, on the part of the hedging instrument that is effective, are recognised in equity until such time as the hedged item affects profit or loss. Any ineffective portion of the fair value movement on the hedging instrument is recognised in profit or loss.

### Embedded derivatives

IAS 39 requires derivatives that are embedded in non-derivative contracts to be accounted for separately at fair value through profit or loss.

***Note:** IAS 32 and IAS 39 and IFRS 7 were issued as separate Standards but are applied in practice as a unit because they deal with the same accounting and financial risk issues. IAS 39 deals with the recognition and measurement issues of financial instruments. IAS 32 deals with presentation issues and IFRS 7 deals with disclosure issues.*

## 3.33 IAS 40 (REVISED): INVESTMENT PROPERTY

IAS 40 (revised) on "Investment Property" was issued in December 2003 and is applicable to annual periods beginning on or after 1 January 2005.

IAS 40 prescribes the accounting treatment for investment property and related disclosure requirements. Investment property is land and/or buildings held to earn rentals or for capital appreciation or both. An investment property should generate cash flows that are largely independent of the other assets held by the entity.

Investment property includes land and building or part of a building or both. It excludes:

- ◆ Owner occupied property (IAS 16)
- ◆ Property held for sale (IAS 2)
- ◆ Property being constructed or developed (IAS 11- until completion)
- ◆ Biological assets (IAS 41)

## **SUMMARY**

Investment property is initially recognised at cost comprising the purchase price and directly attributable transaction costs (for instance legal services, transfer taxes, and other transaction costs). However, general administrative expenses as well as start-up costs are excluded. Subsequent to initial recognition, investment property is carried either at:

- ◆ Cost less accumulated depreciation and any accumulated impairment losses, as prescribed by IAS 16 on “Property, Plant and Equipment”, or
- ◆ Fair value. Fair value is the price at which the property could be exchanged between knowledgeable, willing parties in an arm’s length transaction.

Movements in fair value are recognised immediately in profit or loss.

The measurement model is applied consistently to all investment property. However, an entity may choose either the fair value model or the cost model for investment property backing liabilities that pay a return linked directly to the fair value of specified assets including that investment property, regardless of the model chosen for all other investment property.

Transfers to, or from, the investment property classification are made only when there is evidence of a change in use.

Subsequent expenditures on investment property are recognized as expenses if they restore the performance standard. These expenditures are capitalized when it is probable that economic benefits in excess of the original standard of performance will flow to the entity.

The gain or loss on derecognition of an item of investment property is the difference between the net disposal proceeds, if any, and the carrying amount of the item. The gain or loss is included in profit or loss.

IAS 40 specifies disclosures about investment property.

### **3.34 IAS 41: AGRICULTURE**

IAS 41 on “Agriculture” is applicable for periods beginning on or after 1 January 2003.

IAS 41 prescribes the accounting treatment, financial statement presentation, and disclosures related to agricultural activity. It applies to biological assets, agricultural produce at the point of harvest, and government grants related to biological assets. A biological asset is a living animal or plant.

IAS 41 does not apply to:

- ◆ Land related to agricultural activity (IAS 16 on “Property, Plant and Equipment”);
- ◆ Intangible assets related to agricultural activity (IAS 38 on “Intangible Assets”); and
- ◆ The processing of agricultural produce after harvest for instance, processing grapes into wine or wool into yarn (IAS 2 on “Inventories” or another applicable Standard).

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### SUMMARY

A biological asset is measured on initial recognition and at each balance sheet date at its fair value less estimated point-of-sale costs. Agricultural produce harvested from an entity's biological assets is measured at its fair value less estimated point-of-sale costs at the point of harvest. Point-of-sales costs include commissions, levies, and transfer duties and taxes.

A gain or loss arising on initial recognition at fair value less point-of-sale costs and from a change in fair value less point-of-sale costs is included in profit or loss.

An unconditional government grant related to a biological asset is recognised as income when the grant becomes receivable; a conditional government grant is recognised when the conditions attaching to the grant are met.

IAS 41 specifies disclosures related to agricultural activity.

### Illustration

In year 20X0 a farmer plants an orange orchard that costs him \$25,000. At the end of year 20X1, the following facts regarding the orchard are available:

**Disease** there has been widespread disease in the orange tree population. As a result there is not an active market for the orchard, but the situation is expected to clear in 6 months. After the 6 months, it should also be clear which types of trees are susceptible to infection and which ones are not. Until that time, nobody is willing to risk an infected orchard.

**Precedent.** The last sale by the farmer of an orchard was 6 months ago at a price of \$15,000. He is not sure which way the market has gone since then.

**Local values.** The farmers in the region have an average value of \$19,500 for their orchards of a similar size.

**National values.** The farmer recently read in a local agricultural magazine that the average price of an orange orchard is \$22,500.

What is the correct valuation of the orange tree orchard?

### Solution

The valuation would be the fair value less estimated point-of-sales costs. Fair value is determined as follows:

- ◆ Use active market prices – there are none, due to the disease.
- ◆ Use other relevant information, such as:
  - The most recent market transaction \$150,000
  - Market prices for similar assets \$195,000
  - Sector benchmarks \$225,000



If the fair value cannot be determined, then the valuation would be determined at cost, less accumulated depreciation and accumulated impairment losses: \$25,000.

However, there are other reliable sources available for the determination of fair value. Such sources should be used – the mean value of all the available indicators above would be used (in the range of \$15,000- \$22,500).

In addition, the farmer would consider the reasons for the differences between the various sources of other information, prior to arriving at the most reliable estimate of fair value.

In the absence of recent prices, sector benchmarks and other information, the farmer should calculate the fair value as comprising the cost price, less impairments less depreciation: resulting in a valuation of \$25,000.

#### **4. INTERNATIONAL FINANCIAL REPORTING STANDARDS**

IASs were issued between 1973 and 2001 by Board of the International Accounting Standards Committee (IASC). In April 2001 the IASB adopted all IASs and continued the development, calling new standards IFRSs.

Although IASs are no longer produced, they are still in effect unless replaced by an IFRS, whether in its entirety or part of.

**International Financial Reporting Standards** in a broad sense comprise:

- ◆ **Framework for the Preparation and Presentation of Financial Statements**—stating basic principles and grounds of IFRS
- ◆ **IAS**—standards issued before 2001
- ◆ **IFRS**—standards issued after 2001
- ◆ **SIC**—interpretations of accounting standards, giving specific guidance on unclear issues
- ◆ **IFRIC**—newer interpretations, issued after 2001

#### **5. OVERVIEW OF INTERNATIONAL FINANCIAL REPORTING STANDARDS**

##### **5.1 IFRS 1: FIRST-TIME ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS**

On 19th June 2003, the International Accounting Standards Board issued IFRS 1 on “First-Time Adoption of International Financial Reporting Standards”. It applies on entities, which adopts IFRSs for the first time by an explicit and unreserved statement of compliance with IFRSs. IFRS 1 has come into effect for a period beginning on or after 1<sup>st</sup> January 2004.

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### **SUMMARY**

In general, IFRS 1 requires an entity to comply with each IFRS effective at the reporting date for its first IFRS financial statements. In particular, in its opening IFRS balance sheet an entity must:

- ◆ recognise all assets and liabilities whose recognition is required by IFRSs;
- ◆ not recognise items as assets or liabilities if IFRSs do not permit such recognition;
- ◆ re-classify items that it recognised under previous GAAP as one type of asset, liability or component of equity, that are a different type of asset, liability or component of equity under IFRSs; and
- ◆ apply IFRSs in measuring all recognised assets and liabilities.

The transition provisions in other IFRSs do not apply to a first-time adopter's transition to IFRSs.

### **Definition of first-time adoption**

A first-time adopter is an entity that, for the first time, makes an explicit and unreserved statement that its general purpose financial statements comply with IFRSs. An entity is treated as a first-time adopter even if, in the preceding year, it prepared IFRS financial statements for internal management use, as long as those IFRS financial statements were not and given to owners or external parties such as investors or creditors. If a set of IFRS financial statements was given to an external party in the preceding year, then the entity will already be considered to be on IFRSs, and IFRS 1 does not apply.

An entity can also be a first-time adopter if, in the preceding year, its published financial statements asserted:

- ◆ Compliance with some but not all IFRSs.
- ◆ Included only a reconciliation of selected figures from previous GAAP to IFRSs. (Previous GAAP means the GAAP that an entity followed immediately before adopting to IFRSs.)

However, an entity is not a first-time adopter if, in the preceding year, its published financial statements asserted:

- ◆ Compliance with IFRSs even if the auditor's report contained a qualification with respect to conformity with IFRSs.
- ◆ Compliance with both previous GAAP and IFRSs.

### **Opening IFRS Balance Sheet**

An entity has to prepare an opening IFRS Balance Sheet at the date of transition to IFRSs. This should be the starting point for its accounting under IFRSs. It is not required to present that opening balance sheet in its first IFRS based financial statements. However, to comply with IAS 1

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Presentation of Financial Statements , an entity's IFRS based financial statements should include at least one year of comparative information under IFRS[ Para 36 , IFRS-1].

Example: Company X proposes to prepare and present IFRS for the financial year 2005-06, i.e. Balance Sheet Date 31.3.2006. How should the company carry out transition?

- ◆ Prepare opening IFRS Balance Sheet as on 1.4.2004 – this is termed as transition date.
- ◆ The company has to present comparative information for one year, such comparatives should be as per IFRS – so it has to restate the accounts of 2004-05 as per IFRS.
- ◆ Prepare and present IFRS based Financial Statements for 2005-06
- ◆ Then effectively the company has apply IFRS on and from 1.4.2004.
- ◆ Accounting policies: Select its accounting policies based on IFRSs in force at 31 March 2006. (The exposure draft that preceded IFRS 1 had proposed that an entity could use the IFRSs that were in force during prior periods, as if the entity had always used IFRS. That option is not included in the final standard) . It is not allowed to use different version of IFRS applicable in earlier periods. However, an entity can apply those IFRS which are not mandatory but early application is allowed.

Paras 7-9 of IFRS 1 requires adoption of current version of IFRSs which would enhance comparability because information in a first time adopter's first financial statements is prepared on a consistent basis over time and would provide comparative information prepared using latest version of the IFRSs.

### **Adjustments required to move from previous GAAP to IFRSs at the time of first-time adoption**

#### **1. *Derecognition of some of the existing assets and liabilities:***

- (i) The entity should eliminate previous-GAAP assets and liabilities from the opening balance sheet if they do not qualify for recognition under IFRSs. Examples are deferred expenditure, which are not to be treated as asset like -

- ◆ Research expenditure;
- ◆ Start-up, pre-operating, and pre-opening costs;
- ◆ Training expenses;
- ◆ Advertising and promotion; and
- ◆ Moving and relocation

In case the entity's previous GAAP had recognised these as assets, these assets should be eliminated in the opening IFRS balance sheet with a corresponding reduction in the retained earning.

- (ii) If the entity's previous GAAP had allowed accrual of liabilities for restructurings, future operating losses, or major overhauls which do not meet the conditions for

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recognition as a provision under IAS 37, these items should be eliminated in the opening IFRS balance sheet with a corresponding increase in the retained earnings.

- (iii) If the entity's previous GAAP had allowed recognition of reimbursements and contingent assets that are not virtually certain, these are eliminated in the opening IFRS balance sheet.

### 2. *Recognition of some new assets and liabilities:*

- (i) The entity should recognise all assets and liabilities that are required to be recognised by IFRS which are not recognised under previous GAAP. Examples may include -

- ◆ IAS 39 requires recognition of all derivative financial assets and liabilities, including embedded derivatives. These were not recognised under many local GAAPs.
- ◆ IAS 19 requires an employer to recognise its liabilities under defined benefit plans. These are not just pension liabilities but also obligations for medical and life insurance, vacations, termination benefits, and deferred compensation. In the case of "over-funded" plans, this would be a defined benefit asset.
- ◆ IAS 37 requires recognition of provisions as liabilities like an entity's obligations for restructurings, onerous contracts, decommissioning, remediation, site restoration, warranties, guarantees, and litigation.
- ◆ Deferred tax assets and liabilities would be recognised in conformity with IAS 12.

### 3. *Reclassification:* The entity should reclassify opening balance sheet items presented as per previous GAAP into the appropriate IFRS classification. Examples may include -

- ◆ IAS 10 does not permit classifying dividends declared or proposed after the balance sheet date as a liability at the balance sheet date. In the opening IFRS balance sheet these would be reclassified as a component of retained earnings.
- ◆ If the entity's previous GAAP had allowed treasury stock (an entity's own shares that it had purchased) to be reported as an asset, it would be reclassified as a component of equity under IFRS.
- ◆ Items classified as identifiable intangible assets in a business combination accounted for under the previous GAAP may be required to be classified as goodwill under IAS 22 because they do not meet the definition of an intangible asset under IAS 38. The converse may also be true in some cases.
- ◆ As per principles given in IAS 32 for classifying items as financial liabilities or equity, redeemable preferred shares and puttable shares that may have been

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classified as equity under previous GAAP would be reclassified as liabilities in the opening IFRS balance sheet.

- ◆ Note that IFRS 1 makes an exception from the "split-accounting" provisions of IAS 32. If the liability component of a compound financial instrument is no longer outstanding at the date of the opening IFRS balance sheet, the entity is not required to reclassify out of retained earnings and into other equity the original equity component of the compound instrument.
  - ◆ The reclassification principle would apply for the purpose of defining reportable segments under IAS 14.
  - ◆ The scope of consolidation might change depending on the consistency of the previous-GAAP requirements to those in IAS 27. It is possible that IFRS will require consolidated financial statements where they were not required before.
  - ◆ Some offsetting (netting) of assets and liabilities or of income and expense items that had been acceptable under previous GAAP may no longer be acceptable under IFRS.
4. Measurement: If an entity adopts IFRS for the first time in its annual financial statements for the year ended 31 March 2006, in general it would use the measurement principles in IFRSs in force at 31 March 2006.

### **Exemptions**

IFRS 1 grants limited exemptions from these requirements in specified areas where the cost of complying would be likely to exceed the benefits to users of financial statements. Exemptions exist in the following areas:

- ◆ business combinations;
- ◆ fair value or revaluation as deemed cost for certain non-current assets;
- ◆ defined benefit employee benefit plans;
- ◆ cumulative translation differences;
- ◆ compound financial instruments;
- ◆ assets and liabilities of subsidiaries, associates and joint ventures;
- ◆ designation of previously recognised financial instruments;
- ◆ share-based payment transactions; and
- ◆ insurance contracts.

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### **Exceptions to retrospective applications of other IFRSs**

IFRS 1 prohibits retrospective application of some aspects of IAS 39, IAS 10 and IFRS 5 considering the implementation difficulties:

- a) Derecognition of financial assets or liabilities;
- b) Hedge accounting;
- c) Estimates and
- d) Assets classified as held for sale and discontinued operations.

Para 27 of IFRS 1 requires a first time adopter to apply derecognition requirements of IAS 39 prospectively. Para 27 A of IFRS allows to apply derecognition requirements retrospectively only if the information needed was obtained at the time of initially accounting for those transactions.

Para 28 of IFRS requires a first time adopter to measure all derivatives at fair value, and eliminate all deferred losses and gains arising on derivatives. As per Para 29 of IFRS 1 a hedging relationship that does not satisfy the requirements of IAS 39 should not be reflected in the IFRS balance sheet.

Para 33 of IFRS 1 requires the first time adopter to make estimates under IFRSs at the date of transition that were not required under previous GAAP. To achieve consistency with IAS 10 those estimates should reflect conditions existed at the date of transition.

Non-current assets ( or disposal groups) that meet the criteria are to be classified as ' held for sale' and operations that meet the criteria are to be classified as ' discontinued' after the effective date of IFRS 5. An entity having date of transition to IFRS before 1.1.2005 shall apply the transitional provision prospectively whereas an entity having transition date on or after 1.1.2005 should apply IFRS 5 retrospectively.

### **Explanations to transition to IFRSs**

The first time adopter should explain how the transition from previous GAAP to IFRSs affected the financial statements. This is achieved by reconciliations. Reconciliations should cover –

- ◆ Reconciliations of equity on the end of latest period presented in the entity's most recent financial statements;
- ◆ Reconciliations of profit or loss reported under previous GAAP latest period presented in the entity's most recent financial statements; and

## **5.2 IFRS 2: SHARE-BASED PAYMENT**

IFRS 2 on "Share-Based Payment" was issued on 19th February 2004 and applies to annual periods beginning on or after 1 January 2005. IFRS 2 applies to all share-based payment transactions other than business combinations, which are addressed by IFRS 3 on "Business Combinations". However, the principal impact of IFRS 2 will be on the accounting for employees' and directors' share options and other share-based incentives, it also deals with issuance of shares (and rights to shares) in return for services and goods.

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IFRS 2 prescribes the financial reporting by an entity when it undertakes a share based payment transaction. It applies to grants of shares, share options or other equity instruments made after 7 November 2002 that had not yet vested at the effective date of the IFRS. IFRS 2 applies retrospectively to liabilities arising from share-based payment transactions existing at the effective date. This standard specifically covers:

- ◆ The criteria for defining a share based payment.
- ◆ The distinction and accounting for the various types of share based payments namely: equity settled, cash settled and transactions in which the entity receives or acquires goods or services and where there is an option to settle via equity instruments.

### **SUMMARY**

IFRS 2 requires an entity to reflect in its profit and loss and financial position the effects of share-based payment transactions, including expenses associated with share options granted to employees.

A share based payment transaction is a transaction in which the entity receives goods or services as consideration for equity instruments of the entity. It includes transactions where the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or through the issuance of equity instruments.

### **EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTION**

For equity-settled share-based payment transactions with employees (and others providing similar services), the measurement of the transaction amount is based on the fair value of the equity instruments granted. Fair value is measured at grant date. The valuation focuses on the specific terms and conditions of a grant of shares or share options to employees. In general, vesting conditions are not taken into account in the grant date valuation but the number of equity instruments included in the measurement of the transaction amount is adjusted so that, ultimately, the transaction amount is based on the number of equity instruments that vest. Listed shares should be measured at market price. Options should be measured

- ◆ On the basis of the market price of any equivalent traded options; or
- ◆ Using an option pricing model in the absence of such market prices; or
- ◆ At intrinsic value when they cannot be measured reliably on the basis of market prices or on the basis of an option pricing model.

In the rare cases where the entity is required to measure the equity instruments at their intrinsic value, it remeasures the instruments at each reporting date until final settlement and recognizes any change in intrinsic value in profit or loss.

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The entity should recognize an asset (for example, inventory) or an expense (for example, services received or employee benefits) and a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction. Therefore, an entity recognizes an asset or expense and a corresponding increase in equity.

- ◆ On grant date if there are no vesting conditions or if the goods or services have already been received;
- ◆ As the services are rendered if non-employee services are rendered over a period; or
- ◆ Over the vesting period for employee and other share-based payment transactions where there is a vesting period.

If the equity instruments granted do not vest until the counterparty completes a specified period of service, the amount recognized should be adjusted over any vesting period for changes in the estimate of the number of securities that will be issued but not for changes in the fair value of those securities. Therefore, on vesting date the amount recognized is the exact number of securities that can be issued as of that date, measured at the fair value of those securities at grant date.

If the entity cancels or settles a grant of equity instruments during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

- ◆ The entity accounts for the cancellation or settlement as an acceleration of vesting by recognizing immediately the amount that otherwise would have been recognized over the remainder of the vesting period.
- ◆ The entity recognizes in equity any payment made to the employee on the cancellation or settlement to the extent that the payment does not exceed the fair value at repurchase date of the equity instruments granted.
- ◆ The entity recognizes as an expense the excess of any payment made to the employee on the cancellation or settlement over the fair value at repurchase date of the equity instruments granted.
- ◆ The entity accounts for new equity instruments granted to the employee as replacement equity instruments for the cancelled equity instruments as a modification of the original grant of equity instruments. The difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments at the date the replacement equity instruments are granted is recognized as an expense.

### CASH-SETTLED SHARE-BASED PAYMENT TRANSACTION

The entity should recognize an asset (for example, inventory) or an expense (for example, services received or employee benefits) and a liability if the goods or services were received in a cash-settled share-based payment transaction.



Until the liability is settled, the entity should remeasure the fair value of the liability at each reporting date and at the date of settlement, with any changes in fair value recognized in profit or loss for the period.

### **SHARE-BASED PAYMENT TRANSACTIONS WITH CASH ALTERNATIVES**

For share-based payment transactions in which the terms of the arrangement provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments, the entity should account for that transaction, or the components of that transaction, as a cash-settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets, or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

IFRS 2 specifies disclosures about share-based payment transactions.

### **5.3 IFRS 3 BUSINESS COMBINATIONS**

IFRS 3 Business Combinations was issued in March 2004 and is applicable for business combinations for which the agreement date is on or after 31st March 2004.

IFRS 3 prescribes the financial reporting by an entity when it undertakes a business combination. A business combination is the bringing together of separate entities or businesses into one reporting entity. IFRS 3 does not apply to:

- ◆ business combinations in which separate entities or businesses are brought together to form a joint venture;
- ◆ business combinations involving entities or businesses under common control;
- ◆ business combinations involving two or more mutual entities; and
- ◆ business combinations in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest.

### **SUMMARY**

All business combinations are accounted for by applying the purchase method, which views the business combination from the perspective of the acquirer. The acquirer is the combining entity that obtains control of the other combining entities or businesses (the acquiree).

The acquirer measures the cost of a business combination as the aggregate of:

- ◆ the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus
- ◆ any costs directly attributable to the business combination. Any adjustment to the cost of the combination, that is contingent on future events, is included in the cost of the

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combination at the acquisition date if the adjustment is probable and can be measured reliably.

The acquirer allocates the cost of the business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities at their fair value at the date of acquisition, except for non-current assets that are classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. Such assets held for sale are recognised at fair value less costs to sell.

Goodwill, being the excess of the cost over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities, is recognised as an asset. Goodwill is subsequently carried at cost less any accumulated impairment losses in accordance with IAS 36 Impairment of Assets. If the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities exceeds the cost of the combination, the acquirer:

- ◆ reassesses the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination; and
- ◆ recognises immediately in profit or loss any excess remaining after that reassessment.
- ◆ IFRS 3 specifies the accounting treatment:
  - ◆ for business combinations that are achieved in stages;
  - ◆ where fair values can only be determined provisionally in the period of acquisition;
  - ◆ where deferred tax assets are recognised after the accounting for the acquisition is complete; and
  - ◆ for previously recognised goodwill, negative goodwill and intangible assets.

IFRS 3 also specifies disclosures about business combinations and any related goodwill.

### Illustration

H Ltd. acquired a 70 percent interest in the equity shares of F. Ltd. For an amount of \$ 750,000 on January 1, 20x1. The abridged balance sheets of both companies at the date of acquisition were as follows:

|                          | H. Ltd. \$,000 | F Ltd.\$'000 |
|--------------------------|----------------|--------------|
| Identifiable Assets able | 8,200          | 2,000        |
|                          | <u>750</u>     | <u>--</u>    |
|                          | <u>8,900</u>   | <u>2,000</u> |
| Equity                   | <u>6,000</u>   | <u>1,200</u> |
| Identifiable Liabilities | <u>2,950</u>   | <u>2,000</u> |

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The fair value of the identifiable assets of F Ltd. Amounts to \$ 2,800,000 and the fair value of its liabilities is \$ 800,000. Demonstrate the result of the acquisition.

**Solution**

|                                       | H. Ltd.\$000 | Minority \$'000 |
|---------------------------------------|--------------|-----------------|
| Fair value of Assets Less Liabilities | 2,000        | 360             |
| Minority Interest                     | <u>600</u>   | <u>240</u>      |
| Fair Value of Net Acquisition         | 1,400        | 600             |
| Cost of Acquisition                   | <u>(750)</u> |                 |
| Gain                                  | <u>650</u>   |                 |

The abridged consolidated balance sheet at the date of acquisition will appear as follows

|                      | \$ ,000             |
|----------------------|---------------------|
| Assets               | 11,000 <sup>a</sup> |
| Shareholder's Equity | 6,650 <sup>b</sup>  |
| Minority Interest    | 600                 |
| Liabilities          | 3,750 <sup>c</sup>  |
|                      | 11,000              |

a = 8,200+2,800

b = 6,000+650 (gain included in profit or loss)

c= 2,950 + 800

#### **5.4 IFRS 4 INSURANCE CONTRACTS**

IFRS 4 Insurance Contracts was issued in March 2004 and is applicable for annual periods beginning on or after 1 January 2005. IFRS 4 prescribes the financial reporting for insurance contracts by any entity that issues such contracts. It applies to insurance contracts issued, reinsurance contracts held and financial instruments issued with a discretionary participation feature. It does not apply to:

- ◆ product warranties issued directly by a manufacturer, dealer or retailer (IAS 18 Revenue and IAS 37 Provisions, Contingent Liabilities and Contingent Assets);
- ◆ employers' assets and liabilities under employee benefit plans (IAS 19 Employee Benefits) and retirement benefit obligations reported by defined benefit retirement plans (IAS 26 Accounting and Reporting by Retirement Benefit Plans);
- ◆ contractual rights or obligations that are contingent on the future use of or right to use a non-financial item, as well as lessee's residual value guarantees on finance leases (IAS 17 Leases; IAS 18 Revenue and IAS 38 Intangible Assets);

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- ◆ financial guarantees entered into or retained on transferring financial assets or financial liabilities within the scope of IAS 39;
- ◆ contingent consideration payable or receivable in a business combination (IFRS 3 Business Combinations);
- ◆ direct insurance contracts that an entity holds as a policyholder.

An entity need not apply some aspects of IFRS 4 to comparative information that relates to annual periods beginning before 1 January 2005.

### SUMMARY

IFRS 4 is phase I of the IASB's project on insurance contracts. An entity is temporarily exempt from some requirements of other IFRSs, including the requirement in IAS 8 to consider the Framework in selecting accounting policies for insurance contracts. However, IFRS 4:

- ◆ prohibits recognition as a liability of provisions for possible future claims under insurance contracts that are not in existence at the reporting date (such as catastrophe provisions and equalisation provisions);
- ◆ requires assessment of the adequacy of recognised insurance liabilities and recognition of any impairment of reinsurance assets;
- ◆ requires an entity to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to present insurance liabilities without offsetting them against related reinsurance assets.

An entity may change its accounting policies for insurance contracts only if, as a result, its financial statements are more relevant and no less reliable, or more reliable and no less relevant. In particular, an entity must not introduce any of the following practices, although it may continue using accounting policies that involve them:

- ◆ measuring insurance liabilities on an undiscounted basis;
- ◆ measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services;
- ◆ using non-uniform accounting policies for the insurance contracts of subsidiaries;
- ◆ measuring insurance liabilities with excessive prudence.

There is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts. When an insurer changes its accounting policies for insurance liabilities, it may reclassify some or all financial assets as 'at fair value through profit or loss'.

IFRS 4 specifies the following:

- ◆ An entity need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract.
- ◆ An entity is required to unbundle (ie account separately for) deposit components of some insurance contracts.
- ◆ An entity may apply 'shadow accounting' (that is, account for both realised and unrealised gains or losses on assets in the same way relative to measurement of insurance liabilities).
- ◆ Discretionary participation features contained in insurance contracts or financial instruments may be recognised separately from the guaranteed element and classified as a liability or as a separate component of equity.

IFRS 4 also specifies disclosures about:

- ◆ The amounts in the entity's financial statements that arise from insurance contracts; and
- ◆ The amount, timing and uncertainty of future cash flows from insurance contracts.

## **5.5 IFRS 5 NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS**

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations was issued in March 2004 and is applicable for annual periods beginning on or after 1 January 2005.

IFRS 5 prescribes the accounting for assets held for sale, and the presentation and disclosure of discontinued operations. The measurement provisions of IFRS 5 apply to all non-current assets and disposal groups, except for:

- ◆ deferred tax assets (IAS 12 Income Taxes);
- ◆ assets arising from employee benefits (IAS 19 Employee Benefits);
- ◆ financial assets within the scope of IAS 39 Financial Instruments: Recognition and Measurement;
- ◆ non-current assets that are accounted for in accordance with the fair value model in IAS 40 Investment Property;
- ◆ non-current assets that are measured at fair value less estimated point-of-sale costs in accordance with IAS 41 Agriculture; and
- ◆ contractual rights under insurance contracts as defined in IFRS 4 Insurance Contracts.

### **SUMMARY**

**Assets held for sale** A non-current asset (or disposal group) is classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through

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continuing use. That is, the asset (or disposal group) is available for immediate sale and its sale is highly probable.

A non-current asset (or disposal group) classified as held for sale is measured at the lower of fair value less costs to sell and its carrying amount. Any impairment loss on write-down of the asset (or disposal group) to fair value less costs to sell is recognised in profit or loss. Any gain on subsequent increase in fair value less costs to sell is also recognised in profit or loss, but not in excess of the cumulative impairment loss already recognised on the asset either in accordance with IFRS 5 or IAS 36 Impairment of Assets.

### **Discontinued Operations**

A discontinued operation is a component of an entity that either has been disposed of or is held for sale. It may be a subsidiary, or a major line of business or geographical area. It will have been a cash-generating unit (or group of cash-generating units) as defined in IAS 36 Impairment of Assets.

Disclosures of discontinued operations include:

- ◆ analysis of the post-tax profit or loss into revenue, expenses, pre-tax profit or loss, and the related income tax expense;
- ◆ the gain or loss recognised on measurement to fair value less costs to sell or on disposal, and the related income tax expense;
- ◆ net cash flows attributable to operating, investing and financing activities;
- ◆ assets held for sale separately from all other assets; and
- ◆ liabilities of a disposal group held for sale separately from all other liabilities.

## **5.6 IFRS 6 EXPLORATION FOR AND EVALUATION OF MINERAL RESOURCES**

On 10 December 2004, the International Accounting Standards Board issued IFRS 6 Exploration and Evaluation of Mineral Resources. IFRS 6 has come into effect for a period beginning on or after 1<sup>st</sup> January 2006.

### **SUMMARY**

IFRS 6 permits an entity to develop an accounting policy for exploration and evaluation of assets without specifically considering the requirements of paragraphs 11 and 12 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. Thus, an entity adopting IFRS 6 may continue to use the accounting policies applied immediately before adopting the IFRS. This includes continuing to use recognition and measurement practices that are part of those accounting policies.

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- ◆ IFRS 6 requires entities recognising exploration and evaluation assets to perform an impairment test on those assets when facts and circumstances suggest that the carrying amount of the assets may exceed their recoverable amount.
- ◆ IFRS 6 varies the recognition of impairment from that in IAS 36 Impairment of Assets but measures the impairment in accordance with that Standard once the impairment is identified.
- ◆ IFRS 6 requires disclosure of information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources, including
  - (a) its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets.
  - (b) the amounts of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.
- ◆ IFRS 6 is effective for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity adopts IFRS 6 before 1 January 2006, transitional relief is available for some comparative disclosures.

June 2005: Amendments to IFRS 6 and IFRS 1 Adopted

On 30 June 2005 the IASB issued amendments to IFRS 1 and IFRS 6 to clarify that an entity that both (a) adopts IFRSs for the first time before 1 January 2006 and (b) applies IFRS 6 before that date is exempted not only from providing comparative prior-period disclosures but also from applying the recognition and measurement requirements of IFRS 6 in the prior comparative period.

**Illustration**

Rybak Petroleum purchases an oil well for \$100 million. It estimates that the well contains 250 million barrels of oil. The oil well has no salvage value. If the company extracts and sells 10,000 barrels of oil during the first year, how much depletion expense should be recorded?

- a. \$4,000
- b. \$10,000
- c. \$25,000
- d. \$250,000

**Solution**

**Choice a. is correct. Depletion expense is \$4,000.**

Depletion Rate = Current period production / Total barrels of production

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$$= \frac{10,000}{250,000,000}$$
$$=.00004$$

Depletion expense = Purchase price x Depletion rate

$$= 100,000,000 \times .00004$$

$$= \$4,000$$

Choice b. is incorrect. The choice incorrectly uses the depletion rate multiplied by the total barrels of oil in the well rather than the depletion rate multiplied by purchase price.

Choice c. is incorrect. The choice incorrectly divides current production of 10,000 barrels divided by the purchase price, then multiplies this incorrect depletion rate by the total number of barrels of oil in the well.

Choice d. is incorrect. The choice incorrectly assumes a 0.001 depletion rate multiplied by the total number of barrels of oil in the well.

## 5.7 IFRS 7 FINANCIAL INSTRUMENTS: DISCLOSURES

On 18 August 2005, the International Accounting Standards Board issued IFRS 7 Financial Instruments: Disclosures. IFRS 7 will come into effect for a period beginning on or after 1<sup>st</sup> January 2007.

Overview of IFRS 7

- ◆ Adds certain new disclosures about financial instruments to those currently required by IAS 32;
- ◆ Replaces the disclosures now required by IAS 30; and
- ◆ Puts all of those financial instruments disclosures together in a new standard on Financial Instruments: Disclosures. The remaining parts of IAS 32 deal only with financial instruments presentation matters.

Disclosure Requirements of IFRS 7:

- ◆ An entity must group its financial instruments into classes of similar instruments and, when disclosures are required, make disclosures by class.
- ◆ The two main categories of disclosures required by IFRS 7 are:



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1. Information about the significance of financial instruments.
2. Information about the nature and extent of risks arising from financial instruments.  
Information about the significance of financial instruments

Balance Sheet Disclosure of the significance of financial instruments for an entity's financial position and performance. This includes disclosures for each of the following categories:

- ◆ Financial assets measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition.
- ◆ Held-to-maturity investments.
- ◆ Loans and receivables.
- ◆ Available-for-sale assets.
- ◆ Financial liabilities at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition.
- ◆ Financial liabilities measured at amortised cost.

Special disclosures about financial assets and financial liabilities designated to be measured at fair value through profit and loss, including disclosures about credit risk and market risk and changes in fair values

- ◆ Reclassifications of financial instruments from fair value to amortised cost or vice versa
- ◆ Disclosures about derecognitions, including transfers of financial assets for which derecognition accounting is not permitted by IAS 39
- ◆ Information about financial assets pledged as collateral and about financial or non-financial assets held as collateral
- ◆ Reconciliation of the allowance account for credit losses (bad debts).
- ◆ Information about compound financial instruments with multiple embedded derivatives.
- ◆ Breaches of terms of loan agreements.
- ◆ Income Statement and Equity

Items of income, expense, gains, and losses, with separate disclosure of gains and losses from:

- ◆ Financial assets measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition.
- ◆ Held-to-maturity investments.
- ◆ Loans and receivables.
- ◆ Available-for-sale assets.

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- ◆ Financial liabilities measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition.
- ◆ Financial liabilities measured at amortised cost.
  - Interest income and interest expense for those financial instruments that are not measured at fair value through profit and loss
  - Fee income and expense
  - Amount of impairment losses on financial assets
  - Interest income on impaired financial assets
  - Other Disclosures
  - Accounting policies for financial instruments
  - Information about hedge accounting, including:
    - ◆ Description of each hedge, hedging instrument, and fair values of those instruments, and nature of risks being hedged.
    - ◆ for cash flow hedges, the periods in which the cash flows are expected to occur, when they are expected to enter into the determination of profit or loss, and a description of any forecast transaction for which hedge accounting had previously been used but which is no longer expected to occur.
    - ◆ If a gain or loss on a hedging instrument in a cash flow hedge has been recognised directly in equity, an entity should disclose the following:
      - The amount that was so recognised in equity during the period.
      - The amount that was removed from equity and included in profit or loss for the period.
      - The amount that was removed from equity during the period and included in the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non-financial liability in a hedged highly probable forecast transaction.
    - ◆ For fair value hedges, information about the fair value changes of the hedging instrument and the hedged item.
    - ◆ Hedge ineffectiveness recognised in profit and loss (separately for cash flow hedges and hedges of a net investment in a foreign operation).
- ◆ Information about the fair values of each class of financial asset and financial liability, along with:
  - Comparable carrying amounts.
  - Description of how fair value was determined.

- Detailed information if fair value cannot be reliably measured.

Note that disclosure of fair values is not required when the carrying amount is a reasonable approximation of fair value, such as short-term trade receivables and payables, or for instruments whose fair value cannot be measured reliably.

### **Nature and extent of exposure to risks arising from financial instruments**

#### **Qualitative disclosures**

- ◆ The qualitative disclosures describe:
- ◆ Risk exposures for each type of financial instrument.
- ◆ Management's objectives, policies, and processes for managing those risks.
- ◆ Changes from the prior period.

#### **Quantitative disclosures**

- ◆ The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. These disclosures include:
  - ◆ Summary quantitative data about exposure to each risk at the reporting date.
  - ◆ Disclosures about credit risk, liquidity risk, and market risk as further described below.
  - ◆ Concentrations of risk.

#### **Credit Risk**

- ◆ Disclosures about credit risk include:
  - ◆ Maximum amount of exposure (before deducting the value of collateral), description of collateral, information about credit quality of financial assets that are neither past due nor impaired, and information about credit quality of financial assets whose terms have been renegotiated.
  - ◆ For financial assets that are past due or impaired, analytical disclosures are required.
  - ◆ Information about collateral or other credit enhancements obtained or called.

#### **Liquidity Risk**

- ◆ Disclosures about liquidity risk include:
  - ◆ A maturity analysis of financial liabilities.
  - ◆ Description of approach to risk management.

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### **Market Risk**

- ◆ Market risk is the risk that the fair value or cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk reflects interest rate risk, currency risk, and other price risks.
- ◆ Disclosures about market risk include:
  - ◆ A sensitivity analysis of each type of market risk to which the entity is exposed.
  - ◆ IFRS 7 provides that if an entity prepares a sensitivity analysis for management purposes that reflects interdependencies of more than one component of market risk (for instance, interest risk and foreign currency risk combined), it may disclose that analysis instead of a separate sensitivity analysis for each type of market risk.

### **Application Guidance**

An appendix of mandatory application guidance is part of the standard.

There is also an appendix of non-mandatory implementation guidance that describes how an entity might provide the disclosures required by IFRS 7.

### **Effective Date**

IFRS 7 is effective for annual periods beginning on or after 1 January 2007, with earlier application encouraged. Early appliers are given some relief with respect to comparative prior period disclosures.

### **Withdrawn and Amended Pronouncements**

IFRS 7 supersedes:

- ◆ IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions
- ◆ The disclosure requirements of IAS 32 Financial Instruments: Presentation and Disclosure. However the presentation requirements of IAS 32 remain unchanged.

## **5.8 IFRS 8 OPERATING SEGMENTS**

On 30 November 2006, the International Accounting Standards Board issued IFRS 8 Operating Segments. IFRS 8 will come into effect for a period beginning on or after 1<sup>st</sup> January 2009.

### **Overview of IFRS 8**

The basic principle for issuing IFRS 8 is that an entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

This IFRS shall apply to:

- (a) the separate or individual financial statements of an entity:
  - (i) whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or
  - (ii) that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
- (b) the consolidated financial statements of a group with a parent:
  - (i) whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or
  - (ii) that files, or is in the process of filing, the consolidated financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

The IFRS specifies how an entity should report information about its operating segments in annual financial statements and, as a consequential amendment to IAS 34 *Interim Financial Reporting*, requires an entity to report selected information about its operating segments in interim financial reports. It also sets out requirements for related disclosures about products and services, geographical areas and major customers.

The IFRS requires an entity to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments that meet specified criteria. Operating segments are components of an entity about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Generally, financial information is required to be reported on the same basis as is used internally for evaluating operating segment performance and deciding how to allocate resources to operating segments.

The IFRS requires an entity to report a measure of operating segment profit or loss and of segment assets. It also requires an entity to report a measure of segment liabilities and particular income and expense items if such measures are regularly provided to the chief operating decision maker. It requires reconciliations of total reportable segment revenues, total profit or loss, total assets, liabilities and other amounts disclosed for reportable segments to corresponding amounts in the entity's financial statements.

The IFRS requires an entity to report information about the revenues derived from its products or services (or groups of similar products and services), about the countries in which it earns revenues and holds assets, and about major customers, regardless of whether that information is used by management in making operating decisions. However, the IFRS does

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not require an entity to report information that is not prepared for internal use if the necessary information is not available and the cost to develop it would be excessive.

The IFRS also requires an entity to give descriptive information about the way the operating segments were determined, the products and services provided by the segments, differences between the measurements used in reporting segment information and those used in the entity's financial statements, and changes in the measurement of segment amounts from period to period.

The above defined IASs and IFRSs can be classified into following categories.

### **PRESENTATION**

|        |                                                                  |
|--------|------------------------------------------------------------------|
| IFRS 1 | First-Time Adoption of IFRS                                      |
| IAS 1  | Presentation of Financial Statements                             |
| IAS 7  | Cash Flow Statements                                             |
| IAS 8  | Accounting Policies, Changes in Accounting Estimates, and Errors |

### **BALANCE SHEET AND INCOME STATEMENT**

|        |                                                                          |
|--------|--------------------------------------------------------------------------|
| IFRS 2 | Share-Based payment                                                      |
| IFRS 4 | Insurance Contracts                                                      |
| IAS 2  | Inventories                                                              |
| IAS 11 | Construction Contracts                                                   |
| IAS 12 | Income Taxes                                                             |
| IAS 16 | Property, Plant, and Equipment                                           |
| IAS 17 | Leases                                                                   |
| IAS 18 | Revenue                                                                  |
| IAS 19 | Employee Benefits                                                        |
| IAS 20 | Accounting for Government Grants and Disclosure of Government Assistance |
| IAS 21 | The Effects of Changes in Foreign Exchange Rates                         |
| IAS 23 | Borrowing Costs                                                          |
| IAS 36 | Impairment of Assets                                                     |
| IAS 37 | Provisions, Contingent Liabilities, and Contingent Assets                |
| IAS 38 | Intangible Assets                                                        |
| IAS 39 | Financial Instruments: Recognition and Measurement                       |
| IAS 40 | Investment Property                                                      |
| IAS 41 | Agriculture                                                              |

**GROUP STATEMENTS**

|        |                                                |
|--------|------------------------------------------------|
| IFRS 3 | Business Combinations                          |
| IAS 27 | Consolidated and Separate Financial Statements |
| IAS 28 | Investments in Associates                      |
| IAS 31 | Interests in Joint ventures                    |

**DISCLOSURE**

|        |                                                              |
|--------|--------------------------------------------------------------|
| IFRS 5 | Non-current Assets Held for Sale and Discontinued Operations |
| IFRS 6 | Exploration for and Evaluation of Mineral Resources          |
| IFRS 7 | Financial Instruments: Disclosures                           |
| IFRS 8 | Operating Segments                                           |
| IAS 10 | Events After the Balance Sheet Date                          |
| IAS 24 | Related-Party Disclosures                                    |
| IAS 26 | Accounting and Reporting by Retirement Benefit Plans         |
| IAS 29 | Financial Reporting in Hyperinflationary Economies           |
| IAS 32 | Financial Instruments: Presentation                          |
| IAS 33 | Earnings per Share                                           |
| IAS 34 | Interim Financial Reporting                                  |

**6. INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE (IFRIC).**

Interpretations of IASs and IFRSs are developed by the International Financial Reporting Interpretations Committee (IFRIC). IFRIC is the new name for the Standing Interpretations Committee (SIC) approved by the IASC Foundation Trustees in March 2002. SIC had been created in 1997 to enhance the rigorous application and worldwide comparability of financial statements that are prepared using International Accounting Standards (IAS) by interpreting potentially contentious accounting issues.

Interpretations are part of IASB's authoritative literature (see IAS 1, Presentation of Financial Statements). Therefore, financial statements may not be described as complying with International Accounting Standards unless they comply with all the requirements of each applicable Standard and each applicable Interpretation issued by the International Financial Reporting Interpretations Committee.

Interpretations are part of IASB's authoritative literature (see IAS 1, Presentation of Financial Statements). Therefore, financial statements may not be described as complying with International Accounting Standards unless they comply with all the requirements of each applicable Standard and each applicable Interpretation issued by the International Financial Reporting Interpretations Committee.

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### 7. OVERVIEW OF INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS

Interpretations of IASs and IFRSs are developed by the International Financial Reporting Interpretations Committee (IFRIC). IFRIC is the new name for the Standing Interpretations Committee (SIC) approved by the IASC Foundation Trustees in March 2002.

#### 7.1 IFRIC 1: CHANGES IN EXISTING DECOMMISSIONING, RESTORATION AND SIMILAR LIABILITIES

- ◆ Final Interpretation 1 issued on 27 May 2004
- ◆ Effective for annual periods beginning on or after 1 September 2004

Reference

IAS 37, Provisions, Contingent Liabilities and Contingent Assets

#### SUMMARY

IFRIC contains guidance on accounting for changes in decommissioning, restoration and similar liabilities that have previously been recognised both as part of the cost of an item of property, plant and equipment under IAS 16 and as a provision (liability) under IAS 37. An example would be a liability that was recognised by the operator of a nuclear power plant for costs that it expects to incur in the future when the plant is shut down (decommissioned). The interpretation addresses subsequent changes to the amount of the liability that may arise from (a) a revision in the timing or amount of the estimated decommissioning or restoration costs or from (b) a change in the current market-based discount rate.

IAS 37 requires the amount recognised as a provision to be the best estimate of the expenditure required to settle the obligation at the balance sheet date. This is measured at its present value, which IFRIC 1 confirms should be measured using a current market-based discount rate. The Interpretation deals with three kinds of change in an existing liability for such costs.

The two main kinds of change dealt with in the Interpretation are those that arise from:

- (a) the revision of estimated outflows of resources embodying economic benefits. For example, the estimated costs of decommissioning a nuclear power plant may vary significantly both in timing and amount; and
- (b) revisions to the current market-based discount rate.

Most entities account for their property, plant and equipment using the cost model. Where this is so, these changes are required to be capitalised as part of the cost of the item and depreciated prospectively over the remaining life of the item to which they relate. This is consistent with the treatment under IAS 16 of other changes in estimate relating to property, plant and equipment.



In the spirit of convergence, the IFRIC considered the US GAAP approach in Statement of Financial Accounting Standards No. 143 Accounting for Asset Retirement Obligations. The Interpretation treats changes in estimated cash flows in a similar way to SFAS 143. However, SFAS 143 does not require any adjustment to the cost of the item, or to the provision, to reflect the effect of a change in the current market-based discount rate. The IFRIC did not choose this approach because IAS 37, unlike US GAAP, requires provisions to be measured at the current best estimate, which should reflect current discount rates. Also, the IFRIC considered it important that both kinds of change should be dealt with in the same way.

Where entities account for their property, plant and equipment using the fair value model, a change in the liability does not affect the valuation of the item for accounting purposes. Instead, it alters the revaluation surplus or deficit on the item, which is the difference between its valuation and what would be its carrying amount under the cost model. The effect of the change is treated consistently with other revaluation surpluses or deficits. Any cumulative deficit is taken to profit or loss, but any cumulative surplus is credited to equity.

The third kind of change dealt with by the Interpretation is an increase in the liability that reflects the passage of time – also referred to as the unwinding of the discount. This is recognised in profit or loss as a finance cost as it occurs.

## **7.2 IFRIC 2: MEMBERS' SHARES IN CO-OPERATIVE ENTITIES AND SIMILAR INSTRUMENTS**

- ◆ Final Interpretation 2 issued 25 November 2004
- ◆ Effective for annual periods beginning on or after 1 January 2005

### **Reference**

- ◆ IAS 32 Financial Instruments: Disclosure and Presentation

### **SUMMARY**

Members' shares in co-operative entities have some characteristics of equity. They also give the holder the right to request redemption for cash, although that right may be subject to certain limitations. IFRIC 2 gives guidance on how those redemption terms should be evaluated in determining whether the shares should be classified as financial liabilities or as equity. Under IFRIC 2, shares for which the member has the right to request redemption are normally liabilities. However, they are equity if:

- ◆ the entity has an unconditional right to refuse redemption, or
- ◆ local law, regulation, or the entity's governing charter imposes prohibitions on redemption. But the mere existence of law, regulation, or charter provisions that would prohibit redemption only if conditions (such as liquidity constraints) are met, or are not met, does not result in members' shares being equity.

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### **7.3 IFRIC 3 EMISSION RIGHTS**

The IASB withdrew IFRIC 3 at its meeting in June 2005

### **7.4 IFRIC 4 DETERMINING WHETHER AN ARRANGEMENT CONTAINS A LEASE**

- ◆ IFRIC 4 Issued 2 December 2004
- ◆ Effective for annual periods beginning on or after 1 January 2006

#### **Reference**

- ◆ IAS 17, Leases

#### **SUMMARY**

In recent years arrangements have developed that do not take the legal form of a lease but which convey rights to use assets in return for a payment or series of payments. Examples of such arrangements include:

- ◆ outsourcing arrangements;
- ◆ telecommunication contracts that provide rights to capacity; and
- ◆ take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services.

The Interpretation specifies that an arrangement that meets the following criteria is, or contains, a lease that should be accounted for in accordance with IAS 17 Leases:

- ◆ Fulfilment of the arrangement depends upon a specific asset. The asset need not be explicitly identified by the contractual provisions of the arrangement. Rather it may be implicitly specified because it is not economically feasible or practical for the supplier to fulfil the arrangement by providing use of alternative assets.
- ◆ The arrangement conveys a right to control the use of the underlying asset. This is the case if any of the following conditions is met:
  - (i) the purchaser in the arrangement has the ability or right to operate the asset or direct others to operate the asset (while obtaining more than an insignificant amount of the output of the asset).
  - (ii) the purchaser has the ability or right to control physical access to the asset (while obtaining more than an insignificant amount of the output of the asset).
  - (iii) there is only a remote possibility that parties other than the purchaser will take more than an insignificant amount of the output of the asset and the price that the purchaser will pay is neither fixed per unit of output nor equal to the current market price at the time of delivery.

## **7.5 IFRIC 5 RIGHTS TO INTERESTS ARISING FROM DECOMMISSIONING, RESTORATION AND ENVIRONMENTAL FUNDS**

IFRIC 5 issued on 16 December 2004 and is effective for annual periods beginning on or after 1 January 2006

### **References**

IAS 8, IAS 27, IAS 28, IAS 31, IAS 37, IAS 39 and SIC 12

### **SUMMARY**

Some entities have obligations to decommission assets or to perform environmental restoration or rehabilitation. Some such entities contribute to a fund established to reimburse the decommissioning, restoration or rehabilitation costs when they are incurred. The fund may be set up to meet the decommissioning costs of a single contributor or for many contributors.

The issues addressed in IFRIC 5 are:

- ◆ How should a contributor account for its interest in a fund?
- ◆ When a contributor has an obligation to make additional contributions, how should that obligation be accounted for?

Under IFRIC 5:

- ◆ If an entity recognises a decommissioning obligation under IFRSs and contributes to a fund to segregate assets to pay for the obligation, it should apply IAS 27, Consolidated and Separate Financial Statements, SIC-12, Consolidation—Special Purpose Entities, IAS 28, Investments in Associates, and IAS 31, Interests in Joint Ventures, to determine whether decommissioning funds should be consolidated, proportionately consolidated or accounted for under the equity method.
- ◆ When a fund is not consolidated, proportionately consolidated, or accounted for under the equity method, and that fund does not relieve the contributor of its obligation to pay decommissioning costs, the contributor should recognise:
  - ◆ its obligation to pay decommissioning costs as a liability, and
  - ◆ its rights to receive reimbursement from the fund as a reimbursement under IAS 37.
- ◆ A right to reimbursement should be measured at the lower of (i) the amount of the decommissioning obligation recognised and (ii) the contributor's share of the fair value of the net assets of the fund. Changes in the carrying amount of this right (other than contributions to and payments from the funds) should be recognised in profit or loss.
- ◆ When a contributor has an obligation to make potential additional contributions to the fund, that obligation is a contingent liability within the scope of IAS 37. When it becomes probable that the additional contributions will be made, a provision should be recognised.

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IFRIC 5 amends IAS 39 Financial Instruments: Recognition and Measurement to exclude from its scope rights to reimbursement for expenditure required to settle a liability recognised as a provision. Such rights will be accounted for in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

### **7.6 IFRIC 6 LIABILITIES ARISING FROM PARTICIPATING IN A SPECIFIC MARKET - WASTE ELECTRICAL AND ELECTRONIC EQUIPMENT**

IFRIC 6 Issued on 1st September and Effective Date of IFRIC 6 is financial periods beginning on or after 1 December 2005

#### **References**

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

#### **SUMMARY**

IFRIC 6 clarifies when certain producers of electrical goods are required to recognise a liability under IAS 37 for the cost of waste management relating to the decommissioning of waste electrical and electronic equipment supplied to private households.

The European Union's Directive on Waste Electrical and Electronic Equipment (WE&EE) has raised questions about when the liability of certain electrical goods manufacturers for the decommissioning of such waste should be recognised. The Directive prescribes that the cost of waste management for equipment that has been sold to private households before 13 August 2005 should be borne by producers of that type of equipment that are in the market during the period specified in the applicable legislation of the individual member state (the measurement period). The manufacturers have to contribute to costs in proportion to their respective share of the market by type of equipment.

The issue that IFRIC 6 addresses is: if an entity has an obligation to contribute to waste management costs based on its share of the market in a measurement period, what is the event under paragraph 14(a) of IAS 37 that gives rise to a liability:

- ◆ the manufacture or sale of the historical household equipment?
- ◆ participation in the market during the measurement period?
- ◆ the incurrence of costs in the performance of waste management activities?

IFRIC 6 concludes that the event that triggers liability recognition is participation in the market during the measurement period. The measurement period is a period in which market shares are determined for the purposes of allocating waste management costs. IFRIC 6 states that it is this date, rather than the date of production of the equipment or incurrence of costs, that is the triggering event for liability recognition.

### **Examples**

1. Country A determines that producers within its jurisdiction will be responsible for 'historical' household waste management costs in proportion to their respective share of the market for that type of equipment in each calendar year. The government notifies participants in the relevant markets in February each year of their market share for the immediately preceding calendar year. Waste management costs for the current year are allocated on this basis.
2. Company Z began operations in September 2005 and manufactures domestic washing machines. Even though it was not responsible for producing any 'historical' WE&EE, because it participates in the market currently it will contribute to the cost of recycling historical WE&EE in proportion to its market share during the measurement period.
3. Company T ceased to produce domestic refrigerators in 2004. Because T no longer produces domestic refrigerators (i.e., its market share is zero), it has no obligation to fund the collection and recycling of historical WE&EE it produced.

The IFRIC's conclusion on this issue is a pragmatic one. The WE&EE Directive attaches the liability for the disposal of historical waste to currently active producers and distributors on the basis of their current market share – irrespective of the extent of their participation in the market at the time the equipment was produced. To apply the Directive retrospectively was not thought practicable. Working with this result, the IFRIC determined that the only workable 'past event' (required by IAS 37 for recognising a liability) was current participation in the market, evidenced by sales in that market.

IFRIC 6 is effective for financial periods beginning on or after 1 December 2005. Earlier application is encouraged.

### **7.7 IFRIC 7 APPLYING THE RESTATEMENT APPROACH UNDER IAS 29 FINANCIAL REPORTING IN HYPERINFLATIONARY ECONOMIES**

IFRIC 7 Issued on 24 November 2005 and effective Date of IFRIC 7 is annual periods beginning on or after 1 March 2006

#### **References**

IAS 29 Financial Reporting in Hyperinflationary Economies

### **SUMMARY**

IAS 29 Financial Reporting in Hyperinflationary Economies requires that the financial statements of an entity that reports in the currency of a hyperinflationary economy should be stated in terms of the measuring unit current at the balance sheet date. Comparative figures for prior period(s) should be restated into the same current measuring unit. IFRIC 7 contains

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guidance on how an entity would restate its financial statements in the first year it identifies the existence of hyperinflation in the economy of its functional currency.

The restatement approach on which IAS 29 is based distinguishes between monetary and non-monetary items. However, in practice there has been uncertainty about how an entity goes about restating its financial statements for the first time, especially deferred tax balances and comparatives.

The main requirements of the Interpretation are:

- ◆ In the period in which the economy of an entity's functional currency becomes hyperinflationary, the entity shall apply the requirements of IAS 29 as though the economy had always been hyperinflationary. The effect of this requirement is that restatements of non-monetary items carried at historical cost are made from the dates at which those items were first recognised; for other non-monetary items the restatements are made from the dates at which revised current values for those items were established.
- ◆ Deferred tax amounts in the opening balance sheet are determined in two stages:
  - ◆ Deferred tax items are remeasured in accordance with IAS 12 after restating the nominal carrying amounts of the non-monetary items in the opening balance sheet by applying the measuring unit at that date.
  - ◆ The deferred tax items remeasured in this way are restated for the change in the measuring unit from the date of the opening balance sheet to the date of the closing balance sheet.

IFRIC 7 is effective for annual periods beginning on or after 1 March 2006. Earlier application is encouraged.

## 7.8 IFRIC 8 SCOPE OF IFRS 2

IFRIC 8 Issued on 12 January 2006 and effective date of IFRIC 8 is annual periods beginning on or after 1 May 2006

References

IFRS 2 Share-based Payment

### SUMMARY

IFRIC 8 *Scope of IFRS 2* clarifies that IFRS 2 *Share-based Payment* applies to arrangements where an entity makes share-based payments for apparently nil or inadequate consideration.

IFRIC 8 explains that, if the identifiable consideration given appears to be less than the fair value of the equity instruments granted or liability incurred, this situation typically indicates that other consideration has been or will be received. IFRS 2 therefore applies.

IFRIC 8 is effective for annual periods beginning on or after 1 May 2006. Earlier application is encouraged.

## 7.9 IFRIC 9 REASSESSMENT OF EMBEDDED DERIVATIVES

IFRIC Interpretation 9 *Reassessment of Embedded Derivatives* issued on 1 March 2006 and its effective date is annual periods beginning on or after 1 June 2006

### References

IAS 39 Financial Instruments: Recognition and Measurement

### SUMMARY

An embedded derivative as a component of a hybrid (combined) financial instrument that also includes a non-derivative host contract. Some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

An example is the conversion option in convertible debt. The fair value of the convertible (hybrid) instrument changes, in part, with movements in the fair value of the equity shares into which it is convertible – which would be similar to a stand-alone option.

IAS 39 requires an entity, when it first becomes a party to a hybrid contract, to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and accounted for as if they were stand-alone derivatives.

IFRIC 9 addresses:

- ◆ whether IAS 39 requires such an assessment to be made only when the entity first becomes a party to the hybrid contract, or whether the assessment be reconsidered throughout the life of the contract.
- ◆ whether a first-time adopter of IFRSs should make its assessment on the basis of the conditions that existed when the entity first became a party to the contract, or those prevailing when the entity adopts IFRSs for the first time.

IFRIC 9 concludes that an entity must assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required.

A first-time adopter must assess whether an embedded derivative is required to be separated on the basis of the conditions that existed at the date it first became a party to the contract, unless there was a subsequent change in terms of the contract that significantly modified the cash flows.

IFRIC 9 is effective for annual periods beginning on or after 1 June 2006. Earlier application is encouraged.

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### 7.10 IFRIC 10 INTERIM FINANCIAL REPORTING AND IMPAIRMENT

IFRIC Interpretation 10 *Interim Financial Reporting and Impairment* issued on 20 July 2006 and its effective date is annual periods beginning on or after 1 November 2006

#### References

IAS 34 Interim Financial Reporting

#### SUMMARY

The Interpretation addresses an apparent conflict between the requirements of IAS 34 Interim Financial Reporting and those in other standards on the recognition and reversal in financial statements of impairment losses on goodwill and certain financial assets. IFRIC 10 concludes that:

An entity shall **not** reverse an impairment loss recognised in a previous interim period in respect of goodwill or an investment in either an equity instrument or a financial asset carried at cost.

An entity shall not extend this consensus by analogy to other areas of potential conflict between IAS 34 and other standards.

IFRIC 10 is effective for annual periods beginning on or after 1 November 2006. Earlier application is encouraged.

### 7.11 IFRIC 11 GROUP AND TREASURY SHARE TRANSACTIONS

IFRIC Interpretation 11 *IFRS 2: Group and Treasury Share Transactions* was issued on 2 November 2006 and its effective date is annual periods beginning on or after 1 March 2007.

#### References

IAS 8 Accounting Policies, Changes in Estimates and Errors

IAS 32 Financial Instruments: Presentation

IFRS 2 Share-based Payment

#### SUMMARY

IFRIC 11 provides guidance on applying IFRS 2 in three circumstances:

- ◆ Share-based payment involving an entity's own equity instruments in which the entity chooses or is required to buy its own equity instruments (treasury shares) to settle the share-based payment obligation – is this an equity-settled or cash-settled transaction?
- ◆ A parent grants rights to its equity instruments to employees of its subsidiary – how to account in the individual entities' financial statements?



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- ◆ A subsidiary grants rights to equity instruments of its parent to its employees – how to account in the individual entities' financial statements?

Share-based payment involving an entity's own equity instruments in which the entity chooses or is required to buy its own equity instruments (treasury shares) to settle the share-based payment obligation

These should always be accounted for as equity-settled share-based payment transactions under IFRS 2.

A parent grants rights to its equity instruments to employees of its subsidiary

Assuming the transaction is accounted for as equity-settled in the consolidated financial statements, the subsidiary must measure the services received using the requirements for equity-settled transactions in IFRS 2, and must recognise a corresponding increase in equity as a contribution from the parent.

A subsidiary grants rights to equity instruments of its parent to its employees

The subsidiary accounts for the transaction as a cash-settled share-based payment transaction.

Therefore, in the subsidiary's individual financial statements, the accounting treatment of transactions in which a subsidiary's employees are granted rights to equity instruments of its parent would differ, depending on whether the parent or the subsidiary granted those rights to the subsidiary's employees. This is because the IFRIC concluded that, in the former situation, the subsidiary has not incurred a liability to transfer cash or other assets of the entity to its employees, whereas it has incurred such a liability in the latter situation (being a liability to transfer equity instruments of its parent).

## **7.12 IFRIC 12 SERVICE CONCESSION ARRANGEMENTS**

IFRIC Interpretation 12 *IFRS 12: Service Concession Arrangements* was issued on 30 November 2006 and its effective date is annual periods beginning on or after 1 January 2008.

References:

IFRS 1 First-time Adoption of International Financial Reporting Standards

IFRS 7 Financial Instruments: Disclosures

Framework for the Preparation and Presentation of Financial Statements

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

IAS 11 Construction Contracts

IAS 16 Property, Plant and Equipment

IAS 17 Leases

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IAS 18 Revenue

IAS 20 Government Grants

IAS 23 Borrowing Costs

IAS 32 Financial Instruments: Disclosure and Presentation

IAS 36 Impairment of Assets

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

IAS 38 Intangible Assets

IAS 39 Financial Instruments: Recognition and Measurement

IFRIC 4 Determining whether an Arrangement contains a Lease

SIC-29 Disclosure - Service Concession Arrangements

### **SUMMARY**

#### **Service Concession Arrangements Defined**

Service concession arrangements are arrangements whereby a government or other body grants contracts for the supply of public services – such as roads, energy distribution, prisons or hospitals – to private operators. The objective of this project of the IFRIC is to clarify how certain aspects of existing IASB literature are to be applied to service concession arrangements.

#### **Two Types of Service Concession Arrangements**

IFRIC 12 draws a distinction between two types of service concession arrangement.

- ◆ In one, the operator receives a financial asset, specifically an unconditional contractual right to receive cash or another financial asset from the government in return for constructing or upgrading the public sector asset.
- ◆ In the other, the operator receives an intangible asset – a right to charge for use of the public sector asset that it constructs or upgrades. A right to charge users is not an unconditional right to receive cash because the amounts are contingent on the extent to which the public uses the service.

IFRIC 12 allows for the possibility that both types of arrangement may exist within a single contract: to the extent that the government has given an unconditional guarantee of payment for the construction of the public sector asset, the operator has a financial asset; to the extent that the operator has to rely on the public using the service in order to obtain payment, the operator has an intangible asset.

### **Accounting – Financial asset model**

The operator recognises a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services. The operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator

- (a) specified or determinable amounts or
- (b) the shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements.

The operator measures the financial asset at fair value.

### **Accounting – Intangible asset model**

The operator recognises an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.

The operator measures the intangible asset at fair value.

### **Operating revenue**

The operator of a service concession arrangement recognises and measures revenue in accordance with IASs 11 and 18 for the services it performs.

### **Accounting by the Government (Grantor)**

IFRIC 12 does not address accounting for the government side of service concession arrangements. IFRSs are not designed to apply to not-for-profit activities in the private sector or the public sector. However, the International Public Sector Accounting Standards Board (IPSASB) has started its own project on service concession arrangements, which will give serious consideration to accounting by grantors. The principles applied in IFRIC 12 will be considered as part of the project.

## **7.13 CUSTOMER LOYALTY PROGRAMMES**

IFRIC Interpretation 13 *IFRS 13 Customer Loyalty Programmes* was issued 28 June 2007 and its effective date is annual periods beginning on or after 1 July 2008.

References:

IAS 18 Revenue

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

IAS 38 Intangible Assets

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### **SUMMARY**

IFRIC 13 Customer Loyalty Programmes addresses accounting by entities that grant loyalty award credits (such as 'points' or travel miles) to customers who buy other goods or services. Specifically, it explains how such entities should account for their obligations to provide free or discounted goods or services ('awards') to customers who redeem award credits.

Key Provisions:

- ◆ An entity that grants loyalty award credits shall allocate some of the proceeds of the initial sale to the award credits as a liability (its obligation to provide the awards). In effect, the award is accounted for as a separate component of the sale transaction.
- ◆ The amount of proceeds allocated to the award credits is measured by reference to their fair value, that is, the amount for which the award credits could have been sold separately.
- ◆ The entity shall recognise the deferred portion of the proceeds as revenue only when it has fulfilled its obligations. It may fulfil its obligations either by supplying the awards itself or by engaging (and paying) a third party to do so.
- ◆ If at any time the expected costs of meeting the obligation exceed the consideration received, the entity has an onerous contract for which IAS 37 would require recognition of a liability.
- ◆ If IFRIC 13 causes an entity to change its accounting policy for customer loyalty awards, IAS 8 applies.

### **7.14 IFRIC 14: IAS 19 – THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION**

IFRIC 14 was issued 4 July 2007, and its Effective Date of IFRIC 14: Annual periods beginning on or after 1 January 2008. Earlier application permitted.

### **References**

IAS 19 Employee Benefits

### **SUMMARY**

In many countries, laws or contractual terms require employers to make minimum funding payments for their pension or other employee benefit plans. This enhances the security of the retirement benefit promise made to members of an employee benefit plan.

Normally, such statutory or contractual funding requirements would not affect the measurement of the defined benefit asset or liability. This is because the contributions, once paid, become plan assets and the additional net liability would be nil. However, paragraph 58 of IAS 19 Employee Benefits limits the measurement of the defined benefit asset to the 'present value of economic benefits available in the form of refunds from the plan or

reductions in future contributions to the plan.' IFRIC 14 addresses the interaction between a minimum funding requirement and the limit placed by paragraph 58 of IAS 19 on the measurement of the defined benefit asset or liability.

When determining the limit on a defined benefit asset in accordance with IAS 19.58, under IFRIC 14 entities are required to measure any economic benefits available to them in the form of refunds or reductions in future contributions at the maximum amount that is consistent with the terms and conditions of the plan and any statutory requirements in the jurisdiction of the plan. The entity's intentions on how to use a surplus (for instance, whether the entity intends to improve benefits rather than reduce contributions or get a refund) must be disregarded.

Such economic benefits are regarded as available to an entity if the entity has an unconditional right to realise them at some point during the life of the plan or when the plan is settled, even if they are not realisable immediately at the balance sheet date. Such an unconditional right would not exist when the availability of the refund or the reduction in future contribution would be contingent upon factors beyond the entity's control (for example, approval by third parties such as plan trustees). To the extent the right is contingent, no asset would be recognised.

#### **Economic benefits available as a refund**

If an entity has an unconditional right to a refund

- (a) during the life of the plan, without assuming that the plan liabilities must be settled in order to obtain the refund, or
- (b) assuming the gradual settlement of the plan liabilities over time until all members have left the plan, or
- (c) assuming the full settlement of the plan liabilities in a single event (i.e. as a plan wind-up),

it shall recognise an asset measured as the amount of the surplus at the balance sheet date that it has a right to receive as a refund. This is the fair value of the plan assets less the present value of the defined benefit obligation, less any associated costs, such as taxes.

If the refund is determined as the full amount or a proportion of the surplus, rather than a fixed amount, the amount shall be calculated without further adjustment for the time value of money, even if the refund is realisable only at a future date, as both the defined benefit obligation and the fair value of plan assets are already measured on a present value basis.

#### **Economic benefits available as a reduction in contributions**

In the absence of a minimum funding requirement, IFRIC 14 requires entities to determine economic benefits available as a reduction in future contributions as:

- ◆ the present value of the future service cost to the entity (excluding costs borne by employees) over:

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- ◆ the shorter of the expected life of the plan; and
- ◆ the expected life of the entity;
- ◆ determined using assumptions consistent with those used to determine the defined benefit obligation (including the discount rate); and
- ◆ based on conditions that exist at the balance sheet date.
- ◆ This means, an entity shall assume
- ◆ no change to the benefits provided by a plan in the future until the plan is amended, and
- ◆ a stable workforce unless it is demonstrably committed at the balance sheet date to make a reduction in the number of employees covered by the plan.

IFRIC 14 contains illustrative examples that outline the accounting treatments under a number of different scenarios.

### **Effective date and transition**

IFRIC 14 is effective for annual periods beginning on or after 1 January 2008. Earlier application is permitted.

The Interpretation is to be applied from the beginning of the first period presented in the financial statements for annual periods beginning on or after the effective date. The IFRIC had initially proposed full retrospective application, but decided to amend the transitional provisions reflecting concerns from constituents.

## **8. STANDING INTERPRETATIONS COMMITTEE – AN OVERVIEW**

SIC had been created in 1997 to enhance the rigorous application and worldwide comparability of financial statements that are prepared using International Accounting Standards (IAS) by interpreting potentially contentious accounting issues.

### **8.1 SIC 1:CONSISTENCY – DIFFERENT COST FORMULAS FOR INVENTORIES**

Superseded and incorporated into *IAS 2 (Revised 2003)*

### **8.2 SIC 2: CONSISTENCY - CAPITALISATION OF BORROWING COSTS**

Superseded by *IAS 23 (Revised 2003)*

### **8.3 SIC 3: ELIMINATION OF UNREALISED PROFITS AND LOSSES ON TRANSACTIONS WITH ASSOCIATES**

Superseded by *IAS 28 (Revised 2003)*

#### **8.4 SIC 4 (DRAFT 4) CLASSIFICATION OF FINANCIAL INSTRUMENTS - ISSUER'S SETTLEMENT OPTION**

In March 1999, the IASC Board issued IAS 39: Financial Instruments: Recognition and Measurement. As a result, the SIC did not proceed with SIC-4.

#### **8.5 SIC 5 CLASSIFICATION OF FINANCIAL INSTRUMENTS - CONTINGENT SETTLEMENT PROVISIONS**

Superseded by and incorporated into *IAS 32 (Revised 2003)*

#### **8.6 SIC 6 COSTS OF MODIFYING EXISTING SOFTWARE**

Superseded by and incorporated into *IAS 16 (Revised 2003)*

#### **8.7 SIC 7 INTRODUCTION OF THE EURO**

This SIC has been Revised in December 2003 and is effective from 1 January 2005,

References

*IAS 21 The Effects of Changes in Foreign Exchange Rates*

#### **SUMMARY**

This Interpretation addresses how the introduction of the Euro, resulting from the European Economic and Monetary Union (EMU), affects the application of *IAS 21 The Effects of Changes in Foreign Exchange Rates*. SIC 7 states that the requirements of *IAS 21* should be strictly applied when a country joins the EU's Economic and Monetary Union. Therefore:

- ◆ foreign currency monetary assets and liabilities resulting from transactions continue to be translated into the functional currency at the closing rate. Any resulting exchange differences are recognised as income or expense immediately, except that an entity continues to apply its existing accounting policy for exchange gains and losses related to hedges of the currency risk of a forecast transaction.
- ◆ cumulative exchange differences relating to the translation of financial statements of foreign operations continue to be classified as equity and are recognised as income or expense only on the disposal of the net investment in the foreign operation; and
- ◆ exchange differences resulting from translating liabilities denominated in participating currencies are not included in the carrying amount of related assets.

#### **8.8 SIC 8 FIRST-TIME APPLICATION OF IASS AS THE PRIMARY BASIS OF ACCOUNTING**

Superseded by *IFRS 1*, June 2003.

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### **8.9 SIC 9 BUSINESS COMBINATIONS - CLASSIFICATION EITHER AS ACQUISITIONS OR UNITINGS OF INTERESTS**

Superseded by and incorporated into *IFRS 3* effective 31 March 2004.

### **8.10 SIC 10: GOVERNMENT ASSISTANCE - NO SPECIFIC RELATION TO OPERATING ACTIVITIES**

SIC 10 has been issued on July 1998 and is effective from 1 August 1998.

#### **References**

IAS 20, Accounting for Government Grants and Disclosure of Government Assistance

#### **SUMMARY**

In some countries, government assistance to enterprises can be aimed at encouragement or long-term support of business activities either in certain regions or industry sectors. Conditions to receive such assistance may not be specifically related to the operating activities of the enterprise. The issue is whether such government assistance is "a government grant" within the scope of IAS 20 and should therefore be accounted for in accordance with this Standard.

Under SIC 10, government assistance to enterprises that is aimed at encouragement or long-term support of business activities either in certain regions or industry sectors meets the definition of government grants in IAS 20. Such grants should therefore not be credited directly to shareholders' interests.

### **8.11 SIC 11: FOREIGN EXCHANGE - CAPITALISATION OF LOSSES RESULTING FROM SEVERE CURRENCY DEVALUATIONS**

Superseded by IAS 21 (Revised 2003)

### **8.12 SIC 12: CONSOLIDATION – SPECIAL PURPOSE ENTITIES**

SIC 12 has been issued on November 1998 and is effective from annual financial periods beginning on or after 1 July 1999. It was amended by IFRIC on November 2004 to remove the exclusion of equity compensation plans from the scope of SIC 12

#### **References**

IAS 27, Consolidated and Separate Financial Statements

#### **SUMMARY**

SIC 12 addresses when a special purpose entity should be consolidated by a reporting enterprise under the consolidation principles in IAS 27. Under SIC 12, an entity must



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consolidate a special purpose entity ("SPE") when, in substance, the entity controls the SPE. The control of an SPE by an entity may be indicated if:

- ◆ The SPE conducts its activities to meet the entity's specific needs
- ◆ The entity has decision-making powers to obtain the majority of the benefits of the SPE's activities
- ◆ The entity is able to obtain the majority of the benefits of the SPE's activities through an 'auto-pilot' mechanism
- ◆ By having a right to the majority of the SPE's benefits, the entity is exposed to the SPE's business risks
- ◆ The entity has the majority of residual interest in the SPE

Examples of SPEs include entities set up to effect a lease, a securitisation of financial assets, or R&D activities. The concept of control used in IAS 27 requires having the ability to direct or dominate decision making accompanied by the objective of obtaining benefits from the SPE's activities.

Some enterprises may also need to separately evaluate the topic of derecognition of assets, for example, related to assets transferred to an SPE. In some circumstances, such a transfer of assets may result in those assets being derecognised and accounted for as a sale. Even if the transfer qualifies as a sale, the provisions of IAS 27 and SIC 12 may mean that the enterprise should consolidate the SPE. SIC 12 does not address the circumstances in which sale treatment should apply for the reporting enterprise or the elimination of the consequences of such a sale upon consolidation.

**8.13 SIC 13: JOINTLY CONTROLLED ENTITIES - NON-MONETARY CONTRIBUTIONS BY VENTURERS**

SIC 13 has been issued on November 1998 and is effective from annual financial periods beginning on or after 1 January 1999.

**References**

IAS 31, Financial Reporting of Interests In Joint Ventures

**SUMMARY**

SIC 13 clarifies the circumstances in which the appropriate portion of gains or losses resulting from a contribution of a non-monetary asset to a jointly controlled entity (JCE) in exchange for an equity interest in the JCE should be recognised by the venturer in the income statement.

SIC 13 indicates that under IAS 31.39, recognition of gains or losses on contributions of non-monetary assets is appropriate unless:

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- (a) the significant risks and rewards related to the non-monetary asset are not transferred to the jointly controlled entity;
- (b) the gain or loss cannot be measured reliably; or
- (c) similar assets are contributed by the other venturers.

Non-monetary assets contributed by venturers are similar when they have a similar nature, a similar use in the same line of business and a similar fair value. A contribution meets the similarity test only if all significant component assets included in the contribution are similar to each of the significant component assets contributed by the other venturers. A gain should also be recognised if, in addition to the equity interest in the jointly controlled entity, the venturer receives consideration in the form of either cash or other assets which are dissimilar to the non-monetary assets contributed.

### **8.14 SIC 14: PROPERTY, PLANT AND EQUIPMENT - COMPENSATION FOR THE IMPAIRMENT OR LOSS OF ITEMS**

Superseded by and incorporated into *IAS 16 (Revised 2003)*

### **8.15 SIC 15: OPERATING LEASES - INCENTIVES**

SIC 15 has been issued on July 1999 and is effective from Lease terms beginning on or after 1 January 1999.

References

IAS 17, Leases

#### **SUMMARY**

In SIC-15, the SIC clarifies the recognition of incentives related to operating leases by both the lessee and lessor. The Interpretation indicates that lease incentives (such as rent-free periods or contributions by the lessor to the lessee's relocation costs) should be considered an integral part of the consideration for the use of the leased asset. IAS 17.24 and .42 (rev. 1997) require an enterprise to treat incentives as a reduction of lease income or lease expense. As they are an integral part of the net consideration agreed for the use of the leased asset, incentives should be recognised by both the lessor and the lessee over the lease term, with each party using a single amortisation method applied to the net consideration.

### **8.16 SIC 16: SHARE CAPITAL - REACQUIRED OWN EQUITY INSTRUMENTS (TREASURY SHARES)**

Superseded by and incorporated into *IAS 32 (Revised 2003)*

### **8.17 SIC 17: EQUITY - COSTS OF AN EQUITY TRANSACTION**

Superseded by and incorporated into *IAS 32 (Revised 2003)*

**8.18 SIC 18: CONSISTENCY - ALTERNATIVE METHODS**

Superseded by IAS 8 (Revised 2003)

**8.19 SIC 19: REPORTING CURRENCY - MEASUREMENT AND PRESENTATION OF  
FINANCIAL STATEMENTS UNDER IAS 21 AND IAS 29**

Superseded by IAS 21 (Revised 2003)

**8.20 SIC 20 EQUITY ACCOUNTING METHOD - RECOGNITION OF LOSSES**

Superseded by IAS 28 (Revised 2003)

**8.21 SIC 21: INCOME TAXES - RECOVERY OF REVALUED NON-DEPRECIABLE ASSETS**

SIC 21 has been issued on July 2000 and is effective from 15 July 2000

References

IAS 12, Income Taxes

**SUMMARY**

SIC 21 deals with cases where a non-depreciable asset (freehold land) is carried at revaluation under IAS 16. No part of the carrying amount of such an asset is considered to be recovered through its use. Therefore, SIC 21 concludes that the deferred tax liability or asset that arises from revaluation must be measured based on the tax consequences that would follow from the sale of the asset rather than through use. In some jurisdictions, this will result in the use of a capital gains tax rate rather than the rate applicable to corporate earnings.

**8.22 SIC 22: BUSINESS COMBINATIONS - SUBSEQUENT ADJUSTMENT OF FAIR  
VALUES AND GOODWILL INITIALLY REPORTED**

Superseded by and incorporated into *IFRS 3*

**8.23 SIC 23: PROPERTY, PLANT AND EQUIPMENT - MAJOR INSPECTION OR  
OVERHAUL COSTS**

Superseded by and incorporated into *IAS 16 (Revised 2003)*

**8.24 SIC 24: EARNINGS PER SHARE - FINANCIAL INSTRUMENTS THAT MAY BE  
SETTLED IN SHARES**

Superseded by and incorporated into *IAS 33 (Revised 2003)*

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### **8.25 SIC 25: INCOME TAXES - CHANGES IN THE TAX STATUS OF AN ENTERPRISE OR ITS SHAREHOLDERS**

SIC 25 has been issued on July 2000 and is effective from 15 July 2000

References

IAS 12, Income Taxes

#### **SUMMARY**

A change in the tax status of an enterprise or its shareholders does not give rise to increases or decreases in the pre-tax amounts recognised directly in equity. Therefore, SIC 25 concludes that the current and deferred tax consequences of the change in tax status should be included in net profit or loss for the period. However, where a transaction or event does result in a direct credit or charge to equity, for example the revaluation of property, plant or equipment under IAS 16, the related tax consequence would still be recognised directly in equity.

### **8.26 SIC 26: (DRAFT) PROPERTY, PLANT AND EQUIPMENT - RESULTS OF INCIDENTAL OPERATIONS**

At its April 2001 meeting, IASB did not approve the proposed Interpretation.

### **8.27 SIC 27: EVALUATING THE SUBSTANCE OF TRANSACTIONS IN THE LEGAL FORM OF A LEASE**

SIC 27 is effective from 31 December 2001

References

IAS 1, Presentation of Financial Statements, IAS 17, Leases, and IAS 18, Revenue.

#### **SUMMARY**

SIC 27 addresses issues that may arise when an arrangement between an enterprise and an investor involves the legal form of a lease. Among the provisions of SIC 27:

- ◆ Accounting for arrangements between an enterprise and an investor should reflect the substance of the arrangement. All aspects of the arrangement should be evaluated to determine its substance, with weight given to those aspects and implications that have an economic effect. In this respect, SIC 27 includes a list of indicators that individually demonstrate that an arrangement may not, in substance, involve a lease under IAS 17, Leases.
- ◆ If an arrangement does not meet the definition of a lease, SIC 27 addresses whether a separate investment account and lease payment obligation that might exist represent assets and liabilities of the enterprise; how the enterprise should account for other

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obligations resulting from the arrangement; and how the enterprise should account for a fee it might receive from an Investor. SIC 27 includes a list of indicators that collectively demonstrate that, in substance, a separate investment account and lease payment obligations do not meet the definitions of an asset and a liability and should not be recognised by the enterprise. Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, should be accounted for under IAS 37 or IAS 39, depending on the terms. Further, it agreed that the criteria in IAS 18.20 should be applied to the facts and circumstances of each arrangement in determining when to recognise a fee as income that an Enterprise might receive.

- ◆ A series of transactions that involve the legal form of a lease is linked, and therefore should be accounted for as one transaction, when the overall economic effect cannot be understood without reference to the series of transactions as a whole.

**8.28 SIC 28: BUSINESS COMBINATIONS – 'DATE OF EXCHANGE' AND FAIR VALUE OF EQUITY INSTRUMENTS**

Superseded by and incorporated into *IFRS 3*

**8.29 SIC 29: DISCLOSURE – SERVICE CONCESSION ARRANGEMENTS**

SIC 29 is effective from 31 December 2001

References

An Interpretation of IAS 1, Presentation of Financial Statements

**SUMMARY**

SIC 29 prescribes the information that should be disclosed in the notes to the financial statements of a concession operator and a concession provider when the two parties are joined by a service concession arrangement. A service concession arrangement exists when an enterprise (the concession operator) agrees with another enterprise (the concession provider) to provide services that give the public access to major economic and social facilities.

Examples of service concession arrangements involve water treatment and supply facilities, motorways, car parks, tunnels, bridges, airports and telecommunication networks. Examples of arrangements that are not service concession arrangements include an enterprise outsourcing the operation of its internal services (for instance, employee cafeteria, building maintenance, and accounting or information technology functions).

Under SIC 29, the following should be disclosed in each period:

- ◆ a description of the arrangement;

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- ◆ significant terms of the arrangement that may affect the amount, timing, and certainty of future cash flows (such as the period of the concession, re-pricing dates, and the basis on which re-pricing or re-negotiation is determined);
- ◆ the nature and extent (quantity, time period, or amount, as appropriate) of:
  - rights to use specified assets;
  - obligations to provide or rights to expect provision of services;
  - obligations to acquire or build items of property, plant and equipment;
  - obligations to deliver or rights to receive specified assets at the end of the concession period;
  - renewal and termination options; and
  - other rights and obligations (for instance, major overhauls); and
- ◆ changes in the arrangement occurring during the period.

### **8.30 SIC 30: REPORTING CURRENCY - TRANSLATION FROM MEASUREMENT CURRENCY TO PRESENTATION CURRENCY**

Superseded by IAS 21 (Revised 2003)

### **8.31 SIC 31: REVENUE - BARTER TRANSACTIONS INVOLVING ADVERTISING SERVICES**

SIC 31 is effective from 31 December 2001.

#### **References**

IAS 18, Revenue

#### **SUMMARY**

Under IAS 18, revenue cannot be recognised if the amount of revenue is not reliably measurable. SIC 31 deals with the circumstances in which a seller can reliably measure revenue at the fair value of advertising services received or provided in a barter transaction. Under SIC 31, revenue from a barter transaction involving advertising cannot be measured reliably at the fair value of advertising services received. However, a seller can reliably measure revenue at the fair value of the advertising services it provides in a barter transaction by reference only to non-barter transactions that:

- ◆ involve advertising similar to the advertising in the barter transaction;
- ◆ occur frequently;
- ◆ represent a predominant number of transactions and amount when compared to all transactions to provide advertising that is similar to the advertising in the barter transaction;

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- ◆ involve cash and/or another form of consideration (such as marketable securities, non-monetary assets, and other services) that has a reliably measurable fair value; and
- ◆ do not involve the same counter party as in the barter transaction.

### **8.32 SIC 32: INTANGIBLE ASSETS - WEBSITE COSTS**

SIC 32 is effective from 25 March 2002

References

IAS 38, Intangible Assets

#### **SUMMARY**

SIC 32 concludes that a website developed by an enterprise using internal expenditure, whether for internal or external access, is an internally generated intangible asset that is subject to the requirements of IAS 38, Intangible Assets.

SIC 32 identifies the following stages of website development:

- ◆ Planning
- ◆ Application and infrastructure development
- ◆ Content development
- ◆ Operating

SIC 32 addresses the appropriate accounting treatment for internal expenditure on each of those stages of development and operation:

- (a) A website arising from development should be recognised as an intangible asset if, and only if, in addition to complying with the general requirements described in IAS 38.19 for recognition and initial measurement, an enterprise can satisfy the requirements in IAS 38.45. In particular, an enterprise may be able to satisfy the requirement to demonstrate how its website will generate probable future economic benefits under IAS 38.45(d) when, for example, the website is capable of generating revenues, including direct revenues from enabling orders to be placed. An enterprise is not able to demonstrate how a website developed solely or primarily for promoting and advertising its own products and services will generate probable future economic benefits, and consequently all expenditure on developing such a website should be recognised as an expense when incurred.
- (b) Any internal expenditure on the development and operation of an enterprise's own website should be accounted for in accordance with IAS 38. The nature of each activity for which expenditure is incurred (eg training employees and maintaining the website) and the website's stage of development or post-development should be evaluated to

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determine the appropriate accounting treatment. For example:

- ◆ **Planning.** The Planning stage is similar in nature to the research phase in IAS 38.42-.44. Expenditure incurred in this stage should be recognised as an expense when it is incurred.
  - ◆ **Application and Infrastructure Development.** The Application and Infrastructure Development stage, the Graphical Design stage and the Content Development stage, to the extent that content is developed for purposes other than to advertise and promote an enterprise's own products and services, are similar in nature to the development phase in IAS 38.45-.52. Expenditure incurred in these stages should be included in the cost of a website recognised as an intangible asset in accordance with this Interpretation when the expenditure can be directly attributed, or allocated on a reasonable and consistent basis, to preparing the website for its intended use. For example, expenditure on purchasing or creating content (other than content that advertises and promotes an enterprise's own products and services) specifically for a website, or expenditure to enable use of the content (such as a fee for acquiring a licence to reproduce) on the website, should be included in the cost of development when this condition is met. However, in accordance with IAS 38.59, expenditure on an intangible item that was initially recognised as an expense in previous financial statements should not be recognised as part of the cost of an intangible asset at a later date (for instance, when the costs of a copyright have been fully amortised, and the content is subsequently provided on a website).
  - ◆ **Content Development.** Expenditure incurred in the Content Development stage, to the extent that content is developed to advertise and promote an enterprise's own products and services (such as digital photographs of products) should be recognised as an expense when incurred in accordance with IAS 38.57(c). For example, when accounting for expenditure on professional services for taking digital photographs of an enterprise's own products and for enhancing their display, expenditure should be recognised as an expense as the professional services are received during the process, not when the digital photographs are displayed on the website.
  - ◆ **Operating.** The Operating stage begins once development of a website is complete. Expenditure incurred in this stage should be recognised as an expense when it is incurred unless it meets the criteria in IAS 38.60.
- (c) A website that is recognised as an intangible asset under SIC 32 should be measured after initial recognition by applying the requirements of IAS 38.63-.78. The best estimate of a website's useful life should be short.

### 8.33 SIC 33: CONSOLIDATION AND EQUITY METHOD - POTENTIAL VOTING RIGHTS AND ALLOCATION OF OWNERSHIP INTERESTS

Superseded by IAS 27 (Revised 2003) and by IAS 28 (Revised 2003)



## **9. US GAAPS**

GAAP refers to accounting policies and procedures that are widely used in practice. Unlike India where accounting has its basis in law, US GAAP has evolved to be a collection of pronouncements issued by particular accounting organisation. **US GAAP** are the accounting rules used to prepare financial statements for publicly traded companies and many private companies in the United States. Generally accepted accounting principles for local and state governments operates under a different set of assumptions, principles, and constraints, as determined by the Governmental Accounting Standards Board (GASB).

In the United States, as well as in other countries practicing under the English common law system, the government does not set accounting standards, in the belief that the private sector has better knowledge and resources. The Securities and Exchange Commission (SEC) has the ultimate authority to set US accounting and financial reporting standards for public (listed) companies. The SEC has delegated this responsibility to the private sector led by the Financial Accounting Standards Board (FASB). Other private sector bodies including the American Institute of Certified Public Accountants (AICPA) and the FASB's Emerging Issues Task Force (EITF) also establish authoritative accounting standards in the United States. Interpretations of the Financial Accounting Standard Board (FIN) also provide implementation and interpretation guidance. The SEC has the statutory authority to establish GAAP for filings made with it. While allowing most of the standard settings to be done in the private sector, the SEC is still very active in both its oversight responsibility as well as establishing guidance and interpretations, as it believes appropriate. US GAAP have the reputation around the world of being more prescriptive and detailed than accounting standards in other countries. In order to organise and make clear what is meant by US GAAP, a GAAP hierarchy has been established which contains four categories of accounting principles. The sources in the higher category carry more weight and must be followed when conflicts arise. The table given below summarises the current GAAP hierarchy for financial statements of non-governmental entities.

### **Established Accounting Principles in the US**

|              |                                                                                                                                                                                                                                    |
|--------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Category (a) | Financial Accounting Standards Board (FASB) Statements and Interpretations, American Institute of Certified Public Accountants (AICPA), Accounting Principles Board (APB) Opinions, and AICPA Accounting Research Bulletins (ARB). |
| Category (b) | FASB Technical Bulletins, cleared AICPA Industry Audit and Accounting Guides, and cleared AICPA Statement of Position (SOPs).                                                                                                      |
| Category (c) | Consensus positions of the FASB Emerging Issues Task Force (EITF) and cleared Accounting Standards Executive Committee of the AICPA (ACSEC) Practice Bulletins.                                                                    |

## 2.118 Financial Reporting

|                             |                                                                                                                                                                                                                                                                                                                            |
|-----------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Category (d)                | AICPA Accounting Interpretations, FASB Implementation Guides (QSAs), and widely recognised and prevalent industry practices.                                                                                                                                                                                               |
| Other Accounting Literature | Other accounting literature, including FASB concepts statements, APB Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; Pronouncements of other professional associations or regulatory agencies; AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles. |

The US GAAP provisions differ somewhat from International Financial Reporting Standards though efforts are underway to reconcile the differences so that reports created under international standards will be acceptable to the SEC for companies listed on US markets.

### 9.1 AICPA

The AICPA sets *generally accepted* professional and technical standards for CPAs in many areas. Until the 1970's, the AICPA held a monopoly in this field. In the 1970's, however, it transferred its responsibility for setting generally accepted accounting principles (GAAP) to the newly formed Financial Accounting Standards Board (FASB.) Following this, it retained its standards setting function in areas such as financial statement auditing, professional ethics, attest services, CPA firm quality control, CPA tax practice and financial planning practice. Before passage of the Sarbanes-Oxley law, AICPA standards in these areas were considered "generally accepted" for all CPA practitioners.

**Accounting Principles Board (APB) Opinions** were published by Accounting Principles Board (APB). APB was the main organization setting the US GAAP and its opinions are still an important part of it.

### 9.2 FASB

The **Financial Accounting Standards Board (FASB)** is a private, not-for-profit organization whose primary purpose is to develop generally accepted accounting principles in the United States (US GAAP). The FASB's mission for the private sector is similar to that of the Governmental Accounting Standards Board (GASB) for local and state governments in the United States. The FASB was created in 1973, replacing the Accounting Principles Board of the American Institute of Certified Public Accountants (AICPA). The FASB's mission is "to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information."

The U.S. Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. The SEC designated the FASB as the organization responsible for setting accounting standards for public companies in the U.S.

FASB has so far issued 158 Statements of Financial Accounting Standards (FAS).

### **9.3 COMPONENTS OF US GAAP**

Given below are important components of US GAAP:

- ◆ FASB Statement of Financial Accounting Standards (FAS).
- ◆ FASB Interpretations (FIN).
- ◆ FASB Statements of Financial Accounting Concepts(FAS Conc.).
- ◆ FASB Technical Bulletins (FTB).
- ◆ AICPA Accounting Research Bulletins (ARB).
- ◆ AICPA Accounting Principles Board Opinions (APB Opinions)
- ◆ AICPA Accounting Interpretations (AIN).

Not only there are an extremely large number of different standards under US GAAP, the volume and complexity is also increasing. This complexity of US GAAP makes it critically important that the independent accountants that are assisting a company in filing with the SEC are knowledgeable and experts in US GAAP.

Given below is the list of important US GAAPs Pronouncements:

**Table 1**

**List of FASB Statements of Financial Accounting Standards**

| <i>Number</i> | <i>Title</i>                                                                                                     |
|---------------|------------------------------------------------------------------------------------------------------------------|
| FAS 2         | Accounting for Research and Development Cost                                                                     |
| FAS 3         | Reporting Accounting Changes in Interim Financial Statements<br>(an amendment of APB Opinion No. 28)             |
| FAS 4         | Reporting Gains and Losses from Extinguishments of Debt (an<br>amendment of APB Opinion No. 30)                  |
| FAS 5         | Accounting for Contingencies                                                                                     |
| FAS 6         | Classification of Short Term Obligations Expected to be Refinanced (an<br>amendment of Chapter 3A of ARB No. 43) |
| FAS 7         | Accounting and Reporting by Development Stage Enterprises                                                        |
| FAS 11        | Accounting for Contingencies – Transition Method (an amendment of<br>FAS 5)                                      |
| FAS 13        | Accounting for Leases                                                                                            |
| FAS 15        | Accounting by Debtors and Creditors for Troubled Debt Restructurings                                             |
| FAS 16        | Prior Period Adjustments                                                                                         |

## **2.120 Financial Reporting**

|        |                                                                                                                                              |
|--------|----------------------------------------------------------------------------------------------------------------------------------------------|
| FAS 19 | Financial Accounting and Reporting by Oil and Gas Producing Companies                                                                        |
| FAS 22 | Changes in the Provisions of Leases Agreements Resulting from Refundings of Tax Exempt Debt (an amendment of FAS 13)                         |
| FAS 23 | Inception of the Lease (an amendment of FAS 13)                                                                                              |
| FAS 25 | Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies (an amendment of FAS 19)                                   |
| FAS 27 | Classification of Renewals or Extension of Existing Sales Type or Direct Financing Leases (an amendment of FAS 13)                           |
| FAS 28 | Accounting for Sales with Leasebacks (an amendment of FAS 13)                                                                                |
| FAS 29 | Determining Contingent Rentals (an amendment of FAS 13)                                                                                      |
| FAS 34 | Capitalization of Interest Cost                                                                                                              |
| FAS 35 | Accounting and Reporting by Defined Benefit Pension Plans                                                                                    |
| FAS 37 | Balance Sheet Classification of Deferred Income Taxes (an amendment of APB Opinion No. 16)                                                   |
| FAS 42 | Determining Materiality for Capitalization of Interest Cost (an amendment of FAS 34)                                                         |
| FAS 43 | Accounting for Compensated Absences                                                                                                          |
| FAS 45 | Accounting for Franchise Fee Revenue                                                                                                         |
| FAS 47 | Disclosure of Long Term Obligations                                                                                                          |
| FAS 48 | Revenue Recognition when right of Return Exists                                                                                              |
| FAS 49 | Accounting for Product Financing Arrangements                                                                                                |
| FAS 50 | Financial Reporting in the Record and Music Industry                                                                                         |
| FAS 51 | Financial Reporting by Cable Television Companies                                                                                            |
| FAS 52 | Foreign Currency Translation                                                                                                                 |
| FAS 57 | Related Party Disclosures                                                                                                                    |
| FAS 58 | Capitalization of Interest Cost in Financial Statements that include Investments Accounted for by the Equity Method (an amendment of FAS 34) |
| FAS 60 | Accounting and Reporting by Insurance Enterprises                                                                                            |
| FAS 61 | Accounting for Title Plant                                                                                                                   |
| FAS 62 | Capitalization of Interest Cost in Situations involving certain Tax-Exempt Borrowings and certain Gifts and Grants (an amendment of FAS 34)  |

**2.121**

**International Accounting Standards, International Financial Reporting Standards,  
their interpretations and US GAAPs- An Overview**

|        |                                                                                                                                                                                                           |
|--------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| FAS 63 | Financial Reporting by Broadcasters                                                                                                                                                                       |
| FAS 65 | Accounting for certain Mortgage Banking Activities                                                                                                                                                        |
| FAS 66 | Accounting for Sale of Real Estate                                                                                                                                                                        |
| FAS 67 | Accounting for Costs and Initial Rental Operations of Real Estate Projects                                                                                                                                |
| FAS 68 | Research and Development Arrangements                                                                                                                                                                     |
| FAS 69 | Disclosures about Oil and Gas Producing Activities (an amendment of FAS No. 19, 25, 33 and 39)                                                                                                            |
| FAS 71 | Accounting for Effects of Certain Types of Regulations                                                                                                                                                    |
| FAS 72 | Accounting for Certain Acquisitions of Banking or Thrift Institutions (an amendment of APB Opinion No. 17, an interpretation of APB Opinion Nos. 16 and 17 and an amendment of FASB Interpretation No. 9) |
| FAS 84 | Induced Conversions of Convertible Debt (an amendment of APB Opinion No. 26)                                                                                                                              |
| FAS 86 | Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed                                                                                                                    |
| FAS 87 | Employer's Accounting for Pensions                                                                                                                                                                        |
| FAS 88 | Employer's Accounting for Settlements and Curtailments of Defined Benefit Pension Plans for Termination Benefits                                                                                          |
| FAS 89 | Financial Reporting and Changing Prices                                                                                                                                                                   |
| FAS 90 | Regulated Enterprises – Accounting for Abandonments and Disallowances of Plant Costs (an amendment of FAS 71)                                                                                             |
| FAS 91 | Accounting for Non-refundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (an amendment of FAS Nos. 13,60 and 65 and a rescission of FAS 17)         |
| FAS 92 | Regulated Enterprises – Accounting for Phase in Plans (an amendment of FAS 71)                                                                                                                            |
| FAS 93 | Recognition of Depreciation by Not For Profit Organizations                                                                                                                                               |
| FAS 94 | Consolidation of all Majority Owned Subsidiaries (an amendment of ARB No. 51, with related amendments of APB Opinion No. 18 and Chapter 12 of ARB No. 43)                                                 |
| FAS 95 | Statement of Cash Flows                                                                                                                                                                                   |
| FAS 97 | Accounting and Reporting by Insurance Enterprises for Certain Long Duration Contracts and for Realized Gains and Losses from the Sale of Investments                                                      |

## 2.122 Financial Reporting

|         |                                                                                                                                                                                                                                                                                                                                                                                   |
|---------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| FAS 98  | Accounting for Leases : <ul style="list-style-type: none"><li>❖ Sale - Leaseback Transactions Involving Real Estate</li><li>❖ Sale – Type Leases of Real Estate</li><li>❖ Definition of Lease Term</li><li>❖ Initial Direct Costs of Direct Financing Leases (an amendment of FASB Statements No. 13,66 and 91 and a rescission of FAS 26 and Technical Bulletin 79-11)</li></ul> |
| FAS 99  | Deferral of Effective Date of Recognition of Depreciation by Not –for-Profit Organizations (an amendment of FAS 93)                                                                                                                                                                                                                                                               |
| FAS 101 | Regulated Enterprises – Accounting for the Discontinuation of Application (an amendment of FAS 71)                                                                                                                                                                                                                                                                                |
| FAS 102 | Statement of Cash Flows - Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale (an amendment of FAS 95)                                                                                                                                                                                                                  |
| FAS 104 | Statement of Cash Flows – Not Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flow from Hedging Transactions (an amendment of FAS 95)                                                                                                                                                                                                             |
| FAS 106 | Employers' Accounting for Post-retirement Benefits other than Pensions                                                                                                                                                                                                                                                                                                            |
| FAS 107 | Disclosures about Fair Value of Financial Instruments                                                                                                                                                                                                                                                                                                                             |
| FAS 109 | Accounting for Income Taxes                                                                                                                                                                                                                                                                                                                                                       |
| FAS 110 | Reporting by Defined Benefit Pension Plans of Investment Contracts (an amendment of FAS 35)                                                                                                                                                                                                                                                                                       |
| FAS 111 | Rescission of FASB Statement No. 32 and Technical Corrections                                                                                                                                                                                                                                                                                                                     |
| FAS 112 | Employers 'Accounting for Post-employment Benefits (an amendment of FASB Statement Nos. 5 and 43)                                                                                                                                                                                                                                                                                 |
| FAS 113 | Accounting and Reporting for Reinsurance of Short Duration and Long Duration Contracts                                                                                                                                                                                                                                                                                            |
| FAS 114 | Accounting by Creditor's for Impairment of a Loan (an amendment of FASB Statement Nos. 5 and 15)                                                                                                                                                                                                                                                                                  |
| FAS 115 | Accounting for Certain Investments in Debt and Equity Securities                                                                                                                                                                                                                                                                                                                  |
| FAS 116 | Accounting for Contributions Received and Contributions Made                                                                                                                                                                                                                                                                                                                      |
| FAS 117 | Financial Statements of Not - for – Profit Organizations                                                                                                                                                                                                                                                                                                                          |
| FAS 118 | Accounting by Creditor's for Impairment of a Loan – Income Recognition and Disclosures (an amendment of FAS 114)                                                                                                                                                                                                                                                                  |
| FAS 120 | Accounting and Reporting by Mutual Life Insurance Enterprises and Insurance Enterprises for Certain Long Duration Participating Contracts                                                                                                                                                                                                                                         |

**2.123**

**International Accounting Standards, International Financial Reporting Standards,  
their interpretations and US GAAPs- An Overview**

|                           |                                                                                                                                                  |
|---------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------|
|                           | (an amendment of FAS Statement Nos. 60,97 and 113 and Interpretation No. 40)                                                                     |
| FAS 123<br>(revised 2004) | Share Based Payment                                                                                                                              |
| FAS 124                   | Accounting for Certain Investments Held by Not – for – Profit Organizations                                                                      |
| FAS 126                   | Exemption from Certain Required Disclosures about Financial Instruments for Certain Non-Public Entities (an amendment of FASB statement No. 107) |
| FAS 128                   | Earning per Share                                                                                                                                |
| FAS 129                   | Disclosure of Information about Capital Structure                                                                                                |
| FAS 130                   | Reporting Comprehensive Income                                                                                                                   |
| FAS 131                   | Disclosures about Segments of an Enterprise and Related Information                                                                              |
| FAS 132<br>(revised 2003) | Employers' Disclosures about Pensions and Other Post Retirement Benefits (an amendment of FASB Statement Nos. 87, 88 and 106)                    |
| FAS 133                   | Accounting for Derivative Instruments and Hedging Activities                                                                                     |
| FAS 134                   | Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise)    |
| FAS 135                   | Rescission of FASB Statement No. 75 and Technical Contracts                                                                                      |
| FAS 136                   | Transfers of Assets to a Not – for – Profit Organization or Charitable Trust that Raises or Holds Contributions for others                       |
| FAS 137                   | Accounting for Derivative Instruments and Hedging Activities – Deferral of the Effective date of FASB Statement No.133                           |
| FAS 138                   | Accounting for Certain Derivative Instruments and Certain Hedging Activities (An amendment of FASB Statement No. 133)                            |
| FAS 139                   | Rescission of FASB Statement No. 53 and Amendment to FASB Statement No. 63, 89 and 121)                                                          |
| FAS 140                   | Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities<br>(A replacement of FASB Statement No. 125)       |
| FAS 141                   | Business Combinations                                                                                                                            |
| FAS 142                   | Goodwill and Other Intangible Assets                                                                                                             |
| FAS 143                   | Accounting for Asset Retirement Obligations                                                                                                      |
| FAS 144                   | Accounting for the Impairment of Disposal of Long-lived Assets                                                                                   |

## **2.124 Financial Reporting**

|         |                                                                                                                                 |
|---------|---------------------------------------------------------------------------------------------------------------------------------|
| FAS 145 | Rescission of FASB statements No. 4, 44 and 64 (Amendment of FAS 13 and Technical Corrections)                                  |
| FAS 146 | Accounting for Costs Associated with Exit or Disposal Activities                                                                |
| FAS 147 | Acquisitions of Certain Financial Institutions (an amendment of FAS 72 & 144 & FIN 9)                                           |
| FAS 149 | Amendment of FAS 133 on Derivative Instruments and Hedging Activities                                                           |
| FAS 150 | Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity                                |
| FAS 151 | Inventory Costs (an amendment of ARB 43 of Chapter 4)                                                                           |
| FAS 152 | Accounting for Real Estate Time-Sharing Transactions (an amendment of FAS 66 and 67)                                            |
| FAS 153 | Exchanges of Non-monetary Assets (an amendment of APB Opinion No. 29)                                                           |
| FAS 154 | Accounting Changes and Error Corrections (a replacement of APB Opinion 20 & FAS 3)                                              |
| FAS 155 | Accounting for Certain Hybrid Financial Instruments (an amendment of FAS 133 and 140)                                           |
| FAS 156 | Accounting for Servicing of Financial Assets (an amendment of FAS 140)                                                          |
| FAS 157 | Fair Value Measurements                                                                                                         |
| FAS 158 | Employer's Accounting for Defined Benefit Pension and Other Post – Retirement Plans (an amendment of FAS 87, 88, 106 and 132 R) |
| FAS 159 | The Fair Value Option for Financial Assets and Financial Liabilities (Including an amendment of FASB Statement No. 115)         |

**Table 2**

### **FASB INTERPRETATIONS**

|       |                                                                                                                                              |
|-------|----------------------------------------------------------------------------------------------------------------------------------------------|
| FIN 1 | Accounting Changes Related to the Cost of Inventory (an interpretation of APB Opinion No. 20)                                                |
| FIN 4 | Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method (an Interpretation of APB Opinion No. 2) |
| FIN 6 | Applicability of FASB Statement No. 2 to Computer Software (an interpretation of FAS 2)                                                      |



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**International Accounting Standards, International Financial Reporting Standards,  
their interpretations and US GAAPs- An Overview**

|        |                                                                                                                                                                                                                    |
|--------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| FIN 7  | Applying FASB Statement No. 7 in Financial Statements of Established, Operating Enterprises (an interpretation of FAS 7)                                                                                           |
| FIN 8  | Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long Term Security (an interpretation of FAS 6)                                                                                      |
| FIN 9  | Applying APB Nos. 16 and 17 when Savings and Loan Association or a Similar Institution is Acquired in a Business Combination Accounted for by the Purchase Method (an interpretation of APB Opinion No. 16 and 17) |
| FIN 14 | Reasonable Estimation of the Amount of a Loss (an interpretation of FAS 5)                                                                                                                                         |
| FIN 18 | Accounting for Income Taxes in Interim Periods (an interpretation of APB Opinion No. 28)                                                                                                                           |
| FIN 19 | Lease Guarantee of the Residual Value of Leased Property (an interpretation of FAS 13)                                                                                                                             |
| FIN 21 | Accounting for Leases in Business Combination (an interpretation of FAS 13)                                                                                                                                        |
| FIN 23 | Leases of Certain Property Owned by a Government Unit or Authority (an interpretation of FAS 13)                                                                                                                   |
| FIN 24 | Leases Involving Only Part of a Building (an interpretation of FAS 13)                                                                                                                                             |
| FIN 26 | Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease (an interpretation of FAS 13)                                                                                                 |
| FIN 27 | Accounting for a Loss on a Sub-lease (an interpretation of FAS and APB Opinion No. 30)                                                                                                                             |
| FIN 30 | Accounting for Involuntary Conversions of Non-monetary Assets to Monetary Assets (an interpretation of APB Opinion No. 29)                                                                                         |
| FIN 33 | Applying FASB Statement No. 34 to Oil and Gas Producing Operations Accounted for by the Full Cost Method (an interpretation of FAS 34)                                                                             |
| FIN 35 | Criteria for Applying the Equity method of Accounting for Investments in Common Stock (an interpretation of APB Opinion No. 18)                                                                                    |
| FIN 36 | Accounting for Exploratory Wells in Progress at the End of a Period (an interpretation of APB Opinion No. 19)                                                                                                      |
| FIN 37 | Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity (an interpretation of APB Opinion No. 52)                                                                            |
| FIN 39 | Offsetting of Amounts Related to Certain Contracts (an interpretation of APB Opinion No. 10 and a FAS 105)                                                                                                         |
| FIN 40 | Applicability of a Generally Accepted Accounting Principles to Mutual                                                                                                                                              |

## 2.126 Financial Reporting

|                          |                                                                                                                                                                                   |
|--------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                          | Life Insurance and Other Enterprises (an interpretation of FAS 12, 60, 97 and 113)                                                                                                |
| FIN 41                   | Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements (an interpretation of APB Opinion No. 10 and a modification of FIN 39)                      |
| FIN 43                   | Real Estates (an Interpretation of FAS 66)                                                                                                                                        |
| FIN 45                   | Guarantor's Accounting and Disclosure Requirements for Guarantees, including (guarantees of indebtedness others (an interpretation of FAS 5, 57 and 107 and rescission of FIN 34) |
| FIN 46<br>(revised 2003) | Consolidation of Variable interest Entities (an interpretation of ARB No. 51)                                                                                                     |
| FIN 47                   | Accounting for Conditional Asset Retirement obligations (an interpretation of FAS 143)                                                                                            |
| FIN 48                   | Accounting for Uncertainty in Income Taxes (an interpretation of FAS 109)                                                                                                         |

**Table 3**

### **FASB Statements of Financial Accounting Concepts**

|       |                                                                             |
|-------|-----------------------------------------------------------------------------|
| CON 1 | Objectives of Financial Reporting by Enterprises                            |
| CON 2 | Qualitative Characteristics of Accounting Information                       |
| CON 4 | Objectives of Financial Reporting by Non-business Organizations             |
| CON 5 | Recognition and Measurement in Financial Statements of Business Enterprises |
| CON 6 | Elements of Financial Statements                                            |
| CON 7 | Using Cash Flow Information and Present Value in Accounting Measurements    |

**Table 4**

### **FASB Technical Bulletins**

|              |                                                                                                     |
|--------------|-----------------------------------------------------------------------------------------------------|
| FTB 79-1 (R) | Purpose and Scope of FASB Technical Bulletins and Procedures for Issuance                           |
| FTB 79-3     | Subjective Acceleration Clauses in Long Term Debt Agreements                                        |
| FTB 79-4     | Segment Reporting of Puerto Rican Operations                                                        |
| FTB 79-5     | Meaning of the Term "Customer" as it Applies to Health Care Facilities under FASB Statement No. 14) |

**International Accounting Standards, International Financial Reporting Standards, 2.127  
their interpretations and US GAAPs- An Overview**

|              |                                                                                                                                                                                                                                                                                                                                                                                                                    |
|--------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| FTB 79-10    | Fiscal Funding Clauses in Lease Agreements                                                                                                                                                                                                                                                                                                                                                                         |
| FTB 79-12    | Interest Rate Used in Calculating the Present Value of Minimum Lease Payments                                                                                                                                                                                                                                                                                                                                      |
| FTB 79-13    | Applicability of FASB Statement No. 13 to Current Value Financial Statements.                                                                                                                                                                                                                                                                                                                                      |
| FTB 79-14    | Upward Adjustments of Guaranteed Residual Values                                                                                                                                                                                                                                                                                                                                                                   |
| FTB 79-15    | Accounting for Loss on a Sub-lease Not Involving the Disposal of a Segment                                                                                                                                                                                                                                                                                                                                         |
| FTB 79-16(R) | Effect of a Change in Income Tax Rate on the Accounting for Leveraged Leases                                                                                                                                                                                                                                                                                                                                       |
| FTB 79-17    | Reporting Cumulative Effect Adjustment from Retroactive Application of FASB Statement No. 13                                                                                                                                                                                                                                                                                                                       |
| FTB 79-18    | Transition Requirement of Certain FASB Amendments and Interpretations of FASB Statement No. 13                                                                                                                                                                                                                                                                                                                     |
| FTB 79-19    | Investor's Accounting for unrealized Losses on Marketable Securities Owned by an Equity Method Invested                                                                                                                                                                                                                                                                                                            |
| FTB 80-1     | Early Extinguishments of debt Through Exchange for Common Stock or Preferred Stock                                                                                                                                                                                                                                                                                                                                 |
| FTB 80-2     | Classification of Debt Restructurings by Debtors and Creditors                                                                                                                                                                                                                                                                                                                                                     |
| FTB 81-6     | Applicability of FASB Statement to 15 Debtors in Bankruptcy Situations                                                                                                                                                                                                                                                                                                                                             |
| FTB 82-1     | Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases                                                                                                                                                                                                                                                                                                                                              |
| FTB 84-1     | Accounting for Stock Issued to Acquire the Results of a Research and Development Arrangement                                                                                                                                                                                                                                                                                                                       |
| FTB 85-1     | Accounting for the Receipt of Federal Home Loan Mortgage Corporation Participating preferred Stock                                                                                                                                                                                                                                                                                                                 |
| FTB 85-3     | Accounting for Operating Leases with Scheduled Rent Increases                                                                                                                                                                                                                                                                                                                                                      |
| FTB 85-4     | Accounting for Purchases of Life Insurance                                                                                                                                                                                                                                                                                                                                                                         |
| FTB 85-5     | Issues Relating to Accounting for Business Combinations, Including <ul style="list-style-type: none"> <li>❖ Costs of Closing Duplicate Facilities of an Acquirer</li> <li>❖ Stock Transactions between Companies under Common Control</li> <li>❖ Downstream Mergers</li> <li>❖ Identical Common Shares for a Pooling of Interests</li> <li>❖ Pooling of Interests by Mutual and Cooperative Enterprises</li> </ul> |
| FTB 85-6     | Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income                                                                                                                                                                                                                                                                           |

## 2.128 Financial Reporting

|          |                                                                                                                                                                                                                                                                                                                                                                                             |
|----------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|          | Statement Classification of Costs Incurred in Defending against a Takeover Attempt                                                                                                                                                                                                                                                                                                          |
| FTB 86-2 | Accounting for an Interest in the Residual Value of a Leased Asset: <ul style="list-style-type: none"><li>❖ Acquired by a Third Party or</li><li>❖ Retained by a Lessor that Sells the Related Minimum Rental Payments</li></ul>                                                                                                                                                            |
| FTB 87-2 | Computation of a Loss on an Abandonment                                                                                                                                                                                                                                                                                                                                                     |
| FTB 87-3 | Accounting for Mortgage Servicing Fees and Rights                                                                                                                                                                                                                                                                                                                                           |
| FTB 88-1 | Issues Relating to Accounting for Leases: <ul style="list-style-type: none"><li>❖ Time Pattern of the Physical Use of the Property in an Operating Lease</li><li>❖ Lease Incentives in an Operating Lease</li><li>❖ Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor</li><li>❖ Money-Over –Money Lease Transactions</li><li>❖ Wrap Lease Transactions</li></ul> |
| FTB 90-1 | Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts                                                                                                                                                                                                                                                                                                        |
| FTB 94-1 | Application of FAS 115 to Debt Securities Restructured in a Troubled Debt Restructuring                                                                                                                                                                                                                                                                                                     |
| FTB 97-1 | Accounting under FAS 123 for Certain Employee Stock Purchase Plans with a Look Back Option                                                                                                                                                                                                                                                                                                  |
| FTB 01-1 | Effective Date for Certain Financial Institutions of Certain Provisions of FAS 140 related to the Isolation of Transferred Financial Assets                                                                                                                                                                                                                                                 |

**Table 5**

### **AICPA Accounting Research Bulletins**

|        |                                                           |
|--------|-----------------------------------------------------------|
| ARB 43 | Restatement and Revision of Accounting Research Bulletins |
| ARB 45 | Long Term Construction Type Contracts                     |
| ARB 46 | Discontinuance of Dating Earned Surplus                   |
| ARB 51 | Consolidated Financial Statements                         |

**Table 6**

### **AICPA Accounting Principles Board Opinions**

|       |                                                         |
|-------|---------------------------------------------------------|
| APB 2 | Accounting for the "Investment Credit"                  |
| APB 4 | Accounting for the "Investment Credit" (Amending No. 2) |

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**International Accounting Standards, International Financial Reporting Standards,  
their interpretations and US GAAPs- An Overview**

|        |                                                                              |
|--------|------------------------------------------------------------------------------|
| APB 6  | Status of Accounting Research Bulletins (Amending ARB 43)                    |
| APB 9  | Reporting the Results of Operations                                          |
| APB 10 | Omnibus Opinion - 1966                                                       |
| APB 12 | Omnibus Opinion – 1967                                                       |
| APB 13 | Amending Paragraph 6 of APB Opinion No. 9, Application to Commercial Banks   |
| APB 14 | Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants |
| APB 18 | The Equity Method of Accounting for Investments in Common Stock              |
| APB 21 | Interest on Receivables and Payables                                         |
| APB 22 | Disclosure of Accounting Policies                                            |
| APB 23 | Accounting for Income Taxes – Special Areas                                  |
| APR 26 | Early Extinguishment of Debt                                                 |
| APB 28 | Interim Financial Reporting                                                  |
| APB 29 | Accounting for Non-monetary Transactions                                     |

**Table 7**

**AICPA Accounting Interpretations**

|              |                                                                  |
|--------------|------------------------------------------------------------------|
| AIN – APB 4  | Accounting for Investment Credit                                 |
| AIN – APB 9  | Reporting the Results of Operations                              |
| AIN – APB 16 | Business Combinations, Not applicable since FAS 141 is in effect |
| AIN – APB 17 | Intangible Assets, Not applicable since FAS 142 is in effect     |
| AIN – APB 18 | The Equity Method of Accounting for Investment in Common Stock   |
| AIN – APB 21 | Interest on Receivable and Payables                              |
| AIN – APB 25 | Accounting for Stock Issued to Employees                         |
| AIN – APB 26 | Early Extinguishment of Debt                                     |
| AIN – APB 30 | Reporting the Results of Operations                              |

**10. FINANCIAL STATEMENTS AS PER US GAAP**

**10.1 BASIC OBJECTIVES**

Financial reporting prepared on the basis of US GAAP should provide information:

- ◆ useful to present to potential investors and creditors and other users in making rational investment, credit, and other financial decisions.

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- ◆ helpful to present to potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts.
- ◆ about economic resources, the claims to those resources, and the changes in them.

### **10.2 FINANCIAL STATEMENT REQUIREMENTS**

#### *10.2.1 For US GAAP Financial Statements*

US GAAP Financial Statements comprise of (i) Statements of income with comparatives of the preceding two accounting periods; (ii) statements of cash flows with comparatives of the preceding two accounting periods; (iii) statements of changes in shareholders' equity with comparatives of the preceding two accounting periods; (iv) statements of comprehensive income with comparatives of the preceding two accounting periods and (v) Balance Sheet with comparatives of one preceding accounting period.

#### *10.2.2 For Non-US GAAP Financial Statements*

The basic financial statements for a non-US company are the same as that of a US company: three years of statements of income, statements of cash flows, statements of changes in shareholders' equity and statements of comprehensive income and two years of balance sheets.

Some companies have not registered with the SEC due to the so-called "reconciliation requirement." Non-US companies are allowed to prepare their financial statements using any comprehensive basis of generally accepted accounting principles (GAAP). However, if US GAAP is not used, a reconciliation from the foreign GAAP to US GAAP must be included as a part of the audited financial statements

### **10.3 RECONCILIATION REQUIREMENTS**

US Securities and Exchange Commission has prescribed Form 20-F, Item 17 of which requires:

- ◆ Description of differences between foreign GAAP and US GAAP
- ◆ Reconciliation of net income from foreign GAAP to US GAAP
- ◆ Reconciliation of the balance sheet i.e., differences in each asset/liability between foreign GAAP and US GAAP – usually presented in the form of a reconciliation of shareholders' equity.
- ◆ Reconciliation of a statement of cash flows between foreign GAAP to US GAAP.
- ◆ Disclosure of earnings per share under US GAAP

Item 18 of Form 20-F requires

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The same information as required by Item 17 plus all the disclosures required by US GAAP and Regulation S-X – e.g., information on segments, pensions, taxes, fair value of financial instruments, etc.

Companies are required to comply with Item 18 in all capital raising transactions of non-investment grade securities. Item 17 can be used in many other situations including annual reports. As a matter of practice, however, most companies elect to use Item 18 for all filings. Compliance with item 18 allows the company to have continued access to the US market without a delay that could result from preparing the required US GAAP disclosures.

Currently, non-US companies have the option of preparing the statement of comprehensive income using either Foreign GAAP or US GAAP. If the company elects to present this statement using Foreign GAAP, the staff encourages, but does not require, the disclosure of comprehensive income under US GAAP.

### **10.4 REASONS FOR THE RECONCILIATION REQUIREMENT**

There are two primary reasons for the reconciliation requirement:

#### **1. Provides same level of competition**

US companies would be placed at a competitive disadvantage in the competition for capital if non-US companies were not required to provide US GAAP information. For example, a company reporting higher net income for particular transaction on the basis of any other country's GAAP would certainly score more than the US company reporting less income for the same transaction as per US GAAP. This also applies to disclosure. For example, many US companies would prefer not to disclose segment information for competitive reasons. If a non-US company did not have to disclose this information it would have an unfair advantage over a US company.

#### **2. Permits comparison of financial statement or information**

The reconciliation allows a US investor to compare the results of financial statements of US companies not only with other US companies but also with other foreign companies. For example, AT&T, MCI Worldcom and others compete with foreign telecommunications companies for capital, and the reconciliation allows their results to be compared on a constant basis.

*Why non-US Companies do not prefer Reconciliation?*

Reasons why non-US companies do not prefer to provide a reconciliation to US GAAP are:

1. Reporting two different amounts for net income and other amounts can be confusing to users of the financial statements.
2. Companies are required to present information under a basis for which they do not manage the business. While making certain business decisions, management will

## **2.132 Financial Reporting**

consider the effect on the primary financial statements. Management generally does not consider the consequences of reporting under US GAAP. Accordingly, US GAAP net income may differ if US GAAP were used as the primary basis for external reporting.

3. It can reduce flexibility that some companies enjoy under a different GAAP. For example, IAS is less prescriptive and generally more flexible regarding revenue and expense recognition than US GAAP.
4. There is an additional cost of preparing US GAAP information and getting it audited.

*The SEC recognized that the preparation of US GAAP information can be extremely difficult in an initial public offering (IPO). Accordingly, in 1994, the SEC reduced the number of years that had to be reconciled in an IPO from five years (three years audited and two additional years as part of selected financial data) to two years. One year of US GAAP information is added each year until there are five years of US GAAP data in the selected financial data.*

## **10.5 RECOMMENDATIONS FOR PREPARING THE RECONCILIATION**

### **10.5.1 Balance Sheet**

Reconciliation of shareholders' equity should be in a sufficient detail to allow a reconstruction of a balance sheet that complies with US GAAP and Regulation S-X. Do not-

- ◆ Record items net of tax – all reconciling items should be presented gross with a separate adjustment for taxes;
- ◆ Present adjustments that affect several balance sheet items as one adjustment – for example do not present an adjustment called purchase accounting; rather, the effect would need to be allocated to each balance sheet item;
- ◆ Combine different adjustments that affect the same balance sheet item – each difference must be described and quantified; and
- ◆ Present items net of depreciation or amortization expense – these amounts should also be presented gross with separate disclosure of the amount of accumulated depreciation/amortization.

### **10.5.2 Income Statement**

Reconciliation should be in a sufficient detail to allow a reconstruction of the major items on the income statement under US GAAP and Regulation S-X. Do not-

- ◆ Record items net of tax;
- ◆ Present adjustments that affect several income statement items as one adjustment; and
- ◆ Combine different adjustments that affect the same income statement item.



### **10.6.3 Cash Flow Statement**

While reconciling the financial statements prepared on the basis of different GAAPs, following are the errors that have been noted frequently:

- ◆ Lack of identifying non-cash investing and financing activities;
- ◆ Presenting net activity that should be presented gross;
- ◆ Lack of discussion of the effect of differences in the definition of cash; and differences in classification not adequately disclosed.

Companies should prepare a statement of changes in shareholders' equity using balances determined under US GAAP as a proof of the reconciliation balances and provide appropriate disclosure of changes in the equity accounts on a US GAAP basis.

## **11. MAJOR ISSUES DISCUSSED BY VARIOUS US GAAPs - AN OVERVIEW**

Before a set of US GAAP financial statements is presented, it is intended to discuss certain basic concepts, which are followed in the preparation of US GAAP financial statements.

### **11.1 BALANCE SHEET CLASSIFICATION**

For a proper classified balance sheet, an enterprise should classify the balance sheet items into current and non-current items. This type of classified balance sheets help to determine the working capital readily. For accounting purposes, current assets are those assets, which are reasonably expected to be realized in cash, or sold or consumed during the normal operating cycle of the business i.e. normally a year. The term 'current liabilities' is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources (properly classifiable as current assets) or the creation of other current liabilities.

However, enterprises in several specialized industries including broker dealers, real estate, life insurance companies for which current / non-current classification has not much relevance may prepare unclassified balance sheet.

Given below are the concepts of current assets, current liabilities and operating cycle:

- |                            |    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
|----------------------------|----|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Items<br>Current<br>Assets | of | <ul style="list-style-type: none"><li>(a) Trade Accounts, notes, and acceptances receivable;</li><li>(b) Cash available for current operations and items which are the equivalent of cash;</li><li>(c) Inventories of merchandise, raw materials, goods in process, finished goods, operating supplies and ordinary maintenance materials and parts;</li><li>(d) Receivables from officers, employees, affiliates, and others if collectible in the ordinary course of business within a year;</li></ul> |
|----------------------------|----|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

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- (e) Marketable securities representing the investment of cash available for current operations;
- (f) Instalment of deferred accounts and notes receivable if they conform generally to normal trade practices and terms within the business; and
- (g) Pre-paid expenses such as insurance, interests, rents, taxes unused royalties, current paid advertising service not yet received and operating suppliers.

Prepaid expenses are not current assets in that sense that they will be converted into cash within normal operating cycle. But, they represent use of current assets during the operating cycle, if not paid in advance.

Items  
excluded from  
Current  
Assets

- (a) Land and other natural resources.
- (b) Depreciable assets
- (c) Receivables arising from unusual transactions such as sale of capital assets, or loans or advances to affiliates, officers or employees which are not expected to be collected within a period of twelve months.
- (d) Cash surrender value of insurance policies.
- (e) Investments in securities (whether marketable or not) or advances which have been made for the purposes of control, affiliation, or other continuing business advantage.
- (f). Cash and claims to cash which are restricted as to withdrawal or use for other than current operations. They are designated for expenditure in the acquisition or construction of non-current assets or used for liquidation of long term debts.
- (g) Long term pre-payments which are fairly chargeable to the operations of several years, or deferred charges such as unamortised debt discount and expense, bonus payments under a long term lease, costs of management of factory lay out or removal to a new location, and certain types of research and development expenses.

Meaning of  
Operating  
Cycle

The ordinary operations of a business involved a circulation of capital within the current asset group. The average time intervening between the acquisition of materials or services entering the process and the final cash realization constitutes an operating cycle. In case several operating cycles occurring within a year, a one-year period is to be used as a basis for the segregation of current assets.

However, the period of operating cycle is more than twelve months, the longer period should be used. Where a particular business has not clearly defined operating cycle, the one year rule should govern.

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|                                                  |    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|--------------------------------------------------|----|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Items<br>Current<br>Liabilities                  | of | <ul style="list-style-type: none"> <li>(a) Collections received as advance of the delivery of goods or performance of services.</li> <li>(b) Debts, which arise from operations directly, related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties and income and other taxes</li> <li>(c). Payable incurred in the acquisition of materials or supplies to be used in the production of goods or in providing services to be offered for sale.</li> <li>(d) Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually twelve months. For example short term debt arising from acquisition of capital assets, serial maturities of long term obligations, amount required to be expected within one year under sinking fund provisions.</li> <li>(e) Estimated or accrued amounts which are expected to be required to cover expenditures within the year for known obligations, i.e., provision for bonus, provision for product warranty.</li> </ul> |
| Items<br>excluded from<br>current<br>liabilities |    | <ul style="list-style-type: none"> <li>(a) Contractual obligation falling at an early date which is expected to be refunded.</li> <li>(b) Debts to be liquidated by funds which have been accumulated in accounts of a type not properly classified as current assets.</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |

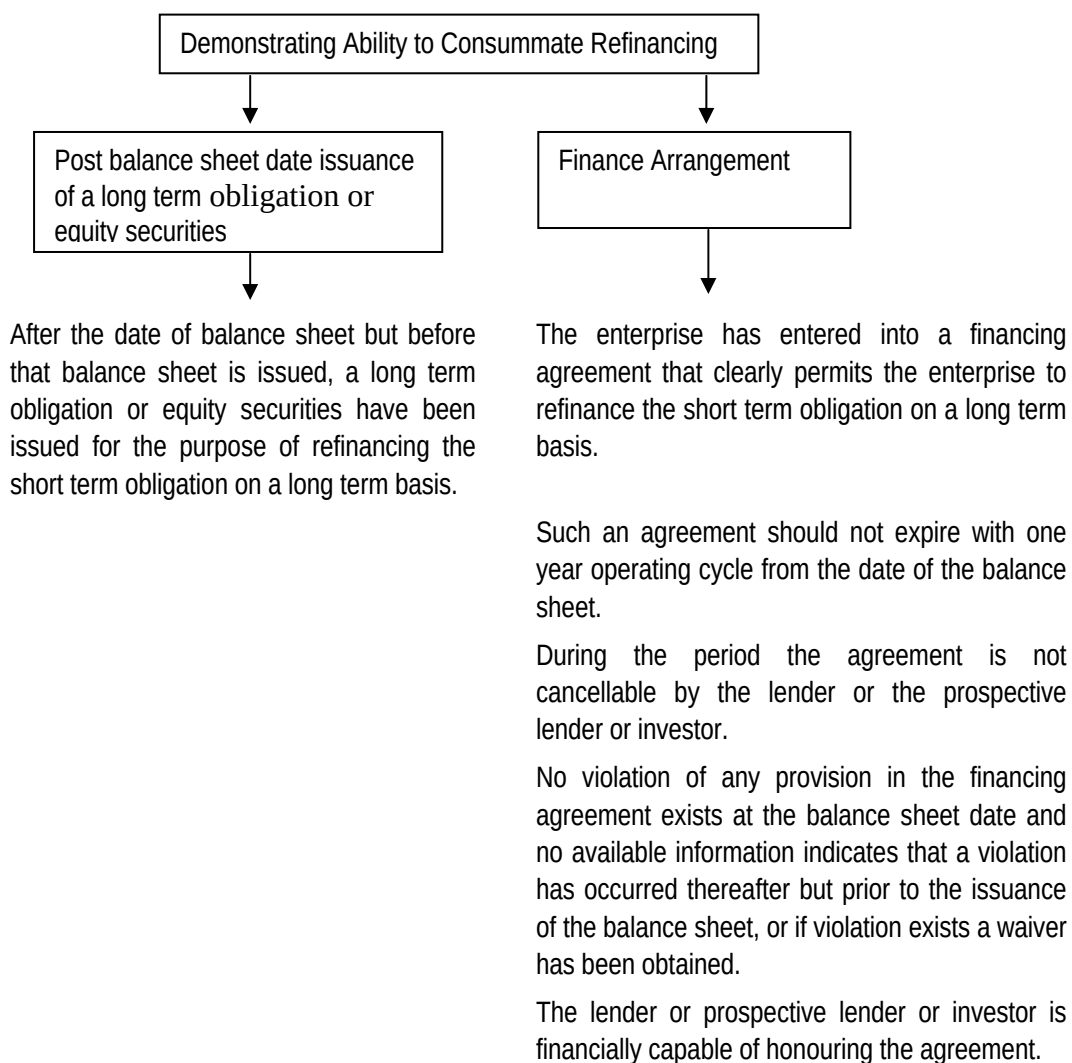
It also includes long term obligations that are or will be callable by the creditor either because the debtor's violation of provision of the debt agreement at the balance sheet date makes the obligation callable or because the violation, if not cured within a specified grace period, will make the obligation callable. Such callable obligations are to be classified as current liabilities unless one of the following conditions is met:

- (a) The creditor has waived or subsequently lost the right to demand repayment for more than one year (or operating cycle, if longer) from the balance sheet date;
- (b) For long term obligations containing a grace period within which the debtor may cure the violation, it is probable that the violation will be cured within that period, thus preventing the obligation from becoming callable.

*Classification of Short Term Obligations Expected to be Refinanced [FAS 6]:* Some short term obligations that are expected to be refinanced on a long term basis are not expected to use enterprise's working capital. Examples include commercial paper, construction loan, etc. Refinancing a short obligation on a long term basis means either replacing it with a long term obligation or with equity securities or renewing, extending or replacing it with short term obligations for an uninterrupted period extending beyond one year from the date of an enterprise's balance sheet.

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The enterprise's intent to refinance the short term obligation on a long term basis is supported by an ability to consummate the refinancing demonstrated in either of two ways:



In case an enterprise's ability to consummate an intended refinancing of a short obligation on long term basis (A), the amount of such short term obligation (STO) is excluded from current liabilities.

When  $(A) < \text{STO}$ ,  $(\text{STO}) - (A)$  to be excluded from current liabilities.

When  $(A) = \text{STO}$ , total amount of (STO) to be excluded from current liabilities.

The amount to be excluded is to be reduced further, if the available information indicates the fund will not be available.

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The amount to be excluded is decided on the basis of best estimate, when the available funds fluctuate.

If the short term liabilities are excluded from current liabilities by virtue of FAS 6, the notes to the financial statements shall include a general description of the financing agreement. It shall also include the terms of any new obligation incurred or expected to be incurred or equity securities issued or expected to be issued as a result of refinancing.

*Should long-term debt be classified as a current liability if the long-term debt agreement contains a subjective clause that may accelerate the due date?*

A subjective acceleration clause contained in a financing agreement that would otherwise permit a short-term obligation to be refinanced on a long-term basis would preclude that short-term obligation from being classified as a long-term. That paragraph does not address financing agreements other than those related to short term obligations.

In some situations, the circumstances (for example, recurring losses or liquidity problems) would indicate that long-term debt subject to a subjective acceleration clause should be classified as a current liability. Other situations would indicate only disclosure of the existence of such clauses. It would seem that neither reclassification nor disclosure would be required if the likelihood of the acceleration of the due date were remote, such as when the lender historically has not accelerated due dates of loans containing similar clauses and the financial condition of the borrower is strong and its prospects bright.

## **11.2 BALANCE SHEET DISPLAY**

The offsetting of related assets and liabilities in the balance sheet is permitted only when there is a right to set off.

A right to set off is debtor's local right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right to set off exists when these four conditions are met:

- ◆ Each of the two parties owes the other determinable amount;
- ◆ The reporting party has the right to set off the amount owed by the other party;
- ◆ The reporting party intends to set off;
- ◆ The right of set off is enforceable in law [Para 5, FIN 39].

Generally debts may be set off if they exist between mutual debtors each, acting in the capacity as both debtor and creditor. However, State laws about the right to set off may be different from those normally provided by the contract or as a matter of common law. Legal constraint should be taken into account to determine whether right to set off exists.

**Offsetting Government Securities Against Tax Payable:** Generally, tax payable is not an offset against cash or other assets. Most of the government securities are not by their terms

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designed for the payment of tax. In exceptional circumstances the purchase of government securities may be acceptable for the payment of taxes. Only in those cases off-set is allowed.

**Offsetting Forward, Interest Rate Swap, Currency Swap, Option and Other Conditional or Exchange Contracts:** Fair value of those contracts or an accrued receivable or payable arising from those contracts, rather than the notional amount or amounts to be exchanged, is recognized in the balance sheet. Unless the four conditions stated in Para 5, FIN 39 are met, the fair value of contracts in loss position should not be offset against the fair value of contracts in a gain position. Similarly, amounts recognized as accrued receivables should not be off-set against amounts recognized as accrued payable unless a right to setoff exists.

There is special Guidance for master netting arrangement. It means existence of multiple contracts, whether for the same type of conditional or exchange contract or for different types of contracts, with a single counterparty that are subject to a contractual agreement. Such an agreement provides for the net settlement of all contracts through a single payment in single currency in the event of default or on termination of any one contract.

When fair value amounts recognised for forward, interest rate swap, currency swap, option and other conditional or exchange contracts are executed with same counterparty under a master netting arrangement, they are offset items. The reporting entity has to find out net fair value of the position under master netting arrangement and report it as an asset or liability in the Balance Sheet.

While deciding the offset the following concepts are used:

| Source                                                                               | Principles                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|--------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| FASB Concepts Statement No. 6 Elements of Financial Statements Paragraphs 34 and 43. | <p>Amounts recognized forward, interest rate swap, currency swap, option, and other conditional or exchange contracts are not "valuation account". The fair value recognized in the financial statement are measurements of the rights and obligations associated with the contracts already executed. Therefore, they are assets and liabilities in their own rights.</p> <p>A separate item that reduces or increases the carrying amount of an asset is sometimes found in financial statement. For example, an estimate of uncollectible amounts reduces receivable to the amount expected to be collected, or a premium on a bond receivable increases the receivable to its costs or present value. Those "valuation accounts" are part of the related assets. they are not assets in their own right or nor liabilities.</p> <p>A separate item that reduces or increases the carrying amount of liability is sometime found in financial statement for example, a bond premium or discount increases or decreases the value of a bond payable to its proceeds or present value. Those "valuation accounts"</p> |

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are part of the related liability. They are not liabilities in their own right nor assets.

The fair value is recognized for conditional or exchange contracts are not "valuation accounts" as those "valuation accounts" exists only as a part of a measurement of an asset or a liability, not as a complete measurement of an asset or a liability.

FAS 107 disclosures  
about Fair Value of  
Financial Instruments  
Paragraph 40

Fair Value of financial instrument depicts the market's assessment of the present value of net future cash flows directly or indirectly embodied in them, discounted to reflect both current interest rates and markets assessment of the risk that the cash flow will not occur.

While para 40, of FAS 107 requires Fair Value measurement, conditional nature of the contracts covered under master netting arrangement reflects that the eventual cash flow consequences are not discernable from the amounts reported in the balance sheet. On the contrary, FAS 105 requires additional information about financial instruments that results from those contracts, even if they are recognized at fair value, be disclosed in the financial statements as there are practical limit on the information conveyed through fair value.

FASB Concepts  
Statement No. 1  
Objectives of Financial  
Reporting by Business  
Enterprises Paragraph  
37

Financial reporting should provide information to help investors, creditors and other to assess the amounts, timing and uncertainty of prospective net cash inflows to the related enterprise.

In the context of the above mentioned concept statement, amount of credit risk exposures of forward, interest rate swap, currency swap, option, or other conditional or exchange contracts reflect credit risk on a net basis when enter into with the same counterparty.

Boards Conclusion

In view of the above, Board decided to permit offsetting of the fair value recognized for forward, interest rate swap, currency swap, option or other conditional or exchange contracts if they are executed with the same counterparty under master netting arrangement. That arrangement effectively consolidate individual contracts into a single arrangement between the parties. The failure to make one payment under the master netting arrangement could entitle the other party to terminate the entire arrangement and to demand the net settlement of all contracts.

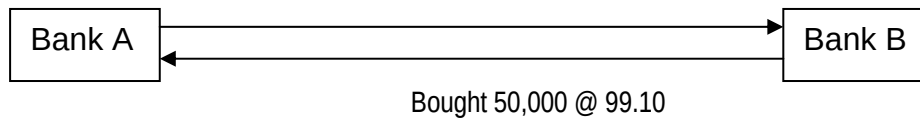
The Board believes that presentation of a net basis would reflect the credit risk in a better manner than it would have been had the individual fair value was presented in the balance sheet.

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*Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements:*  
Repurchase agreement refers to a transaction that is accounted for as a collateralized borrowing in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or specified securities.

Reverse repurchase agreement refers to a transaction that is accounted for as a collateralized lending in which the buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances.

Sold 50,000 @ 99.00



FIN 41 allows an enterprise to offset amounts recognized as payables under repurchase agreements and amount recognized as receivables under reverse repurchase agreements on fulfillment of the following conditions:

- (a) The repurchase and reverse repurchase agreements are executed with the same counterparty;
- (b) The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreements;
- (c) The repurchase and reverse repurchase agreements are executed in accordance with a master netting arrangement;
- (d) The securities underlying the repurchase and reverse repurchase agreements exist in "book entry" form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian;
- (e) The repurchase and reverse repurchase agreements will be settled on a securities transfer system as prescribed below;
- (f) The enterprise intends to use the same account in the clearing bank or the other financial institutions at the settlement date in transacting both (1) the cash inflows resulting from the settlement of the reverse repurchase agreement and (2) the cash outflows in settlement of the offsetting purchase agreement.

*Qualified Settlement System:* In a security transfer system for repurchase and reverse repurchase agreements, cash transfers are initiated by notification from the owner of the record of the securities to its securities custodian for transferring those securities to the counterparty of the agreement. Under associated banking arrangement, each party to a same day settlement of both repurchase agreement and of reverse repurchase agreement would be obligated to pay gross amount of the cash for the securities transferred from its counterparty.



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But by a notification to the securities custodian this gross obligation can be reduced and net settlement can take place.

Thus, each party is responsible for maintaining available cash on deposit only for the net amount. If both the parties transfer appropriate securities in settlement of the repurchase and reverse repurchase agreement, the party with a net receivable will not need any cash to facilitate the settlement, while the party with the net payable will need only the net amount due at the end of the business day.

**Example:** Bank A purchases 50,000 units of 90 days T-Bills @ Rs.99 from Bank B. at the end of the same day Bank A repurchases from Bank B 50,000 units of 90 day T-Bills @ Rs.99.10. So as per the gross obligation for the first leg of the transaction Bank B needs to pay Rs.49,50,00,000 and for the second leg Bank A needs to pay Rs.49,55,000. By notification to the securities custodian both Bank A and Bank B can make arrangement for the net payment of Rs.5,000. The transactions should be carried out through the same clearing bank. If these conditions are fulfilled, then offsetting is allowed.

As per para 3 of FASB Interpretation No.41 the reporting enterprise has the choice to offset the qualified repurchase and reverse repurchase agreements. Such a choice should be applied consistently. However, net receivable arising out of such a transaction cannot be offset against net payables arising out of another set of transactions.

**Illustration of Offsetting Assets and Liabilities**

The offsetting of assets and liabilities is an important issue to consider when determining financial statement presentation of current assets and current liabilities. Any time items are set off, information that would otherwise be available is lost. In addition, important financial statement relationships may be altered when assets and liabilities are set off. Consider the following example:

**Current Assets**

|                         |        |
|-------------------------|--------|
| Receivable from M Co.   | \$100  |
| Other assets            | 400    |
|                         | \$400  |
| Current Liabilities     |        |
| Payable to M Co.        | \$75   |
| Other liabilities       | \$ 175 |
|                         | \$250  |
|                         | =====  |
| Current ratio (500/250) | 2:1    |

Now, consider the same situation, except the \$75 payable to M Co. is offset against the \$100 receivable from M Co.:

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### **Current Assets**

|                           |              |
|---------------------------|--------------|
| Net receivable from M Co. |              |
| (\$100 - \$ 75)           | \$25         |
| Other assets              | <u>\$400</u> |
|                           | <u>\$425</u> |

### **Current Liabilities**

|                   |               |
|-------------------|---------------|
| Other liabilities | <u>\$ 175</u> |
|-------------------|---------------|

|                         |       |
|-------------------------|-------|
| Current ratio (500/250) | 2:4:1 |
|-------------------------|-------|

When offsetting is applied, the individual amounts of the receivable and payable are not presented, and only the net amount of \$25 is present in the balance sheet. Further, the current ratio is significantly altered by the offsetting activity. This is a simple example, but it illustrates the impact of offsetting, and thus its importance as a financial statement reporting issue.

## 11.3 COMPREHENSIVE INCOME

One important feature of US GAAP financial statements is the computation of comprehensive income. Items of income statement can be classified into two categories – (i) those which are included in computing current operating performance (or dirty surplus) and (ii) those which are included in computing all-inclusive performance of the current period (clean surplus). For the measurement of current operating performance extraordinary and non-operating gains and losses are excluded from income. On the contrary, for the purpose of measurement of all-inclusive performance all revenues, expenses, gains and losses are recognized during the period and included in income regardless of whether they are considered to be result of operations of the period.

Generally, all inclusive income measurement is followed in the US GAAP with the exceptions that certain changes in assets and liabilities are not reported in the income statement. Such changes are included in the separate component of equity in the Balance Sheet.

FAS 130 discusses how to report and display comprehensive income and its components. Given below are the important features of FAS 6:

| <i>Issues</i> | <i>Para References to FAS 130</i> | <i>Description</i>                                                                                                                                                                                                                                                          |
|---------------|-----------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Definition    | 8-10                              | The change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. |

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|                                             |       |                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|---------------------------------------------|-------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                             |       | <p>Comprehensive income includes net income and other items. Net income means a measurement of financial performance resulting from the aggregation of revenues, expenses, gains and losses that are not items of other comprehensive income.</p> <p>Other comprehensive income means revenues, expenses, gains and losses that under generally accepted accounting principles are included in comprehensive income but excluded from net income.</p> |
| Classifications within net income           | 16    | <p>Items classified under net income are displayed under various classifications:</p> <ul style="list-style-type: none"> <li>(i) Income from continuing operations;</li> <li>(ii) Income discontinuing operations;</li> <li>(iii) Extraordinary Items; and</li> <li>(iv) Cumulative effects of changes in accounting principle.</li> </ul>                                                                                                            |
| Classifications within net income           | 17    | <p>Items under other comprehensive income are classified by their nature. for example:</p> <ul style="list-style-type: none"> <li>(i) Foreign currency items;</li> <li>(ii) Minimum pension liability adjustments;</li> <li>(iii) Unrealized Gains and Losses on Certain Investments in debt and equity securities.</li> </ul> <p>Additional classification may arise from future accounting standards.</p>                                           |
| Classifications within comprehensive income | 15    | <p>Comprehensive income is divided into two components (i) Net Income and (ii) Other Comprehensive Income. If an enterprise that does not have any item of other comprehensive income in any period presented is not required to report comprehensive income.</p> <p>All components of comprehensive income is reported in the financial statements in the period in which they are recognized.</p>                                                   |
| Reclassification adjustments                | 18-21 | <p>Adjustments are made to avoid double counting comprehensive income. For example, when an investment security is realized, realized gain or loss occurs. There may be unrealized gain or loss already recognized against this income in other comprehensive income in any of the prior periods.</p>                                                                                                                                                 |

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So when realized gain/loss on realization of an investment security is recognized in the net income, appropriate portion of the unrealized gain/loss should be eliminated from other comprehensive income. This adjustment is termed as "reclassification adjustment".

No reclassification adjustment is determined for minimum pension liability.

Reclassification adjustment for foreign currency translation is limited to translation gains/losses realized upon sale or complete/substantially complete liquidation of an investment in a foreign entity.

An enterprise may display reclassification adjustments in the face of the financial statements in which comprehensive income is presented or by notes.

*Other comprehensive income* – This term refers to revenues, expenses, gains or losses that are excluded in the net income under generally accepted accounting principles but included in the comprehensive income. Under current accounting standards, items of other comprehensive income are-

- ◆ *Foreign currency translation adjustments:* If an entity's functional currency is a foreign currency, translation adjustments result from the process of translating that entity's financial statements into reporting currency. Translation adjustments shall not be included in determining net income but shall be reported in other comprehensive income. [FAS 52, Para 13].
- ◆ Gains and losses on foreign currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing as of the designation date. Such gains or losses shall not be included in determining net income but shall be reported in other comprehensive income.
- ◆ Gains or losses on inter-company foreign currency transactions that are of a long term investment nature (i.e., settlement is not planned or anticipated in the foreseeable future), when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting enterprise's financial statements. Such gains or losses shall not be included in determining net income but shall be reported in other comprehensive income.
- ◆ The effective portion of the gain or loss on derivative instruments designated and qualifying as cash flow hedging instrument is reported as a component of other comprehensive income. [Para 30(b)(2), FAS 133]/

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- ◆ Unrealized gains or losses for trading securities shall be included in earnings. Unrealized holding gains or losses for “available for sale” securities shall be excluded from earnings and reported in other comprehensive income until realized [Para 13, FAS 115].
- ◆ However, all or a portion of the unrealized holding gain or loss of an “available for sale” securities that is designated as being hedged in a fair value hedge are recognized in earnings for the period.
- ◆ For a debt security transferred into the “available for sale” category from the “held to maturity” category, the unrealized holding gain or loss at the date of transfer is reported in other comprehensive income [Para 33 (b), FAS 130].
- ◆ For individual securities classified as either “available for sale” or “held to maturity”, it is necessary to determine whether a decline in fair value below amortized cost is “other than temporary”. If it is probable that the investor will be unable to collect all amounts due according to the contractual terms of debt security not impaired at acquisition, it is considered that “other than temporary” impairment has occurred. In case the decline is “other than temporary” in nature, individual security will be written down to fair value and such a fair value is taken on new cost basis.
- ◆ Subsequently, if fair value increases, net cost basis is not changed. Subsequent increase in fair value for “available for sale” securities is included in other comprehensive income. [Para 534(d), FAS 133. Para 16, FAS 115 and Para 33(d), FAS 130].
- ◆ Net loss recognized pursuant to pension cost as per para 36, FAS 87 as an additional pension liability not yet recognized as net periodic pension cost is included in other comprehensive income

***Presentation of Comprehensive Income?***

FAS 130 provides four alternative approaches for displaying comprehensive income-

- ◆ *One Statement Approach* which includes other comprehensive income within the Income Statement.
- ◆ *Two Statement Approach* in which net income is computed through Income Statement and a separate Statement of Comprehensive Income is prepared.
- ◆ *Statement of Changes in Equity Approach (Alternative 1)*, which shows change in various items of equity in Tabular manner. This method is widely used.
- ◆ *Statement of Changes in Equity Approach (Alternative 2)*. Under this method various items of equity is presented one by one.

No specific format has been prescribed for reporting comprehensive income. However, an enterprise is encouraged to display the components of other and total comprehensive income below the total for net income in a statement that reports results of operations or in separate

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statement of comprehensive income that begins with net income. [Para 23, FAS 130]. It is possible to display components of other comprehensive income (a) net of related tax effects or (b) before related tax effects with a deduction of tax effect [Para 24, FAS 130]. This is covered in One-Statement and Two Statement approaches. An alternative is to display comprehensive income in a section of equity. This is covered in statement of Changes in Equity approach.

**Example:** *One Statement Approach*

### Statement of Income and Comprehensive Income

Year ended 31-12-2006

|                                                                              |            | \$             |
|------------------------------------------------------------------------------|------------|----------------|
| Revenues                                                                     |            | 230,000        |
| Expenses                                                                     |            | -140,000       |
| Other Gains and Losses                                                       |            | 10,000         |
| Gains on Sale of Securities                                                  |            | <u>2,000</u>   |
| Income from operations before Tax                                            |            | 102,000        |
| Income Tax Expense                                                           |            | <u>-34,000</u> |
| Income before Extraordinary Items and Cumulative Effect of Accounting Change |            | 68,000         |
| Extraordinary Item, Net of tax                                               |            | <u>-2,000</u>  |
| Income before Cumulative Effect of Accounting Change                         |            | 66,000         |
| Cumulative effect of Accounting Change, Net of tax                           |            | <u>2,000</u>   |
| Net Income (A)                                                               |            | <u>68,000</u>  |
| Other Comprehensive Income, net of tax                                       |            |                |
| (i) Foreign Currency Translation Adjustments                                 |            | 40             |
| (ii) Unrealized Gains on Securities                                          |            |                |
| (a) Unrealized Holding Gains arising during the period                       | 300        |                |
| (b) Less: Reclassification Adjustment for Gains included in Net Income       | <u>-50</u> | 250            |
| (iii) Minimum pension liability adjustment                                   |            | <u>-100</u>    |
| Other Comprehensive Income (B)                                               |            | <u>190</u>     |
| Total Comprehensive Income (A +B)                                            |            | <u>68,190</u>  |

#### Notes:

- (1) Alternatively, it is possible to present various items of other comprehensive income at gross amount from which income tax should be deducted.

**Example** *Two-Statement Approach*

**Statement of Income and Comprehensive Income**

*Year ended 31-12-2006*

|                                                                              | \$             |
|------------------------------------------------------------------------------|----------------|
| Revenues                                                                     | 230,000        |
| Expenses                                                                     | -140,000       |
| Other Gains and Losses                                                       | 10,000         |
| Gains on Sale of Securities                                                  | <u>2,000</u>   |
| Income From Operations Before Tax                                            | 102,000        |
| Income Tax Expense                                                           | <u>-34,000</u> |
| Income Before Extraordinary Items and Cumulative Effect of Accounting Change | 68,000         |
| Extraordinary Item, Net of tax                                               | <u>-2,000</u>  |
| Income Before Cumulative Effect of Accounting Change                         | 66,000         |
| Cumulative Effect of Accounting Change, Net of tax                           | <u>2,000</u>   |
| Net Income                                                                   | <u>68,000</u>  |

**Statement of Comprehensive Income**

*Year ended 31-12-2006*

|                                                                        | \$  | \$            |
|------------------------------------------------------------------------|-----|---------------|
| Net Income (A)                                                         |     | 68,000        |
| Other Comprehensive Income, net of tax                                 |     |               |
| (i) Foreign Currency Translation Adjustments                           |     | 40            |
| (ii) Unrealized Gains of Securities                                    |     |               |
| (a) Unrealized Holding Gains arising during the period                 | 300 |               |
| (b) Less: Reclassification Adjustment for Gains included in Net Income | -50 | 250           |
| (iii) Minimum pension liability adjustment                             |     | <u>-100</u>   |
| Other Comprehensive Income (B)                                         |     | <u>190</u>    |
| Total Comprehensive Income (A+ B)                                      |     | <u>68,190</u> |

**Notes:** (1) Alternatively, it is possible to present various items of other comprehensive income at gross amount from which income tax should be deducted.

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**Example:** A Ltd. purchased 2,000 equity securities that are classified as “available for sale” instruments for \$ 5. Fair value of such securities was \$ 7.5 as on December 31, 2005 and \$ 8 as on December 31, 2006. There was no dividend declared on such securities. Those securities were sold as on December 31, 2006. Assume 30% tax rate.

Let us see how to compute unrealized holding gain for inclusion in other comprehensive income and how to reclassify such unrealized holding gain when the securities were sold.

### Computation of Holding Gain

|                                                       | Before Tax  | Income Tax  | After Tax   |
|-------------------------------------------------------|-------------|-------------|-------------|
| Holding Gain recognized in Other Comprehensive Income |             |             |             |
| Year Ended December 31, 2005                          | 5000        | 1500        | 3500        |
| Year Ended December 31, 2006                          | <u>1000</u> | <u>300</u>  | <u>700</u>  |
|                                                       | <u>6000</u> | <u>1800</u> | <u>4200</u> |

### Amounts Reported in Net Income and Other Comprehensive Income

For the year ended December 31, 2005 and December 31, 2006

|                                                        | 2005         | 2006          |
|--------------------------------------------------------|--------------|---------------|
| Net Income:                                            |              |               |
| Gain on sale of securities                             |              | 6,000         |
| Income Tax Expense                                     |              | <u>1,800</u>  |
| Net Gain Realized in Net Income                        |              | <u>4,200</u>  |
| Other Comprehensive Income                             |              |               |
| Holding Gain arising during the period, net of tax     | <u>3,500</u> | <u>700</u>    |
| Reclassification Adjustments, net of tax               | 0            | -4,200        |
| Net Gain/Loss recognized in Other Comprehensive Income | <u>3,500</u> | <u>-3,500</u> |
| Total Impact on Comprehensive Income                   | <u>3,500</u> | <u>700</u>    |

## 11.4 RESULTS OF OPERATIONS

Financial Accounting Standards Board concludes that the results of continuing operations should be reported separately from discontinued operations. Also gain or loss from disposal of a segment of a business is included along with the results of discontinued operations. Presentation of an Income Statement distinguishing continuing and discontinuing operations would appear as follows:



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|                                                                                                       |      |      |
|-------------------------------------------------------------------------------------------------------|------|------|
| Particulars                                                                                           |      |      |
| Income from continuing operations before income taxes                                                 | XXXX |      |
| Provision for Income Taxes                                                                            | XXX  |      |
| Income from Continuing Operations                                                                     |      | XXXX |
| Discontinued Operations:                                                                              |      |      |
| Income (Loss) from Operations of Discontinued Division                                                | XXXX |      |
| Loss on Disposal of Division X, including provision for Operating Losses during phase out period less | XXX  |      |
| Net Income                                                                                            |      | XXXX |

Extraordinary items should be separately presented in the Income Statement:

In the absence of discontinuing operations and changes in accounting principles, the following main captions should appear in the Income Statement if extraordinary items are reported:

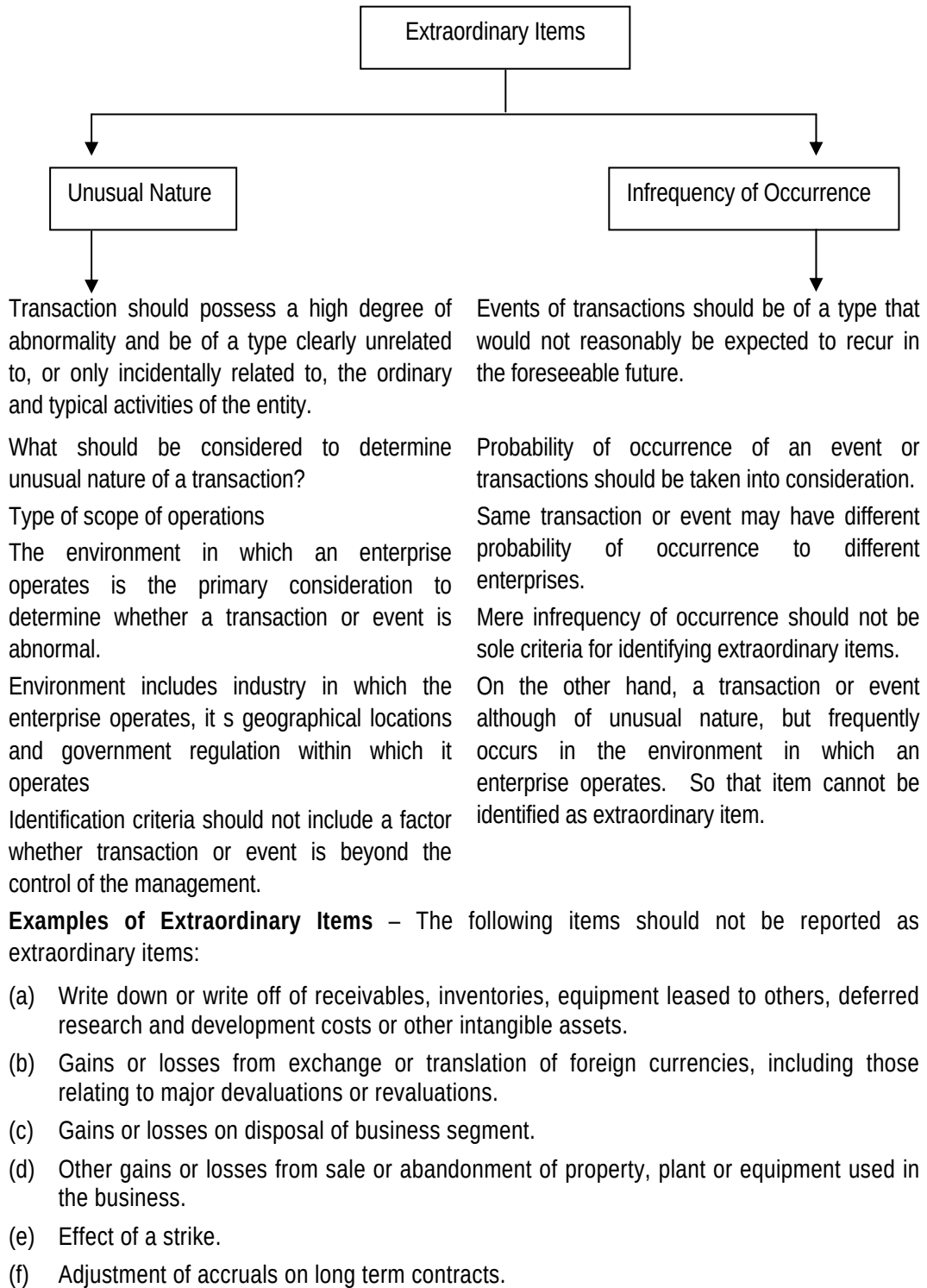
|                                                  |  |      |
|--------------------------------------------------|--|------|
| Particulars                                      |  |      |
| Income before Extraordinary Items                |  | XXXX |
| Extraordinary items less applicable Income Taxes |  | XXX  |
| Net Income                                       |  | XXXX |

- ◆ The caption Extraordinary items should be used to identify separately the effects of events and transactions and other disposal of business.
- ◆ Descriptive captions and amounts for individual extraordinary events and transactions should be presented preferably on the face of the income statement. Alternatively, amount and nature of different extraordinary items should be disclosed by way of notes.
- ◆ Income tax applicable to extraordinary items should be presented preferably on the face of the income statement. Alternatively, amount of income tax effect on extraordinary items should be disclosed by way of notes.

### **11.5 EXTRAORDINARY ITEMS**

Extraordinary items are events and transactions that are distinguishing by their unusual nature and infrequency of occurrence. Two criteria for the identification of extraordinary items are (i) unusual nature and (ii) infrequency of occurrence.

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In rare situations an event or transaction may meet both the criteria of unusual nature and infrequency of occurrence and gains or losses may arise therefrom. Such gains and losses include gains or losses stated in items (a) to (d) above. When such items occur in the ordinary course of valuation, they are not regarded as extraordinary items but when the circumstance is different, they may be regarded as extraordinary items. For example, when such gains or losses occur as direct result of major casualty like an earthquake, an expropriation, or a prohibition under a newly enacted law or regulation that clearly meets the two criteria specified above, it is treated as an extraordinary item.

*Materiality and Aggregation:* Individual extraordinary item should be material in relation to income before extraordinary item. If an extraordinary item is material in relation to income before extraordinary item or to the trend of annual earning before extraordinary item, it should be separately disclosed on the face of the income statement as an extraordinary item. Materiality of extraordinary items is evaluated item-wise. However, the effect of series of related transactions arising from a single specific unusual event of infrequent nature should be aggregated to test the materiality.

A material event or transaction that is either of unusual nature or of infrequent nature should be disclosed on the face of income statement separately as a component of income from continuing operations. Such an event or transaction should not be classified as an extraordinary item.

### **11.6 DISPOSAL OF BUSINESS SEGMENT**

Disposal may be by way of sale or abandonment. The plan of disposal should include to the minimum-

- ◆ Identification of the major assets to be disposed of;
- ◆ Expected method of disposal;
- ◆ period expected to be required for completion of disposal;
- ◆ An active programme to find a buyer if disposal is by sale;
- ◆ The estimated results of operations of the segment from the measurement date to the disposal date;
- ◆ Estimated proceeds or salvage to be realized by disposal.

Disposal date is the date on which sale is closed if the disposal is by sale. If the disposal is by abandonment, it is the date on which operation ceases.

*How to measure gain or loss on disposal of a business segment?*

#### **Issues**

Step 1: Estimate net realizable value

#### **Description**

Estimates are made at the measurement date about the net realizable value of the business

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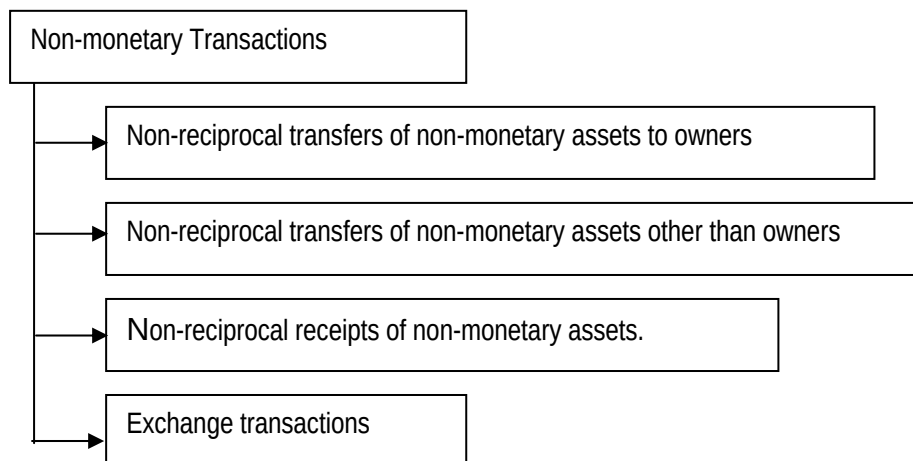
|                                                                                                                                 |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|---------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Find out loss/gain on disposal                                                                                                  | <p>segment which is to be disposed of.</p> <p>Expenses to be incurred for the disposal is considered while determining the net realizable value.</p> <p>Determine the loss comparing net realizable value with the carrying amount of net assets.</p> <p>Provision is created for such loss. Gain is not recognized until realized.</p>                                                                                                                                                        |
| Step 2: If the plant of disposal is to be carried out over a period of time and business is to be continued during that period. | <p>(a) There may be estimated loss taking into account revenues and expenses for continuing operations between the measurement date and disposal date. Such loss is included in the loss computed in Step 1.</p> <p>(b) There may be estimated gain arising out of continuing business during the measurement date and the disposal date. Such gain should be taken into account to the extent of loss estimated in Step 1. Any gain above that should be recognized as and when realized.</p> |
| General Principle                                                                                                               | <p>Gain or loss should be limited to those amounts that can be projected with reasonable accuracy.</p> <p>Generally, it is expected that the plan of disposal will be carried out within a period of one year from the measurement date.</p>                                                                                                                                                                                                                                                   |
| Costs and expenses directly associated with disposal                                                                            | <p>Includes-</p> <ul style="list-style-type: none"><li>◆ Severance pay</li><li>◆ Additional pension cost</li><li>◆ Employee relocation expenses</li></ul> <p>Future rentals on long term leases.</p>                                                                                                                                                                                                                                                                                           |
| Disclosures by way of notes                                                                                                     | <p>This is in addition to provision for estimated loss on disposal shown in the income statement as component of discontinued operations:</p> <ul style="list-style-type: none"><li>◆ Identity of the business segment to be disposed of;</li><li>◆ Expected disposal date, if known;</li></ul>                                                                                                                                                                                                |

- ◆ Expected manner of disposal;
- ◆ A description of the remaining assets and liabilities of the segment planned to be disposed of;
- ◆ Income or loss from the segment between the measurement date and the balance sheet date.

Such information should accompany data of prior estimates.

### 11.7 NON-MONETARY TRANSACTIONS

APB Opinion No.29 is the principal document in this regard. Let us first understand the meaning of the term non-monetary transactions. Such transactions are classified into four types:



Monetary assets are assets whose amounts are fixed in terms of units of currency. Examples are cash, receivables, notes payable in cash, etc. Non-monetary assets are, on the contrary, which are not monetary assets.

Non-reciprocal transfer means transfer of assets or services in one direction. This may be from the enterprise to the owner or any other entity. On the other hand, this may be from the owner or other entity to the enterprise.

|                                      |                                                                                                                                                                                                                                                                                                    |
|--------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Non-reciprocal transfers with owners | <p>Examples:</p> <p>Distribution of non-monetary assets to stockholders as dividends;</p> <p>Distribution of non-monetary assets to stockholders for redemption or acquisition of outstanding capital stock;</p> <p>Distribution of non-monetary assets to a group of stockholders pursuant to</p> |
|--------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

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a plan of rescission or other settlements relating to a prior business combination.

Non-reciprocal

transfers with other  
than owners

Example:

Contribution of non-monetary assets by an enterprise to a charitable organization.

Non-reciprocal

receipts of non-  
monetary assets  
from other than  
owners

Example: Land received from Government free of cost.

Exchange

Transactions

Exchange of non-monetary assets between the enterprise and another entity other than stockholders.

### ***Measurement and accounting-***

- ◆ In general, accounting for non-monetary transactions should be based on the fair values of the assets (services) involved. This is same basis as is used for monetary transactions. This means cost of a non-monetary asset acquired in exchange of another non-monetary asset between an enterprise and another entity is the fair value of assets surrendered. for example, X Ltd. wants to exchange a Building A carried at cost less depreciation Rs.10 lacs for another Building B. The fair value of the Building a to be surrendered is Rs.25 lacs. So the cost of the Building B should be taken at Rs.25 lacs and gain of Rs.15 lacs should be recognized.
- ◆ Fair value of the asset received should be adopted as the basis if that is more clearly evident than the fair value of asset surrendered. In case fair value of Building A is not available, whereas fair value of Building B is available through competitive quotations. Fair value of Building B is Rs.22 lacs. In such a case, the transaction should be recorded at fair value of non-monetary asset received.
- ◆ Similarly, a non-monetary asset received in a non-reciprocal transfer should be recorded at the fair value of asset received.
- ◆ A non-monetary asset transferred to stockholders or any other entity in a non-reciprocal transfer should be recorded at fair value of the asset transferred. Gain or loss is accordingly recognized taking the difference between the fair value and carrying amount.
- ◆ The fair value of an entity's own stock re-acquired may be a more clearly evident measure of the fair value of the non-monetary asset distributed to acquire stock for treasury or for retirement.
- ◆ Disclosure: Nature of non-monetary transactions should be disclosed in the financial statements.

However, in cases there may be a need for modification of the above stated principle:

- ◆ Accounting for non-monetary transaction should not be based on the fair values of the assets transferred unless those fair values are determinable within reasonable limits. Fair values are determined with reference to estimated realizable value in a cash transaction of the same or similar assets or services received in exchange. Fair value is regarded as not determinable within reasonable limits if major uncertainties exist about the realisability of the value of the asset.
- ◆ In case fair value of the non-monetary asset received or surrendered cannot be determined within a reasonable limit, then the transaction should be recorded at the carrying amount of the asset surrendered.
- ◆ That apart, if the exchange is not essentially the culmination of the earning process, accounting for an exchange of a non-monetary asset between the enterprise and another entity should be recorded at the carrying amount of the asset surrendered. Two examples are cited in APB Opinion No.29 to explain the exchanges that do not culminate in the earning process:
  1. An exchange of product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to exchange.
  2. An exchange of productive assets not held for sale in the ordinary course of business for a similar productive asset or an equivalent interest in the same or similar productive asset.

***Involuntary Conversion*** – Sometimes non-monetary assets are converted involuntarily to monetary assets. Example is acquisition of land by Government. The gain or loss on such a conversion is the difference between the carrying amount of the non-monetary asset and the amount received. However, when an involuntary conversion takes place and subsequently, the monetary asset is used to acquire another non-monetary asset, these two sets of transactions although linked but for accounting purposes they are separate and independent transactions. Accordingly, they should be regarded as two sets of monetary transactions.

### **11.8 TRANSACTIONS WITH RELATED PARTIES**

Related parties include transactions between (a) parent company and subsidiary, (b) subsidiaries of a common parent; (c) an enterprise and trust for the benefit of common parent; (d) an enterprise and its principal owners, management, or members of their immediate families and (e) affiliates.

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Important terms are defined as follows:

| Terms            | Definition                                                                                                                                                                                                                                                                                                                                                                                                  |
|------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Principal Owners | Owners of more than 10% of the voting interest of the enterprise.                                                                                                                                                                                                                                                                                                                                           |
| Management       | Persons who are responsible for achieving objectives of the enterprise and who have authority to establish policies and make decisions by which the objectives are achieved. Management normally includes board of directors, the chief executive officer, chief operating officer, vice president in charge of principal business functions and other persons who perform similar policy making functions. |
| Immediate family | Family members who the principal owner or member of management may control or influence or get controlled or influenced because of family relationship                                                                                                                                                                                                                                                      |
| Control          | The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract or otherwise.                                                                                                                                                                                                                              |
| Affiliate        | A party that, directly or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with an enterprise.                                                                                                                                                                                                                                                       |

**Related party transactions** – Transactions between related parties occur in the normal course of business. Some examples of common type of related party transactions are-

- ◆ Sales, purchases and transfers of personal property;
- ◆ Services received or furnished, [Accounting, management, engineering and legal services];
- ◆ use of property and equipment by lease or otherwise;
- ◆ Borrowings and lending;
- ◆ Guarantees;
- ◆ Maintenance of bank balances as compensating balances for another;
- ◆ Inter-company billing based on allocations of common costs;
- ◆ Filing of consolidated tax returns.



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Transactions with related parties are considered even if there is accounting recognition. If a parent renders some service to its subsidiary free of cost, which both the parties do not recognize, still the transaction should be considered as related party transaction.

**Disclosures** – Related party transactions should be disclosed in the financial statements except for those which are eliminated for the purpose of consolidation.

Disclosures include:

- (a) Nature of related party relationship;
- (b) Description of the transactions including the transactions in which no amounts or nominal amounts are ascribed;
- (c) Amount of the transaction; and
- (d) Amount due from or to related parties.

When there exists common ownership or common control that affect the operating results or financial position of the enterprise as compared to a situation wherein control exists, it is necessary to disclose such relationship even if no transaction occurred between the parties.

### **11.9 CONSOLIDATION**

Consolidated financial statements are primarily presented for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single enterprise with one or more branches or division. Consolidated financial statements are prepared when there is ownership of majority interest characterized by direct or indirect ownership of more than fifty per cent voting shares. However, there are exceptions to this general rule:

- ◆ A subsidiary is not consolidated where control is likely to be temporary;
- ◆ A subsidiary is not consolidated where it does not rent with the majority owners (for example, if the subsidiary is in legal reorganization or in bankruptcy);
- ◆ There may be a situation wherein minority interest is so large in relation to the equity of the shareholders of the parent in the consolidated net assets, that the presentation of separate financial statements of the two companies are more meaningful and useful (withdrawn by FAS 94).

In deciding the consolidation policy, the aim should be to make the financial presentation meaningful. The user should be given information, which is suitable for decision making. Even though a group of companies is heterogeneous in character, it may be better to make full consolidation than to present large number of separate statements. On the other hand, separate statements may be preferable for a banking/insurance/finance subsidiary of a manufacturing company. This was the original position of the ARB 51. However, there was

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an increasing tendency of “non-homogeneity” exception to avoid consolidation. This led to introduction of FAS 94 that demands consolidation of all majority owned subsidiaries except:

- ◆ A subsidiary is not consolidated where control is likely to be temporary;
- ◆ A subsidiary is not consolidated where it does not ret with the majority owners (for example, if the subsidiary is in legal re-organization or in brankruptcy);
- ◆ A subsidiary in which there are governmentally imposed uncertainties which cast significant doubt about the ability of the parent to control subsidiary.

In those exceptional cases, investment in subsidiaries is accounted for under cost method. Equity method accounting is followed for investments in common stock of corporate joint venture and investment in common stock for an investor that give rise to significant influence. Unincorporated joint venture and/or partnership are directly consolidated. EITF 85-28 explains that a special purpose subsidiary created to originate collateralized mortgage debt (which the parent company did itself) must be consolidated.

A difference in fiscal period of the parent and the subsidiary company does not justify the exclusion of consolidation. It is possible for a subsidiary to follow a fiscal year which is close to the fiscal year of the parent company. Generally, the difference in the fiscal year ending of the parent and the subsidiary should not be more than three months. in case it is more than three months, a disclosure should be made about the significant events which materially affect the financial position or results of operations.

Every consolidated financial statement should disclose the consolidation policy. It is possible to make it apparent by headings or other information, but in other cases it is given by way of footnotes.

### Consolidation Procedure

Explained below is US GAAP consolidation procedure:

- ◆ Consolidation financial statements are prepared in a similar way for a pooling of interest as for a purchase.
- ◆ Stage by stage acquisition: When the parent purchases a subsidiary in more than one block, each acquisition is on a step-by-step basis. Consolidation is not done until control exists. Any goodwill or negative goodwill is determined at each step.
- ◆ Elimination of inter-company balances: Examples of inter-company balances are inter-company open account balances, security holdings, sales and purchases, interest, dividend, etc.
- ◆ Elimination of profit or loss on inter company transaction: This is applicable for assets remaining within the group. Complete elimination of profit or loss arising out of inter-company transactions on the assets remaining on the balance sheet date, which are consolidated, is required.

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- ◆ **Minority interest:** It is the portion of minority stockholders' equity in the subsidiary. In the consolidated balance sheet minority interest is presented between the liability section and the stockholders' equity section. In case minority interest is insignificant, it is often included in other liabilities. Elimination of profit or loss in inter-company transaction is not affected by the existence of minority interest. In other words, unrealized profit in assets in the consolidated balance sheet arising out of inter-company transactions should be eliminated in full not to the extent of majority interest.
- ◆ If income tax has been paid on inter-company profit on assets remaining within the group, such taxes should be deferred. Alternatively, elimination of inter-company profit should be reduced appropriately.
- ◆ **Unincorporated Subsidiaries:** FAS 94 eliminated the requirement of pursuance of equity method accounting for unincorporated subsidiaries. When a majority owned subsidiary is not consolidated, equity method is considered to be the appropriate choice.

**Example:** [Pooling of interest method accounting for business combination]. This is discussed to explain the principle of pooling interest which should be applied for consolidation as well.

Company A acquires 100% of the shares of Company B and Company C on the basis of the following information:

| <i>Amount in \$ million</i> | <i>A</i> | <i>B</i> | <i>C</i> |
|-----------------------------|----------|----------|----------|
| Liabilities                 | 100      | 15       | 15       |
| Common Stock Par \$         | 500      | 200      | 200      |
| Additional Paid in Capital  | 300      | 0        | 100      |
| Retained Earnings           | 200      | 20       | 100      |
| Liabilities & Equity        | 1100     | 235      | 415      |
| Assets                      | 1100     | 235      | 415      |
| Shares issued by A (No.)    |          | 15       | 35       |
| Par Value                   |          | 150      | 350      |

In the pooling of A and B, A paid \$ 150 million to B which is \$ 50 million less than the latter's Common Stock. So this excess should be added to the paid in capital of the combined balance sheet. In the pooling of A and C, A paid \$ 350 million to C which is more than latter's common stock, so the difference is deducted from the Paid in Capital of C first and in case the deficit remains, it is deducted from the retained earnings of C.

**Theorem 1:** Sum of the individual Common Stock > Combined Common Stock, the Combined Paid In Capital should be increased by the difference.

**Theorem 2:** Sum of the individual Common Stock < Combined Common Stock, first decrease the Combined Paid In Capital and then retained earnings by the difference.

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### *Pooling of Interest Between A & B*

|                                 | A&B         | A&B         |
|---------------------------------|-------------|-------------|
| Liabilities                     | 115         | 115         |
| Common Stock par \$ 10          | 650         | 850         |
| Additional Paid in Capital      | 350         | 300         |
| Retained Earnings               | 220         | 250         |
| <b>Liabilities &amp; Equity</b> | <b>1335</b> | <b>1515</b> |

In case the amount paid exceeds the combined equity then deficit should be shown as asset.

The same principle should be extended for consolidation. The control may be acquired through cash acquisition of common stock.

**Example:** [Application of pooling of interest for initial consolidation] Company acquires B and C in cash which has been shown as investments at cost:

| <i>Amount in \$ million</i>     | <i>A</i>    | <i>B</i>   | <i>C</i>   |
|---------------------------------|-------------|------------|------------|
| Liabilities                     | 100         | 15         | 15         |
| Common Stock Par \$ 10          | 500         | 200        | 200        |
| Additional Paid in Capital      | 300         | 0          | 100        |
| Retained Earnings               | 200         | 20         | 100        |
| <b>Liabilities &amp; Equity</b> | <b>1100</b> | <b>235</b> | <b>415</b> |
| Assets other than Investments   | 600         | 235        | 415        |
| Investments in B at cost        | 150         |            |            |
| Investments in C at cost        | 350         |            |            |
| <b>Assets</b>                   | <b>1100</b> | <b>235</b> | <b>415</b> |

Now for the purpose of preparation of consolidated balance sheet applying pooling of interest method, common stock of the B and C should be adjusted against investment.

Common Stock > Investments = Surplus: Adjust this surplus against Paid In Capital of the acquired company and if any balance of surplus is left, adjust that against the retained earnings of the acquired company. Finally, any further balance should be adjusted against the paid in capital and retained earnings of the acquirer.

### *Initial Consolidation*

| <i>In Million \$</i>   | <i>A&amp;B</i> | <i>A&amp;C</i> |
|------------------------|----------------|----------------|
| Liabilities            | 115            | 115            |
| Common Stock Par \$ 10 | 500            | 500            |

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|                               |             |             |
|-------------------------------|-------------|-------------|
| Additional Paid in Capital    | 350         | 300         |
| Retained Earnings             | 220         | 250         |
| Liabilities & Equity          | 1185        | 1165        |
| Assets other than Investments | 835         | 1015        |
| Investments at cost           | 350         | 150         |
| <b>Assets</b>                 | <b>1185</b> | <b>1165</b> |

Now comparing the pooling interest combination and consolidation we find the same type of equity patter.

**Example:** [Inclusion of Minority Interest]: Now we include minority interest in Example 64.2. Assume that Company a acquired 90% stake in B and C.

|                                 |             |            |            |
|---------------------------------|-------------|------------|------------|
| Amount in \$ million            | A           | B          | C          |
| Liabilities                     | 100         | 15         | 15         |
| Common Stock Par \$ 10          | 500         | 200        | 200        |
| Additional Paid in Capital      | 300         | 0          | 100        |
| Retained Earnings               | 200         | 20         | 100        |
| <b>Liabilities &amp; Equity</b> | <b>1100</b> | <b>235</b> | <b>415</b> |
| Assets other than Investments   | 600         | 235        | 415        |
| Investments in B at cost        | 150         |            |            |
| Investment in C at cost         | 350         |            |            |
| <b>Assets</b>                   | <b>1100</b> | <b>235</b> | <b>415</b> |

10% of the equity of the acquiring company should be treated as Minority Interest and balance should be treated as Company A's share in the equity of the subsidiary.

First compare 90% common stock with investments. Find out the excess/deficit.

Adjust the excess deficit against 90% interest in paid in capital and retained earnings.

|                            |      |      |
|----------------------------|------|------|
|                            | A&B  | A&C  |
| Liabilities                | 115  | 115  |
| Minority Interest          | 22   | 40   |
| Common Stock Par \$ 10     | 500  | 500  |
| Additional Paid in Capital | 330  | 290  |
| Retained Earnings          | 218  | 220  |
| Liabilities & Equity       | 1185 | 1165 |

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|                                 |     |      |
|---------------------------------|-----|------|
| Assets other than Investments   | 835 | 1015 |
| Investments at cost             | 350 | 150  |
| Excess/deficit                  | 30  | -170 |
| To be adjusted against:         |     |      |
| Paid in capital of subsidiary   | -30 | 100  |
| retained Earnings of subsidiary | 0   | 70   |

The subsequent consolidation should take care of the change in retained earnings. Share of the parent company should be added to the retained earning of the parent and the minority's share should be added to the minority interest.

**Example:** [Subsequent consolidation] After the date of acquisition of the company B, balance sheet of the parent A and company B in the next balance sheet were as follows:

| <i>Consolidated Balance Sheet</i> |             | <i>\$ in Million</i> |
|-----------------------------------|-------------|----------------------|
|                                   | T1          | T0                   |
| Liabilities                       | 180         | 115                  |
| Minority Interest                 | 27          | 22                   |
| Common Stock Par \$ 10            | 500         | 500                  |
| Additional Paid in Capital        | 330         | 330                  |
| Retained Earnings                 | 413         | 218                  |
| <b>Liabilities &amp; Equity</b>   | <b>1450</b> | <b>1185</b>          |
| Assets other than Investments     | 1100        | 835                  |
| Investments at cost               | 350         | 350                  |
| Assets                            | 1450        | 1185                 |
| Profit during the year            | 150         | 50                   |
| Minority Interest                 |             | 5                    |
| Parent's share                    |             | 45                   |

If one enterprise purchases two or more blocks of stock of another enterprise at various dates and eventually obtains control of the other enterprise, the date of acquisition for the purpose of consolidation should be determined evaluating the circumstances. In case small purchases are made on different dates followed by purchase that gives control, for the sake of convenience, the date of last purchase is taken as the date of acquisition.

**Example:** A Ltd. acquired 20% stake in B Ltd. on 1-1-2000 for \$ 600,000 and another 50% on 1.1.2001 for \$ 1,600,000. Let us determine the goodwill/negative goodwill in two stages on the basis of the following information:

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|                                                 |           |
|-------------------------------------------------|-----------|
|                                                 | \$        |
| Common stock of B Ltd. on 1.1.2000 at par value | 1,00,000  |
| Paid in capital on 1.1.2000                     | 1,00,000  |
| Retained Earnings 1.1.2000                      | 2,00,000  |
| Retained Earnings on 1.1.2001                   | 3,00,000  |
| Retained earnings on 31.12.2001                 | 4,00,000  |
| Computation of Goodwill/Negative Goodwill:      |           |
|                                                 | \$        |
| 20% of Book Value [20% *\$4,00,000]             | 8000,000  |
| Less: Cost of Investments                       | 6000,000  |
| Negative Goodwill                               | 200,000   |
| 50% of Book Value [50% *3,00,000]               | 1,500,000 |
| Less: Cost of Investments                       | 1,600,000 |
| Goodwill                                        | 100,000   |

#### **11.10 CASH FLOW STATEMENT**

FAS 95 explains that information about cash flow is required to-

- ◆ Assess the enterprise's ability to generate positive future net cash flows;
- ◆ Assess the enterprise's ability to meet its obligation, its ability to pay dividend, and its needs for external financing;
- ◆ Assess the effects on an enterprise's financial position of both its cash and non-cash investing and financing transactions during the period. [Para 5, FAS 95].

#### **Cash and Cash Equivalents**

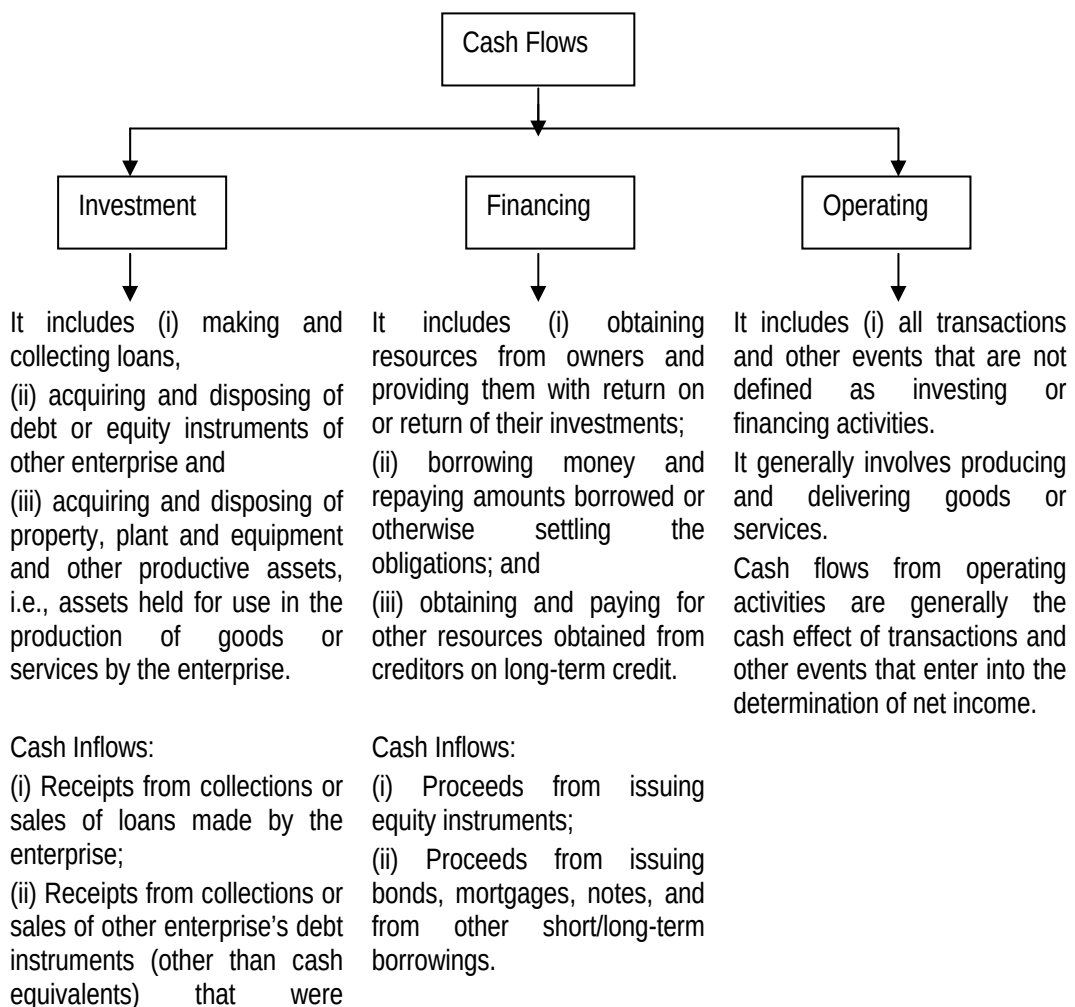
A statement of cash flow explains cash and cash equivalents rather than ambiguous term such as fund. Para 8, FAS 95 defined cash equivalents as short term highly liquid investments that are (a) readily convertible to known amounts of cash and (b) having insignificant risk of changes in value because of interest rate change as their maturity is very near. Generally, investments with original maturities of three months or less qualify under this definition to be classified as cash equivalents. Examples are treasury bills, commercial paper, money market funds. Cash purchases and sales of these securities are part of the enterprise's cash management activities than classifying them as operating, financing or investment activities.

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However, an enterprise is required to adopt a policy regarding classification of cash equivalents. It is not necessary to include all items that qualify the definition stated in Para 8, FAS 95 as cash equivalents for the purpose of preparation of cash flow statement. For example, a banking company may decide to classify all qualified investments as cash equivalents whereas a finance company, which largely invests in short-term securities, may like to classify such investments as investment activities. So, it is necessary to disclose the policy adopted for classifying cash equivalents. Any change in such policy should be treated as change in accounting principles that shall be affected by restating financial statements for earlier years.

### Cash Flow Classifications

In a statement of cash flow, various items of cash receipts and payment are classified into cash flows from investing, financing and operating activities.





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purchased by the enterprise;

(iii) Receipts from sale of property, plant and equipment and other productive assets;

Cash flow from investing activities

Cash outflows:

(i) Disbursements for loans made by the enterprise;

(ii) Payments to acquire debt instruments of other entities;

Cash flow from financing activities

Cash Outflows:

(i) Payments of dividends and other distributions to owners, including outlays to reacquire the enterprise's equity instruments;

(ii) Repayment of amounts borrowed;

(iii) Other principal payments to creditors who have extended long-term credit.

Cash flow from operating activities.

Cash Outflows:

(i) Cash payments to acquire materials for manufacturing or goods for resale, including principal payments on accounts and both short and long term notes payable to suppliers for those materials or goods;

(ii) Cash payments to other suppliers and employees for goods and services;

(iii) Cash payments to governments for taxes, duties, fines, other fees or penalties;

(iv) Cash payments to lenders and other creditors for interest;

(v) All other cash payments that do not stem from transactions defined as investing or financing activities such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

The following items qualify for net reporting (as their turnover is quick, amounts are large and the maturities are short):

- ◆ Investments other than cash equivalents;
- ◆ Loans receivables and
- ◆ Debt whose original maturities are three months or less. [Para 13, FAS 95].

**Exemptions to Certain Enterprises** – FAS 102 allows pension plans and certain other employee benefit plans that present financial information in accordance with FAS 35 not to prepare a statement of cash flow. Also a statement of cash flow is not required to be prepared by an investment enterprise or common trust fund if the following conditions are fulfilled:

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- ◆ All of the enterprise's investments are highly liquid;
- ◆ Substantially all of the enterprise's investments are carried at market value;
- ◆ The enterprise has little or not debt based on average debt outstanding during the period;
- ◆ The enterprise provides a statement of changes in net assets.

**Special Classification of cash flows** – Banks, brokers and dealers in securities and other enterprises may carry securities and other assets in a trading account. Securities for which market value is determined using matrix techniques described in the AICPA Audit and Accounting guide, Audit of Investment Companies, would meet this condition. Other securities for which market value is not readily available are not included in this category.

Cash receipts and payments resulting from purchases and sales of securities and other assets stated above are classified as a part of operating activities of these enterprises in cash those assets are acquired for resale and are carried at market value in the trading account. [Para 9, FAS 102]

Some loans are similar to securities held in a trading account. They are originated or purchased specifically for resale and are held for short periods of time. Cash flows from these loans are also classified as "cash flows from operating activities" if those loans are acquired specifically for resale and carried at market value or lower of cost or market value [Para 9, FAS 102].

Cash flows from purchases, sales, and maturities of available for sale securities are classified as cash flows from investment activities and reported gross in the statement of cash flows [Para 132 (a), FAS 115].

**Foreign Currency Cash Flows** – Cash flows of an enterprise with foreign currency transactions or foreign operations are converted in reporting currency equivalent applying exchange rates in effect at the time of the cash flows.

It is possible to use a weighted average exchange rate for translation the result is substantially the same. The statement shall report the effect of exchange rate changes on cash balances held in foreign currencies as a separate part of the reconciliation of change in cash and cash equivalents [Para 25, FAS 25].

### **Content and Form of Statement of Cash Flows**

A Statement of cash flows for a period shall report net cash provided or used by operating, investing and financing activities, and the net effect of those flows on cash and cash equivalents during the period in a manner that reconciles the beginning and ending cash and cash equivalents [Para 26, FAS 95].

An enterprise may adopt direct method of determining operating cash flows. Alternatively, it is possible to follow indirect method of determining operating cash flows.

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Major classes of operating cash flows which should be reported when an enterprise report operating cash flows under direct method are:

- ◆ Cash collected from customers, including lessees, licenses, and the like;
- ◆ Interest and dividend received;
- ◆ Other operating cash receipts;
- ◆ Cash paid to employees and other suppliers of goods and services including suppliers of insurance, advertising and the like;
- ◆ Interest paid;
- ◆ Income taxes paid;
- ◆ Other operating cash payments [Para 27, FAS 95].

Under indirect method, an enterprise can determine operating cash flows by adjusting net income. This requires adjustment of:

- ◆ The effects of all deferrals of past operating cash receipts and payments, such changes in inventory, deferred income, receivables and payables.
- ◆ The effects which are part of investing and financing activities, for example gains and losses arising out of extinguishments debt, sale of tangible fixed assets, etc.

A reconciliation of net income to net operating cash flow should be provided irrespective of the fact whether direct method or indirect method is followed. That reconciliation should report all major classes of reconciling items. When direct method is followed, reconciliation shall be provided in a separate schedule. If the indirect method is used, the reconciliation may be reported within the Statement of Cash flows or provided in a separate schedule with the Statement of Cash Flows reporting only the net cash flows from operating activities. When reconciliation is shown within the Statement of cash Flows, all reconciling items should be shown clearly. [Paras 29-30, FAS 95].

With cash flows from investing activities outlays for acquisition of property, plant and equipment should be presented separately from the sale proceeds such items. Similarly, cash flows from financing activities should present separate proceeds of borrowings from repayment of debt.

**Other Issues**

Information about investing and financing activities which do not involve cash receipts and cash payments but affect assets and liabilities (non-cash transactions) should be disclosed in a separate schedule, either narrative or summarized. If there are only few transactions, those may be presented on the same page as the Statement of Cash Flows. Otherwise those reported elsewhere in the financial statements.

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Financial statements should not present cash flow per share. The reason for this decision is very important to understand that encompasses capital recovery issue. Earning per share is computed with reference to earnings which take care of capital maintenance, but operating cash flows ignore the capital maintenance issue: "Earning per share focuses attention on earnings available for common stockholders, and that concept guides the calculation of, and adjustments to, the numerator of the ratio because the concepts underlying its calculation, such as capital maintenance (the distinction between the return of capital and return on capital) focus on return on stockholders on their investments. Net cash flow from operating activities is not comparable to net income because recovery of capital is not a factor in its calculation, and net cash flow from operating activities includes both return on and returns of investments."

### 11.11 EARNINGS PER SHARE (EPS)

EPS is an important measure of corporate performance for investors and other users of financial statements. They generally are believed to be of value to investors in weighing the significance of a corporation's net income and of changes in its net income from period to period in relation to the shares the investors holds or may acquire. FAS 128 requires EPS information to be presented in the income statement of publicly held companies. An investment company or a wholly owned subsidiary company is not required to presents information regarding EPS.

#### Types of EPS

When potential reduction, called dilution, of EPS figures is inherent in a company's capital structure, a dual presentation of EPS is required namely:

#### 1. Basic Earnings Per Share

$$\frac{\text{Income available to common stockholders}}{\text{Weighted average no. of common shares outstanding}}$$

Shares issued during the period and shares re-acquired during the period shall be weighted for the period they remained outstanding.

Income Available to Common Stockholders=

| <i>Continuing Operations</i>                             | <i>Total</i>                                             |
|----------------------------------------------------------|----------------------------------------------------------|
| Income from continuing operations                        | Net Income                                               |
| Less: Dividends declared on preferred stock              | Less: Dividends declared on preferred stock              |
| Less: Dividend Accumulated on cumulative preferred stock | Less: Dividend Accumulated on cumulative preferred stock |
| Loss from continuing operations                          | Net Loss                                                 |
| Add: Dividend declared on preferred stock                | Add: Dividends declared on preferred stock               |

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*Add: Dividend Accumulated on cumulative preferred stock*      *Add: Dividend Accumulated on cumulative preferred stock*

Weighted average number of shares used as denominator of earning per share is simple average number of shares.

|                           |   |                         |
|---------------------------|---|-------------------------|
| No. of shares outstanding | X | No. of Days outstanding |
| Si                        | X | Di                      |

$$\text{Weighted average No. of shares} = \left[ \sum Si \times \sum Di \right] / \sum Di$$

## **2. Diluted Earnings Per Share**

When there are potential common shares in the capital structure of an enterprise, it requires to present diluted the earning share. For the purpose of “diluted earning per share” computation, income is increased by dividend on convertible preferred stock and after tax interest cost on convertible debentures. Determination of diluted earning per share involves increases in denominator, as if the convertible instruments are outstanding from the beginning for the full year of convertible. Adjustments should be made certain contracts that give the issuer or holder with a choice of settlement method. Diluted EPS should be based on most advantageous conversion rate from the standpoint of the holders.

$$\frac{\text{Income Available to Common Stockholders} + \text{Effect of Assumed Conversions}}{\text{Weighted Average Shares} + \text{Dilutive Potential Common Shares}}$$

The computation of diluted earning per share does not include assumed conversion of any securities that have antidilutive effect on the earning per share. For this purpose all potential common shares are tested separately for the impact of diluteness and those potential common shares are arranged from most dilutive and least dilutive. See Example 66.1.

### **Presentation of Earning Per Share Information**

Para 149 explains how to present earning per share information. This is illustrated here using information developed in Example 66.1. Entities, that have simple capital structure with only common stock outstanding, are required to present basic earning per share income from continuing operations and for net income on the face of the income statements. All other entities are required to present basic and diluted earning per share for income from continuing operations and for net income on the face of the income statement with equal prominence [Para 36, FAS 128].

An entity, that reports discontinued operations, extraordinary items, cumulative effect of an accounting change, can present basic and diluted earning per share either on the face of the income statement or in the notes to financial statements [Para 37, FAS 128].

Earning per share data shall be presented for all periods for which income statement or summary income statement is presented. If diluted EPS data is presented for one period, they

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shall be reported for all the periods presented even if the data are same as the basic EPS. If the diluted and basic EPS are of the same amount, dual presentation can be accomplished in one line on the income statement [Para 38, FAS 128].

Disclosure as per Para 149, FAS 128:

|                                                                | <i>For the Year<br/>Ended 2001</i> |
|----------------------------------------------------------------|------------------------------------|
| Earning Per Common Share                                       |                                    |
| Income Before Extra-ordinary Items and Accounting Change       | 0.556                              |
| Extra-ordinary Items                                           | (0.033)                            |
| Accounting Change                                              | --                                 |
| Net Income                                                     | 0.524                              |
| Earning Per Common Share-assuming dilution                     |                                    |
| Income Before Extra-ordinary Items and Accounting Change       | 0.518                              |
| Extra-ordinary Items                                           | (0.030)                            |
| Accounting Change                                              | --                                 |
| Net Income                                                     | 0.488                              |
| Sum of the four quarter EPS is not necessarily the annual EPS. |                                    |

### Reconciliation

Para 40, FAS 128 requires disclosure of the following:

A reconciliation of the numerators and denominators of the basic and diluted earning per share computation for the income from continuing operations. The reconciliation shall include the individual income and share amount effects of all securities that affect earning s per share.

The effect that has given to preferred dividends in arriving at the income available to common stock holders.

Securities that could potentially dilute basic earning EPS in future that were not included in the computation of diluted EPS because to do so would have anti-dilutive for the period(s) presented.

In addition, it is necessary to disclose the transactions occurred after the balance sheet but before the issuance of the financial statements that would have changed materially the number of common shares or potential common shares outstanding for the purpose of computation of basic and diluted EPS.

[Reconciliation as per Para 40, FAS 128]

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| <i>For the year ended 2001</i>                                          |                               |                                 |                                       |
|-------------------------------------------------------------------------|-------------------------------|---------------------------------|---------------------------------------|
|                                                                         | <i>Income<br/>(numerator)</i> | <i>Shares<br/>(Denominator)</i> | <i>Per share<br/>Amount<br/>(Rs.)</i> |
| Income Before Extra-ordinary Items and Accounting change                | 93                            |                                 |                                       |
| Less: Preferred Stock Dividend                                          | 8                             |                                 |                                       |
| Basic EPS                                                               |                               |                                 |                                       |
| Income available to common stockholders                                 | 85                            | 152.75                          | 0.556                                 |
| Less: Converted shares already included in the computation of basic EPS |                               |                                 |                                       |
| Effect of dilutive securities                                           |                               |                                 |                                       |
| Convertible preferred stock                                             | 8                             | --                              |                                       |
| Convertible debentures                                                  | 42                            | 13.25                           |                                       |
| Diluted EPS                                                             |                               |                                 |                                       |
| Income available to common stockholders + assumed conversions           | 135                           | 164.00                          | 0.518                                 |

**Options and Warrants**

The dilutive effect of outstanding call options and warrants issued by the reporting entity shall be reflected in diluted EPS by application of treasury stock method. There is an alternative method termed "reverse treasury stock method", which is also applied in cases.

**Treasury stock method:** Under this method exercise of options and warrants is assumed at the beginning of the period and common shares are assumed to be issued. Proceeds from the exercise of the option are assumed to be used for the purchase of stock at the average market price during the period. The incremental shares (the difference between the number of shares assumed issued and the number of shares assumed purchased) shall be included in the denominator of the diluted EPS computation.

Options and warrants have the dilutive effect under treasury stock method only when the average market price is above the exercise price, i.e., for in the money options. But previously, reported EPS data are not retroactively adjusted as a result of changes in market prices of common stock.

When options and warrants are exercised and common shares are issued, how to include these shares in the denominator for computing diluted EPS and basic EPS? Common shares to be issued on assumed conversion are included in the diluted EPS denominator weighing for the period warrants or options are not exercised. Common shares to be issued on assumed

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conversion are included in the basic EPS denominator weighing for the period such shares are outstanding.

### Contingently Issuable Stock

Sometimes shares are issued on satisfaction of certain conditions. These are termed as contingently issuable shares. Paras 3035, FAS 128 deal with the technique of including such shares in the computation of diluted EPS.

Given below are the requirements of FAS 128:

- |         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|---------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Para 39 | <ul style="list-style-type: none"><li>(a) Include contingently issuable shares from the beginning of the period in which all the necessary conditions are satisfied.</li><li>(b) If all the necessary conditions are not fulfilled, include such No. of shares from the beginning of the period which would be issuable at the end of the period if that was the end of the contingency period. Also impact on earning should be dilutive.</li></ul>                                      |
| Para 31 | If attainment or maintenance of a specified amount of earnings is the condition and if that amount has been attained, the additional shares should be considered outstanding for the purpose of computing diluted EPS.                                                                                                                                                                                                                                                                    |
| Para 32 | <p>The number of shares to be contingently issued may depend on the market price of the stock at a future date.</p> <p>In such a case, computation of diluted EPS reflect the number of shares to be issued based on the current market price at the end of the period. Of course, the impact of such issue should be dilutive.</p>                                                                                                                                                       |
| Para 33 | <p>In some cases, the number of contingently issuable shares may depend on both future earnings and future periods of the shares.</p> <p>In that case, the determination of number of shares included in diluted EPS shall depend on fulfillment of both the conditions, i.e., earnings to date and market price at the end of the period.</p> <p>In case both the conditions are not met at the end of the period, no contingently issuable shares shall be included in diluted EPS.</p> |
| Para 34 | If the contingency is based on a condition other than earning or market price (for example, opening a certain number of retail stores), the contingent shares shall be included in the computation of diluted EPS based on the assumption that the current status of the condition will remain unchanged until the end of the contingency.                                                                                                                                                |
| Para 35 | Contingently issuable potential common shares are included in the computation of diluted EPS in case (a) such shares are assumed to be issued, and (b) their impact should be computed applying treasury stock method.                                                                                                                                                                                                                                                                    |



### **Other Issues**

Given below are the other issues relating to computation of earning per share:

- ◆ The impact of right issue is to be computed in the same manner as discussed in IAS 33.
- ◆ The impact of bonus issue, stock split and reverse stock split should be computed in the same manner as stated in IAS 33.
- ◆ Impact of stock based compensation arrangement should be computed in the same manner as has been disc used for option and warrants, i.e., applying treasury stock method.
- ◆ Contracts that require the reporting entity repurchase its own stock, such as written put options or forward contract are included in the computation of diluted earning per share if their impact is dilutive. If those contracts are “in the money” during the reporting period, the potential dilutive effect on EPS should be computed using reverse treasury stock method. Under this method, it is assumed that at the beginning of the period sufficient stocks are issued to raise money to satisfy the contract. Proceeds are used to buy back the shares under written put option. Selling price is lower than the exercise price for “in the money contract”.

$$\text{Dilutive Impact} = [X \times N/M - N]$$

Where X = Exercise price, N = Number of outstanding put option, M = Current market price.

Let us assume that X = Rs.100, M = Rs.90 and N = 100000.

So sufficient funds to finance buy back when put option is exercised by the holder =  $X \times N = 100,00,000$ .

So number of shares to be sold =  $100,00,000/90 = 111111$

Dilutive Impact = 111111.

- ◆ Purchased call options and purchased put options are anti-dilutive in nature under both treasury stock method or reverse treasury stock method so they are not included in the computation of diluted EPS [Para 25, FAS 128].

### **Illustration of Determining Weighted-Average Shares**

|                                    |                |
|------------------------------------|----------------|
| Common stock outstanding, 1/1/20X6 | 200,000 shares |
|------------------------------------|----------------|

|                                                                                   |               |
|-----------------------------------------------------------------------------------|---------------|
| Preferred stock (convertible into 2 shares of common stock) outstanding, 1/1/20X6 | 50,000 shares |
|-----------------------------------------------------------------------------------|---------------|

|                                                                                            |           |
|--------------------------------------------------------------------------------------------|-----------|
| Convertible debentures (convertible into 100 shares of common stock for each \$1,000 bond) | \$100,000 |
|--------------------------------------------------------------------------------------------|-----------|

On March 31, ABC reacquired 5,000 shares of its own common stock.

On May 1, 20,000 shares of ABC preferred stock were converted into common stock.

On July 1, \$50,000 of ABC convertible debentures was converted into common stock.

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On September 30, ABC reacquired 5,000 shares of its common stock.

### *Computation of Weighted-Average Shares*

|    |                                                                                        |                |
|----|----------------------------------------------------------------------------------------|----------------|
| 1. | Common stock outstanding, 1/1/X6                                                       | 200,000        |
| 2. | Common stock reacquired, 3/31/X6 ( $5,000 \times \frac{9}{12}$ )                       | (3,750)        |
| 3. | Conversion of preferred stock on 5/1/X6 ( $20,000 \times 2 \times \frac{8}{12}$ )      | 26,667         |
| 4. | Conversion of convertible debentures on 7/1/X6 ( $50 \times 100 \times \frac{6}{12}$ ) | 2,500          |
| 5. | Common stock reacquired on 9/30/X6 ( $5,000 \times \frac{3}{12}$ )                     | <u>(1,250)</u> |
|    | Total weighted average shares, 20 X 6                                                  | <u>224,167</u> |

- 1. Common stock outstanding:** Because the 200,000 shares of common stock were outstanding for the entire year, all the shares are included in the weighted average shares.
- 2. Common stock reacquired:** On March 31, 20X6, 5,000 shares were reacquired, which means that 9/12 of the year they were not outstanding. Since the 5,000 shares are already included in the 200,000 shares (1 above), that portion which was not outstanding during the full year must be deducted. Thus, 9/12 of the 5,000 shares, or 3,750 shares, are excluded from the computations, which means that only 196.250 of the 200,000 shares were outstanding for the full year.
- 3. Conversion of preferred:** On May 1, 20X6, 20,000 shares of the preferred were converted into common stock. Since the conversion rate is 2 for 1, an additional 40,000 shares were outstanding from May 1 to the end of the year. Thus, 8/12 of the 40,000 shares, or 26,667 shares, are included in the weighted average shares outstanding for the year.
- 4. Conversion of convertible debentures:** On July 1, 20X6, \$50,000 of the convertible debentures were converted into common stock. The conversion rate is 100 shares for each \$1,000 bond, which means that the \$50,000 converted consisted of fifty \$1,000 bonds, or 5,000 shares of common stock. Since the conversion was on July 1, only 6/12 of the 5,000 shares, or 2,500 shares, are included in the weighted average shares outstanding for the year.
- 5. Common Stock reacquired:** 5,000 additional shares out of the 200,000 shares outstanding at the beginning of the year were reacquired on September 30, which means that for 3/12 of the year they were not outstanding. Thus, 3/12 of 5,000 shares, or 1,250 shares, must be excluded from the computation of weighted average shares outstanding for the year.

## **11.12 SEGMENT REPORTING**

### **Scope, Objectives and Basic Principles**

FAS 131 requires public business enterprises to report certain information about operating segments in complete sets of financial statements of the enterprise and in condensed interim financial reports issued to the shareholders. Public business enterprises are those which have issued debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over the counter market including local or regional markets) and that are required to file financial statements with the SEC or that provide financial statements for the purpose of issuing any class of securities in a public market.

It is not applicable to parent companies, subsidiaries, joint ventures or investees accounted for by the equity method if those enterprises' "separate company" statements are also consolidated or combined in a combined set of financial statements. Also both the separate financial statements and the consolidated/combined financial statements are included in the same financial report. However, FAS 131 is not applicable to those enterprises if they are public enterprises and their financial statements are issued separately.

*Objectives:* Disclosure of segments and related information is to provide information about the different types of business activities in which an enterprise engages and the different economic environments in which it operates to help users of financial statements:

- ◆ Better understand the enterprise's performance;
- ◆ Better assess its prospects for future net cash flows; and
- ◆ Make an informed judgement about the enterprise as a whole.

An enterprise might meet these objectives by providing a complete set of financial statements that are disaggregated in several different ways, for example, by products and services, by geography, by legal entity or by type of customers. However, it is not feasible to provide all such various types of information. Accordingly, FAS 131 suggests to adopt "management approach".

Under "management approach" is based on the way that management organizes a segment within the enterprise for the purpose of operating decision and assessing performance. So the segments become evident from the internal organizational structure of the enterprise. Therefore, it is possible to provide the information in a cost effective and timely manner.

FAS 131 requires that an enterprise should report measure of segment profit or loss and certain items included in determining segment profit or loss, segment assets, and certain related items. It does not require that an enterprise reports segment cash flow.

As per FAS 131 reportable segment is "operating segment" which should be identified in accordance with paras 1—15, FAS 131 or that results from aggregating two or more segments in accordance with para 17, FAS 131 and that exceeds quantitative thresholds mentioned in

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para 18, FAS 131. There is no such concept of primary segment and secondary segment as stated in the IAS 14. However, FAS 131 requires information about major customers (Paras 39, FAS 131).

### Segment Report

Operating Segment` Other Information

Information

Information about Products and Services

Information about Geographic Areas

Information about Major Customers

### Reportable Segments

Operating segment is the reportable segment for the purpose of FAS 131. An enterprise is required to identify operating segment in accordance with paras 10-15 of FAS 31.

Given below are identification criteria of an operating segment:

| Issues and Para reference to FAS 131                                    | Description                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|-------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Para 10: Definition                                                     | <p>Operating segment is a component of an enterprise:</p> <ul style="list-style-type: none"><li>(a) that engages in business activities from which it may earn revenues and incur expenses;</li><li>(b) whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about decisions about resources to be allocated to the segment and assess its performance;</li><li>(c) for which discrete financial information is available.</li></ul> <p>An operating segment may engage in business activities for which it has yet to earn revenues. For example, start up segment maybe an operating segment before earning revenues.</p> |
| Para 11: Part of the business enterprise which is not operating segment | <p>Parts of the business enterprise which do not earn revenue are not classified as operating segment.</p> <p>For example, corporate headquarters or certain functional departments that earn revenue which is only incidental, pension and retirement benefit</p>                                                                                                                                                                                                                                                                                                                                                                                                                         |

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|                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
|--------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                              | plans, etc., are not operating segments.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| Para 12: Chief operating decision maker                      | <p>This signifies a function not an officer.</p> <p>The function is to (i) allocate resources to a segment, and (ii) assess performance of the segment.</p> <p>Often this may signify the Chief Executive Officer or Chief Operating Officer. It may also signify a committee comprising of enterprise's President, Vice-President and others.</p>                                                                                                                                                                                                                                                                                                                                                                         |
| Para 13: Factors to be considered for identification         | <p>Three factors are stated in Para 10, namely, revenue earning capability, review of operating results and availability of discrete financial information.</p> <p>When the chief operating officer uses more than one set of segment information, other factors may identify a single set of components as constituting an enterprise's operating segments. These may include nature of business activities, existence of manager responsible for them and information presented to the board of directors.</p> <p>This means it is possible to identify an operating segment on the basis of nature of activities.</p>                                                                                                   |
| Para 14: Identify segment by function of the segment manager | <p>Generally, an enterprise operates through a segment manager. Even the chief decision maker may a segment manager. It again signifies by function. The function is the over responsibility of running a particular set of activities. Segment manager is accountable for such activities and has to maintain regular contract with the chief operating decision maker to discuss operating results, financial results, forecasts, or plan for the segment.</p> <p>In case three characteristics specified in Para 10 is applicable to more than one components of an enterprise, but there is only one set for which the segment manager is responsible, that set of components are identified as operating segment.</p> |

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Para 14: Identify segment by function of the segment manager

Generally, an enterprise operates through a segment manager. Even the chief decision maker may be a segment manager. It again signifies by function. The function is the overall responsibility of running a particular set of activities. Segment manager is accountable for such activities and has to maintain regular contact with the chief operating decision maker to discuss operating results, financial results, forecasts, or plan for the segment.

In case three characteristics specified in Para 10 are applicable to more than one component of an enterprise, but there is only one set for which the segment manager is responsible, that set of components are identified as operating segment.

Para 15: Segment identification in a matrix organization

In matrix organization, a segment manager is responsible for managing a different product or service line world-wide and others are responsible for managing only certain geographical locations. Characteristics stated in Para 10 are then identified with reference to a set of overlapping components.

The chief decision maker uses both set of information for managing the business.

In such a case, the components based on products and services should be the operating segment.

Para 17: Aggregation criteria

Two more operating segments are aggregated when into a single operating segment when they have same economic characteristics and similar in the following areas as well:

- ◆ the nature of products and services;
- ◆ the nature of the production processes;
- ◆ the type or class of customer for their products and services;
- ◆ the methods used to distribute their products or provide their services; and

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|                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|---------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                                                                                                         | <ul style="list-style-type: none"> <li>◆ if applicable, the nature of regulatory environment.</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| <p>Para 18: Quantitative thresholds</p> <p>Check whether a segment fulfils any of these criteria.</p> <p>If yes, select them as reportable segment.</p> | <p>Separate information about an operating segment is necessary when a segment meets any of the quantitative thresholds:</p> <p>(i) Reported revenue (including sales or external customers and inter-segment transfers) is 10% or more of the combined revenue (internal and external) of all reported operating segments.</p> <p>(ii) Absolute amount of its reported profit or loss is 10% or more of the greater of (a) the combined reported profit of all operating segments that did not report a loss or (b) the combined reported loss of all operating segments that did report a loss.</p> <p>(iii) Its assets are 10% or more of the combined assets of all operating segments.</p> |
| <p>Para 19: Combine other segments that do not satisfy the criteria specified in Para 18, but satisfies aggregation criteria stated in Para 17.</p>     | <p>An enterprise may combine information about operating segments that meets the quantitative thresholds in case a segment does not meet the criteria stated in Para 18, but meets majority of the aggregation criteria.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| <p>Paras 20: Separate Operating segments should cover at least 75% of consolidated Revenue.</p>                                                         | <p>Check the total of revenue of the segments identified applying the criteria stated in Para 18 and para 19.</p> <p>Combined revenue of all those segments should cover 75% of the consolidated revenue.</p> <p>In case this threshold limit is not reached new operating segment should be identified ignoring threshold stated in para 18. The process should continue until aggregate revenue of all identified segments exceeds 75% of the consolidated revenue.</p>                                                                                                                                                                                                                       |
| <p>Para 21: All other segment category</p>                                                                                                              | <p>Remaining segments are aggregated into "all other" segment category.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| <p>Para 22: Reportable segment of the immediately preceding period</p>                                                                                  | <p>Management judged an operating segment as reportable segment in the immediately preceding year. That segment does not meet</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |

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the quantitative thresholds during the current year.

Still that segment shall be continued to be reportable segment even if it no longer meets the criteria stated in Para 18.

Para 23: New segment identified during the current period and re-arrangement of the comparative data.

For the new segment identified during the current period due to fulfillment of the quantitative thresholds stated in Para 18, it is necessary to restate prior period segment data presented for comparative purposes unless it is impracticable to do so.

Para 24: Limit to number of segments to be reported to avoid information overload.

Although no precise limit has been determined as the number of segments to be identified as reportable in accordance with paras 18-23, when reportable segment reaches above 10, the enterprise needs to consider whether a practical limit has been reached.

### Segment Disclosures

What information should be disclosed for a reportable segment?

- ◆ General information as described in Paragraph 26;
- ◆ Information about profit/loss of the segment including certain revenues and expenses included in reported segment profit or loss, segment assets and the basis of measurement as described in Paragraphs 27-31;
- ◆ Reconciliation of the totals of segment revenues, reported profit or loss, assets and other significant items to corresponding enterprise amount as described in Paragraph 32;
- ◆ Interim reporting information as described in Paragraph 33.

| <i>Items</i>                                                  | <i>Description</i>                                                                                                                                                                                                                                                                                                   |
|---------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Para 26: General information disclosures                      | (a) Factors used to identify reportable segment.<br>(b) Types of product or services from which the reportable segment derives its revenues.                                                                                                                                                                         |
| Para 27: Information about profit/loss, revenues and expenses | Enterprise should report measure of profit/loss for each reportable segment.<br>An enterprise should disclose the following information if the chief operating decision maker review the following:<br>(a) Revenues from external customers;<br>(b) Revenues from transactions with other operating segments for the |



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same enterprise;

(c) Interest revenue;

(d) Interest expense;

(e) Depreciation, depletion and amortization expense;

(f) Unusual items;

(g) Equity in the net income of the investees accounted for the equity method;

(h) Income tax expense or benefit;

(i) Extraordinary items;

(j) Significant non-cash items other than depreciation, depletion and amortization expense.

Para 28: disclosure of special items segment assets

An enterprise should disclose the following items separately if the specified amounts are reviewed by the chief operating decision maker:

(a) Amount of investment in equity method investees;

(b) Total expenditures for additions to long lived assets other than financial instruments, long term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs, and deferred tax assets.

Para 29: Measurement Follow the measures supplied to the chief operating decision maker

The amount of each segment item reported shall be the measure reported to the chief operating decision maker.

Adjustments and eliminations made in preparing enterprise's general purpose financial statements and allocations of revenues, expenses and gains or losses shall be included in determining profit/loss of the reported segment only if they are included in the segment's profit/loss used by chief operating decision maker.

If amounts are allocated to reported segment profit or loss or assets, those amounts shall be allocated on a reasonable basis.

Para 30: Use measures used by the chief operating decision maker

In the chief operating decision maker uses only one measure of profit or loss or only one measure of segment assets for assessing the segment performance that should be used for the purpose of segment reporting.

In case the chief operating decision maker uses more than one measure, that measure should be used which is most consistent with the enterprise's consolidated financial statements.

Para 31: Explanation to the measurement

Minimum disclosures:

a. The basis accounting for transactions between reportable segments;

b. Nature of any differences between the measurement of the (i) reportable segments' profits or losses, and (ii) the enterprise's

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consolidated income before taxes, extraordinary items, discontinued operations and cumulative effect of changes in accounting policies. These differences can be resolved through reconciliation stated in Para 32, FAS 131. If not, differences should be explained. Differences may arise because of accounting policies, allocation of centrally incurred costs, etc.

c. Nature of any differences between the measurement of the (i) assets of the reportable segment and (ii) the enterprise's consolidated assets. These differences can be resolved through reconciliation stated in para 32, FAS 131. If not, differences should be explained. Differences may arise because of accounting policies and policies for allocation of jointly used assets.

d. Nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measurement of segment profit or loss.

e. Nature and effect of any asymmetrical allocation to segments, for example, effect of allocation of depreciation expense to a segment without allocating the related depreciable asset.

### Para 30: Reconciliation

An enterprise has to provide reconciliation of the following:

- a. Total of reportable segment revenues to enterprise's total revenue.
- b. Total reportable segment's profit or loss to the enterprise's consolidated income before income taxes, extraordinary items, discontinued operations and cumulative effect of change in accounting policy.
- c. Total of reportable segment's assets to the enterprise's consolidated assets.
- d. Total of reportable significant item of information disclosed to the corresponding consolidated amount.

All significant reconciling items shall be separately identified and described.

### Para 31: Interim period information

An enterprise shall disclose the following information about each reportable segment:

- a. Revenues from external customers;
- b. Inter segment revenue;
- c. A measure of segment profit or loss;
- d. Total assets for which there has been a material change from the amount disclosed in the last annual report;

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e. A description of differences from the last annual report in the basis of segmentation or in the basis of measurement of segment profit or loss.

f. A reconciliation of the total of the reportable segment's measures of profit or loss to the enterprise's consolidated income before income taxes, extraordinary items, discontinued operations and cumulative effect of change in accounting policy.

Para 31: Change in internal reporting organization and corresponding reporting segment

There is a need for restatement of the previously reported information which are used as comparatives unless it is impracticable to do so. Comparative of the interim financial reports should also be restated.

Para 32: Enterprise-wide disclosures

Paras 37-39 requires to disclose information about products and services, geographic areas and major customers. This disclosure requirements should be applicable to all enterprises including those which have only single reporting segment.

Para 37: Information about products and services

Give details of revenues for each product and service on the basis of the information included in the general purpose financial statement. If it is impracticable to do so, the fact should be disclosed.

Para 38: Information about geographic areas`

Disclose the following geographic information:

- a. Revenues from external customers (1) attributed to the enterprise's country of domicile, (2) all foreign countries in total.
- b. Long lived assets other than financial instruments, long term customer relationships of a financial institutions, mortgage and other servicing rights, deferred acquisition costs, and deferred tax assets located in (1) enterprise's country of domicile, (2) all foreign countries in total.

Para 39: Information about Major Customers

Disclose if revenues from a single customer amount to 10% or more of an enterprise's revenues. There is no need to disclose identity of the customer.

An insuring entity is considered as a customer of a health care facility provider.

FAS 131 gives importance of the management for use of financial information for the purposes of segment reporting. It does not follow the pattern of primary segment and secondary segment used in IAS 14. On the contrary it demands disclosure of revenues of products and services, geographical information and information about major customer.

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### **11.13 ACCOUNTING POLICIES, ACCOUNTING CHANGES AND ADJUSTMENTS OF FINANCIAL STATEMENTS FOR PRIOR PERIODS**

#### **Accounting Policies**

Accounting policies are specific accounting principles and the methods of applying those principles that are judged by the management of the enterprises to be the most appropriate in the circumstances.

Information about accounting policies adopted by the enterprise is essential for providing fair view of financial position [Para 5, APB 22], cash flows [Para 152(b), FAS 95], and results of operations. Those statements are prepared in accordance with generally accepted accounting principles. Para 8, APB Opinion 22 requires that a description of all significant accounting policies of the reporting should be included as an integral part of the financial statements.

The disclosure of accounting policies should cover-

- ◆ Basis of consolidation;
- ◆ Depreciation methods;
- ◆ Amortization of intangibles;
- ◆ Inventory pricing;
- ◆ Accounting for Research and Development costs including basis for amortization;
- ◆ Translation of foreign currencies;
- ◆ Recognition of profit on a long term construction type contracts;
- ◆ Recognition of revenue from franchising and leasing operations;

Disclosure of accounting policies should not repeat details presented elsewhere as part of financial statements.

There is flexibility in disclosure of significant accounting policies. the disclosure is particularly useful if given in a separate Summary of Significant Accounting Policies preceding the notes to financial statements or as the initial note. FASB Interpretation 40 requires mutual Life Insurance enterprises to disclose significant accounting policies used in the preparation of financial statements.

#### **Accounting Change**

Accounting change is a change in (a) an accounting principle, (b) an accounting estimate or (c) the reporting enterprise. The correction of an error in previously issued financial statements is not deemed to be an accounting change. APB Opinion 20 discusses the issues relating to accounting changes. It applies to financial statements that purport to present financial position [Para 3, APB 20], Cash flows [Para 152(a), FAS 95] and results of operations in conformity with the generally accepted accounting principles.

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*Change in accounting principle* - A change in accounting principles results from adoption of generally accepted accounting principles different from the one used previously for reporting purposes. The term accounting principles includes "not only accounting principles and practices but also methods of applying them". The following are not considered as changes in accounting principle:

- ◆ Initial adoption of accounting principle for the recognition of events or transactions occurring for the first time or that previously were immaterial in effect.
- ◆ Adoption or modification of an accounting principle in recognition of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurred.

Examples of change in accounting principles are-

- ◆ A change in the method of inventory pricing;
- ◆ A change in depreciation policy;
- ◆ A change in accounting method for long term construction type contracts;
- ◆ A change in accounting for research and development costs.

*Change in Accounting Estimates* – Changes in accounting estimates are necessary consequences of periodic presentation of financial statements. Preparing financial statements require estimating the effects of future events. Examples of estimates are – uncollectible receivables, inventory obsolescence, service life and salvage value of depreciable assets, warranty costs, periods benefited by deferred costs etc. Changes in accounting estimates occur as new events occur, more experience is acquired, or as additional information is obtained.

*Change in Reporting Entity* – One special type of change in accounting principles results in financial statements which in effect are those of a different reporting entity. This type is limited mainly to (a) presenting consolidated financial statements in place of individual financial statements; (b) changing specific subsidiaries comprising group companies; (c) changing companies included in the combined financial statements. A different group of companies comprise the reporting entity after each change.

In the preparation of financial statements there is presumption that an accounting principle once adopted will not be changed in accounting for events and transactions of similar kinds. Consistent use of accounting principles over the period enhances the utility of the financial statements by facilitating the users in understanding comparative data.

In case there is a change in accounting principle, the justification of change should clearly explain why the newly adopted accounting principle is preferable. The nature of and justification for a change in accounting principle shall be disclosed in the financial statements [Para 17, APB 20].

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In case previous period's data are restated, the public confidence in financial statements gets affected. On the other hand, if the previous year's data are not restated the quality of the comparative data and their utility in users' decision making gets minimized. To make a balance between the two, the US GAAP requires to present cumulative effect of accounting change on the face of the income statement of the period in which the change is effected. In addition, it is required that a set of proforma information should be included showing effect of change if carried in the previous periods presented.

That apart, summaries of financial information for a number of periods are commonly included in the financial reports. The summaries often show condensed income statements, including related earning per share amounts for five years or more. In summary financial information that includes an accounting period in which a change in accounting principle was made, the amount of cumulative effect of change that was included in net income of the period of the change shall be shown separately along with net income and related per share amounts.

For effecting change in accounting principles the following steps are followed:

- ◆ Financial statements for prior periods included for comparative purposes shall be presented as previously reported;
- ◆ The cumulative effect of changing to a new accounting principle on the amount of retained earnings at the beginning of the period in which change has been made is computed and presented in the income statement.
- ◆ The effect of change in income before extraordinary items and net income should be disclosed.
- ◆ Income before extraordinary items and net income are computed on proforma basis giving effect to the change in accounting policy and this is shown on the face of the income statement.

The above-stated steps are not applicable to (i) adjustments for prior period items which is discussed in Para 68.3 separately, (ii) other changes stated in items (1) to (3) below:

- (1) Certain changes in accounting principles are such that advantage or retroactive effect outweigh disadvantages. In such cases prior period data should be restated, examples are-

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- (a) a change from LIFO method of inventory pricing to another method;
  - (b) a change in method of accounting for long term construction type contracts;
  - (c) a change to or from the full cost method of accounting that is used in the extractive industries and
  - (d) a change from retirement, replacement, betterment accounting to depreciation accounting.
- (2) *Initial public distribution:* It is possible to change accounting principles in connection with forthcoming public offerings with a view to present better financial information for current period. This is possible when effect of accounting change is favourable. Therefore, in such cases prior periods data should be restated.
- (3) When a change in accounting principle is effected to conform with the recommendations of the AICPA statement of position [Para 5, FIN 20] or FASB Technical Bulletin or a consensus of the FASB EITF, such change should be accounted for in accordance with requirement of Para 5, FIN 20. This Para explains "For the purpose of applying APB Opinion No.20, an enterprise making a change in accounting principle to conform with the recommendations of an AICPA statement of position does not specify the manner of reporting a change in accounting principle to conform with its recommendations, an enterprise making a change in accounting principle to conform with the recommendations of the statement shall follow the change as specified by Opinion No.20."

## **11.14 BUSINESS COMBINATION**

### **OVERVIEW**

A business combination occurs when two or more entities combine to form a single entity. An asset combination results when one company acquires the assets of one or more other companies, or when a new company is formed to acquire the assets of two or more existing companies. In an asset combination, the target companies cease to exist as operating entities and may be liquidated or become investment companies. An acquisition of stock combination occurs when one company acquires 50% of the outstanding voting common stock of one or more target companies, or when a new company is formed to acquire controlling interest in the outstanding voting common stock of two or more target companies.

Until 2001m two basic methods of accounting existed for business combinations: (1) the purchase method and (2) the pooling-of-interests method. In 2001, the FASB issued FAS0141 (Business Combinations), which eliminated the pooling-of-interests method.

In a purchase method combination, the combined entity reports the assets and liabilities of the target company at fair market value on the date of acquisition. Any excess of the fair market value of the consideration given over the fair market value of the net assets acquired is reported as goodwill. If the fair market value of the consideration given is less than the fair market value of the net assets acquired, the resulting excess of fair value of acquired net assets over the cost of the

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acquired entity is allocated, on a pro rata basis, against certain assets acquired in the business combination. If any excess over cost remains after reducing certain assets to zero, the remaining excess is recognized as an extraordinary gain. The operating statements for purchase method combinations report combined results only for the period subsequent to the combination.

GAAP for business combinations are found in the following authoritative pronouncements:

### BACKGROUND

For many years, GAAP for business combinations was included in APB-16 and allowed two significantly different methods – the purchase method and the pooling-of-interests method. The purchase method, as the name implies, was based on the assumption that a purchase transaction had occurred (i.e., one entity has purchased the other). This type of transaction was usually executed via the transfer of cash or other assets or through a capital stock transfer. A new cost basis for the assets acquired and the liabilities assumed arose, and goodwill often was established as a result of the business combination. The pooling-of-interests method, on the other hand, was intended for business combinations in which the shareholders of the combining entities became shareholders of a combined company. The essence of a pooling was that the shareholders of the combining companies neither withdrew nor invested assets, but exchanged shares in accordance with a ratio that preserved their interests in the combining companies.

APB-16 was based on an assumption that a business combination was a purchase unless 12 very specific criteria were met, in which case the business combination was a pooling-of-interests. For business combinations initiated after June 30, 2001, the pooling-of-interests method is no longer available and, therefore, that method is not covered in this *Guide* other than for historical reference.

While the primary source of authoritative guidance on business combinations is FAS-141, other pronouncements also address issues related to business combinations. For example:

- ◆ FAS-109 (Accounting for Income Taxes) requires that a liability or asset be recognized for the deferred tax consequences of differences between the assigned values and the tax bases of the assets and liabilities (other than non-deductible goodwill and leveraged leases) recognized in a purchase business combination.
- ◆ FAS-87 (Employers' Accounting for Pensions) requires that assets and liabilities recorded under the purchase method include a liability for the projected benefit obligation in excess of plan assets or an asset for plan assets in excess of the projected benefit obligation, thereby eliminating any previously existing unrecognized net gain or loss, unrecognized prior service cost, or unrecognized net obligation or net asset existing prior to the business combination.

Each of the above issues relating to business combinations is addressed in this chapter.



## **THE PURCHASE METHOD OF ACCOUNTING FOR BUSINESS COMBINATIONS**

### **Scope**

For the purposes of applying FAS-141, a business combination occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that (or those) other entity (or entities) (FAS-141, par 9). FAS-141 applies to combinations involving either incorporated or unincorporated entities. Business combinations may take a variety of forms, such as (FAS-141, par. 10):

- ◆ One or more entities are merged or become subsidiaries.
- ◆ One entity transfers net assets or its owners transfer their interests to another.
- ◆ All entities transfer net assets or the owners of those entities transfer their equity interests to a newly formed entity.

The acquisition of some or all of the non-controlling interests in a subsidiary is not a business combination, although that type of transaction is covered in FAS-141, par. 11). FAS-141 does not apply to combinations between not-for-profit organizations. Similarly, FAS-141 does not apply to the acquisition of a for profit organization by a not-for-profit organization (FAS-141, par. 12).

### **Method of Accounting**

All business combinations subject to the requirements of FAS-141 are to be accounted for by the purchase method (FAS-141, par. 13).

The purchase of some or all the non-controlling interests in a subsidiary is also required to be accounted for by the purchase method, whether acquired by the parent, the subsidiary itself, or another affiliate (FAS-141, par. 14).

### **Applying the Purchase Method**

#### *Determining the Acquiring Entity*

A first step in applying the purchase method is to determine the acquiring entity (FAS-141, par. 15). In a business combination effected through an exchange of equity interests, the entity that issues the equity interests is generally the acquiring entity. Typically the acquiring entity is the larger entity. Often, the combined entity uses the name of the acquiring entity. Circumstances differ, however, and all pertinent facts and circumstances should be considered in determining the acquiring entity (FAS-141, par. 17)

Following are several factors that are particularly important in determining the acquiring entity:

1. *The relative voting rights in the combined entity after the combination* – The acquiring entity is the entity whose owners retain or receive the larger portion of the voting rights (FAS-141, par. 17a).

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2. *The existence of a large minority voting interest when no other owner or organized group of owners has a significant voting interest* – The acquiring entity is typically the combining entity whose single owner or organized group of owners holds the largest minority voting interest in the combined entity (FAS-141, par. 17b).
3. *The composition of the governing body of the combined entity*- The acquiring entity is the combining entity whose owners or governing body has the ability to elect or appoint a voting majority of the governing body of the combined entity (FAS-141, par. 17c).
4. *The composition of the senior management of the combined entity*- The acquiring entity is the combining entity whose senior management dominates that of the combined entity (FAS-141, par. 17d).
5. *The terms of the exchange of equity securities* – The acquiring entity is the combining entity that pays a premium over market value of the equity securities of the other combining entity or entities (FAS-141, par. 17e).

### **Determining Cost**

Determining the cost of the acquisition is similar to determining the cost of assets acquired individually. Cash payment shall be used to measure the cost of an acquired entity. Similarly, the fair value of other assets distributed as consideration and the fair values of liabilities incurred are used to measure the cost of an acquired entity (FAS-141, par. 20).

The fair value of securities traded is generally more clearly evident than the fair value of an acquired entity and, thus, generally should be used to determine cost in a business combination. If the quoted market price is not the fair value of the equity securities, the consideration received shall be estimated even though measuring directly the fair value of net assets received is difficult. Both the net assets received, including goodwill, and the extent of the adjustment of the quoted market price of the shares issued shall be weighed in determining the amount to be recorded. Independent appraisals may be used to aid in determining fair values of securities. Indirectly and general expenses associated with a business combination should be expensed as incurred (FAS-141, par. 24).

A business combination may include contingent consideration. Cash and other assets distributed, securities issued unconditionally, and amounts of contingent consideration that are determinable at the date of acquisition shall be included in the cost of an acquired entity and recorded at that date. Contingent consideration shall be recorded when the contingency is resolved and consideration is issued or becomes issuable. In general, the issuance of additional securities or distribution of other consideration when contingencies are resolved result in an additional element of cost of an acquired entity (FAS-141, pars. 25-27).

### **Allocating Cost**

An acquiring entity shall allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition. Following are general

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guidelines for the recording of assets acquired and liabilities assumed, except goodwill (FAS-141, par. 37):

- ◆ Marketable securities- fair value
- ◆ Receivables-present value of amounts to be received.
- ◆ Inventories (finished goods and merchandise) – estimated selling prices less the costs of disposal and a reasonable profit allowance.
- ◆ Inventories (work-in-process)- estimated selling prices less the costs to complete, costs of disposal, and reasonable profit margin
- ◆ Inventories (raw materials)- current replacement cost.
- ◆ Plant and equipment (to be used) – current replacement cost
- ◆ Plant and equipment (to be sold) – fair value less cost to sell
- ◆ Intangible assets-estimated fair values
- ◆ Other assets (e.g., land, natural resources, nonmarketable securities)- appraised values.
- ◆ Accounts and notes payable, long-term debt, and other claims payable-present values of amounts to be paid determined at appropriate current interest rates.
- ◆ Liability for the projected benefit obligation in excess of plan assets (or vice versa)- amounts determined in accordance with FAS-87 (Employers' Accounting for Pensions).
- ◆ Liability for accumulated postretirement benefit obligation in excess of the fair value of plan assets (or vice versa)- amounts determined in accordance with FAS-106 (Employers' Accounting for Postretirement Benefits Other Than Pensions)
- ◆ Liabilities and accruals- present values of amounts to be paid determined at appropriate interest rates
- ◆ Other liabilities and commitments (e.g., unfavourable lease, contracts)-present value of amounts to be paid determined at appropriate current interest rates.

### *Intangible Assets*

An intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights. If this condition is not met, an intangible asset shall be recognized as an asset only if it is separable (i.e., is capable of being sold, transferred, licensed, rented, or exchanged). An assembled workforce cannot be recognized apart from goodwill (FAS-141, par. 39).

The fair value of a preacquisition contingency shall be included in the allocation of the purchase price under the following circumstances (FAS-141, par. 40):

- ◆ The fair value of the preacquisition contingency can be determined during the allocation period.

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- ◆ Information available prior to the end of the allocation period indicates that it is probable that an asset exists, a liability has been incurred, or an asset has been impaired at the consummation of the business combination, and the asset or liability can be reasonably estimated.

### *Goodwill*

Any excess of the cost of an acquired entity over the amounts assigned to assets acquired and liabilities assumed is recognized as goodwill. Goodwill so recorded is accounted for in accordance with FAS-142 (FAS-141, par. 43).

### *Excess of Fair Value over Cost*

The sum of the amounts assigned to assets acquired and liabilities assumed may exceed the cost of the acquired entity. The excess shall be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to the acquired assets except (a) financial assets other than investments accounted for by the equity method, (b) assets to be disposed of by sale, (c) deferred income taxes, (d) prepaid assets related to pension and other postretirement benefit plans, and (e) any other current assets. Any excess remaining after reducing to zero the amounts that otherwise would have been assigned to those assets is recognized as an extraordinary gain. That extraordinary gain generally is recognized in the period which the business combination is completed (FAS-141, pars. 44 and 45)

## **Financial Statement Disclosure**

### *General Information*

Notes to the financial statements shall include the following information in the period in which a business combination that has a material effect on the financial statements is completed (FAS-141, par. 51):

1. The name and brief description of the acquired entity and the percentage of voting stock acquired.
2. The primary reasons for the acquisition.
3. The period for which the results of operations of the acquired entity are included in the income statement of the combined entity.
4. The cost of the acquired entity, the number of shares of equity interest issued or issuable, the value assigned to the interests, and the basis for determining that value.
5. A condensed balance sheet including the amount assigned to each major asset and liability caption of the acquired entity at the acquisition date.
6. Contingency payments, options, or commitments specified in the acquisition agreement and the accounting treatment of each.

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7. The amount of purchased research and development assets acquired and written off in the period and the location of the write-off in the income statement.
8. For any purchase price allocation that is not final, that fact and the reasons therefore.

*Intangible Asset Information*

Notes to the financial statements shall include the following information regarding intangible assets and goodwill (FAS-141, par. 52):

- ◆ For intangible assets subject to amortization:
  - Amount assigned to any major intangible asset class
  - Amount of any significant residual value, in total and by major intangible asset class
  - Weighted-average amortization period, in total and by major intangible asset class.
- ◆ For intangible assets not subject to amortization, the total amount assigned and the amounts assigned to any major intangible asset class.
- ◆ For goodwill:
  - Total amount of goodwill and the amount that is expected to be deductible for tax purposes.
  - The amount of goodwill by reportable segment (assuming the entity is required to disclose segment information in accordance with FAS-131 (Disclosures about Segments of an Enterprise and Related Information)).

*Special Disclosures for Public Companies*

Notes to financial statements shall include the following supplemental information on a pro forma basis for the period in which a material business combinations occurs (FAS-141, par 54):

- ◆ Results of operations for the current period as though the combination had been completed at the beginning of the period.
- ◆ Results of operations for the comparable prior period as though the combination had been completed at the beginning of that period if comparative financial statements are presented.

These supplemental disclosures must include revenue, income before extraordinary items and the cumulative effect of accounting changes, net income, and earnings per share (FAS-141, par. 55).

In the period in which an extraordinary gain is recognized related to a business combination, the notes also shall disclose information consistent with paragraph 11 of APB-30 (Reporting the Results of Operations- Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions) (FAS – 141, Par. 56).

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### *Interim Financial Statements*

The summarized interim financial information of a public enterprise shall disclose the following information if a material business combination is completed during the current year (FAS-141, par. 58):

1. The general disclosures described above.
2. Supplemental pro forma information that discloses the results of operations for the current interim period and the current year to date of the most recent interim statement of financial position presented as though the business combination had been completed at the beginning of the period being reported on.
3. The nature and amount of any material, nonrecurring items included in the reported pro forma results of operations.

### **Types of Purchase Business Combinations**

A business combination may be accomplished in one of two ways. The acquiring company may purchase the assets (asset acquisition) of the target company. In this instance, normally the target company is liquidated and only one entity continues. Alternatively, the acquiring company may purchase more than 50% (upto 100%) of the outstanding voting common stock of the target company. In this instance, the financial statements of the two entities are consolidated in accordance with ARB-51 (Consolidated Financial Statements), as amended by FAS-94 (Consolidation of All Majority-owned Subsidiaries).

In an asset purchase, entrees are made to record the assets and assume the liabilities of the target company on the books of the acquiring company. If the purchase price exceeds the fair market value of the net assets, goodwill is recorded in the acquisition entry. If the fair market value of identifiable assets exceeds the purchase price, the resulting excess of fair value of acquired net assets over cost is a cated to reduce all of the acquired assets except (a) financial assets of than investments accounted for by the equity method, (b) assets to disposed of by sale, (c) deferred income taxes, (d) prepaid as related to pension and other postretirement benefit plans, and (e) other current assets (FAS-141, par. 44). If an excess of fair value acquired net assets over cost remains unallocated, the resulting amount is treated as an extraordinary gain (FAS-141, par. 45).

Goodwill is not necessarily the difference between cost and book value of an investment, unless the book value is equal to the fair value of the underlying assets. The underlying assets represented by an investment individually are assigned a fair value at the date of acquisition, and if the assigned fair values are less than the amount of the investment, the difference is goodwill. For consolidation purposes, the acquisition of a stock investment may be considered the purchase price paid for an interest in the underlying net assets of a business.

If any excess of cost over acquired book value is allocated to depreciable assets, the depreciation expense of subsequent periods must be increased to spread the amount of such excess over the remaining life of the assets.

### **Cost Determination**

The recorded cost of an acquisition is equal to the determinable amount of cash and other net assets that are unconditionally surrendered at the date of acquisition. Contingent consideration is recorded if it is determinable at the date of the acquisition. Other contingent consideration, the amount of which is not determinable at the acquisition date, is disclosed.

Contingent consideration may be on the basis of maintaining or achieving specific earning levels over future periods, or on a security maintaining or achieving a specific market price. When a contingent consideration based on earnings is achieved, the acquiring company records the current fair value of the additional consideration. At this juncture, it is more than likely that the increase in the cost of the acquisition will be in the form of goodwill.

When contingent consideration arises on the basis of maintaining or exceeding a specific market price for the securities issued to consummate the acquisition, the acquiring company will have to issue additional securities or transfer other assets in accordance with the contingency arrangements. The issuance of the additional contingency securities is based on their then-current fair value, but does not increase the overall cost of the acquisition because the recorded cost of the original securities issued is reduced by the same amount. The only item that changes is the total number of shares issued for the acquisition.

### **Illustration of Contingent Consideration**

MRK Company issues 1,000 shares of its common stock to a seller for an acquisition. The market price of the stock, at the date of the sale, is \$12 per share, and MRK guarantees that if, at the end of two years, the market price is less than \$12 per share, it will issue additional shares to make up any difference. Under the agreed-upon conditions, MRK deposits 500 shares of stock with an independent escrow agent. At the end of the two years, the market price of the stock is \$10 per share, and the escrow agent delivers 200 shares to the seller in accordance with the seller's instructions. The remainder of the shares is returned to MRK.

In accordance with FAS-141, MRK records the acquisition at \$12,000 (\$12 per share x 1,000). MRK records the issuance of the 200 additional shares at the current market price of \$10 per share for a total of \$2,000, and correspondingly reduces the original stock issued to \$10 per share, for a total of \$10,000. The total acquisition price remains \$12,000, and only the number of shares issued changes from 1,000 to 1,200.

When debt securities are issued in an acquisition and additional debt securities are issued subsequently as contingent consideration the reduction in value results in the recording of a discount on the debt securities. Discounts arising in this manner are amortized over the life of the securities, commencing from the date the additional securities are issued.

Contingent consideration that provides compensation for services or use of property are accounted for as expenses of the appropriate period upon resolution of the contingency.

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Interest or dividends paid or accrued on contingent securities during the contingency period are accounted for in the same manner as the underlying security. Therefore, interest expense or dividend distributions on contingent securities are not recorded until the contingency is resolved. In the event a contingency is resolved that results in the payment of an amount for interest or dividends, that amount is added to the cost of the acquisition at the date of distribution.

### **Allocating Cost**

Acquired assets are recorded at their fair market value. Any excess of the purchase price over the fair market value of identifiable assets acquired less liabilities assumed is recorded as goodwill.

Registration and issue costs of equity securities given in a business combination accounted for by the purchase method are deducted from the fair value of the securities. Any direct costs incurred are treated as consideration and are included as part of the total cost of the acquisition. Liabilities and commitments for expenses of closing a plant that is being acquired are direct costs of the acquisition and are recorded at the present values of amounts to be paid. However, the costs incurred in closing facilities already owned by the acquiring company that duplicate other facilities which are being acquired are not recognized as part of the cost of acquisition. Direct costs include only out-of-pocket costs incurred in effecting the business combination. These include finders' fees and fees paid to outside consultants for accounting and legal services, engineering evaluations, and appraisals. Internal costs incurred in a purchase business combination must be expensed as incurred.

### **Acquisition of Pension Plan Assets and Liabilities**

When a single-employer defined benefit pension plan is acquired as part of a business combination, an excess of the projected benefit obligation over the plan assets is recognized as a liability and an excess of plan assets over the projected benefit obligation is recognized as an asset. The recognition of a new liability or new asset by the purchaser, at the date of a business combination, results in the elimination of any (a) previously existing unrecognized net gain or loss, (b) unrecognized prior service cost, and (c) unrecognized net obligation or net asset that existed at the date of initial application of FAS-87 (FAS-87, par. 74).

In subsequent periods, the differences between the purchaser's net pension cost and contributions will reduce the new liability or new asset recognized at the date of combination to the extent that the previously unrecognized net gain or loss, unrecognized prior service cost, or unrecognized net obligation are considered in determining the amounts of contributions to the plan. In addition, the effects of an expected plan termination or curtailment are considered by the purchaser in calculating the amount of the projected benefit obligation at the date of a business combination (FAS-87, par. 74).

FAS-106 (Employers' Accounting for Postretirement Benefits Other Than Pensions) has a similar requirement relating to the purchase of assets and liabilities of a postretirement benefit plan other than pensions, and is discussed in the GAAP Guide Level A chapter titled "Postemployment and Postretirement Benefits Other Than Pensions."



### **Different Classes of Capital Stock**

In computing a parent's investment in a subsidiary, an important consideration is to isolate those elements of the subsidiary's stockholders' equity to which the parent company is actually entitled. For instance, if the subsidiary had a minority interest, it must be excluded in computing the parent's interest. Other items that must be considered are different classes of stock, dividends in arrears, and liquidating dividends. If another class of stock is participating, it must share in the retained earnings of the subsidiary to the extent of its participation. If another class of stock is cumulative as to dividends, and dividends are in arrears, the amount of dividends in arrears must be deducted from retained earnings before determining the parent's interest in the subsidiary's stockholders' equity.

The following are guidelines for preferred stock issues:

1. Nonparticipating and noncumulative preferred stocks require no apportionment of retained earnings.
2. Nonparticipating and cumulative preferred stocks require an apportionment only to the extent of any dividends in arrears.
3. Participating preferred stock requires an apportionment of retained earnings, under all circumstances. The apportionment is made based on the total dollar amount of the par or stated values of the securities involved.

### **Step-by-Step Acquisition**

A corporation may acquire a target company in more than one transaction. In this case, any goodwill or excess of fair value of acquired net assets over cost involved is computed at the time of each step-by-step transaction. When control is achieved, it is necessary to adjust any earlier step acquisition accounted for by the cost method to the equity method. The result of this treatment is that the parent's portion of the undistributed earnings of the subsidiary for the period prior to achieving control is added to the investment account of the parent.

### **Stock Exchanges – Companies under Common Control**

In an exchange of stock between two of its subsidiaries, one or both of which is partially owned, a parent company accounts for its minority interest at historical cost, if the minority shareholders are not a party to the exchange transaction. Under this circumstance, the minority interest remains outstanding and is not affected by the transaction. The acquisition of all or part of a minority interest between companies under common control, regardless of how acquired, is never considered a transfer or exchange by the companies under common control.

The term *business combination* does not apply to the transfer of net assets or the exchange of shares between companies under common control. Therefore, the acquisition of some or all of the stock held by minority shareholders of a subsidiary is not a business combination. The acquisition of some or all of the stock held by minority stockholders of a subsidiary, whether acquired by the

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parent, the subsidiary itself, or another affiliate, should be accounted for by the purchase method (fair value). Under this circumstance, the minority interest is affected by the transaction and the result is that a new minority interest is created in a different subsidiary.

### **11.15 ISSUES IN INVENTORY VALUATION AND REVENUE RECOGNITION**

#### **Basic Principles**

The term "inventory" is used to designate the aggregate of those items of tangible personal property, that (a) are held for sale in the ordinary course of business (finished goods), (b) are in process of production for such sale (Work in Process), or (c) are to be currently consumed either directly or indirectly in the production of goods and services to be available for sale (raw materials and supplies).

Inventories do not include long term assets which are subject to depreciation. Any depreciable assets retired from regular use and held for sale are not classified as inventory. Certain materials and supplies purchased for production may be used for the construction of long term assets. These items are not excluded from the inventory as they represent a small portion of the inventory.

Inventories are primarily valued at cost. A departure from cost basis of pricing is required when the utility of goods is no longer as great as its costs. If the utility of the goods is reduced by damage, deterioration, obsolescence, changes in price levels, or other causes, a loss should be recognized applying the rule of pricing inventories "at cost or market price whichever is lower".

The rule of "cost or market, whichever is lower" provide a means of measuring the residual usefulness of an inventory expenditure. In applying this rule, however, judgment should always be exercised and no loss shall be recognized unless the evidence indicates clearly that a loss has been sustained. In case evidence provides that cost of the inventory will be recovered in the normal course of business, no loss shall be recognized even if the replacement or reproduction cost is lower. This might be true for production under firm sale contract.

As used in the phrase "cost or market" the term "market" means current replacement cost (by purchase or by reproduction) except that-

- (a) Market shall not exceed net realizable value (estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal);
- (b) Market shall not be less than net realizable value reduced by an allowance for an approximate normal profit margin.

Say, cost of the inventory is Rs.10 million, replacement cost Rs.6 million selling price less cost of disposal Rs.8 lacs. Normal profit margin is 10% of net selling price. In this case market cannot be less than Rs.7.2 million.

In another case, cost of the inventory is Rs.10 million, replacement cost of Rs.9 million, selling price less cost of disposal Rs.8 lacs. In this case market cannot be more than Rs.8 million.

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This is a major conceptual difference in US GAAP inventory valuation.

The "lower of the cost or market" rule is applied separately for each item of inventory. But when raw materials or supplies are at less than cost, but when it enters into the finished goods it is possible to recover its costs. In such "lower of the cost or market" rule is not applied.

If substantial and unusual losses result from the application of this "lower of the cost or market" rule, such loss should not be included in cost of goods sold. Such loss should be separately charged to income statement.

### **Basic Principles of Revenue Recognition**

Profit is realized when a sale in the ordinary course of business is effected. Revenues shall be ordinarily recognized at the time transaction is completed with appropriate provision for uncollectible amounts [Para 12, APB 10].

*Application of Instalment Method of Accounting* – When collection of revenue is not reasonably assured, instalment method of revenue recognition is applied. As per this method revenue is recognized to the extent of cash collection. For example, Company A sold machinery by which the customers pay in instalment. Out of the sales during the year Rs.10 million, instalments collected is Rs.4 million and amount written off 0.5 million. The company earns gross profit of 20% on sales. So profit to be deferred is 20% of 3.5 million, i.e., 0.7 million.

*Revenue recognition when Right to Return Exists* – The product may be returned for refund of purchase price, for a credit applied to other purchases or in exchange for other products. Revenues from sale transactions that offer right to return are recognized if all of the following conditions are met:

- ◆ The seller's price to the buyer is substantially fixed at the date of sale;
- ◆ The buyer has paid the seller or the buyer is obligated to pay the seller, and obligation is not contingent on resale of the product;
- ◆ The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage to the product;
- ◆ The buyer acquiring the product has economic substance apart from that provided by the seller;
- ◆ The seller does not have significant obligation for future performance to directly bring about resale of the product by the buyer;
- ◆ The amount of the future return can be reasonably estimated.

If any portion of sales revenue is not recognized as any of the conditions are not met, such revenue should be recognized when the privilege to return expires.

*Recognition of Franchise Revenue* – A franchisee, a party who has been granted business rights to operate the franchise business, pays initial franchise fee and continuing franchise fee to the

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franchisor. Initial franchise fee is the consideration for establishing the franchise relationship and providing some initial services. Occasionally, the fee includes consideration for initially required equipment and inventory. Initial services include: (a) assistance in the site selection, (b) assistance in obtaining facilities including related financing and architectural and engineering services, (c) assistance in advertising, (d) training of the franchisee's personnel, (e) preparation and distribution of manuals, (f) book keeping and advertising services and (g) Inspection, testing and other quality control programmes.

Franchise fee is recognized as revenue when all the material services and conditions are satisfied by the franchisor. Substantial performance means the franchisor has no remaining obligation or intent, either by agreement or trade practice. Sometimes large initial franchise fees are agreed upon and continuing franchise fees are not sufficient to cover the cost of the continuing services, then a portion of the initial franchise fees should be deferred and amortized over the life of the franchise. The deferral should be based on cost of services and a reasonable profit.

Accounting for Product Financing Arrangements – In a product financing arrangement, the sponsor (the enterprise seeking the financing) sells the product to another entity and in related transaction it agrees to buy the product (or a substantial identical product). For example, in stock lending system, the seller gets back the same securities of different distinctive nos.

Company A sells 10000 units of goods to F @ Rs.10 per unit with agreement to repurchase it @Rs.11 per unit after 15 days. Should the company recognize Rs.1,00,000 as sales and Rs.1,10,000 as purchases?

The sponsor shall record sale. The amount received from F is recognized as a liability. The difference between the sale and purchase price is treated as financing cost and should be accounted for accordingly.

Other types of product financing arrangements are:

- ◆ Sponsor does not buy back the products. A third party buys back the product from which the sponsor buys back.

Important characteristics of product financing arrangement are-

- ◆ The product covered by the arrangement is stored in the sponsor's premises;
- ◆ The sponsor can use or sell the products;
- ◆ The debt of the entity that purchases the product is guaranteed by the sponsor.

The above-mentioned characteristics indicate that a sale transaction is in fact a financing arrangement.

*Accounting for separately Priced Extended Product Warranty and Product Maintenance –* Extended product warranty is an agreement to provide warranty protection in addition to the scope of coverage of the manufacturer's original warranty. A product maintenance contract is an agreement to perform certain agreed upon services to maintain a product for specified period of

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time. Such a contract is regarded as separately priced, if the customer has the option to purchase the services. For example, a machinery costs Rs.10 million without warranty and the Rs.11 million with warranty. In this case it is separately priced as the customer can choose with warranty or without warranty products.

Revenue from the separately priced warranty contract or maintenance contract is deferred and recognized as per straight line method over the period in which service is rendered. In case the historical data provide better evidence of the costs of services rendered under the contract, then revenue should be recognized in proportion to costs incurred in performing services under the contract.

### **11.16 FOREIGN CURRENCY TRANSLATION**

#### **Background**

This standard applies for (i) financial accounting and reporting for foreign currency transactions in financial statements of a reporting enterprise and for translating foreign currency financial statements that are incorporated in the financial statements of the reporting enterprise by consolidation, combination or other equity method of accounting.

Important terms that will help understanding FAS 52:

|                               |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|-------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Foreign Entity                | An operation (e.g., division, subsidiary, branch, joint venture) whose financial statements are prepared in a currency other than the reporting currency of the reporting entity.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| Foreign Currency Transactions | Transactions in which the terms are denominated in a currency other than the entity's functional currency. Foreign currency transactions occur when a company:<br>(1) purchases (imports) or sells (exports) on credit merchandise or services the prices being denominated in a foreign currency;<br>(2) buys or sells assets or incurs or settles liabilities denominated in foreign currency;<br>(3) takes out or gives international loans in which the amounts payable or receivable are denominated in a foreign currency;<br>(4) is a participant in an unperformed forward exchange contract; and<br>(5) borrows or lends money, and the amounts payable or receivable are expressed in a foreign currency. |
| Foreign Currency Translation  | Conversion in a company's reporting currency those amounts denominated or measured in a different currency.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| Foreign Currency Statements   | Financial statements using as the measuring unit a functional currency other than the reporting currency of the business.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| Foreign Currency              | A currency other than the functional currency of a business. For example,                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |

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|                                 |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|---------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                 | the dollar could be a foreign currency for a foreign entity. Composite of currencies (e.g., special drawing rights) may be used to establish prices or denominate amounts of loans.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| Reporting Currency              | The currency the business prepares its financial statements in typically U.S. dollars.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| Local Currency                  | The currency of a particular foreign country.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| Transaction gain or loss        | <p>Transaction gain or loss is produced from redeeming receivables/payables that are fixed in terms of amounts of foreign currency received/paid.</p> <p>An example is a French subsidiary having a receivable denominated in francs from a Swiss customer. A transaction gain or loss takes place when there is a change in exchange rates between the functional currency and the currency in which a foreign currency transaction is denominated. It constitutes an increase or decrease in (1) the actual functional currency cash flows realized upon settlement of foreign currency transactions and (2) the expected functional currency cash flows on unsettled foreign currency transactions.</p> <p>Adjustments derived from translating financial statements from the entity's functional currency into the reporting one.</p> |
| Monetary assets and liabilities | Cash, receivables, and obligations to pay a fixed amount of debt.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| Non-monetary Items              | Items all balance sheet items except for cash, claims to cash, and cash obligations.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
| Currency swap                   | The exchange between two business entities of the currencies of two different countries in accordance with a contract to reexchange the two currencies at the same exchange rate at an agreed upon future date.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| Forward exchange contract       | It is an agreement to exchange different currencies at a specified future date and at a specified rate.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |

### Functional Currency

An entity's functional currency is the currency of the primary economic environment in which the entity operates. This is the currency of the environment in which the entity primarily generates and expends cash.

The assets, liabilities, and operations of a foreign entity shall be measured using functional currency [Para 5, FAS 52].

Annex A to FAS 52 provides guidance for the determination of functional currency of a foreign entity.

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| <i>Salient Factors</i>     | <i>Economic</i> | <i>Para Reference to FAS 52</i> | <i>Use of Foreign currency</i>                                                                                                                                                                       | <i>Use of Parent's currency</i>                                                                                                                                                                             |
|----------------------------|-----------------|---------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Cash Flow Indicators       |                 | 42a                             | Cash flows related to the foreign entity's individual assets and liabilities are primarily in foreign currency and do not directly impact the parent company's cash flows.                           | Cash flows related to the foreign entity's individual assets and liabilities directly impact the parent company's cash flows on a current basis and readily available for remittance to the parent company. |
| Sales Price Indicators     |                 | 42b                             | Sales price for the foreign entity's products are not primarily responsive on short-term basis to changes in exchange rates but determined more by local competition or local government regulations | Sales price for the foreign entity's products are primarily responsive on short-term basis to changes in exchange rates and determined more by worldwide competition or by international; prices.           |
| Sales Market Indicators    |                 | 42c                             | Existence of significant local market even though exports are significant as well.                                                                                                                   | Sales market is mostly parent's currency.                                                                                                                                                                   |
| Expense indicators         |                 | 42d.                            | Expenses are primarily costs even though there are imports.                                                                                                                                          | Costs are primarily obtained from the market wherein the parent company is located.                                                                                                                         |
| Financing Indicators       |                 | 42e                             | Local financing or financing are primarily denominated in local currency.                                                                                                                            | Financing is primarily in the parent's currency.                                                                                                                                                            |
| Inter-company transactions |                 | 421                             | Low volume of inter-company transactions.<br>There is no extensive interrelationship between the operations of the foreign entity and the parent company.                                            | High volume of inter-company transactions.<br>There is extensive interrelationship between the operations of the foreign entity and the parent company.                                                     |

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General guidance:

- ◆ An entity with operations that are relatively self-contained and integrated within a particular country, the functional currency generally would be the currency of that country.
- ◆ An entity operating in different economic environment – Here it is not possible to identify single functional currency. It is left to the Management's judgment to decide the functional currency in which financial results and relationship are measured with greatest degree of relevance and reliability.
- ◆ Once the functional currency is determined, that should be followed consistently. In case the functional currency is changed for significant change in the economic environment in which the foreign entity operates, previously issued financial statements should be restarted.
- ◆ In case the foreign entity's books of record are not maintained in its functional currency, remeasurement is required before the translation into reporting currency.

So when a foreign entity is not maintaining records in functional currency as per FAS guidance, it is necessary to remeasure transactions and events using functional currency and then to translate into reporting currency applying translation principles set out in Paras 15 and 16, FAS 52.

If a foreign entity's functional currency is the reporting currency, but it records transactions and events in currency other than its functional currency, in that case remeasurement will lead to translation. For example, a parent maintains its financial statements in U.S. dollars and owns a foreign subsidiary whose functional currency is British pounds. If some or all of the foreign subsidiary's records are kept in Italian Lira, its financial statements must be remeasured into British pounds before translation into U.S. dollars.

If the functional currency of the foreign entity is the currency of a highly inflationary economy, then remeasurement is necessary into reporting currency assuming that such is the functional currency. A highly inflationary environment is one with a cumulative inflation rate of 100% or more over a three-year period. In other words, the inflation rate must be increasing at a rate of about 33% per year for three consecutive years.

### Translation of Foreign Currency Statements

Paras 12-14, FAS 52 explains principles of translation of foreign currency statements. Functional currency principles demand adoption of the following steps prior to translating the foreign country's financial statements into U.S. reporting requirements:

- ◆ Conform the foreign currency financial statements into U.S. generally accepted accounting principles. The foreign currency financial statements must be in conformity with U.S. GAAP before they are translated to the functional or reporting currency.
- ◆ Ascertain the functional currency of the foreign entity.



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- ◆ Remeasure the financial statements in the functional currency, if required. Gain or loss from remeasurement is included in the remeasured net income

Thereafter apply the following translation principles:

1. *Translation of balance sheet items* – In the usual case, when the foreign currency is the functional currency, assets and liabilities are translated at the currency exchange rate at the balance sheet date of the foreign entity.

Capital accounts are translated using the historical exchange rate of the date(s) when the foreign entity's stock was issued.

Reacquired retained earnings are translated at the translated amount at year-end of the previous year, plus the translated amount of net income for the currency year, less the translated amount of dividends during the current year. If the current exchange rate is unavailable at the balance sheet date, the first available exchange rate after that date should be used.

2. *Translation of items of the Income Statement* – Revenue, expenses, gains, and losses are translated at the exchange rate at the dates those items are recognized. In case translation at the exchange rates at the dates of many revenues, expenses, gains, and losses is impractical, a weighted-average exchange rate for the year can be used in translating income statement items. However, average quarterly or monthly rates may be used if significant revenues and expenses occur at particular times during the year.

3. *Translation of items of Statement of Cash Flows* – Items of cash flows are translated based on the exchange rates in existence at the time of the cash flows. However, a weighted-average rate for the year may be used if that is reasonable and the result is similar. Disclosure should be made in the statement of cash flows for the impact of any exchange rate changes on cash flow.

4. *Treatment of gain or loss on translation adjustments*: When the foreign entity's functional currency is different from the parent's reporting currency (i.e. a foreign currency), there will arise translation adjustments from translating the company's financial statements into the reporting currency. But translation adjustments are unrealized gain or loss. They are reported separately as a component of stockholders' equity.

Translation adjustments are not included in net income unless and until there is a sale or liquidation of the investment in the foreign entity.

If remeasurement from the recording currency to the functional currency is needed before translation, the gain or loss is included in the income statement.

**Example:** Company A's wholly owned subsidiary; B Company, keeps its records in US\$. Since B Company's branch offices are located in Switzerland; its functional currency is the Swiss Franc. Remeasurement of B Company's 2002 financial statements into Swiss Franc resulted in Rs.1 million loss. A should report as a foreign exchange gain Rs.1 million in its income statement for the

## 2.206 Financial Reporting

year ended December 31, 2002. The translation loss of Rs.2 million should be included in the cumulative translation adjustment, which is a separate component of stockholders' equity.

Unlike International Accounting Standard 21, in US GAAP there is no distinction between "foreign operations that are integral to the operations of reporting entity" and foreign entity.

### Accounting for Foreign Currency Transactions

These principles are applicable to both the parent company and foreign entity:

- ◆ Treatment of receivables and payables denominated in currency other than functional currency – Foreign currency transactions produce receivables or payables that are fixed in terms of amount of foreign currency that will be received or paid. A change in exchange rates between functional currency and currency in which the transactions are denominated increases or decreases the settlement cash flows.
  - Increase in settlement cash flows of debtors or decrease in settlement cash flows of creditors, gives rise to transaction gain;
  - Increase in settlement cash flows of creditors or decrease in settlement cash flows of debtors, gives rise to transaction loss;

A transaction gain or loss is included in the determination of net income for the period.

- ◆ Likewise, a transaction gain or loss may arise between the date of transaction and date of settlement of cash flows that occur before the balance sheet date. This is realized gain or loss.

Other type of realized gain or loss is on the assets and liabilities denominated in currency other than functional currency outstanding on the previous balance sheet date which is settled during the currency period.

This realized gain or loss is accounted for in the net income for the period.

- ◆ General principles to be followed in recognizing transactions that occur in currency other than functional currency:
  - Record all assets, liabilities, revenues, expenses,. Gain or loss arising from the transaction is measured and recorded in the functional currency of the entity using exchange rate in effect on the date of transaction.
  - At each balance sheet, recorded balances of assets and liabilities denominated in currency other than functional currency are restated to reflect exchange rate of the balance sheet date.

### Transactions Gains or Losses to be excluded from the determination of Net Income

Gains or losses on the following foreign currency transactions are not included in the net income for the period but should be reported in the same manner as translation adjustments stated in

## **International Accounting Standards, International Financial Reporting Standards, 2.207 their interpretations and US GAAPs- An Overview**

Para 13, FAS 52 arising out of translation from functional currency of foreign entity to the reporting currency, i.e., accounting in a separate section of equity):

- ◆ Foreign currency transactions that are designated as effective hedge of a net investment in a foreign entity. [Para 20, FAS 52].
- ◆ Inter-company foreign currency transactions that are of a long-term investment nature, when the entities to the transactions are consolidated, combined or accounted for by the equity method in the reporting enterprise's financial statements. [Para 20, FAS 52].
- ◆ Gain or loss on a forward contract or other foreign currency transactions that is intended to hedge an identifiable foreign currency commitment is deferred and included in the measurement of the related foreign currency transaction. However, loss is not deferred if such deferral leads to recognizing loss in a later period (s). A foreign currency transaction is considered a hedge of an identifiable foreign currency commitment on fulfillment of the following conditions:
  - (a) the foreign currency transaction is designated and is effective as a hedge of a foreign currency commitment;
  - (b) the foreign currency commitment is firm.

Deferral is applicable to the hedge portion only on an after-tax basis. A gain or loss so deferred shall be included as an offset to the related tax effects in the periods in which such tax effects are recognized. Gain or loss that arises from the portion of the transaction that is in excess of the amount required for hedge should be deferred.

Further, any gains or losses on a forward exchange contract applicable to a period subsequent to the transaction date of the related commitment cannot be deferred.

Deferred gain or loss on hedging a foreign currency commitment that is sold or terminated is not recorded until the associated identifiable transaction occurs, except if the transaction are likely to result in a loss.

A forward exchange contract may be entered into a hedge an identifiable foreign currency commitment. A gain or loss on a forward exchange contract that is intended to hedge a foreign currency commitment (such as an agreement to purchase or sell equipment) shall be deferred and included in the measurement of the related foreign currency transaction (i.e., the purchase or sale).

A forward exchange contract may be entered into a hedge exposure from a recognized receivable or payable denominated in a foreign currency. A gain or loss is recognized for changes in the spot rate of the applicable currency; however, this gain or loss is offset by the transaction loss or gain recognized from the associated receivable or payable.

### **Forward exchange contracts**

A company may enter into forward exchange contract to hedge a position or for speculation. Gains or losses on forward exchange contracts that are not for hedging are included in the determination

## 2.208 Financial Reporting

of net income. Agreements that are essentially same as forward contracts are currency swaps. Accordingly, gains and losses of currency swap transactions are recorded in the same manner.

*How to determine gain or loss on forward contract (other than speculative contracts)?*

1. Find out the spot rate at the balance sheet date.
2. Find out the forward rate at the inception of the contract.
3. Find out the spot rate at the date of inception of the forward contract.
4. Find out the amount of the contract.
5. Gain or loss on forward contract = (4) \* [(1) – (3)].
6. Discount or premium on forward contract = (4) \* [(2) – (3)].

Example: An Indian Company entered into a forward contract for US \$-10 million on 1-10-2002. On the date of inception forward rate is Rs.49.2, spot rate is Rs.48.8 and on the balance sheet date spot rate is Rs.48.9.

Gain on forward contract: \$10 million \* [Rs.48.9 – Rs.48.8] = Rs.1 million

Forward Premium = \$10 million \* [Rs.49.2 – Rs.48.8] = Rs.4 million. (Loss)

- ◆ What is the treatment of forward premium? Charge to the Income Statement.
- ◆ What is the treatment of gain or loss if it is not part of a hedge? Charge to Income Statement.
- ◆ What is the treatment of gain or loss if it is part of a hedge? Defer and adjust with the loss or gain of related hedge asset or liability.

### Disclosures

Footnote disclosure is required of:

- ◆ Profits earned from overseas. This also includes the amount of foreign earnings in excess of amounts received in the United States.
- ◆ Foreign currency transaction gains or losses, including that associated with forward exchange contracts.
- ◆ The impact on unsettled balances regarding foreign currency transactions.
- ◆ Cumulative transaction adjustments reported in stockholders' equity. This includes the reasons for the change in the balance from the beginning to the end of the year.
- ◆ Gains or losses arising from hedging a foreign currency position.
- ◆ Effect of exchange rate changes on operating results and financial position.

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This disclosure includes the impact of a change in exchange rates from the prior year to the currency year associated with translation of revenues and expenses. It also includes the effect of a change in exchange rate on revenue and cost components, such as sales volume, sales price, and cost of sales. The nature of restated figures should be noted.

- A significant change in exchange rate taking place after year-end and before the audit report date. This is a subsequent event disclosure.

### 12. SIGNIFICANT DIFFERENCES AND SIMILARITIES BETWEEN INDIAN ACCOUNTING STANDARDS, IAS / IFRS AND US GAAPs

This table focuses on measurement similarities and differences most commonly found in practice. This summary, not necessarily justify the differences of details that exist among Indian Accounting Standards, IAS / IFRS and US GAAPs. Even if the summary given is similar, there can be differences in the detailed application, which could have a material impact on the financial statements. One should study this table with references to all relevant Accounting Standards, IAS / IFRS or US GAAPs where applicable in that country.

| Topic                                        | Indian Accounting Standards                                                                                                                                                                                                                                                                                              | IFRS / IAS                                                                                                                                                                                                                                                                                  | US GAAPs                                                                                                                          |
|----------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------|
| Historical cost                              | Historical cost is used for valuing the assets. It is one of the accounting concept. However, property, plant and equipment may be revalued to fair value.<br><br>Certain derivatives are carried at fair value but no accounting standards on derivatives and biological assets have been issued by the ICAI till date. | For valuation purpose, in general, historical cost is used but some intangible assets; property plant and equipment and also investments may be revalued to fair value.<br><br>IFRS / IAS also requires revaluation of Derivatives, biological assets and certain securities at fair value. | US GAAPs do not recommend revaluation of assets except for certain types of securities and derivatives to fair value.             |
| First-time adoption of accounting frameworks | In India, there is no specific guidance on first time adoption of Accounting                                                                                                                                                                                                                                             | There is a specific statement by IASB to apply IFRS for the first time.<br><br>First time adoption                                                                                                                                                                                          | First-time adoption of US GAAP requires retrospective application. However, US GAAP does not give specific guidance on first time |

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|                                      |                                                                                                                                         |                                                                                                                                                                                                                                                                                                 |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
|--------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                      | frameworks.                                                                                                                             | of IFRS requires full retrospective application of IFRS effective at the reporting date for IFRS based financial statements of an entity.<br>It has provided certain reliefs, exemptions and imposes certain requirements and disclosures.                                                      | adoption of its accounting principles.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| Constituents of financial statements | Required a company's standalone- two years' balance sheets, income statements, cash flow statements, and accounting policies and notes. | Two years' consolidated balance sheets, income statements, cash flow statements, changes in equity and accounting policies and notes.<br>In some circumstances or on a voluntary basis, an entity may present standalone financial statements along with its consolidated financial statements. | For US Companies and SEC registrants (public companies) two years' balance sheet and three years income statements, cash flow statements, changes in equity statement and accounting policies and notes. However, in certain circumstances for foreign private issuers there is a relief from the three-year requirement.<br>Non-US companies with registered securities in US have an option to prepare their financial statements, either based on US GAAPs or on IFRS along with the reconciliation of net income and equity to US GAAPs, as a disclosure in the notes. |
| Balance sheet                        | Accounting standards do not prescribe a particular format of balance sheet. It accepts the format                                       | IFRS too do not prescribe any particular format of balance sheet. As per requirements of IFRS, certain items                                                                                                                                                                                    | Entities may present either a classified or non-classified balance sheet. Decreasing order of liquidity is used for the presentation of the items on the face of the balance                                                                                                                                                                                                                                                                                                                                                                                               |

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|                  |                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                |
|------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                  | <p>prescribed by the Companies Act or by other industry regulations like banking, insurance, as applicable. However, accounting Standard states certain items, which must be presented on the face of the balance sheet.</p>                                            | <p>must be presented on the face of the balance sheet.</p> <p>There is a requirement of separate presentation of total assets and total liabilities. A liquidity presentation of assets and liabilities is used, instead of a current/non-current presentation, only when a liquidity presentation provides more relevant and reliable information.</p> | <p>sheet.</p> <p>Public companies should follow SEC regulations.</p>                                                                                                                                                           |
| Income statement | <p>Accounting standards do not prescribe a particular format of income statement. Industry-specific formats are prescribed by industry regulations. However, accounting Standard states certain items, which must be presented on the face of the income statement.</p> | <p>IFRS too do not prescribe any particular format of income statement. An entity selects the presentation of its expenses either by function or nature. Expenses by nature are disclosed as a footnote if an entity selects functional presentation. However, IFRS requires certain items to be presented on the face of the income statement.</p>     | <p>US GAAP requires income statement to be presented in either of two formats - single-step or multiple-step format.</p> <p>Expenditures are presented by function.</p> <p>Public companies should follow SEC regulations.</p> |

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|-------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Extraordinary items                                   | Events or transactions, clearly distinct from the ordinary activities of the entity, which are not expected to recur frequently and regularly, are termed as extraordinary items. Disclosure of the nature and amount of such item is required in the income statement to perceive the impact on current and future profits. | Not allowed.                                                                                                                                                                                                                                                                                                               | Defined as being both infrequent and unusual, and are rare. Negative goodwill is presented as an extraordinary item on the face of the income statement net of taxes. Disclosure of such is required either in the income statement or in the notes. |
| Statement of changes in share (stock) holders' equity | No separate statement is prepared for it. A separate schedules of 'Share capital' and 'Reserves and surplus' is prepared to show the changes in shareholders' equity.                                                                                                                                                        | It is a primary statement required to be prepared as a part of financial statements unless Statement of recognized income and expenses (SoRIE) is prepared as a primary statement. Statement shows capital transactions with owners, accumulated profits' movement and a reconciliation of all other components of equity. | SEC rules allow certain information to be included in the notes and not in the primary statement.                                                                                                                                                    |
| Cash flow statements –                                | Both indirect and direct method are used in the preparation of cash flow statement..                                                                                                                                                                                                                                         | Similar to Indian Accounting Standard. But cash includes                                                                                                                                                                                                                                                                   | Similar to IFRS, but more specific guidance for items included in each category. Both direct and indirect                                                                                                                                            |



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|                                |                                                                                                                                                                                                                                                     |                                                                                                                                                                                                                                               |                                                                                                                                                                                                 |
|--------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                | <p>Cash flows are divided into three broad categories namely- operating, investing and financing.</p> <p>Cash includes cash equivalents with short-term maturities (typically less than three months) except that bank overdrafts are excluded.</p> | <p>cash equivalents like investments with short-term maturities (typically less than three months) and may include bank overdrafts repayable on demand but do not include short term borrowings as they are considered as financing item.</p> | <p>method is used. However, a reconciliation of net income to cash flows from operating activities is disclosed if the direct method is used.</p> <p>Similar to Indian Accounting Standard.</p> |
| Changes in accounting policy   | <p>In the year of change, the effect of change is included in income statement of that year and also the impact of change is disclosed.</p>                                                                                                         | <p>Retrospective effect of the change in accounting policy is accounted. Also comparative figures are restated; where the effect of period(s) not presented is adjusted against opening retained earnings.</p>                                | <p>Similar to IFRS from the date of adoption of FAS 154.</p>                                                                                                                                    |
| Change in accounting estimates | <p>Change is accounted in the income statement of the current year when identified. In general no retrospective effect is accounted for such change</p>                                                                                             | <p>Similar to Indian Accounting Standard</p>                                                                                                                                                                                                  | <p>Similar to Indian Accounting Standard</p>                                                                                                                                                    |
| Definition of subsidiary       | <p>Based on voting control or control over the composition of the board of directors. The existence of</p>                                                                                                                                          | <p>Control is presumed to exist when parent owns, directly or indirectly through subsidiaries, more than one half of an</p>                                                                                                                   | <p>Similar to IFRS. However, a bipolar consolidation model is used, which distinguishes between a variable interest model and a voting interest model.</p>                                      |

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|                                   |                                                                                                                                                        |                                                                                                                                                                                                                                                            |                                                                                                                                                                  |
|-----------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                   | currently exercisable potential voting rights is not taken into consideration.                                                                         | entity's voting power.<br>The existence of currently exercisable potential voting rights is also taken into considerations.<br>A parent could have control over an entity in circumstances where it holds less than 50% of the voting rights of an entity. | Control can be direct or indirect and may exist with a lesser percentage of ownership (voting interest model).                                                   |
| Definition of associate           | Based on significant influence; presumed if 20% or greater interest or participation in entity's affairs.                                              | Similar to Indian accounting Standard                                                                                                                                                                                                                      | Similar to IFRS, although the term 'equity investment' is used instead of 'associate'.                                                                           |
| Presentation of associate results | In consolidated financial statements; equity method is used. Share of post-tax results is shown.<br>In standalone financials; at cost less impairment. | In consolidated financial statements; equity method is used. Share of post-tax results is shown.<br>In standalone financial; at cost or at fair value in accordance with IAS 39.                                                                           | In consolidated financial statements; similar to IFRS.                                                                                                           |
| Definition of joint venture       | Contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.<br>Exclusion if it meets        | Contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.<br>Exclusion if                                                                                                                     | A corporation owned and operated by small group of businesses as a separate and specific business or project for the mutual benefit of the members of the group. |

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|                                                              |                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|--------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                              | the definition of a subsidiary                                                                                                                                                                                                                                       | investment is held-for-sale.                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| Presentation of jointly controlled entities (joint ventures) | In consolidated financial statements, proportional consolidation is used.<br><br>In standalone financials; at cost less impairment.                                                                                                                                  | In consolidated financial statements, both proportional consolidation and equity method is permitted.<br><br>In standalone financials; at cost or at fair value in accordance with IAS 39.                                                                                                                        | In consolidated financial statements; equity method is required except in specific circumstances.<br><br>In standalone financials; at cost or equity method is used.                                                                                                                                                                                                                                                                      |
| Business combinations                                        | No particular Standard has been issued by ICAI till date. However all business acquisitions are business combinations except pooling of interest method for certain amalgamations                                                                                    | All business acquisitions are Combinations as per IFRS 3                                                                                                                                                                                                                                                          | All business acquisitions are Combinations.                                                                                                                                                                                                                                                                                                                                                                                               |
| Purchase method-values on acquisition                        | For an entity acquired and held as a subsidiary, the assets acquired and liabilities assumed are incorporated in their existing carrying amounts for consolidation purposes.<br><br>On amalgamation, they may be incorporated at their existing carrying amounts or, | Assets, liabilities and contingent liabilities of acquired entity are fair valued. If control is obtained in a partial acquisition of a subsidiary, the full fair value of assets, liabilities and contingent liabilities, including portion attributable to the minority (non-controlling) interest, is recorded | Similar to IFRS, except minority interest is stated at pre-acquisition carrying value of net assets, and contingent liabilities of the acquiree are not recognised at the date of acquisition. Specific rules exist for acquired in-process research and development (generally expensed) and contingent liabilities.<br><br>Some restructuring liabilities relating solely to the acquired entity may be recognized if specific criteria |

## 2.216 Financial Reporting

|                                                                              |                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                       |                                                                                                         |
|------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------|
|                                                                              | <p>alternatively, the consideration is allocated to individual identifiable assets and liabilities at their fair values. On business acquisition, they may be incorporated at their fair values or value of surrendered assets.</p> <p>No separate restructuring provision is recognized on acquisition.</p> | <p>on consolidated balance sheet. Goodwill is recognised as the residual between the consideration paid and the percentage of the business acquired. Liabilities for restructuring activities are recognized only when acquiree has an existing liability at acquisition date. Liabilities for future losses or other costs expected to be incurred as a result of the business combination cannot be recognized.</p> | about restructuring plans are met.                                                                      |
| Minority interests at acquisition                                            | Stated at minority's share of pre-acquisition carrying value of net assets.                                                                                                                                                                                                                                  | Stated at minority's share of the fair value of acquired identifiable assets, liabilities and contingent liabilities.                                                                                                                                                                                                                                                                                                 | Similar of Indian Accounting Standard                                                                   |
| Purchase method- goodwill and intangible assets with indefinite useful lives | Goodwill on consolidation and business acquisitions; no specific guidance-practice varies, between no amortization versus amortization over a period not exceeding 10                                                                                                                                        | Capitalised but not amortised. Goodwill and indefinite-lived intangible assets are reviewed for impairment at least annually at either the cash-generating unit (CGU) level or groups of CGUs, as                                                                                                                                                                                                                     | Similar to IFRS, although the level of impairment testing and the impairment test itself are different. |

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|                                 |                                                                                                                                                                                                                                                                                                                                                                                                  |                                                                                                                                                                                                                     |                                                                                                                                                                                                                                            |
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|                                 | <p>years;<br/>Goodwill on amalgamation is amortised over a period not exceeding 5 years, unless a longer period is justified;<br/>Goodwill is reviewed for impairment whenever an indication of impairment exists at the CGU level.<br/>Intangible assets are not classified into indefinite useful lives category. All intangible assets are amortised over a period not exceeding 10 years</p> | applicable.                                                                                                                                                                                                         |                                                                                                                                                                                                                                            |
| Purchase method-Capital Reserve | <p>Negative goodwill is recorded in equity as capital reserve, which is not amortised to income.<br/>However, in case of an amalgamation, the fair value of intangible assets with no active market is reduced to the extent of capital reserve, if any, arising on the amalgamation.</p>                                                                                                        | The identification and measurement of acquiree's identifiable assets, liabilities and contingent liabilities are reassessed. Any excess remaining after reassessment is recognised in Income statement immediately. | Any remaining excess after reassessment is used to reduce proportionately the fair values assigned to non-current assets (with certain exceptions). Any excess is recognized in the income statement immediately as an extraordinary gain. |
| Pooling of interests method     | Required for certain amalgamations when all the                                                                                                                                                                                                                                                                                                                                                  | Prohibited.                                                                                                                                                                                                         | Same as IFRS.                                                                                                                                                                                                                              |

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|                             |                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                               |
|-----------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                             | specified conditions are met.                                                                                                                                                                  |                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                               |
| Revenue recognition         | <p>Indian Accounting Standard on revenue recognition does not give any guidance on revenue measurement.</p> <p>Revenue from services is recognized only on the completion of the services.</p> | <p>IFRS states that based on several criteria, which require the recognition of revenue when risks and rewards have been transferred and the revenue can be measured reliably.</p> <p>Revenue from services is recognized in proportion to the state of completion of the transaction at the balance sheet date.</p> | <p>Detailed guidance exists for specific types of transactions for the purpose of revenue recognition. US GAAP laid emphasis on persuasive evidence that an arrangement exists, and delivery has occurred or services have been rendered.</p> |
| Construction contracts      | <p>Percentage of completion method is recommended if the outcome can be reliably measured. Expected loss to be recognized as an expense immediately.</p>                                       | <p>Accounted for using percentage-of-completion method. Complete contract method is not allowed.</p>                                                                                                                                                                                                                 | <p>Similar to IFRS. However, completed contract method is permitted in rare circumstances when the extent of progress of completion cannot be measured reliably.</p>                                                                          |
| Employee share compensation | <p>Guidance note issued by ICAI requires measurement of cost of benefits arising from employee share compensation plans on fair value. Alternatively, the guidance note allows use of the</p>  | <p>Expense for services purchased is recognized. Corresponding amount recorded either as a liability or an increase in equity, depending on whether transaction is determined to be cash or equity-settled. Amount to</p>                                                                                            | <p>With the adoption of FAS 123R, similar model to IFRS. Compensation expense is generally recognized based on fair value of awards at grant date.</p>                                                                                        |

**International Accounting Standards, International Financial Reporting Standards, 2.219  
their interpretations and US GAAPs- An Overview**

|                                        |                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                        |                                                                                                                       |
|----------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------|
|                                        | intrinsic value method.                                                                                                                                                                                                     | be recorded is measured at fair value of shares or share options granted.                                                                                                                                                                                              |                                                                                                                       |
| Acquired intangible assets             | If recognition criterias are satisfied then it can be capitalized. all intangibles are amortised over useful life with a rebuttable presumption of not exceeding 10 years. Revaluations are not permitted.                  | If recognition criterias are satisfied then it can be capitalized. It is amortised over useful life. Intangibles assigned an indefinite useful life are not amortised but reviewed at least annually for impairment. Revaluations are permitted in rare circumstances. | Similar to IFRS, except revaluations are not permitted.                                                               |
| Internally generated intangible assets | Research costs are expensed as incurred. Development cost is capitalized and amortised only when specific criteria are met.                                                                                                 | Similar to Indian Accoutning Standard.                                                                                                                                                                                                                                 | Research and development costs are expensed as incurred. Some software and website development costs are capitalized. |
| Property, plant and equipment          | Historical cost is used. Revaluations are permitted, however, frequency of revaluation has not mentioned. On revaluation, an entire class of assets is revalued, or assets to be revalued are selected on systematic basis. | Historical cost or revalued amounts are used. On opting revaluation option, regular valuations of entire classes of assets are required.                                                                                                                               | Historical cost is used; revaluations are not permitted.                                                              |

## 2.220 Financial Reporting

|                                              |                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                        |                                                                                                                                                                                                                               |
|----------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Non-current assets held for sale or disposal | There is no requirement to classify and present an asset as held for sale on the face of the balance sheet or in the notes.                                                                                                                                                                                                                                                                             | Non-current asset is classified as held for sale if its carrying amount will be recovered through a sale transaction rather than through continuing use. A non-current asset classified as held for sale is measured at the lower of its carrying amount and fair value less costs to sell. Comparative balance sheet is not restated. | Similar to IFRS.                                                                                                                                                                                                              |
| Impairment of assets                         | Assets are impaired at higher of fair value less costs to sell and value in use based on discounted cash flows.<br>Impairment test is to be conducted every year and if there is upward increase in the value of asset than reversal of impairment losses is required in certain circumstances.<br>Assets are not separately classified or disclosed as held for sale on the face of the balance sheet. | Similar to Indian Accounting Standard.<br>However, assets are classified and disclosed separately on the face of the balance sheet as held for sale or disposal.                                                                                                                                                                       | Impairment is assessed on undiscounted cash flows for assets to be held and used. If less than carrying amount, impairment loss is measured using market value or discounted cash flows.<br>Reversal of losses is prohibited. |



**International Accounting Standards, International Financial Reporting Standards, 2.221  
their interpretations and US GAAPs- An Overview**

|                                   |                                                                                                                                                   |                                                                                                                                                                                                                                                                            |                                                                                                                                                        |
|-----------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------|
| Capitalisation of borrowing costs | There is no choice rather to capitalize the borrowing cost.                                                                                       | Permitted as a policy choice for all qualifying assets, but not required.                                                                                                                                                                                                  | Required.                                                                                                                                              |
| Investment property               | Treated as a long-term investment and is carried at cost less impairment..<br>Revaluation of such property is not applicable.                     | IFRS gives the choice of measuring the investment property at depreciated cost or fair value, with changes in fair value recognized in the income statement.<br>Regular revaluations should be made so that the carrying amount does not differ materially from fair value | Treated the same as for other properties (depreciated cost). Industry-specific guidance applies to investor entities (for example investment entities) |
| Inventories                       | Carried at lower of cost and net realizable value. FIFO or weighted average method is used to determine cost. LIFO method is however, prohibited. | Carried at lower of cost and net realizable value. For cost determination, FIFO or weighted average method is used. LIFO basis of valuation is prohibited.<br>Reversal is required for subsequent increase in value of previous write-downs.                               | Similar to IFRS; however, use of LIFO is permitted. Reversal of write-down is prohibited.                                                              |
| Biological assets                 | No specific guidance has been issued. Historical cost is used.in general.                                                                         | Measured at fair value less estimated point-of-sale costs.                                                                                                                                                                                                                 | No specific guidance has been issued. Historical cost is used.in general.                                                                              |

## 2.222 Financial Reporting

|                                   |                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                           |
|-----------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------|
| Financial assets – measurement    | Long-term investments, loans and receivables are carried at cost less impairment; whereas current investments are carried at lower of cost and fair value. Any reduction in the carrying amount and any reversal of such reduction is charged or credited to income statement. | If investments are classified as held to maturity or loans and receivables, they are carried at amortised cost; otherwise at fair value. Unrealised gains/losses on fair value through profit or loss classification (including trading securities) is recognized in income statement. Unrealised gains and losses on available-for-sale investments are recognized in equity. | Similar accounting model to IFRS. However, no ability to designate financial assets at fair value through profit or loss. |
| Derecognition of financial assets | Limited guidance. In general, derecognized based on transfer of risks and rewards. Guidance note issued by ICAI on securitization requires derecognition based on control                                                                                                      | Financial assets are derecognized firstly on risks and rewards basis; while control is the secondary test.                                                                                                                                                                                                                                                                     | Derecognised based on control. Requires legal isolation of assets even in bankruptcy.                                     |
| Provisions – general              | Provisions relating to present obligations from past events recorded if outflow of resources is probable and can be reliably estimated. Discounting of                                                                                                                         | Provisions relating to present obligations from past events recorded if outflow of resources is probable and can be reliably estimated. Provisions are                                                                                                                                                                                                                         | Similar to IFRS, with rules for specific situations such as environmental liabilities. Loss contingencies, etc.           |

**International Accounting Standards, International Financial Reporting Standards, 2.223  
their interpretations and US GAAPs- An Overview**

|                   |                                                                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |                                                                                                                                                                                                                       |
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|                   | provision is not permitted.                                                                                                                                                                                                                                                                                                                                                                                  | discounted to present value where the effect of the time value of money is material.                                                                                                                                                                                                                                                                                                                                                                                          |                                                                                                                                                                                                                       |
| Contingencies     | Contingent liabilities are disclosed unless the probability of outflows is remote. Contingent gains are neither recognized nor disclosed.                                                                                                                                                                                                                                                                    | Unrecognised possible losses and probable gains are disclosed.                                                                                                                                                                                                                                                                                                                                                                                                                | Similar to IFRS                                                                                                                                                                                                       |
| Government grants | <p>Grants related to fixed assets are shown as deduction from the gross value of the assets concerned.</p> <p>Revenue related government grants are recognized on a systematic basis in the income statement over the periods to match them with the related costs.</p> <p>Grants in the nature of promoter's contribution are credited to capital reserve and treated as a part of shareholder's funds.</p> | <p>Revenue based grants are deferred in the balance sheet and released to the income statement to match the related expenditure that they are intended to compensate.</p> <p>Capital based grants are deferred and matched with the depreciation on the asset for which the grant arises.</p> <p>Grants related to recognized assets are either presented in the balance sheet as deferred income and amortised. Entities may offset capital grants against asset values.</p> | Similar to IFRS, except when conditions are attached to grant. In this case, revenue recognition is delayed until such conditions are met. Long-lived asset contributions recorded as revenue in the period received. |

## 2.224 Financial Reporting

|                                                                               |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                             |
|-------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------|
| Dividends on ordinary equity shares                                           | Presented as an appropriation to the income statement. Dividends are accounted in the year when proposed.                                                                                                                                                                                                                                                                                                                                                                      | Presented as a deduction in the statement of changes in shareholders' equity in the period when authorized by shareholders. Dividends are accounted in the year when declared.                                                                                                                                                                                                                                                                       | Similar to IFRS.                                                                            |
| Derivatives and other financial instruments – cash flow and fair value hedges | No comprehensive guidance; except for:<br>(a) forward exchange contracts intended for trading or speculation purpose are carried at fair value; whereas those forward exchange contracts not held for speculative or trading purpose, the premium or discount on it is amortised over life of the contract and the exchange difference is recognized in income;<br>(b) equity index futures and options and equity stock options are carried at lower of cost or market value. | Derivatives and hedge instruments are measured at fair value; changes in fair value are recognized in income statement except for effective portion of cash flow hedges, where the changes are deferred in equity until effect of underlying transaction is recognized in income statement. Gain/loss from hedge instruments that is used to hedge forecast transaction may be included in cost of non-financial asset/liability (basis adjustment). | Similar to IFRS, except no 'basis adjustment' on cash flow hedges of forecast transactions. |
| Derivatives and other financial instruments – net                             | No specific guidance.                                                                                                                                                                                                                                                                                                                                                                                                                                                          | Effective portion of gains/losses on hedges of net                                                                                                                                                                                                                                                                                                                                                                                                   | Similar to IFRS. Gains/losses are                                                           |

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their interpretations and US GAAPs- An Overview**

|                                          |                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |                                                                                                            |
|------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------|
| investment<br>hedges                     |                                                                                                                                                                                              | <p>investments is recognized in equity; ineffective portion is recorded in income statement.</p> <p>Gains/losses held in equity are transferred to income statement on disposal or partial disposal of investment.</p>                                                                                                                                                                                                                                                                              | transferred to income statement upon sale or complete or substantially complete liquidation of investment. |
| Functional<br>currency-<br>determination | <p>Functional currency determination is not required.</p> <p>It assumes that an entity normally uses the currency of the country in which it is domiciled in recording its transactions.</p> | <p>If indicators are mixed and functional currency is not obvious, judgement is used to determine functional currency that most faithfully represents economic results of entity's operations by focusing on currency of primary economic environment in which entity operates.</p> <p>Additional evidences like currency in which funds from financing activities are generated or receipts from operating activities are usually retained are also used to determine the functional currency.</p> | Similar to IFRS. In practice, currency in which cash flows are settled is often the key consideration.     |

## 2.226 Financial Reporting

|                              |                                                                                                                                                                                                                    |                                                                                                                                                                                                                                                                                                                                                                                                                     |                                                                                                                                                                                                                                                                   |
|------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Hyper-inflationary economy   | No specific guidance.                                                                                                                                                                                              | Hyperinflation is indicated by characteristics of economic environment of country, which include:<br>Population's attitude towards local currency and prices linked to price index; and if cumulative inflation rate over three years is approaching, or exceeds, 100%.<br>Entities of hyperinflationary economy have to restate their financial statements using a measurement unit current at balance sheet date. | Hyperinflation is generally indicated by cumulative three-year inflation rate of approximately 100% or more.<br>Generally does not permit inflation-adjusted financial statements; instead requires use of reporting currency (US dollar) as functional currency. |
| Earnings per share – diluted | Weighted average potential dilutive shares are used as denominator for diluted EPS, except in certain circumstances where advance share application money received is treated as dilutive potential equity shares. | Weighted average potential dilutive shares are used as denominator for diluted EPS.                                                                                                                                                                                                                                                                                                                                 | Similar to IFRS.                                                                                                                                                                                                                                                  |
| Related-party transactions   | Determined by level of direct or indirect control, joint control and significant influence of one party over another or common control by another entity.                                                          | Determined by level of direct or indirect control, joint control and significant influence of one party over another or common control by                                                                                                                                                                                                                                                                           | Similar to IFRS. Exemptions from disclosures are narrower than under IFRS.                                                                                                                                                                                        |

**International Accounting Standards, International Financial Reporting Standards, 2.227  
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|                   |                                                                                                                                                                                                                                                                                                                                                                                                          |                                                                                                                                                                                                                                                                                                                                                                                                                               |                                                                                                                                                                                                                                                                                                                                                                                                       |
|-------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                   | <p>However, the determination may be based on legal form rather than substance.</p> <p>Hence, the scope of parties covered under the definition of related party could be less than under IFRS or US GAAP.</p> <p>Exemption from disclosure for certain SMEs having turnover or borrowings below certain limit. No exemption for separate financial statements of subsidiaries.</p>                      | <p>another entity.</p> <p>Name of the parent entity is disclosed and, if different, the ultimate controlling party, regardless of whether transactions occur. For related-party transactions, nature of relationship (seven categories), amount of transactions, outstanding balances, terms and types of transactions are disclosed.</p> <p>Some exemptions available for separate financial statements of subsidiaries.</p> |                                                                                                                                                                                                                                                                                                                                                                                                       |
| Segment reporting | <p>Public entities: primary and secondary (business and geographic) segments are reported based on risks and returns and internal reporting structure.</p> <p>Exemption only for certain SMEs having turnover or borrowings below certain threshold.</p> <p>Group accounting policies or entity accounting policies apply.</p> <p>Disclosures for primary segment include revenues, results, capital</p> | Similar to Indian Accounting Standard                                                                                                                                                                                                                                                                                                                                                                                         | <p>Reporting based on operating segments, and the manner in which chief operating decision-maker evaluates financial information for purposes of allocating resources and assessing performance.</p> <p>Internal financial reporting policies apply (even if accounting policies differ from group accounting policy).</p> <p>Disclosures of liabilities and geographical capex are not required.</p> |

## 2.228 Financial Reporting

|                                                            |                                                                                                                                                                                                                                                                                                                                                                                                          |                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                             |
|------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                            | expenditures (capex), total assets, total liabilities and other items. For secondary segment, revenues, total assets and capex are reported.                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                             |
| Discontinued operations- definition and measurement        | Operations and cash flows that can be clearly distinguished for financial reporting and represent a separate major line of business or geographical area of operations. Measurement of discontinued operations is based on AS 28 and 29                                                                                                                                                                  | Similar definition to Indian Accounting Standard. However, it also includes a subsidiary acquired exclusively with a view to resale. Measured at lower of carrying amount and fair value less costs to sell.                                                                                | Wider definition than IFRS: component that is clearly distinguishable operationally and for financial reporting can be: reporting segment, operating segment, reporting unit, subsidiary or asset grouping. Measurement is same as in IFRS. |
| Discontinued operations- presentation and main disclosures | At a minimum, separately from continuing operations, pre-tax profit or loss, related taxes, pre-tax gain or loss on disposal should be disclosed on the face of the income statement:<br>Income and expenses line items separate from continuing and discontinued operations are disclosed in the notes; however, presented on a combined basis in the income statement.<br>No separate presentation for | At a minimum, a single amount is disclosed on face of income statement, and further analysis disclosed in notes for current and prior periods.<br>Assets and liabilities of discontinued operations are presented separately on balance sheet. No restatement of comparative balance sheet. | Similar to IFRS. Discontinued and held-for-sale operations are reported as separate line items on face of income statement before extraordinary items.                                                                                      |



**International Accounting Standards, International Financial Reporting Standards, 2.229  
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|                                               |                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                    |                  |
|-----------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|
|                                               | balance sheet items.<br>Exemption for certain SMEs having turnover or borrowings below certain threshold.                                                                                                                                                                                                                                                                            |                                                                                                                                                                                                                                                    |                  |
| Events occurring after the balance sheet date | Financial statements are adjusted for events after the balance sheet date, providing evidence of conditions at balance sheet date and materially affecting amounts in financial statements (adjusting events) except non-adjusting events which are not required to be disclosed in financial statements but are disclosed in report of approving authority e.g., Director's Report. | Financial statements are adjusted for events after the balance sheet date, providing evidence of conditions at balance sheet date and materially affecting amounts in financial statements (adjusting events). Non-adjusting events are disclosed. | Similar to IFRS. |

*References / Sources:*

Website of IASPLUS

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Accounting Standards and Corporate Accounting Practices

Miller GAAP Guide Level A- 2006

Website of FASB

## CORPORATE FINANCIAL REPORTING

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### 1. INTRODUCTION

An understanding of the conceptual bases of the corporate financial reporting system and of the preparation of financial statement are essential prerequisites to be a good accountant or a financial analyst. This Chapter intends to explain the corporate financial reporting system and issues involved. Regulatory framework of corporate financial reporting in India and practices of Indian Companies are also covered. In last section reporting issues relating to matters that are reported outside the general purpose financial statements are considered.

### 2. CORPORATE FINANCIAL REPORTING SYSTEM

This chapter discusses the conceptual issues of corporate financial reporting. Disclosure being a major aspect of financial reporting, theories of disclosure are also considered. Issues relating to quality of financial reporting and mode of financial reporting are also being dealt with.

#### 2.1 CONCEPT OF CORPORATE FINANCIAL REPORTING

Financial reporting is the communication of financial information of an enterprise to the external world. Bedford conceptualizes the financial reporting process as consisting of four procedural steps:

1. Perception of the significant activity of the accounting entity or in the environment in which the entity performs. Implicit in the traditional perception is the belief that financial transactions represent the significant activities.
2. Symbolizing the perceived activities in such fashion that a database of the activities is available that can then be analyzed to grasp an understanding of the interrelationship of the mass of perceived activities. Conventionally, this symbolization has taken the form of recordings in accounts, journals, and ledgers using well-established bookkeeping and measurement procedures.
3. Analysis of the model of activities in order to summarize the interrelationships among activities and to provide a status picture or map of the entity. Traditionally, this analysis

### 3.2 Financial Reporting

process has been viewed as one of developing accounting reports to provide insights into the nature or entity activities.

4. Communication (transmission) of the analysis to users of the accounting products to guide decision makers in directing future activities of the entity or in changing their relationship with the entity.

First two steps constitute the process of accounting **measurement**, the quantification of an entity's past, and present, or future economic phenomena on the basis of observations and rules. Implicit in this conception are the requirements that (a) there exist some attribute or feature of a business-related objects or event (e.g.; the value of an asset) worthy of measurement and (b) there exist a means of making the measurements (e.g., the use of exchange prices to value enterprise assets). Step 3 and 4 of the financial reporting process constitute **disclosure**. Hence, measurement and disclosure are two dimensions of reporting process and these two aspects are interrelated. Together, they give corporate reporting its substance.

Financial statements are a central feature of financial reporting. The accounting process or financial reporting system, which generates financial information for external users, encompasses following principal financial statements:

1. Balance Sheet (or statement of financial position).
2. Profit & Loss Account (or statement of earnings or income statement).
3. Cash Flow Statement (or statement of cash flows).

These three financial statements, augmented by footnotes and supplementary data (often referred to as 'Notes on Accounts' or 'Notes to the Accounts' in India) are intended to provide relevant, reliable and timely information essential for making investment, credit and similar decision. Such financial statements are called *general purpose financial statements*.

It may be mentioned that the term financial reporting is not restricted to information communicated through financial statements. Financial reporting includes other means of communicating information that relates, directly or indirectly to the information generated through accounting process. Information provided by means of financial reporting other than financial statements may take various forms and relate to various matters. Communication by means of financial reporting other than a formal financial statement is made due to regulatory requirements or customs. In a few occasions, management may communicate any matter voluntarily when it considers such communication is useful to the stakeholders outside the enterprise. Publication of unaudited financial results, news releases, management forecasts and description of future plans are examples of reports that are provided outside the general purpose financial statements.

## 2.2 USERS OF FINANCIAL STATEMENTS

Different classes of users use financial information for different purposes. Identification of the users and their classes is necessary in order to determine the purposes for which they use information. Identification of users helps in defining user group characteristics which impinge on both the specific type of information to be presented and the manner of presentation.

According to the Framework for the Preparation and Presentation of Financial Statements issued by the ICAI in 2000 (hereinafter referred to as 'ICAI Conceptual Framework') the users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.

The common characteristic of external users is their general lack of authority to prescribe the information they want from a company. It is also observed that some users have more resource and influence than others so that they can obtain more information about an enterprise than is generally available to others. These privileged users include managers, large scale equity investors etc. These different user groups have different objectives and diverse information needs. But, general purpose financial statements are prepared to meet the common needs of all types of users. However, all of the information needs of these users cannot be met by such a report. Multiplicity and conflicts of objectives of a wide variety of potential users for general purpose reports make it difficult to design a single set of published statements that can simultaneously provide all necessary information to all possible users.

Traditionally, investors (both existing and potential) are singled out as the dominant user-group of published financial statements. As providers of risk capital to the enterprise, investors need more comprehensive information than other users. The ICAI Conceptual Framework states that the provision of financial statements, which meet the investors' needs, will also meet most of the needs of other users. Also in practice, top priority is given to the information needs of the investors while deciding what items of information should be disclosed in general purpose financial statements.

## 2.3 OBJECTIVES OF CORPORATE FINANCIAL REPORTING

Corporate financial reporting is not an end in itself but is a means to certain objectives. There are debates regarding objective of financial reporting. However, some consensus has been developed on the objectives of financial reporting through the issuance of the conceptual framework. The conceptual framework provides the conceptual basis for generally accepted accounting principles (GAAP). It delineates the characteristics accounting information must possess to be useful in investment and other economic decisions. Like other standard setting bodies, paragraph 22 of the Framework states that the objective of financial statements is to provide information about financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions. The Framework specifies present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public as the users of financial

### 3.4 Financial Reporting

statements.

In USA, the FASB has identified the following major objectives of financial reporting:

- (i) Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.
- (ii) Financial reporting should provide information to help investors, creditors, and others to assess the amount, timing and uncertainty of prospective net cash inflows to the related enterprise.
- (iii) Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events and circumstances that change resources and claims to those resources.
- (iv) Financial reporting should provide information about an enterprise's financial performance during a period.
- (v) The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components.
- (vi) Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise's resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.
- (vii) Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.
- (viii) Financial reporting should provide information that is useful to managers and directors in making decisions in the interest of owners.

Apart from investment decision making another objective of financial reporting is to provide information on management accountability. Management accountability is a broad concept that encompasses stewardship. The accountability relationship may be created by a constitution, a law, a contract an organization make, a custom or even by informal moral obligation. It is considered that management of an enterprise is periodically accountable to the owners not only for safekeeping of resources but also for their efficient and profitable use. Management accountability objective mainly emphasizes reliability aspect of accounting information. Accordingly, compared to relevance, verifiability through adequate documents, records and system is considered dominant consideration for inclusion of any piece of information in the financial statement.

Corporate financial reporting being user oriented and users' need of information being not

same, the role of accounting and financial reporting may vary from country to country. But, financial reporting is central to the process of allocating financial resources in capital markets. Hence, primary purpose of providing useful information to all users, which help them in decision making, is common in all countries.

## **2.4 CAPITAL MARKET & NON-FINANCIAL INFLUENCES ON CORPORATE FINANCIAL REPORTING**

Before examining the financial reporting issue that are bringing complexities in reporting system, a brief sketch the evolution of corporate disclosure may be helpful to understand the framework of present corporate financial reporting.

Till the quarter of the twentieth century, financial reporting was confined to the stewardship reporting, i.e., reporting of the wealth and income earned by the owners. With the growth in size, companies need large sums of money to finance extensive productions and distribution activities. Due to internal financial constraints, companies depend heavily on external capital markets to finance the capital needs. However, investors are seldom in a position to observe on a day-to-day basis, whether saving entrusted to the companies are utilized efficiently and effectively. Hence, investors expect and are provided with an accounting for the stewardship of monies entrusted to the company. Stewardship traditionally refers to the safe keeping of resources and the execution of plans for conserving and utilizing them. Modern concept of accountability of management extends beyond the element of stewardship and covers performance based issues. The managers of the companies accept the accountability phase of their stewardship, or at least recognize in self interest that disclosure through financial reporting process delegates part of the responsibility for assessing the financial status of the company and its performance to the users of financial reporting. But, with the growth of the capital market, the central focus of financial reporting has been shifted from stewardship reporting to decision-oriented financial reporting.

Further, the competition among the companies to obtain external financing at a relatively cheaper rate has impact on corporate disclosure. Companies are now making expanded disclosure to attract capital in domestic capital market and/or in international market and to reduce the firm's cost of capital. There are various research studies that establish that increased firm disclosure has definite impact a firm's overall cost of capital. Such reduction of cost of capital through expanded disclosure has linkage with the theory of behaviour of investors who take investment decision under uncertainty. Increased disclosure in financial reports improves the subjective probability distributions of a security's expected returns in the mind of an investor by reducing the uncertainty associated with that return stream.

Thus, capital market influences are having a major role in sharing the nature of corporate financing reporting that is now driven by the consideration of decision usefulness. The objective of decisional usefulness has formally been incorporated into the conceptual frameworks for the preparation and presentation of financial statements set out by the

### **3.6 Financial Reporting**

standard setting bodies of different countries as well as by the International Accounting Standards Committee.

Apart from accountability to shareholders, there is a growing worldwide trend of holding companies accountable to the public at large. Such a trend is responsible for changing the disclosure practice of companies to a considerable extent. Such a movement is creating companies aware about the disclosure needs of “non-financial shareholders” such as trade unions (interested in terms of employment), government (interested in the macroeconomic impact of operations of corporate sector) and general public (interested in social and environmental impact of corporate actions). Voluntary reporting of employee information, environmental information and other corporate social responsibility reports (e.g. social balance sheet) are example of disclosure arising from non-financial influences. Corporate response to such expanded disclosure requirements are mixed. However, it is desirable that financial reporting should cater needs of all type of users.

## **2.5 QUALITATIVE CHARACTERISTICS OF INFORMATION IN FINANCIAL REPORT**

Information, which is reported to facilitate economic decisions, should possess certain qualitative characteristics. Qualitative characteristics are the attributes that make the information provided in the financial statement useful to the users. ICAI Conceptual Framework earmarks four principal qualitative characteristics viz., understandability, relevance, reliability and comparability. According to the ICAI Conceptual Framework, materiality is not a principal qualitative characteristic. A piece of information is considered to be material when its disclosure or non-disclosure would affect decision or would make a difference in the valuation of the firm. But, in the ICAI Conceptual Framework, materiality is considered as a threshold limit, which needs to be judged before referring to any other qualities of any information provided in financial statements. If any piece of information does not fulfill the threshold criteria, it need not be considered further.

### **2.5.1 Understandability**

Information in annual reports should be presented in such a way that it is readily understandable by users. ICAI Conceptual Framework states that the criterion of understandability requires that the users have a reasonable knowledge of business and economic activities, accounting, and a willingness to study the information with reasonable diligence. It has also suggested that information, which is relevant to the economic decision-making needs of users should not be excluded merely on the ground that it may be difficult for certain users to understand.

### **2.5.2 Relevance**

The concept of relevance is directly related to the decision making needs of users. An information is said to be relevant if it can influence ‘the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting, their past evaluation.

It is suggested that all those items of information, which may aid the users in making predictions or decisions, should be reported. Information, which does not assist users in making decisions, is irrelevant, and hence, should be omitted. Thus, relevance is the dominant criterion of taking decisions regarding information disclosure. *Timeliness* is an important aspect of relevance. Information loses value rapidly in the financial world. As time passes and the future becomes the present, past information became increasingly irrelevant.

### 2.5.3 Reliability

Reliability is another important characteristic of information disclosed. Reliability of information is important to users because it influences their decisions. Reliability encompasses *representational faithfulness*, *verifiability* and *neutrality*. Information is reliable if it is free from material error and bias, and faithfully represents what it purports to represent. Information is reliable to the extent a user can depend upon it to represent the economic conditions or events that it aims to represent. Verifiability relates to measurement aspect and any financial data that cannot be measured accurately are not considered verifiable. Neutrality is concerned with whether financial statement data are biased. Being free from bias implies impartial measurement and reporting by enterprise of its events and transactions.

It is the responsibility of management to report reliable information in annual reports. However, reliability of information differs from item to item. Some item of information presented in annual reports may be more reliable than others.

Unfortunately, relevance and reliability are likely to be opposing qualities. For example, the audit process increases the reliability of financial data, but timeliness and consequently, relevance is worsened. Similarly, a conflict may arise in achieving the objectives of relevance and reliability for certain pieces of information in the annual reports. It is argued that economic decision making orientation of corporate financial reporting makes financial statements oriented towards supply of relevant information that may be subjective or that may not be amenable to objective scrutiny by the auditor. For example, some forecast data, like expected growth in sales during the next three years, might be highly relevant for investment decision. But this information is less reliable than historical figures of sales. In such a case, the management should maintain a balance between these two qualitative characteristics.

Moreover, possibility of error in measuring business events may create difficulty in attaining a high degree of reliability. However, adequate disclosure requires that users should be informed about the data limitations and the magnitude of possible measurement error.

### 2.5.4 Comparability

While taking a decision, the decision maker compares information of possible alternatives that are available to him. In the context of decision making by the users of annual reports, comparison is facilitated by the information provided in such reports. As Hendriksen looks at it, "The primary objective of comparability should be to facilitate the making of predictions and financial decisions by creditors, investors and others." According to him, comparability is "the



### **3.8 Financial Reporting**

quality or state of having enough like characteristics to make comparison appropriate.” The ICAI Conceptual Framework (paragraph 39) enjoins that users must be able to compare financial statements, of an enterprise through time in order to identify trends in its financial position, performance and cash flows, and of different enterprises in order to evaluate their relative financial position, performance and cash flows. For this purpose, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way. The Framework indicates that the important implication of comparability is that users should be informed of the accounting policies employed in the preparation of financial statements, any changes of those policies and the effects of such changes. For achieving comparability, the Framework (paragraph 40) suggests compliance with relevant accounting standards including the disclosure of accounting policies used by the enterprise.

## **2.6 THEORIES OF DISCLOSURE**

### **2.6.1 Concept of Disclosure**

The concept of disclosure is of great significance to the accomplishment of the objectives of financial reporting. Financial reporting is the communication of financial information of an enterprise to the external world. Hendriksen states that disclosure in financial reporting is the presentation of information necessary for optimum operation of efficient capital markets. In a broader sense, disclosure is the communication of both financial and non-financial information for making decisions by external users.

Available disclosure literature suggests that disclosure is not only fundamental to financial reporting but is, at the same time, its most qualitative aspect and the nature and extent of disclosure needed in individual reporting situations is determinable only by expert professional judgment. Disclosure standards and practices are influenced by legal systems, source of finance, political and economic environments, education level and culture.

### **2.6.2 Motives Behind Disclosure**

It is argued that competition for capital is the major motivating force to disclose decision-oriented information to different user groups. Hence, market forces would ultimately shape the nature of corporate disclosure. Corporations not only compete among each other in the capital markets but also attempt to obtain capital at a lower cost. It is indicated by many researchers that there is relationship between a firm's capital cost and its level of disclosure in its annual report. Due to such linkage and decision usefulness of published financial statement, corporate financial reporting is perceived as a pre-requisite for the growth of capital markets. Apart from stock market considerations, there are varieties of considerations that may motivate management of a company to disclose information voluntarily and not wait for mandatory requirements. Some of these important considerations are:

- ◆ Political costs consideration
- ◆ Users' needs consideration, and

- ◆ Ideological goal consideration.

**Political costs consideration:** Fines, penalties, potential public hostility toward the company are the examples of political costs. It is now recognized that political costs may play an important role in decisions relating to additional disclosure in the form of social and environmental information. Disclosure of environmental information can be considered to reassure the public or the regulating agencies that companies were concerned about the environment and were doing everything possible to reduce the negative impact of their activities on the environment.

**Users' needs consideration:** Guthrie and Parker have argued that companies may disclose social information to meet the stakeholders' demand for such information. The argument is based on Users' Utility Model. Disclosure of additional information on a voluntary basis depends on the users' needs, and how these needs are perceived by management of companies.

**Ideological goal consideration:** It has been argued that companies would be motivated to disclose voluntarily additional information to serve their own political and ideological goals. Such disclosure would be guided by companies' agenda, ideologies and goals which are likely to be different for different companies even within the same industry. Consequently, disclosure of such information will vary from company to company.

### 2.6.3 Basic Problems of Disclosure

In disclosing information, business enterprises, particularly corporate entities, are confronted with certain basic problems, the solutions of which need answers to the following questions:

- (i) Who are the users of information or for whom information should be disclosed?
- (ii) What information should be disclosed?
- (iii) How much information should be disclosed?
- (iv) How should information be disclosed?
- (v) When should information be disclosed?

The first question requires identification of users of information. The second question needs the identification of the purposes for which information will be used. The third question relates to the problem of determining quantum of information. The fourth and fifth questions concern the problems of deciding about the mode and timing of disclosure respectively.

Disclosure being the transmission of accounting measurement to the users group, corporate entities views it as a major policy issue. As the disclosure of accounting information is not costless, prepares of financial statement have to make judgments on the allocation of accounting information among various users groups.

From regulator's standpoints, leaving the decision about disclosure in the hand corporate

### **3.10 Financial Reporting**

management or market forces, has not been viewed favourably. It is possible for management to disclose information that is considered helpful to facilitate its external relations programmes and still withhold certain pieces of vital information that is useful for decision making by the users. Hence, greater control over corporate reporting is imposed whenever it is perceived that there is failure to adequately respond to express information needs of different stakeholders.

Thus, the scope of negative sanctions of regulatory controls over corporate disclosure increases when users groups perceive that there are deficiencies on the part of companies in providing adequate disclosure.

### **2.7 ROLE OF AUDITORS**

The audit of financial statements is a legal requirement. The audit provides an external and objective check on the measurement and disclosure aspects of corporate financial reporting. An auditor is appointed by the shareholders, but effectually his appointment is subject to will of management or promoter group. Nevertheless, the auditor is supposed to be independent of management and to serve the shareholders and other users of financial statements. Although, Management is responsible for the preparation of financial statement including the notes, the auditor through the auditor's report states whether financial statements presents fairly, in all material respects the financial position, the results of operations and the cash flows for the accounting period. The auditor is responsible for seeing that the financial statements issued conform with generally accepted accounting principles. Thus, the auditor must agree that accounting policies adopted by the management is appropriate and all estimates are reasonable. Any departure from generally accepted accounting principles (including non-compliance with the measurement and disclosure requirements of the accounting standards) would results in a qualified opinion. Auditor's report is an important accompaniment of financial statements. Because of boilerplate nature of these reports, there is tendency to skip over them while analyzing financial statements. However, such failure to give attention to the auditor's report may cause the user to miss significant information.

### **2.8 QUALITY OF FINANCIAL REPORTING**

Ideally, financial statements should reflect an accurate picture of a company, its financial condition and performance. If the financial statements distort economic reality, capital will be deployed sub-optimally; resources will be misallocated; investors will pay a huge opportunity cost by investing in companies with unrealistic, inflated values and better investment opportunities may get bypassed. Regulations on financial reporting generally provides for penalties and other measures to deter accounting frauds. However, it may be pointed out that management has considerable discretion within the overall framework of generally accepted accounting principles. As results, there are scopes for management to "manipulate" the accounts. Such manipulations mainly relate to management of bottomline (profit or loss) and commonly referred to an earnings management. For an investor or a security analyst it is

important to recognize that many opportunities exist for management to affect the quality of financial statements. Hence, reported earnings may not best represent economic reality or the future operating potential of a firm.

## **2.9 MODE OF FINANCIAL REPORTING**

A number of documents and avenues of communication are available through which companies provide information about its state of affairs to the external users of such information, for example, annual report, interim report, employee report, environmental report, communications with analysts, letters to shareholders and debt holders, question and answer sessions held at annual general meeting, telephone conversations, speeches made by company officials at stock exchanges and so on.

Despite the existence of different sources of information, the annual report is regarded as the most important source of information about a company's affairs.

A typical corporate annual report usually contains a balance sheet, profit and loss account, cash flow and / funds flow statement, and directors' report. Besides, the details of information and additional information are provided in the schedules and notes on accounts, which form parts of financial statements. Annual reports often contain useful supplementary financial and statistical data as well as management comments. Many companies in India now include Management Discussion and Analysis (MD & A) report, corporate governance report, chairman's statement, historical summary, operating positions, highlights of important data etc.

## **3. INDIAN FINANCIAL REPORTING SYSTEM**

India is a federal state with unitary bias. This is perhaps why, unlike in the USA, there is no separate company law for any state in India. Apart from professional regulation, corporate financial reporting in India is governed primarily by one central Act i.e., the Companies Act, 1956. Another body that has a major influence in reshaping Indian financial reporting is the Securities and Exchange Board of India (SEBI). The Companies Act, 1956 prescribes the financial reporting requirements for all the companies registered under it. The reporting requirements that are imposed by the SEBI through its Guidelines and through the Listing Agreement are in addition to those prescribed under the Companies Act. SEBI requirements are to be followed by the companies listed in the Indian stock exchanges. The Companies Act and the SEBI requirements together provide the legal framework of corporate reporting in India. Before elaborating the legal requirements, it may be interesting to discuss the role of the SEBI as it is pioneer to introduce certain changes (e.g., cash flow statement) in the area of corporate financial reporting. Following sections sequentially discuss the role of the SEBI, the Companies Act and SEBI reporting requirements.

### **3.1 ROLE OF THE SEBI**

The Securities and Exchange Board of India (SEBI) was constituted on April 12, 1988, by a

### 3.12 Financial Reporting

resolution passed by the Government of India to deal with all matters relating to the development and regulation of securities market and investor protection. SEBI had no legal teeth, until the Securities and Exchange Board India Act, 1992 (SEBI Act, 1992) was promulgated with effect from 30th January 1992. During the initial years of its working, the function of the SEBI was confined to monitoring the activities of stock exchanges, mutual funds, merchant bankers and other intermediaries engaged in investment business. Subsequently, the SEBI has also taken various initiatives to improve corporate reporting practices to provide investors and other users with quality information that is useful in making economic decisions.

General functions of the SEBI are provided in section 11(1) of the SEBI Act, 1992 that gives prime importance to protection of the interests of the investors. Also the SEBI has power to take such measures as it thinks fit to regulate securities market (section 11). Again, section 11A of the SEBI Act, 1992 provides that the Board may specify by regulations, the matters relating to issue of capital, transfer of securities and other matters incidental thereto and the manner in which such matters shall be disclosed by the companies. Hence, the Board has power to order changes in disclosure requirements regarding issue of shares (i.e., disclosures in offer documents).

SEBI has adopted another scheme to enforce continuous disclosures by the companies. SEBI has power to direct stock exchanges to implement any matters that it considers necessary in the interest of investors, or orderly development of securities market. SEBI has used this power to order changes in listing agreement and such changes are instrumental to bring about improvement in disclosure practices of listed companies in their annual reports. Listing agreement is the standard agreement between a company seeking listing of its securities and the stock exchange where listing is sought. Any stock exchange has power to alter the clauses of listing agreement unilaterally, and companies listed with that exchange are bound to accept such changes to enjoy the facility of listing. Thus, whenever the SEBI suggests any change, it is incumbent on the listed companies to follow such a change. In effect, the SEBI has power to direct the listed companies to follow any changed disclosure requirements.

SEBI has imposed a number of disclosures and other requirements through this route. Some important requirements are as follows:

- ◆ Dispatch of a copy of the complete & full annual report to the shareholders (Clause 32).
- ◆ Disclosure on the Y2K preparedness level (Clause 32).
- ◆ Disclosure of Cash Flow Statement (Clause 32).
- ◆ Disclosure of material developments and price sensitive information (Clause 36).
- ◆ Compliance with Takeover Code (Clause 40B)
- ◆ Disclosure of interim unaudited financial result (Clause 41).

- ◆ Disclosure regarding listing fee payment status and the name and address of each stock exchange where the company's securities are listed (Clause 48B).
- ◆ Corporate governance report (Clause 49).
- ◆ Compliance with Accounting Standards issued by the ICAI ( Clause 50).

Among the changes introduced, the requirements to prepare and disclose Cash Flow Statement (CFS) and the Corporate Governance Report being important, we discuss the SEBI initiatives in detail. Furthermore, we touch upon the disclosure requirements introduced for offer documents that are published by the issuers.

The initiative to introduce the Cash Flow Statements (as a principal financial statement) in India was taken by the SEBI and it has used its power under section 11 of the SEBI Act, 1992 to direct all recognized stock exchange to amend clause 32 of the listing agreement. Amended clause 32 provides for a requirement of appending an audited Cash Flow Statement (CFS) as a part of annual accounts. In its Letter No. SMD(N)/JJ/2331/95 dated 26th June 1995 the SEBI had mentioned the detailed procedure for preparation of CFS and auditing and authentication thereof. As per the SEBI mandate, the requirement of providing a CFS is mandatory for listed companies from the financial year 1994-95 i.e., year ended 31st March 1995. There is no such requirement in Indian Companies Act, 1956 to append any cash flow or fund flow statements with the annual financial statement. When the SEBI mandate was issued, there was no accounting standard issued by the ICAI as regard preparation and presentation of a CFS. The ICAI issued a revised accounting standard (AS 3) on the subject by replacing its standard on Fund Flow Statement in March 1997. After introduction of ICAI standard the SEBI has directed a change in the Listing Agreement to provide that CFS shall be prepared in accordance with the ICAI standard.

SEBI has appointed certain expert committees from time to time to use the power to direct changes in the disclosure requirements effectively. Such committees have recommended changes in disclosure that are generally accepted by the SEBI.

Kumar Mangalam Birla Committee was appointed by the SEBI to suggest changes in the Listing Agreement to promote corporate governance. The major thrust area of the Committee was to suggest model code of corporate governance. To make corporate responsibility meaningful and more stringent, the Committee recommended inclusion of corporate governance report as a part and parcel of annual report. Issues involving corporate governance include disclosure of both financial and non-financial information including accounting information. The recommendations of the Committee are divided into two parts viz., mandatory and non-mandatory recommendations and it is opined that the recommendations should be made applicable to the listed companies. The requirements of appending corporate governance report and Management Discussion and Analysis report are imposed on the basis of the recommendations of the Committee.

SEBI has also sought to address corporate disclosure issues regarding initial public offer

### **3.14 Financial Reporting**

through the appointment of Y.H. Malegam Committee in 1995. The Committee was appointed to review the existing disclosure requirements in offer documents and recommend additions thereto and modifications thereof. The offer documents consist of the prospectus, the application form and the abridged prospectus in the case of a public issue and the letter of offer in the case of a right issue. Among these, the prospectus (including its abridged version) and the letter of offer contain substantial amount of financial disclosures. The committee has opined that investor protection demands that the potential investor is provided with all the information that is necessary for him to take a decision after proper assessment of the risks and benefits of the proposed investment and such information should be accurate, complete, timely and not misleading.

The process of the SEBI has resulted in a changed regime for imposition of financial disclosure requirements that is quick and does not require lengthy process of legislative changes. By virtue of the provisions contained the Listing Agreement (Clause 50), listed companies are now under legal compulsion to comply with all the accounting standards issued by the ICAI.

### **3.2 COMPANIES ACT, 1956**

The Companies Act, 1956 lays down the detailed provisions regarding the maintenance of books of accounts and the preparation and presentation of annual accounts. The Act also prescribes the mechanism for issuance of accounting standards. It specifies the roles and responsibilities of directors and also the matters to be reported upon by them in the annual reports of the companies. Under the provisions of the Act, audit of annual accounts is compulsory for all companies registered under it. The Act extensively deals with the qualification, appointment, removal, rights, duties and liabilities of auditors and provides contents of auditors' report. In case of delinquency/ default by the management or auditor, penal provisions are prescribed. However, despite providing for detailed requirements in respect of maintenance of books of account, preparation and presentation of financial statements and audit of annual accounts, the main thrust under the Companies Act is upon the presentation of a 'true and fair view' of the state of affairs and operating results of the reporting companies.

As the preparation of financial statements contained in annual reports presupposes the existence of a recording procedure of transactions of the reporting entities, the requirements as to the maintenance of books of accounts are also mentioned. We have also discussed statutory recognition of accounting standards, and the concepts of 'true and fair' view in the context of financial statements and Auditors' Report, since both of these have significant bearing upon the preparation and presentation of financial statements in India.

### 3.2.1 Books of Account

The Companies Act requires every company to maintain at its registered office *proper books of account* with respect to the following:

- (a) All receipts and disbursements of money and the matters in respect of which the receipts and disbursement take place;
- (b) All sales and purchases of goods of the company;
- (c) The assets and liabilities of the company (Section 209).

The Act does not mention the name of the books of accounts but it clarifies that proper books of account shall be deemed to be kept with respect to the specified matters, if, such books give a true and fair view of the state affairs of the company or its branch office and explain its transactions; and such books are kept on *accrual basis* and according to the *double entry system* of accounting.

Additionally, if required by the Central Government, a company engaged in production, processing, manufacturing or mining activities is also required to keep cost accounting records i.e. accounts for utilisation of raw materials, labour and other items of cost, as may be prescribed by the Central Government.

Where a company has a branch office, whether in or outside India, the company should keep at the branch office proper books of account relating to the transactions effected at that office. The branch office should send proper summarised returns, made up to a date at intervals of not more than three months, to the company at its registered office.

### 3.2.2 Statutory Recognition of Accounting Standards

Up to 1997 there was no statutory backing of accounting standards in India. There was only professional requirement by the ICAI, the standard-setting body in India for ensuring compliance of accounting standards through audit function by its members. However, in the absence any statutory requirement of the observance of accounting standards on the management of companies, compliance with accounting standards was left to the sweet will of the management.

In 1998 the Companies (Amendment) Ordinance, 1998 was promulgated by the President of India. This Ordinance gave statutory recognition to accounting standards and required the auditor to report on the compliance with accounting standards. The ordinance also provides for the constitution of the National Advisory Committee on Accounting Standards (NACAS). Subsequently, the Companies (Amendment) Act, 1999 was passed in the parliament, which gave legal status to the Companies (Amendment) Ordinance, 1998. Sub-sections (3A), (3B) and (3C) of Section 211 have been inserted in the Act to provide for compliance with accounting standards for the preparation of Profit and Loss Account and the Balance Sheet, and for formation of the NACAS. Consequential change has also been made in the reporting requirement by inserting a new clause (d) to Section 227 (3) that requires the auditor to report



### 3.16 Financial Reporting

on the compliance with accounting standards by the reporting entity. The Amended Act requires that:

- (i) Every Profit and Loss Account and the Balance Sheet of the company should comply with the accounting standards [Section 211(3A)].
- (ii) Where the Profit and Loss Account and the Balance Sheet of the company do not comply with the accounting standards such companies should disclose in its Profit and Loss Account and Balance Sheet, the following, namely; -
  - (a) The deviation from accounting standards,
  - (b) The reasons for such deviation and
  - (c) The financial effect if any, arising due to such deviation [Section 211(3B)].

For this purpose, the expression 'Accounting Standards' means the Standard of Accounting recommended by the Institute of Chartered Accountants of India (ICAI), as may be prescribed by the Central Government in Consultation with the National Advisory Committee on Accounting Standards (NACAS) established under Sub-section (1) of Section 210A [Section 211(3C)].

It has also been provided that until Accounting Standards are prescribed by the Central Government, the standards of accounting specified by the ICAI shall be deemed to be the Accounting Standards [Proviso to Section 211 (3C)].

Although NACAS was established in June 2001 (vide Notification No. 1/5/2001- Cl.V dt. 15-6-2001 issued by the Ministry of Law, Justice & Company Affairs, Department of Company Affairs), it is yet to endorse any accounting standard and the Central Government has not prescribed any Accounting Standard up to December 2006. Hence, companies are required to prepare financial statements in respect of an accounting year ending on or after October 31, 1998 in compliance with the accounting standards specified by the ICAI. So "...the extant position is that all the accounting standards, issued by the Institute which have been made mandatory by the Institute as indicated in the respective standards or made mandatory by way of separate announcement are 'specified' for the purpose of the proviso to section 211 (3C) and section 227(3)(d) of the Act".

#### 3.2.3 Concept of True and Fair

So far as financial reporting and audit of the financial statements are concerned, much emphasis has been placed on the concept of 'true and fair' view under Indian Companies Act. For maintenance of proper books of account as required by the Act, it is necessary that such books give a true and fair view of the state affairs of the company. The Act also requires that every Balance Sheet and Profit and Loss Account should exhibit a true and fair view of the state of affairs and profit or loss of the company respectively [Section 211]. Moreover, the auditors are required to report on the truth and fairness of the financial statements [Section 227].

Generally, the phrase 'true and fair' view signifies that the financial statements should truly and fairly represent the actual financial position as at the end of the accounting period and the profit or loss for that period. However, what is 'true and fair view' has not been defined in the Act. It is negatively stated in sub-section (5) of section 211 that the Balance Sheet and the Profit and Loss Account of a company should be deemed as not showing a true and fair view, if they do not disclose any matters which are required to be disclosed by virtue of the provisions of Schedule VI or by virtue of a notification or an order of the Central Government notifying the disclosure requirement. Thus, one of the tests for determining whether or not the financial statements show a true and fair view is to check whether or not all relevant disclosures as required under law have been properly made.

The phrase 'true and fair' signifies that the auditor should give an opinion as to whether the financial statements represent fairly the actual financial position as at the end of the accounting period and the profit or loss for that period. In this context, it may be noted that the disclosure requirements as laid down by law are the minimum requirements. Hence, if certain information is vital for showing a true and fair view, the financial statements should disclose it, even though there may not be a specific legal requirement for doing so. What constitutes a true and fair view is, thus, a matter of an auditor's judgment in the particular circumstances of a case.

In effect, though the Indian Companies Act imposes responsibility primarily on the management to present a true and fair view of accounts, ultimately, it is the auditors who are to judge and opine on the truth and fairness of the accounts.

#### **3.2.4 Disclosure Requirements under the Companies Act**

Traditionally, corporate enterprises in India have presented financial information through two financial statements, namely, Balance Sheet and Profit and Loss Account (Income Statement). These are the two primary statements that have been prescribed and their contents have been laid down by the Companies Act in India. As stated earlier, a majority of Indian companies are now required to present a Cash Flow Statement as a principal financial statement and by giving recognition to accounting standards, the Companies Act, 1956 indirectly endorses such presentation.

The Act requires that at every annual general meeting, the Board of Directors of the company should place before the company-

- (i) a Balance Sheet as at the end of the financial year ; and
- (ii) a Profit and Loss Account for the financial year [Section 210(1)].

Thus, the primary responsibility for preparation of financial statements and the laying of the same before the company at the annual general meeting is upon the directors of the company. However, they can entrust this duty to some other competent and reliable person who is in a position to discharge it [Section 210(5)].

### **3.18 Financial Reporting**

Apart from Balance Sheet and Profit and Loss Account, a lot of financial and non-financial information is required to be disclosed by companies registered under the Companies Act.

Mandatory information which is required to be disclosed in the corporate annual reports either by virtue of the provisions contained in the Companies Act, 1956 alone or by virtue of such provisions read with the provisions of applicable accounting standards may be grouped under following heads:

- (i) Balance Sheet
- (ii) Profit and Loss Account
- (iii) Narrative Disclosure
- (iv) Cash Flow Statement
- (v) Balance Sheet Abstract and Company's General Business Profile
- (vi) Supplementary Statements
- (vii) Auditors' Report
- (viii) Directors' Report

#### **3.2.4.1 Balance Sheet**

The Companies Act requires that every Balance Sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year. It shall be in the form set out in Part 1 of the Schedule VI, or as near that as the circumstances permit. In preparing the Balance Sheet, the preparers should follow the general instruction for preparations of Balance Sheet under the heading 'Notes' at the end of the aforesaid Part [Section 211(1)].

Part I of Schedule VI to the Companies Act provides the form and contents of the Balance Sheet. Two alternative formats have been provided in Schedule VI - a horizontal form and a vertical form. It is open to a company to choose any of these formats.

The horizontal form of Balance Sheet (given in *Appendix 1*) lays down in detail the contents of the Balance Sheet. It is known as conventional or customary form of Balance Sheet. In this format all assets and liabilities are shown in the right and left hand side respectively. The format classifies assets and liabilities into homogeneous categories and provides for their disclosure more or less in their order of permanence. It also gives detailed instructions in accordance with which various assets and liabilities are to be disclosed. The details of information to be given under each category of assets and liabilities are also given. The various items on the left hand side of the Balance Sheet are classified into following five main categories:

- (i) Share Capital,

- (ii) Reserves and Surplus,
- (iii) Secured Loans,
- (iv) Unsecured Loans, and
- (v) Current Liabilities and Provisions.

Apart from these, the Contingent Liabilities are required to be disclosed by way of a footnote to the Balance Sheet. On the right hand side, the assets are classified into following five main categories:

- (i) Fixed Assets,
- (ii) Investments,
- (iii) Current Assets and Loans and Advances,
- (iv) Miscellaneous Expenditure (to the extent not written off or adjusted), and
- (v) Profit and Loss Account.

The vertical form of Balance Sheet (given in *Appendix 2*) provides for two main heads, namely,

- I. Sources of Funds and
- II. Application of Funds.

Two major sub-groups under the head Sources of Funds are:

- (i) Shareholders' Funds requiring details to be given separately in respect of (a) Share Capital and (b) Reserve and Surplus, and
- (ii) Loan Funds, providing details of (a) Secured Loans and (b) Unsecured Loans.

The classification of various items under the head 'Application of Funds' is almost the same as in case of horizontal form of Balance Sheet except that Current Liabilities are shown as deduction from Current Assets.

General instructions for preparation of the Balance Sheet are contained in the 'Notes' appended to the form of Balance Sheet. The information required to be given under any of the items of the Balance Sheet may be given in separate schedules to be annexed thereto, which also form a part of the Balance Sheet. The figures of the previous year are required to be shown along the figures of the current year. Vertical form is now preferred for presenting the balance sheet in annual report of listed companies.

#### **3.2.4.2 Profit and Loss Account**

Like Balance Sheet, every Profit and Loss Account of a company is required to exhibit a true and fair view of the profit or loss of the company for the financial year. The Profit and Loss Account is required to be prepared as per the requirements of Part II of Schedule VI. [Section

### 3.20 Financial Reporting

211(2)]. In view of the variety of items that can appear in the Profit and Loss Account of various companies, it does not prescribe, any specific format in which this account has to be made up. Instead, only the broad requirements have been stated. Accordingly, the companies are free to prepare and present Profit and Loss Account either in the traditional T-form (according to which, items of expenses are shown on the left-hand side and those of income on the right hand side) or in the vertical form (in which items of income are shown first and items of expenses are reported as a deduction therefrom). The main advantage of the vertical form of presentation is that it makes the Balance Sheet and Profit and Loss Account easily understandable to the users who may not have a basic knowledge of accounts.

However the Profit and Loss Account has to be so made out as to clearly disclose the results of the working of the company during the period covered by the account. Further the Profit and Loss Account has to disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature. Accounting Standard 5 on *Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies* states that 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.

The Profit and Loss Account has to set out various items, as prescribed, relating to the income and expenditure of the company, arranged under convenient heads. The detailed information in respect of various items of income and expenditure can be given in separate schedules, which then form part of profit of Profit and Loss Account. As in the case of Balance Sheet, corresponding amounts for the immediately proceeding financial year for all items shown in the Profit and Loss Account should also be given.

#### 3.2.4.3 Narrative Disclosures

The narrative disclosures that are contained in published company accounts embrace both qualitative and quantitative information. In most cases narrative disclosures are presented in textual form wherein more emphasis is laid on words than on figures. Although most of the narratives disclosed in published company accounts relate to the items of basic financial statements, there are certain narrative disclosures, which focus on things that are not related to financial statement items.

In India requirements as to narrative disclosures stem from the provisions of the Companies Act and that of the accounting standards. These requirements are discussed under the following two broad heads:

- A. Accounting Policies
- B. Notes on Accounts

### **A. Accounting Policies**

Accounting policies often contain a large volume of narratives that have a significant bearing on the financial health and performance of the company. Accounting Standard 1 on *Disclosure of Accounting Policies* issued by the ICAI deals with the disclosure of significant accounting policies followed in the preparation and presentation of financial statements. The purpose of this standard is to promote better understanding of financial statements by ensuring the disclosure of significant accounting policies in the financial statements in an orderly manner. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

According to this standard, going concern, consistency and accrual are fundamental accounting assumptions that underlie the preparation and presentation of financial statements. It specifically requires that if a fundamental accounting assumption is not followed, the fact should be disclosed.

The standard stipulates the following:

- (i) All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.
- (ii) The disclosure of the significant accounting policies as such should form part of the financial statements.
- (iii) The significant accounting policies should normally be disclosed in one place.
- (iv) 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 year of such change.
- (v) In the case of a change in accounting policies that 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 an amount is not ascertainable, wholly or in part, the fact should be indicated.

Though this standard provides general guidance for disclosure of significant accounting policies, it has not stated which ones constitute significant accounting policies. However, a number of accounting standards issued by the ICAI specifically require disclosure of certain accounting policies. Extracts from an annual report is given in Appendix and that extracts include disclosure of accounting policies.

### **B. Notes on Accounts**

The section titled “Notes to the Accounts” or “Notes on Accounts” contains in many cases sizeable data. Notes on Accounts are integral part of the financial statements. Some of the disclosures made under Notes on Accounts are truly speaking extensions of the items of the basic financial statements. While some others provide additional information. Disclosure

### 3.22 Financial Reporting

through notes is done either to comply with statutory requirements or because the company chooses voluntarily to provide details on certain items. Such notes provide information about the accounting methods, assumptions and estimates used by management to develop the data reported in the financial statement. Following are the mandatory disclosure requirements, which may be presented under Notes on Accounts:

1. Contingent Liabilities and Capital Commitment;
2. Disclosure related to Small Scale Industrial Undertakings;
3. Managerial Remuneration;
4. Statement Showing Computation of Net profits for Managerial Remuneration;
5. Payments to the Auditors;
6. Quantitative Information Relating to Capacity and Production;
7. Value of Imports etc.;
8. Earnings and Expenditure in Foreign Currencies;
9. Prior Period Items;
10. Extraordinary Items;
11. Government Grants;
12. Amalgamation;
13. Related Party Transaction;
14. Lease;
15. Disclosure of Interest in Joint Ventures;
16. Disclosure of Earning Per Share;
17. Disclosure of Taxes on Income;

#### 3.2.4.4 Cash Flow Statement

The Companies Act in India does not make any specific requirement for the preparation and presentation of a Cash Flow Statement as it does in the cases of Balance Sheet and Profit and Loss Account. In March 1997, the ICAI has issued the Accounting Standard 3 (AS 3) on *Cash Flow Statement* by replacing the original Accounting Standard 3 on fund flow statement titled '*Changes in Financial Position*' issued in June 1981. Subsequently, it has declared AS 3 as a specified accounting standard for the purpose of Section 211(3C) to be complied with by the companies. Moreover, as per the requirement of clause 32 of the Listing Agreement, it is mandatory for the listed companies to prepare and present a cash flow statement in accordance with AS 3 issued by the ICAI following the 'indirect' method. Apart from listed companies, any enterprise having turnover more than Rest. 50 core in a year or an enterprise

that intends to issue securities is required to prepare and present cash flow statement as a principal financial statements.

In a cash flow statement, cash flows are required to be classified in terms of the activities generating them. AS 3 has identified three types of activities that generate cash flows for an enterprise. These are:

- (i) cash flows generated by operating activities;
- (ii) cash flows generated by investing activities; and
- (iii) cash flows generated by financing activities.

The standard prescribes two alternative methods for presentation of cash flows: direct method and indirect method. The key difference in these two methods lies in their presentation of 'cash flow from operating activities'. In the direct method, operating cash receipts and payments are reported directly. Major classes of gross cash receipts and gross cash payments are disclosed. In the indirect method, cash flows from operating activities are reported by way of adjustments of the reporting period's net profit disclosed in the Profit and Loss Account. Such adjustments are made for

- (i) the effects of transactions of a non-cash nature,
- (ii) any deferrals or accruals of past or future operating cash receipts or payments, and
- (iii) items of income or expense associated with investing or financing cash flows.

Major classes of gross cash receipts and gross cash payments arising from investing and financing activities are presented separately.

#### **3.2.4.5 Balance Sheet Abstract and Company's General Business Profile**

Part IV of Schedule VI requires a company to furnish an abstract of the broad categories of items in the Balance Sheet and the Profit and Loss Account and its general business profile. The abstract also requires earnings per share to be given. The general business profile of the company includes its registration details, and names and description of three principal products/services of the company. The specific disclosure requirements are given in *Appendix 3*.

#### **3.2.4.6 Supplementary Statements**

Pursuant to the provisions Section 212 of the Companies Act, 1956 holding companies are required to provide certain pieces of information in respect of its subsidiary(s) in a supplementary statement in their annual reports.

Under Section 212, the following documents must be attached to the Balance Sheet of a holding company: -

- (a) A copy of the recent Balance Sheet of the subsidiary company (or companies);



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- (b) A copy of the recent Profit and Loss Account of the subsidiary (or subsidiaries);
- (c) A copy of the recent report of the Board of Directors of the subsidiary;
- (d) A copy of the recent report of the auditors of the subsidiary (or subsidiaries).

The aforesaid documents have to be prepared in accordance with the requirements of this Act. The information to be attached to the Balance Sheet of a holding company in respect of the subsidiary companies cannot be more than 6 months old.

In addition to these documents a holding company is required to provide the following statements:

- (i) A statement showing,
- (ii) The extent of the holding company's interest in the subsidiary (or subsidiaries) at the end of the financial year or of the last financial year of the subsidiary (or subsidiaries);
- (iii) The net aggregate amount of profits (after deduction of losses) of the subsidiary (or subsidiaries) so far as they concern the holding company, separately for the current financial year and for previous financial years. The profits have to be segregated between profits already dealt with in the books of the holding company and not so dealt with.

The term 'profits' means profits of a revenue nature and earned after the date of the acquisition of the shares by the holding company.

- (i) Where the financial year of the subsidiary company does not coincide with the financial year of the holding company, a statement showing the following:
- (ii) Whether and to what extent there has been a change in the holding company's interest in the subsidiary company between the end of the financial year or of the last financial year of the subsidiary and the end of the holding company's financial year;
- (iii) Details of any material changes which have occurred between the end of the financial year or of the last financial year of the subsidiary company and the end of the financial year of the holding company in respect of: -
  - (a) The subsidiary's fixed assets;
  - (b) Its investments;
  - (c) The money lent by it; and
  - (d) The moneys borrowed by it for any purpose other than that of meeting current liabilities.

If for any reason the Board of Directors of the holding company is unable to obtain information on the subject of revenue or capital profits, a report in writing to that effect should also be furnished.

### **3.2.5 Disclosure Requirements under Listing Agreement & other SEBI Guidelines**

The disclosure requirements under the Listing Agreement for the presentation of annual reports by listed companies are discussed below. Though there are some overlapping reporting requirements for annual reports under the Listing Agreement and under the Companies Act, many requirements under the Listing Agreement supplement the requirements under the Companies Act for the listed companies.

#### **3.2.5.1 Balance Sheet, Profit and Loss Account and Directors' Report**

Unlike the Companies Act, 1956, Listing Agreement does not provide any guidance for the preparation of Balance Sheet, Profit and Loss Account and the Directors' Report. It merely requires a company to supply a copy of the complete and full Balance Sheet, Profit and Loss Account and the Directors' Report to each shareholder. However, a company may supply a single copy of the complete and full Balance Sheet, Profit and Loss Account and the Directors' Report to shareholders residing in one household. But it must send abridged Balance Sheet to all the shareholders in the same household and on receipt of request it shall supply the complete and full Balance Sheet, Profit and Loss Account and the Directors' Report to any shareholder residing in such household [Clause 32].

#### **3.2.5.2 Cash Flow Statement**

While the Companies Act, 1956 does not make any specific requirement for presentation of the cash flow statement in the annual reports of companies, Listing Agreement specifically asks for the preparation and supply of such statement. It stipulates that cash flow statement should be prepared in accordance with the Accounting Standard on Cash Flow Statement (AS 3) issued by the ICAI, and it shall be presented only under the 'Indirect Method' as given in AS 3 [Clause 32].

#### **3.2.5.3 Related Party Disclosure**

Transactions between related parties may not be at arm's length. Hence, companies are required to make appropriate disclosures in respect of such transactions so that users of financial statements can make their own assessment. Such disclosures have to be made in annual reports in compliance with the accounting standard on Related Party Disclosure (AS 18) issued by the ICAI [Clause 32].

#### **3.2.5.3 Disclosure to be made by Holding Companies and Subsidiary Companies in respect of Loans, Advances and Investments**

Holding companies are required to disclose in their separate financial statements, the amounts at the year end, and the maximum amount during the year, of loans / advances / investments outstanding in respect of the following. Similarly, subsidiary companies are also required to disclose in their financial statements, the amounts at the year end, and the maximum amount during the year, of loans / advances / investments outstanding in respect of the following:

### 3.26 Financial Reporting

- (a) Loans and advances in the nature of loans to holding company by name and amount
- (b) Loans and advances in the nature of loans to associates by name and amount
- (c) Loans and advances in the nature of loans where there is
  - ◆ no repayment schedule or repayment beyond seven years or
  - ◆ no interest or interest below the rate (i.e., the prevailing bank rate) mentioned in section 372A of Companies Act, 1956 by name and amount
- (d) Loans and advances in the nature of loans to firms / companies in which directors are interested by name and amount.

#### 3.2.5.4 Corporate Governance

In India the first attempt was made by the Confederation of Indian Industries (CII) to codify Corporate Governance. But the genesis of the provisions on Corporate Governance contained in clause 49 of the Listing Agreement is the Report of Kumar Mangalam Birla Committee. On 7<sup>th</sup> May 1999, the SEBI had set up a committee under the chairmanship of Sri Kumar Mangalam Birla to formulate the code of Corporate Governance. The SEBI in its meeting held on 25<sup>th</sup> January, 2000 has accepted the recommendations made by the committee and has suggested incorporation of certain matters in the Listing Agreement as clause 49. This clause addresses different aspects of corporate governance. The disclosure requirements contained under this clause are discussed below:

##### (a) Management Discussion and Analysis Report

Management Discussion and Analysis (MD & A) report is a very important document through which management of a company can express its views and opinions on various aspects of a company like performance, success or failure, future plan of the company, forward looking information, etc.

The MD&A complements and supplements the financial statements, but does not form part of the financial statements. The objective in preparing the MD&A should be to improve the reporting company's overall financial disclosure by providing a balanced discussion of the results of operations and financial conditions. Although originally devised as a regulatory document to supplement financial statements, the MD&A report has the potential to be a foundational and integrative business reporting document that provides 'forward-looking information'.

The MD&A serves the laudable purpose of giving investors important disclosures about a company's operations. Although this section contains useful information, investors must heed caution, as the section is unaudited.

By virtue of the provisions contained in clause 49 under the Listing Agreement, the company has to provide a MD & A report to the shareholders. This report may be presented as *part of the directors' report* or as *an addition thereto*. It should include discussion on the following

matters within the limits set by the company's competitive position:

- (i) Industry structure and developments.
  - (ii) Opportunities and threats.
  - (iii) Segment-wise or product-wise performance.
  - (iv) Outlook.
  - (v) Risks and concerns.
  - (vi) Internal control systems and their adequacy.
  - (vii) Discussion on financial performance with respect to operational performance.
  - (viii) Material developments in Human Resources/ Industrial Relations front, including number of people employed.
- (b) Management's Report on Corporate Governance

The listed companies are required to give a detailed compliance report on corporate governance in the separate section on 'Corporate Governance' in their annual reports. The report shall specifically highlight non-compliance of any mandatory requirements with reasons thereof and also the extent to which the non-mandatory requirements have been adopted.

The company should obtain a certificate from the auditors of the company regarding the compliance with the conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report which is sent annually to all the shareholders of the company.

The list of mandatory items as provided in clause 49 of the Listing Agreement is reproduced in *Appendix 4*.

#### **3.2.5.5 Disclosure Requirements for Employee Stock Option and Stock Purchase Scheme**

The SEBI has issued guidelines entitled Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 to provide for disclosure and other requirements regarding share based payments. Clause 12 and clause 19 of the guidelines are relevant for the purpose of reporting by the directors. Clause 12 requires the Board of Directors to disclose either in the Directors' report or in the annexure to the Directors' Report the details of employees stock option scheme (ESOP) like options granted, the pricing formula used, option vested, option exercised etc. Clause 19 requires that Directors' Report or annexure thereto should contain the details of employees stock purchase scheme (ESPS) like the number of shares issued under ESPS, the price at which such shares are issued, consideration received against the issue of such shares etc.

### **3.28 Financial Reporting**

According to Schedule I of the Guidelines employee stock option outstanding will appear in the Balance Sheet as part of Net Worth or Shareholders' Equity. Deferred employee compensation will appear in the Balance Sheet as a negative item as part of Net Worth or Shareholders' Equity.

## **4. CORPORATE REPORTING PRACTICES IN INDIA**

There are few studies that deal with Indian practices of corporate financial reporting. The Institute of Chartered Accountants of India has made survey of corporate reporting practices in India from time to time (1981; 1985). Other notable studies on financial reporting in India are Dasgupta Lal, Chakraborty and Banerjee. An analysis of the findings of these studies reveals that Indian corporate reporting practices are coping with changing needs of the economy and the society. Furthermore, the compliance with statutory disclosure requirement is a general phenomenon. However, in a recent study by Das reveals that there are cases of non-compliance with mandatory disclosure requirements. Thus, there is scope of improvement in the area of reporting of even mandatory disclosure items and role of management is important since the ultimate responsibility of providing information to the users rests on management. It may also be noted that there is a great amount of diversity in corporate reporting. The quality of information provided by the big companies has improved considerably and reports of some Indian companies are internationally competitive. With this brief introduction, we discuss in the following section the current reporting practices of Indian companies.

### **4.1 PUBLISHED FINANCIAL STATEMENTS**

Annual report is major vehicle through which Indian companies are publishing their financial statements. Like companies of any developed countries, Indian annual reports now include much more than the legal minimum requirements. Regarding elements of annual reports, the following are most common:

- ◆ Notice of annual general meeting
- ◆ Chairman's report\*
- ◆ Summary of financial results\*
- ◆ The financial highlights for a number of years\*
- ◆ Director's report
- ◆ Management discussion & analysis
- ◆ Corporate governance report
- ◆ Auditor's report on financial statements
- ◆ Balance sheet
- ◆ Profit and loss account
- ◆ Significant accounting policies

- ◆ Schedules and notes accounts
- ◆ Cash flow statement
- ◆ Supplementary statement u/s 212 of the Companies Act
- ◆ C& AG's Comments on Accounts (in case of Government Companies)
- ◆ Audited consolidated financial statements
- ◆ Information on human resources\*
- ◆ Value added statement\*
- ◆ Corporate social report\*
- ◆ Environmental report\*
- ◆ Information on Brand/ Intangibles\*
- ◆ EVA® report\*

The \* marked elements are provided voluntarily. Regarding last few items disclosure is limited to large companies only. In Appendix 6 extract from Annual Report of National Aluminium Company Limited is given as an example. The students should go through it and try to relate notes with the main items shown in the balance sheet and profit and loss account. They should also try to understand the disclosure techniques relating to items that are disclosed pursuant to requirements of the accounting standards (e.g., Disclosure of accounting policies, EPS, segment information etc.).

#### 4.2 ABRIDGED FORM BALANCE SHEET

Indian Companies Act requires that a copy of every balance sheet (including the profit and loss account, the auditors' report and every document required by law to be annexed or attached, as the case may be, to the balance sheet) which is to be laid before a company in general meeting shall, not less than twenty-one days before the date of the meeting, be sent to every member of company (Sec. 219). Such balance sheet may be called full version balance sheet. But, to reduce the cost of printing and dispatch of full version balance sheet, section 219 (1) (b) (iv) also provides that listed companies may send a statement containing salient features of the balance sheet in the prescribed form. Under Rule 7A of the Companies Rules, Form No. 23AB has been prescribed which deals with abridged form of balance sheet and other disclosures. The form is given in *Appendix 7*.

However, clause 32 of the listing agreement (as amended in September 1994) provides that the company will supply a copy of the complete and full balance sheet, profit and loss account and the directors' report to each shareholders. Hence, after 1994, there was no scope for comparing to send abridged balance sheet. But in 1999, the SEBI has directed a change in clause 32 (vide circular no SMDRP/ POLICY / CIR- 14/98 dated May 19,1999) to provide that the company may supply single copy of complete and full balance sheet and profit & loss

### **3.30 Financial Reporting**

account and directors' report to shareholders residing in one household (i.e. having same address in the Books of the Company/ Registrars/ Share transfer agents). Provided that, the company on receipt of request shall supply the complete and full balance sheet and profit & loss account and directors' report also to any shareholder residing in such household. Further, the company will supply abridged balance sheet to all the shareholders in the same household.

It may be mentioned that sending abridged balance sheet is not a common practice among Indian companies.

## **5. OTHER REPORTS**

### **5.1 DISCLOSURE OF FINANCIAL INFORMATION IN PROSPECTUS**

Prospectus is an important offer document that is issued by a company for making public issue of securities. SEBI (Disclosure & Investor Protection) Guidelines, 2000 *inter- alia* provide contents of the prospectus. There are requirements to disclose certain important pieces of financial information relating to the issuer company and group companies. The major aspect of disclosure of financial information relates to reporting of audited profits and losses and assets and liabilities of the issuer company for each of the five financial year immediately preceding the issue of the prospectus. The requirements of the SEBI Guidelines on audited financial statements are similar to that of Schedule II of the Companies Act, 1956. Requirements of Indian Companies Act are elaborated separately. Other financial information that is to be provided in the prospectus includes.

1. Capital structure of the company
2. Utilization of Issue Proceeds
3. Financial Information of group companies
4. Promise vis-à-vis performance
5. Accounting and other ratios to justify the basis of issue price. (Such ratios shall be based on the financial statements prepared on the basis of Indian Accounting Standards)

It may be noted that abovementioned items are disclosed without any audit / review by independent accountant.

SEBI Guidelines, now allow an issuer company, if it so desires, to include in the offer document, the financial statements prepared on the basis of more than one set of accounting standards (e.g. Indian standards and US GAAPs) subject to disclosure of the material differences arising because of differences in the accounting policies of two different accounting standards.

Requirements of the Indian Companies Act regarding disclosure of financial information in prospectus are discussed under two heads:

- A. Auditor's report in prospectus
- B. Accountant's report in prospectus

**A. Auditor's report in prospectus**

Part IIB of Schedule II of the Companies Act, 1956 requires a report of auditors of the company shall be included in prospectus.

If the company has no subsidiaries, the auditor's report shall-

- (a) so far as regards profits and losses, deal with the profits or losses of the company (distinguishing items of a non-recurring nature) for each of the five financial years immediately preceding the issue of the prospectus; and
- (b) So far as regards assets and liabilities, deal with the assets and liabilities of the company on the last date to which the accounts of the company were made up.

If the company has subsidiaries, the auditor's report shall-

- (c) So far as regards profits and losses, deal with the company's profits and losses on standalone basis and in addition deal either-
  - (i) as a whole with the combined profits and losses of its subsidiaries, so far as they concern members of the company; or
  - (ii) individually with the profits and losses of each subsidiary so far as they concern members of the company, or, instead of dealing separately with the company's profits and losses, deal as a whole with the profits and losses of the company, and, so far as they concern members of the company, with the combined profits or losses of its subsidiaries, and
  - (iii) so far as regards assets and liabilities, deal separately with the company's assets and liabilities on standalone basis and in addition, deal either-
    - (iv) as a whole with the combined assets and liabilities of its subsidiaries, with Or without the company's assets and liabilities, or
    - (v) Individually with the assets and liabilities of each subsidiaries and shall indicate as respects the assets and liabilities of the subsidiaries, the allowance to be made for persons other than members of the company.

**B. Accountant's report in prospectus**

Schedule II B of the Companies Act, 1956, specifies that an accountant should report about the use of proceeds or any part of the proceeds raised by issuing debentures or shares in his report. Any report by accountants mentioned in this schedule shall be made by accountants qualified under this Act for appointment as auditor of a company and shall not be made by any accountant who is an officer or servant, or a partner or in the employment of officer or servant, of the company or of the company's holding company. However, the expression 'officer' shall



### 3.32 Financial Reporting

include a proposed director but not an auditor. So an auditor of the company can make report on the matters mentioned in clauses 4 & 5 of Part II of the Companies Act.

The accountant named in the prospectus is required to report if the proceeds or any part of the proceeds of the issue of shares or debentures are or is to be applied, directly or indirectly, in the purchase of any business or an interest in any business. Business interest means entitlement exceeding fifty per cent share either in the capital or in profits or losses or in both.

A report made by the accountants must cover the following:

- (i) the profit or loss of the business for each of the 5 financial years immediately preceding the issue of prospectus and
- (ii) the assets and liabilities of the business at the last date to which the accounts of business were made up, being the date not more than 120 days before the date of issue of the prospectus.

As per Clause 5, an accountant is required to report if proceeds or any part thereof raised by issue of shares or debentures are or is to be used, directly or indirectly, in any manner that results in acquisition by the company, of shares in any other body corporate and by reason of that acquisition or anything done in consequence thereof or in connection therewith, that body corporate will become a subsidiary of the company.

The report made by the accountant must cover;

- (i) the profit or loss of the other body corporate for each of the 5 financial years immediately preceding the issue of the prospectus and
- (ii) the assets and liabilities of the other body corporate at the last date to which its accounts were made up.

The said report shall:

- (a) indicate how the profit or loss of the other body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the company and what allowance would have fallen to be made, in relation to assets and liabilities so dealt with for holders of other assets, if the company had at all material times held the shares to be acquired, and
- (b) where the other body corporate as subsidiaries, deal with the profits or losses and the assets and liabilities of the body corporate and its subsidiaries in the manner provided by sub clause (2) in relation to the company and its subsidiaries.

As per Clause (2) if the company has no subsidiaries, the report shall:

- (a) so far as regards profits and losses, deal with the profits or losses of the company (distinguishing items of non-recurring nature) for each of the five financial years immediately preceding the issue of the prospectus; and

- (b) so far as regards assets and liabilities, deal with assets and liabilities of the company at the last date to which the accounts of the company were made up.

As per clause 20 of Part III any report required by part II of this schedule, shall either indicate by way of note any adjustments as respects the figures of any profits or losses, or assets and liabilities dealt with by the report which appear to the persons making the report necessary or make those adjustments and indicate that adjustments have been made. If the company carries the business have only to be made up in respect, of 4 such years, 3 such years, 2 such years or 1 such year, Part II of this schedule, shall have effect as if references to 4 financial years immediately preceding the issue of the prospectus cover a period of less than 5 years references to the said 5 financial years shall have effect as if references to a number of preceding the issue of the prospectus were substituted for references to the 5 financial years (clause 19).

It may be mentioned here that clauses, 1,2 and 3 of Part II B of Schedule II require a report be the auditors of a company and clauses 4 and 5 required a report by accountants to be set out in a prospectus. A question may arise as to whether the auditor (referred to in clauses 1,2 and 3) and the accountants (referred to in clauses 4 and 5) are the same person? The Institute of Chartered Accountants of India has issued a Guidance Note on 'Reports in Company Prospectuses.' Para 1.6 of the said Guidance Note clarifies that an auditor of a company is eligible to make report under clauses 4 and 5 of Schedule II. It is important to note that in terms of Section 226(3)(d), a chartered accountant, who is indebted to a company for an amount exceeding Rs. 1,000 is disqualified for appointment as its auditor. However, there seems nothing wrong to prohibit such person from acting as an 'accountant' for the purpose of making a report under clauses 4 and 5 of Part II Schedule II. Thus the, 'auditor' and the 'accountant' may be different persons.

In a nutshell, the accountant named in the prospectus, has to report on profit and loss account and balance sheet of the company, if the proceeds raised by the issue of shares of debentures are used or is intended to be used for purchase of any business, for purchase of subsidiary to the company. The report should ordinarily cover profit or loss, assets and liabilities of the company issuing prospectus for five financial years. If the company is in operation for less than a year, the coverage should be accordingly reduced. In case of acquisition of shares in another body corporate which will become subsidiary to the company which is issuing prospectus, the accountants report should cover profit or loss, assets and liabilities of such subsidiaries also. Reporting of the profit or loss of the subsidiaries should be linked up to reveal how far they concerned members of the company. Reporting of the assets and liabilities should be linked up to reveal the allowance to be made for persons other than members of the company.

## 5.2 UNAUDITED QUARTERLY RESULTS

In India, the requirement of publishing interim financial results was, for the first time,

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introduced by way of publication of unaudited half yearly results through amendments in clause 41 of the listing agreement w. e. f. March 1988 vide Ministry of Finance, Department of Economic Affairs, Stock Exchange Division letter No. F14/2/SE/85-pt dated 9.12.1987. After a decade it was modified requiring publication of unaudited quarterly results with effect from June 1998 vide SEBI letter no SMD/POLICY/CIR-12/98 dated 7.4.98.

All listed companies are now required to furnish unaudited quarterly results in the prescribed proforma within one month from the end of the quarter to the stock exchanges on which it is listed and will publish the same within 48 hours of the conclusion of the board meeting in atleast one national newspaper and one regional language newspaper. The quarterly results shall be prepared on the basis of accrual accounting policy and in accordance with uniform accounting practices for all periods on quarterly basis. It will incorporate a statement of segmentwise revenue; results and capital employed prepared as per AS 17 on Segment Reporting and will also comply with AS 22 on Accounting for Taxes on Income as regards measurement of the requirements of deferred taxes.

*For further details refer to chapter on Interim Reporting.*

## 6. BEST PRESENTED ACCOUNTS

For many years the ICAI has been awarding shields and plaques for best presented accounts. The aim is to encourage companies in presenting accounting information in the financial statements convincingly to serve the information needs of the users in the best possible manner

### 6.1 CONDITIONS FOR ENTRY TO THE ANNUAL COMPETITION FOR THE BEST PRESENTED ACCOUNTS

- I. Before 2004, the Institute of Chartered Accountants of India (ICAI) used to present awards in the following four categories:

**Category I:** This category includes all non-financial public sector/joint sector companies (i.e., companies to which sections 619 and 619B of the Companies Act are applicable) as also non-financial statutory corporations.

**Category II:** This category includes all non-financial private and joint sector companies (where Section 619 and 619B of the Companies Act, 1956 are not applicable).

**Category III:** This category includes financial institutions, banks and financial companies in public, private and joint sectors. 'Financial institution' include all institutions and organisations engaged in financing and allied activities and not doing any other business, e.g., Industrial Development Bank of India, Unit Trust of India, Industrial Credit and Investment Corporation of India Ltd., State Financial Corporation etc.

**Category IV:** This category includes entities such as Port Trusts, Municipal Corporations, Public Utilities not registered under the Companies Act, Co-operative Societies, Public Trusts, Educational and Research Institutions, etc.

However, from 2004-2005 onwards, ICAI has started presenting the awards for Excellence in Financial Reporting in following seven categories:

**Category I:** Manufacturing and Trading enterprises (including processing, mining, plantation, oil and gas enterprises).

**Category II:** Finance sector (including NBFCs, mutual funds, investment bankers, HFCs etc.).

**Category III:** Service sector (including hotels consultancy, transport, stock exchanges, R & D, private hospitals).

**Category IV:** Banking, Insurance and Financial Institutions.

**Category V:** Information Technology, Communication and Entertainment enterprises.

**Category VI:** Infrastructure and Construction sector (including power generation and supply, port trusts, roads).

**Category VII:** Others (Section 25 companies, educational institutions, NGOs, charitable hospitals and other organisations).

II. Before 2004-2005, following Silver Shields and Plaques were given to four different categories of enterprises:

- (a) A Silver Shield for the best presented accounts under Category I and one plaque for the next highly commended accounts.
- (b) A Silver Shield for the best presented accounts under Category II and one plaque to the next highly commended accounts;
- (c) A Silver Shield for the best presented accounts under Category III; and
- (d) A Plaque for the best presented accounts under Category IV.

From 2004-2005, Gold Shields and Silver Shields are presented, in all the seven categories, to the award winners for 'Excellence in Financial Reporting'.

III. The accounts for entry to the competition should relate to the financial year ending on any day between 1st April and 31st March of next year.

IV. Six copies of the following documents (or such other similar documents as are prepared by the Organisation concerned) should be sent to the Secretary, Research Committee, the Institute of Chartered Accountants of India, Indraprastha Marg, New Delhi-110002, so as to reach him before the specified date.

- (a) Balance Sheet

### **3.36 Financial Reporting**

- (b) Profit and Loss Account
  - (c) Directors' Report
  - (d) Chairman's statement or speech at the Annual General Meeting.
- V. No form has to be filled up and no fee is payable.
- VI. Cyclostyled copies of the Annual Report and Accounts will not be accepted. This condition, however, does not apply to entities covered by Category IV.
- VII. In all matters concerning the competition, the decision of the panel of judges appointed by the Institute will be final.

### **6.2 SOME IMPORTANT FACTORS GENERALLY CONSIDERED FOR THE AWARD OF GOLD / SILVER SHIELDS AND PLAQUES FOR THE BEST PRESENTED ACCOUNTS**

1. Compliance with the legal requirements in the preparation and presentation of financial statements as specified by the relevant statute, e.g., the Companies Act, 1956, in case of companies.
2. Basic quality of accounts as judged from the qualifications in the auditor's report, notes to the accounts and compliance with the generally accepted accounting principles such as those enunciated in the Accounting Standards, Statements, Guidance Notes, etc., issued by the Council of the Institute of Chartered Accountants of India and its various Committees.
3. The nature and quality of information presented in the accounts to make the disclosure meaningful. For example:
  - (i) Sufficient details of revenues/expenses for financial analysis, e.g., distinction between manufacturing cost, selling cost, administrative cost.
  - (ii) Use of vertical form as against the conventional "T" form; judicious use of schedules; use of sub-totals; manner of showing comparative figures; ease of getting at figures.
  - (iii) Extent to which additional financial information is provided to the readers through charts and graphs.
  - (iv) Extent of clarity, lucidity and comprehensiveness of the information contained in the financial statements, in the context of a layman.
  - (v) Financial highlights and ratios.
  - (vi) Inclusion of one or more of the information like value added statement, break-up of operations, organisation chart, location of factories/branches, human resource accounting, inflation adjusted accounts, social accounts, etc.
4. The extent to which the (i) Reports of the Governing Body such as Board of Directors Report and/or (ii) Chairman's Statement, if any, are informative. The following aspects

are generally considered relevant in this regard:

- (i) Availability of information regarding different segments and units of the entity, i.e., whether details about each product/service and units, and whether located in the same area or spread in different geographical locations, are given.
  - (ii) Information regarding financial operations, capital raised during the year, financial requirements, borrowings, etc. In respect of multi-product/multi-unit organisations, whether details as per (i) above have been given for financial operations.
  - (iii) Employee relations.
  - (iv) Industry problems and problems peculiar to the enterprise.
  - (v) Information regarding social concerns (e.g., contribution to conservation and development of environment and ecology).
  - (vi) Information on contribution to community development projects, (e.g., medical institutions, educational institutions, provision of sanitary and drinking water, etc.), particularly in areas around location of entity.
  - (vii) Post-balance sheet events not requiring adjustment in accounts but material enough to warrant disclosure and future plans, programmes, market conditions, profitability forecast, environment friendliness, etc.
  - (viii) Manner of review of performance, plans and prospects by the company.
  - (ix) Compliance report on the Corporate Governance, clearly indicating non-compliance with any of the mandatory requirements with the reasons therefor.
  - (x) Directors' Responsibility Statement required under section 217(2AA) of the Companies Act, 1956.
5. Layout of contents, general appearance, presentation and quality of printing.
  6. Timeliness in presenting accounts based on the date of the notice of the Annual General Meeting in respect of which the Annual Report is circulated to the shareholders.

### 6.3 WINNERS OF BEST PRESENTED ACCOUNTS FOR LAST FEW YEARS

1. Shield Panel Awards List after 1998-99.

| Year      | Award                                     |  | Category                |                                  |                      |                                |                                                     |
|-----------|-------------------------------------------|--|-------------------------|----------------------------------|----------------------|--------------------------------|-----------------------------------------------------|
|           |                                           |  | Public Sector Companies | Non-Financial Private Companies. | Non-Financial Sector | Banks & Financial Institutions | Public Co-op. Research and Educational Institutions |
| 1999-2000 | Silver Shield for best presented accounts |  | Indian Oil Corpn. Ltd.  | Infosys Technologies Ltd.        |                      | ICICI Ltd.                     | —                                                   |

### 3.38 Financial Reporting

|            |                                           |                                |                                |            |                                 |
|------------|-------------------------------------------|--------------------------------|--------------------------------|------------|---------------------------------|
|            | Plaque for highly commended accounts      | Bharat Petroleum Corpn. Ltd.   | Decided not to give this award | –          | Decided not to give this award  |
| 2000-2001  | Silver shield for best presented accounts | Bharat Petroleum Corpn. Ltd    | Infosys Technologies Ltd.      | ICICI Ltd. | –                               |
|            | Plaque for highly commended accounts      | Indian Oil Corpn. Ltd.         | i-flex Solutions Ltd.          | –          | Decided not to give this award  |
| 2001-2002` | Silver shield for best presented accounts | Bharat Petroleum Corpn. Ltd    | Infosys Technologies Ltd.      | HDFC Ltd.  | –                               |
|            | Plaque for highly commended accounts      | Decided not to give this award | Dr. Reddy's Laboratories Ltd.  | –          | Decided not to give this award. |

#### ICAI Awards for the year 2002-2003

| Category                                                                                                                                                        | Award         | Name of the Entity               |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------|----------------------------------|
| I Non-Financial Public and Private Sector Companies (Other than those covered by Category III)                                                                  | Silver Shield | Infosys Technologies Limited     |
|                                                                                                                                                                 | Copper Plaque | Dr. Reddy's Laboratories Limited |
|                                                                                                                                                                 | Copper Plaque | Decided not to give this award.  |
| II Financial Institutions in public, private and co-operative sector, such as, banks, insurance companies, NBFCs, etc.                                          | Silver Shield | Decided not to give this award.  |
|                                                                                                                                                                 | Copper Plaque | Decided not to give this award.  |
| III Not-for-Profit Organisations including companies registered under section 25 of the Companies Act, 1956, educational and research institutions, and trusts. | Silver Shield | Decided not to give this award.  |
|                                                                                                                                                                 | Copper Plaque | Decided not to give this award.  |

## ICAI Awards for the year 2003-2004

|     | <b>Category</b>                                                                                                                                             | <b>Award</b>  | <b>Name of the Entity</b>                                     |
|-----|-------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------|---------------------------------------------------------------|
| I   | Non-Financial Public and Private Sector Enterprises (Other than those covered by Category III)                                                              | Silver Shield | Infosys Technologies Limited                                  |
|     |                                                                                                                                                             | Copper Plaque | Siemens Limited                                               |
|     |                                                                                                                                                             | Copper Plaque | Tata Chemicals Limited                                        |
| II  | Financial Institutions in public, private and co-operative sector, such as, banks, insurance companies, NBFCs, etc.                                         | Silver Shield | Housing Development Finance Corporation Limited               |
|     |                                                                                                                                                             | Copper Plaque | Cholamandalam Investment and Finance Company Limited          |
| III | Not-for-Profit Organisations including companies registered under section 25 of the Companies Act, 1956, educational and research institutions, and trusts. | Silver Shield | National Scheduled Castes Finance and Development Corporation |
|     |                                                                                                                                                             | Copper Plaque | Financial Management Service Foundation                       |

## ICAI Awards for the year 2004-005

|     | <b>CATEGORY</b>                                                                                                   | <b>Award</b>  | <b>Name of the Entity</b>                       |
|-----|-------------------------------------------------------------------------------------------------------------------|---------------|-------------------------------------------------|
| I   | <b>Manufacturing and Trading enterprises</b> (including processing, mining, plantations, oil and gas enterprises) | Gold Shield   | Dr. Reddy's Laboratories Limited.               |
|     |                                                                                                                   | Silver Shield | J.B. Chemicals & Pharmaceuticals Ltd.           |
|     |                                                                                                                   | Commendation  | Abhishek Industries Limited                     |
| II  | <b>Finance sector</b> (including NBFCs, mutual funds, investment bankers, HFCs, etc.)                             | Gold Shield   | Housing Development Finance Corporation Limited |
|     |                                                                                                                   | Silver Shield | SBI Capital Markets Limited                     |
| III | <b>Service sector</b> (including hotels, consultancy, transport, stock exchanges, R&D, private hospitals)         | Gold Shield   | Thomas Cook (India) Limited                     |
|     |                                                                                                                   | Silver Shield | The Great India Health Care Management Limited  |
| IV  | <b>Banking, Insurance and</b>                                                                                     | Gold Shield   | ICICI Bank Limited                              |



### 3.40 Financial Reporting

|     |                                                                                                                    |               |                                         |
|-----|--------------------------------------------------------------------------------------------------------------------|---------------|-----------------------------------------|
|     | <b>Financial Institutions</b>                                                                                      | Silver Shield | Andhra Bank                             |
| V   | <b>Information Technology, Communication and Entertainment enterprises</b>                                         | Gold Shield   | Infosys Technologies Limited            |
|     |                                                                                                                    | Silver Shield | Nucleus Software Exports Ltd.           |
|     |                                                                                                                    | Commendation  | Wipro Limited                           |
| VI  | <b>Infrastructure &amp; Construction sector</b><br>(including power generation and supply, port trusts, roads)     | Gold Shield   | The Tata Power Company Limited          |
|     |                                                                                                                    | Silver Shield | Larsen & Toubro Limited                 |
| VII | <b>Others</b> (Section 25 companies, educational institutions, NGOs, charitable hospitals and other organisations) | Gold Shield   | Financial Management Service Foundation |
|     |                                                                                                                    | Silver Shield | Vidya Dairy                             |

ICAI Awards for the year 2005-2006

| Category                                                                                                               | Award         | Name of the Entity                                 | Annual Report and Accounts for the year ended |
|------------------------------------------------------------------------------------------------------------------------|---------------|----------------------------------------------------|-----------------------------------------------|
| I <b>Manufacturing and Trading enterprises</b><br>(including processing, mining, plantations, oil and gas enterprises) | Gold Shield   | Shopper's Stop Limited                             | March 31, 2006                                |
|                                                                                                                        | Silver Shield | Decided not to give this award.                    |                                               |
| II <b>Finance sector</b><br>(including NBFCs, mutual funds, investment bankers, HFCs, etc.)                            | Gold Shield   | Decided not to give any award under this category. |                                               |
|                                                                                                                        | Silver Shield | Decided not to give any award under this category. |                                               |
| III <b>Service sector</b><br>(including hotels, consultancy, transport, stock exchanges, R&D, private hospitals)       | Gold Shield   | Bombay Stock Exchange Limited                      | March 31, 2006                                |
|                                                                                                                        | Silver Shield | Blue Dart Express Limited                          | December 31, 2005                             |

|     |                                                                                                                    |               |                                                 |                |
|-----|--------------------------------------------------------------------------------------------------------------------|---------------|-------------------------------------------------|----------------|
| IV  | <b>Banking, Insurance and Financial Institutions</b>                                                               | Gold Shield   | ICICI Lombard General Insurance Company Limited | March 31, 2006 |
|     |                                                                                                                    | Silver Shield | Decided not to give this award.                 |                |
| V   | <b>Information Technology, Communication and Entertainment enterprises</b>                                         | Gold Shield   | Infosys Technologies Limited                    | March 31, 2006 |
|     |                                                                                                                    | Silver Shield | Mphasis Limited BFL                             | March 31, 2006 |
| VI  | <b>Infrastructure &amp; Construction sector</b><br>(including power generation and supply, port trusts, roads)     | Gold Shield   | The Tata Power Company Limited                  | March 31, 2006 |
|     |                                                                                                                    | Silver Shield | Decided not to give this award.                 |                |
| VII | <b>Others</b> (Section 25 companies, educational institutions, NGOs, charitable hospitals and other organisations) | Gold Shield   | Decided not to give this award.                 |                |
|     |                                                                                                                    | Silver Shield | Decided not to give this award.                 |                |

### Self-examination Questions

1. What are the basic objectives of corporate financial reporting?
2. Do general purpose financial statements satisfy the informational needs of shareholders, creditors, employees and consumers? Why or what not?
3. How do the characteristics of relevance and reliability relate to the concept of useful information?
4. Discuss the legal requirements about furnishing unaudited quarterly results by listed companies in India.
5. Discuss the SEBI requirements for corporate governance report and explain how MD & A disclosure can assist users.
6. Discuss the role of the SEBI to improve corporate financial reporting.
7. Make an outline of an annual report of Indian companies.
8. Discuss the motives behind voluntary disclosure in annual reports.
9. Do you think the legal requirements in India regarding disclosure of financial information

### **3.42 Financial Reporting**

in annual report are adequate from the viewpoint of decision-oriented reporting?

10. Write notes on:

- (a) General purpose financial reporting
- (b) Qualitative characteristics of financial information
- (c) Cash flow statement
- (d) Abridged balance sheet
- (e) Capital market influence on financial reporting
- (f) Narrative disclosure

## Appendices

### Appendix - 1

#### HORIZONTAL FORM OF BALANCE SHEET

(Section 211(1) read with Part I of Schedule VI to Companies Act, 1956)

Balance Sheet of ..... as at .....

| <i>Figures<br/>for the<br/>previous<br/>year<br/>(Rs)</i> | <b>Liabilities</b>  | <i>Figures<br/>for the<br/>previous<br/>year<br/>(Rs)</i> | <i>Figures<br/>for the<br/>previous<br/>year<br/>(Rs)</i> | <b>Assets</b>          | <i>Figures<br/>for the<br/>previous<br/>year<br/>(Rs)</i> |
|-----------------------------------------------------------|---------------------|-----------------------------------------------------------|-----------------------------------------------------------|------------------------|-----------------------------------------------------------|
|                                                           | Share Capital       |                                                           |                                                           | Fixed Assets           |                                                           |
|                                                           | Reserve and         |                                                           |                                                           | Investments            |                                                           |
|                                                           | Surplus             |                                                           |                                                           | Current Assets,        |                                                           |
|                                                           | Secured Loans       |                                                           |                                                           | Loans and Advances     |                                                           |
|                                                           | Unsecured Loans     |                                                           |                                                           | Miscellaneous          |                                                           |
|                                                           | Current Liabilities |                                                           |                                                           | Expenditure (to the    |                                                           |
|                                                           | and Provisions      |                                                           |                                                           | extent not written off |                                                           |
|                                                           |                     |                                                           |                                                           | or adjusted)           |                                                           |
|                                                           |                     |                                                           |                                                           | Profit and Loss        |                                                           |
|                                                           |                     |                                                           |                                                           | Account                |                                                           |
|                                                           | Total               |                                                           |                                                           | Total                  |                                                           |

### Appendix – 2

#### VERTICAL FORM OF BALANCE SHEET

(Section 211(1) read with Part I of Schedule VI to Companies Act, 1956)

Balance Sheet of..... as at .....

|  | Schedule<br>No. | Figures as at<br>the end of<br>Current<br>Financial Year | Figures as<br>at the end<br>of Previous<br>Financial<br>Year |
|--|-----------------|----------------------------------------------------------|--------------------------------------------------------------|
|--|-----------------|----------------------------------------------------------|--------------------------------------------------------------|

#### I. Sources of Funds

- (1) Shareholders' funds:
  - (a) Capital
  - (b) Reserves and surplus

### 3.44 Financial Reporting

- (2) Loan funds:
  - (a) Secured loans
  - (b) Unsecured loans

TOTAL

#### II. Application of Funds

- (1) Fixed assets:
  - (a) Gross: block
  - (b) Less: Depreciation
  - (c) Net block
  - (d) Capital work-in-progress
- (2) Investments
- (3) Current assets, loans and advances:
  - (a) Inventories
  - (b) Sundry debtors
  - (c) Cash and bank balances
  - (d) Other current assets
  - (e) Loans and advances

*Less :*

Current liabilities and provisions

- (a) Liabilities
- (b) Provisions

*Net current assets*

- (4) (a) Miscellaneous expenditure to the extent not written off
- (b) Profit and loss account

TOTAL

### Appendix – 3

#### Balance Sheet Abstract and Company's General Business Profile

##### I. Registration Details

Registration No.

State Code

Balance Sheet Date

## II. Capital raised during the year (Amount in Rs. Thousands)

|              |                   |
|--------------|-------------------|
| Public Issue | Rights Issue      |
| Bonus Issue  | Private Placement |

## III. Position of Mobilisation and Deployment of Funds (Amount in Rs. Thousands)

|                             |                    |
|-----------------------------|--------------------|
| Total Liabilities           | Total Assets       |
| <i>Sources of Funds</i>     |                    |
| Paid-up Capital             | Reserves & Surplus |
| Secured Loans               | Unsecured Loans    |
| <i>Application of Funds</i> |                    |
| Net Fixed Assets            | Investments        |
| Net Current Assets          | Misc. Expenditure  |
|                             | Accumulated Losses |

## IV. Performance of Company (Amount in Rs. Thousands)

|                          |                       |
|--------------------------|-----------------------|
| Turnover                 | Total Expenditure     |
| Profit/Loss before tax   | Profit/Loss after tax |
| Earning per Share in Rs. | Dividend rate %       |

## V. Generic Names of Three Principal Products/ Services of Company (as per monetary terms)

|                              |  |
|------------------------------|--|
| Item Code. No.<br>(ITC Code) |  |
| Product                      |  |
| Description                  |  |

## Appendix – 4

**Suggested List of Items to be included in the Report of Corporate Governance in Annual Reports of the companies**

(Annexure 1B of Clause 49 of the Listing Agreement)

1. A brief statement on company's philosophy on code of governance.

### 3.46 Financial Reporting

#### 2. Board of Directors

- ◆ Composition and category of directors for example promoter, executive, independent non-executive, nominee director, which institution represented as lender or as equity investor.
- ◆ Attendance of each director at the Board of Directors' meetings and the last AGM.
- ◆ Number of other BoDs or Board Committees he / she is a member or chairperson of.
- ◆ Number of Board of Directors' meetings held, dates on which held.

#### 3. Audit Committee

- ◆ Brief description of terms of reference
- ◆ Composition, name of members and chairperson
- ◆ Meetings and attendance during the year

#### 4. Remuneration Committee

- ◆ Brief description of terms of reference
- ◆ Composition, name of members and chairperson
- ◆ Attendance during the year
- ◆ Remuneration policy
- ◆ Details of remuneration to all the directors, as per format in main report.

#### 5. Shareholders Committee

- ◆ Name of non-executive director heading the committee
- ◆ Name and designation of compliance officer
- ◆ Number of shareholders complaints received so far
- ◆ Number not solved to the satisfaction of shareholders
- ◆ Number of pending share transfers

#### 6. General Body Meetings

- ◆ Location and time, where last three AGMs held
- ◆ Whether special resolutions
- ◆ Were put through postal ballot exercise
- ◆ Person who conducted the postal ballot exercise
- ◆ Are propose to be conducted through postal ballot
- ◆ Procedure for postal ballot

7. Disclosures

- ◆ Disclosures on materially significant related party transactions i.e., transactions of the company of material nature, with its promoters, the directors or the management, their subsidiaries or relatives etc., that may have potential conflict with the interests of company at large.
- ◆ Details of non-compliance by the company, penalties, strictures imposed on the company by Stock Exchange or SEBI or any Statutory authority, on any matter related to capital markets, during the last three years.

8. Means of communication

- ◆ Half-yearly report sent to each household of shareholders
- ◆ Quarterly results
- ◆ Which newspapers normally published in
- ◆ Any web-site, where displayed
- ◆ Whether it also displays official news releases; and
- ◆ The presentations made to institutional investors or to the analysts
- ◆ Whether MD & A is a part of annual report or not

9. General Shareholder information

- ◆ AGM : Date, time and venue
- ◆ Financial Calendar
- ◆ Date of Book closure
- ◆ Dividend payment Date
- ◆ Listing on Stock Exchanges
- ◆ Stock Code
- ◆ Market Price Data: High / Low during each month in last financial year
- ◆ Performance in comparison to broad-based indices such as BSE Sensex, CRISIL index etc.
- ◆ Registrar and Transfer Agents
- ◆ Share Transfer System
- ◆ Distribution of Shareholding
- ◆ Dematerialization of shares and liquidity
- ◆ Outstanding GDRs/ ADRs/ Warrants or any Convertible instruments, conversion date and likely impact on equity Plant Locations
- ◆ Address for correspondence.



### 3.48 Financial Reporting

#### Appendix – 5

#### **Extracts from Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999**

In terms of SEBI (Employees Stock Option Scheme and Employees Stock Purchase Scheme) Guidelines, 1999, the following disclosures are required to be made in the annual report of the companies:

*(i) Disclosure of Employees Stock Option [Clause 12]*

The Board of Directors should disclose the following details of the Employees Stock Option Scheme (ESOS) either in the Directors' Report or in the annexure to the Directors' Report:

- (a) options granted;
- (b) the pricing formula;
- (c) options vested;
- (d) options exercised;
- (e) the total number of shares arising as a result of exercise of option;
- (f) options lapsed;
- (g) variation of terms of options;
- (h) money realised by exercise of options;
- (i) total number of options in force;
- (j) employee-wise details of options granted to :-
  - ◆ senior managerial personnel;
  - ◆ any other employee who receives a grant in any one year of option amounting to 5% or more of option granted during the year.
  - ◆ identified employee who were granted option, during any one year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;
- (k) diluted Earnings Per Share (EPS) pursuant to issue of shares on exercise of option calculated in accordance with Internal Accounting Standard (IAS) 33.

*(ii) Disclosure of Employees Stock Purchase [Clause 19]*

The Board of Directors should disclose the following details of the Employees Stock Purchase Scheme (ESPS) either in the Directors' Report or in the annexure to the Directors' Report:

- (a) the details of the number of shares in ESPS;
- (b) the price at which such shares are issued;
- (c) employee-wise details of the shares issued to;
  - ◆ senior managerial personnel;
  - ◆ any other employee who is issued shares in any one year amounting to 5% or more shares issued during the year;
  - ◆ identified employees who were issued shares during any one year equal to or exceeding 1% of the issued capital of the company at the time of issuance;
- (d) diluted Earning Per Share (EPS) pursuant to issuance of shares under ESPS; and
- (e) consideration received against the issuance of shares.

**Appendix 6****Form no. 23-AB***(See Rule 7A)*

Statement Containing Salient Feature of Balance Sheet and Profit and Loss Account etc.,

**As per section 219 (1) (b) (iv)****Form of Abridged Balance Sheet**

Name of the company .....

Abridged balance sheet as at .....

**Particulars****Figures as at the end of**

|  | <b>Current financial year</b> | <b>Previous financial year</b> |
|--|-------------------------------|--------------------------------|
|--|-------------------------------|--------------------------------|

**I. SOURCES OF FUNDS****(1) Shareholders' funds****(a) Capital****(i) Equity****(ii) Preference**

### **3.50 Financial Reporting**

- (b) Reserves and surplus
    - (i) Capital reserve
    - (ii) Revenue reserve
    - (iii) Revaluation reserve
    - (iv) Surplus in profit and loss account
    - (v) Share Premium Reserve
    - (vi) Investment Allowance Reserve
  - (2) Loan funds
    - (a) Debentures (The amount of convertible/Partly convertible debentures indicating the date of conversion)
    - (b) Public deposits
    - (c) Secured loans (other than debentures)
    - (d) Unsecured loans
- Total of (1) (2):

## **II. APPLICATION OF FUNDS**

- (1) fixed assets
  - (a) Net block (Original cost less depreciation)
  - (b) Capital work in progress
- (2) Investments
  - (a) Government securities
  - (b) Investment in subsidiary Companies
  - (c) Quoted
  - (d) Unquoted
- (3) (i) Current assets, loans and advances
  - (a) Inventories
  - (b) Sundry debtors
  - (c) Cash and bank balances
  - (d) Other current assets
  - (e) Loans and advances
- (ii) To subsidiary Companies
- (iii) To others

| <b>Particulars</b>                                                      | <b>Figures as at the end of</b>   |                                    |
|-------------------------------------------------------------------------|-----------------------------------|------------------------------------|
|                                                                         | <b>Current financial<br/>Year</b> | <b>Previous financial<br/>Year</b> |
| Less:                                                                   |                                   |                                    |
| (iv) Current liabilities and provisions                                 |                                   |                                    |
| (a) Liabilities                                                         |                                   |                                    |
| (b) Provisions                                                          |                                   |                                    |
| Net current assets (i-ii)                                               |                                   |                                    |
| (4) Miscellaneous expenditure to the extent not written off or adjusted |                                   |                                    |
| (5) Profit and Loss Account                                             |                                   |                                    |
| Total of 1 to 5                                                         |                                   |                                    |

**Abridged Profit and Loss Account for the year ending**

| <b>Particulars</b>                                                       | <b>Figures for the</b> |                      |
|--------------------------------------------------------------------------|------------------------|----------------------|
|                                                                          | <b>Current Year</b>    | <b>Previous Year</b> |
| <b>I. INCOME</b>                                                         |                        |                      |
| Sales/services rendered (Details to be given separately as per annexure) |                        |                      |
| Dividend                                                                 |                        |                      |
| Interest                                                                 |                        |                      |
| Other income (See Note 5)                                                |                        |                      |
| Total                                                                    |                        |                      |
| <b>II. EXPENDITURE</b>                                                   |                        |                      |
| Cost of goods consumed/sold                                              |                        |                      |
| (i) Opening Stock                                                        |                        |                      |
| (ii) Purchases                                                           |                        |                      |
| Less: Closing Stock                                                      |                        |                      |
| Manufacturing expenses,                                                  |                        |                      |
| Selling expenses                                                         |                        |                      |
| Salaries, wages and other employee benefits.                             |                        |                      |
| Managerial remuneration                                                  |                        |                      |

### 3.52 Financial Reporting

Interest

Depreciation

Auditor's remuneration

Provisions for (i) doubtful debts; and

(ii) Other contingencies (to be specified)

#### Particulars

#### Figures for the

Current Year

Previous Year

Any other expenses (see Note 5)

Total

(iii) Profit / Loss before tax (I-II)

(iv) Provision for taxation

(v) Profit / loss after tax

(vi) Proposed dividend:

(vii) Preference shares

(viii) Equity shares

### III TRANSFER TO RESERVES / SURPLUS

#### Notes to the abridged Balance Sheet and the Abridged Profit and Loss Account.

1. The amounts to be shown here should be the same as shown in the corresponding aggregated heads in the accounts as per Schedule VI or as near there to as possible.
2. The total amount of contingent liabilities and that of capital commitments should be shown separately.
3. All notes forming part of the accounts as per Schedule VI to which specific attention has been drawn by the auditors or which form a subject – matter of a qualification by the auditor should be reproduced.
4. If fixed assets are revalued, the amount of revaluation should be shown separately for the first five years subsequent to the date of revaluation.
5. Any item which constitutes 20% or more of the total income or expenditure (including Provisions) should be shown separately.
6. Amount, if material, by which items shown in the profit and loss account are affected by any change in the basis of accounting, should be disclosed separately.
7. If no provision is made for depreciation, the fact that no provision has been made shall

be stated along with the quantum of arrears of depreciation computed in accordance with section 205 (2) of the Act.

8. Market value of quoted investments (both of current year as also of previous year) should be mentioned.
9. Any note forming part of the accounts as per Schedule VI which is in the nature of any explanation regarding compliance with any law should be reproduced.
10. Important ratio performances such as sales/total assets ratio, operating profit/capital employed ratio, return on net worth, profit/sales ratio.
11. Details of installed capacity and productivity of main items should be disclosed.
12. Notes in abridged balance sheet should be given the same number as in the main balance sheet.
13. The above stated salient features of balance sheet and profit and loss account should be authenticated in the same manner as the main accounts are to be authenticated.
14. Auditor's report and comments if any of the comptroller and auditor general of India under sub-section (4) of section 619, in respect of Government companies, and companies under section 619 B -Should be given in full
15. Director's report - Should be given in full except the information under clause (e) of sub-section (1) and subsection (2A) of section 217 and directors' report should be signed by directors/secretary in the manner prescribed in section 215.

## ACCOUNTING FOR CORPORATE RESTRUCTURING

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### 1. INTRODUCTION

The dictionary meaning of the term 'restructuring' is 'give new structure to; rebuild, rearrange' (the Concise Oxford Dictionary).

Corporate restructuring (CR) is a broad term to denote significant reorientation or realignment of the investment (assets) and/or financing (liabilities) structure of a company through conscious management action with a view to drastically alter the quality and quantum of its future cash flow streams. This broad definition includes such corporate actions as mergers, acquisitions/ amalgamations/ absorption, divestitures, demergers (spin-offs) and debt-equity changes.

The continuing corporate restructuring wave that began in the 80s has been mainly triggered off by a renewed commitment to deliver shareholder value. To that extent both shareholder value management and corporate restructuring are inseparable as the end and the important means to that end. In India, the process of economic liberalisation and globalisation has created its own impetus, due to which, business environment has become highly competitive. Corporates are now restructuring and repositioning their folios to meet the challenges and seize opportunities thrown open by the multilateral trade agenda and emergence of the World Trade Organisation (WTO).

Most of the diversified multi-product companies are restructuring their corporate operations into more homogenous units to achieve synergy in operations. This entails transfer of business units from one company to the other or breaking up of a large group into smaller ones. On the other hand, smaller companies are forming alliances and joint ventures for their survival and growth. The exercise involves strategic planning to cope with the complex changes in the ownership and control and comply with a variety of business laws.

The underlying object of corporate restructuring is efficient and competitive business operations by increasing the market share, brand power and synergies. In the emerging scenario, joint ventures, alliances, mergers, amalgamations and takeovers are becoming the easiest and quickest way to expand capacities and acquire dominance over the market.

## 4.2 Financial Reporting

As Rock and Rock point out, “corporate restructuring can encompass a broad range of transactions but generally alludes to substantial changes in a firm's business portfolio and/or financial structure. Restructuring radically alters a firm's structure, asset-mix and/or organisation so as to enhance the firm's value. These alterations have a significant impact on the firm's balance sheet by redeploying assets (through acquisitions, divestiture and/or work force reduction) or by exploiting unused financial capacity.....”. In the words of Bowman and Singh, “restructuring can be conceptualised as change along one or more of three dimensions : assets, capital structure or management.”

While asset and capital restructuring can be termed as external, organisational restructuring may be referred to as internal; this is based on the significance and impact of the restructuring process on a company's internal or external stakeholders.

## 2. METHODS

The different methods of restructuring and their implications are now discussed below:

- (1) External Restructuring
  - (a) Asset-based (portfolio) restructuring
  - (b) Financial or capital restructuring
- (2) Internal Restructuring
  - (a) Portfolio restructuring (Cost reduction through closure of units, redundancy programmes etc.)
  - (b) Organisational restructuring (Management or organisational restructuring involving decentralisation, delayering, product-market based divisionalisation, matrix structure etc.)
- (3) Amalgamation, absorption or external reconstruction.

## 3. ASSET-BASED RESTRUCTURING

- (i) Mergers and Acquisitions (M & A)

Acquisition of companies/business units or merger with other companies has been one of the most common ways of carrying out restructuring. While acquisition of companies can be “friendly” or “hostile”, merger invariably involves friendly pooling of interest, undertaken by managements of companies of roughly comparable sizes. However, in the Indian context the term merger is used to denote consolidation of separate legal entities, not necessarily of similar sizes, into one through a statutory process of amalgamation. Since the motives of merger or acquisition are the same and both involve transfer of ownership and control of assets and the right to manage corporate cash flows and the difference between the two is very often only a matter of technical detail, the



term mergers and acquisitions (M & A) is often used interchangeably.

Amalgamation has been dealt with in detail in separate chapter.

(ii) Divestitures and Asset Swaps

Divestiture refers to disposal (in favour of third party) of business units, subsidiary companies or significant holdings in associates, often for cash. Asset swap, on other hand, entails simultaneous divesting and acquisition of each others' business by two companies, settling the difference in valuation, if any in cash.

(iii) Demergers or Spin-offs

Demerger has emerged as a major restructuring route for delivering value to shareholders in recent times. Demerger involves spinning off (profitable or robust) parts of a diversified company into a new company and undertaking free distribution of the shares of the new (spun-off) company to the shareholders of the original company.

Unlike in a divestiture, the "parent" company or group does not receive any proceeds from a demerger as the demerged company's shares are directly distributed to the "parent" company's shareholders.

The word Demerger has received statutory recognition in the IT Act. This is defined u/s 2(19AA) of the Act. At the same time, the process of demerger is achieved only through the provisions of Sections 391 – 394 of the Companies Act, which deals with the subject of – "Compromise, Arrangements and corporate Reconstruction". In other words, every scheme of demerger as defined under the IT Act should necessarily be drawn through a scheme of arrangement which is subject to the Court's approval. Briefly stated, in a demerger, ownership rights of shareholder are recognised vis-a-vis the assets of the company in such a way that the shareholder becomes, after the approval of the Court is obtained, the owner of shares in certain new companies which are created for the purpose and transferring segregated business by telescoping them into these companies and allotting shares to the shareholders in a proportionate manner. To put it in a nutshell, if X is a shareholder of A Limited, a company having two lines of businesses, it can split its two businesses into two companies, viz. A Limited and B Limited and allot to the same shareholders shares in both the companies in lieu of the shares in the original company.

An example of this type of practice is reflected in the Demerger of Consumer Products (CP) Division of Godrej Soaps Ltd. as a going concern into Godrej Consumer Products Ltd., a separate company formed for this purpose. This is reproduced from the Scheme of Arrangement entered between the companies :

#### 4.4 Financial Reporting

##### **“REORGANISATION OF THE EQUITY SHARE CAPITAL OF GODREJ SOAPS LIMITED (GSL)**

- I The subscribed and paid up equity capital of GSL be reorganised from Rs. 52005,287,800 divided into 59,828,780 equity shares of Rs. 10/- each fully paid up to Rs. 358,972,680 divided into 59,828,780 equity shares of Rs. 6 each.

The reduction as aforesaid shall be effected as a part of the Scheme only and not in accordance with Section 101 of the Act as the same does not involve either diminution of liability in respect of unpaid share capital or payment to any shareholder of any paid up share capital

- I Accordingly, on this Scheme becoming effective the Authorised, Issued and Subscribed Share Capital of GSL shall be as under :

Rs.

##### Authorised Capital

|                                         |             |
|-----------------------------------------|-------------|
| 133,333,333 Equity shares of Rs. 6 each | 799,999,998 |
|-----------------------------------------|-------------|

|                                                |                      |
|------------------------------------------------|----------------------|
| 100,000,000 Unclassified shares of Rs. 10 each | <u>1,000,000,000</u> |
|------------------------------------------------|----------------------|

1,799,999,998

##### Issued Capital

|                                        |                    |
|----------------------------------------|--------------------|
| 59,828,780 Equity shares of Rs. 6 each | <u>358,972,680</u> |
|----------------------------------------|--------------------|

358,972,680

##### Accounting Treatment in the Books of Godrej Consumer Products Ltd. (GSPL)

- ◆ GCPL shall, upon the arrangement becoming operative, record the assets and liabilities of the C P Division of GSL vested in it pursuant to this Scheme, at the respective book values thereof as appearing in the books of GSL, excluding revaluation, at the close of business of the day immediately preceding the Appointed Date.
- ◆ GCPL shall credit to its Share Capital Account in its books of account the aggregate face value of the new shares issued by it to the members of GSL pursuant to this Scheme.
- ◆ The excess or deficit, if any, remaining after recording the aforesaid entries shall be credited by GCPL to General Reserve or debited to Goodwill, as the case may be.

##### Accounting Treatment in the Books of GSL

- ◆ The difference arising on account of reorganisation of GSL's equity share capital, pursuant to the Scheme, shall be credited to the Capital Reorganisation Account in the books of accounts of GSL.
- ◆ The difference arising between value of assets transferred over the value of liabilities,

upon vesting of the C P Division in GCPL, pursuant to the Scheme, shall be treated in the books of accounts of GSL, as under :

- ◆ To the extent, the aforesaid difference of assets over liabilities pertains to the revaluation of the fixed assets, forming part of the C P Division, shall be debited to the Revaluation Reserve Account.

The difference remaining after debiting the aforesaid to the Revaluation Reserve Account shall be first debited to the Capital Reorganisation Account and the balance of difference remaining, if any, shall be debited to the General Reserve Account of GSL.

The balance remaining, if any, in the Capital Reorganisation Account after adjusting the aforesaid difference shall be credited to the General Reserve Account of GSL”

#### 4. CAPITAL AND FINANCIAL RESTRUCTURING

Needless to state that the distinction between, asset-based and purely financial-side restructuring is often blurred as acquisitions or divestiture has strong financial or capital structure consequences. Nonetheless, the distinction is made on the basis of the dominant motives behind a given restructuring transaction. This type of restructuring includes buy back of shares, debt to equity conversions etc.

##### Illustration 1

The following is the Balance Sheet of Diverse Ltd. having an authorised capital of Rs. 1,000 Crores as on 31st March, 2006:

|                                                 | (Rs. in crores) | Rs.        | Rs.          |
|-------------------------------------------------|-----------------|------------|--------------|
| Sources of funds:                               |                 |            |              |
| Shareholders' funds:                            |                 |            |              |
| Share capital                                   |                 |            |              |
| Equity shares of Rs. 10 each fully paid in cash |                 | 250        |              |
| Reserves and surplus (Revenue)                  |                 | <u>750</u> | 1,000        |
| Loan funds:                                     |                 |            |              |
| Secured against: (a) Fixed assets Rs. 300 Cr.   |                 |            |              |
| (b) Working capital Rs. 100 Cr.                 |                 | 400        |              |
| Unsecured:                                      |                 | <u>600</u> | <u>1,000</u> |
|                                                 |                 |            | <u>2,000</u> |
| Employment of funds:                            |                 |            |              |
| Fixed assets:                                   |                 |            |              |
| Gross block                                     |                 | 800        |              |

#### 4.6 Financial Reporting

|                                                  |              |              |
|--------------------------------------------------|--------------|--------------|
| Less: Depreciation                               | <u>200</u>   | 600          |
| Investments at cost (Market value Rs. 1,000 Cr.) |              | 400          |
| Net current assets:                              |              |              |
| Current assets                                   | 3,000        |              |
| Less: Current liabilities                        | <u>2,000</u> | <u>1,000</u> |
|                                                  |              | <u>2,000</u> |

Capital commitments: Rs. 700 crores.

The company consists of 2 divisions:

- (i) Established division whose gross block was Rs. 200 crores and net block was Rs. 30 crores; current assets were Rs. 1,500 crores and working capital was Rs. 1,200 crores; the entire amount being financed by shareholders' funds.
- (ii) New project division to which the remaining fixed assets, current assets and current liabilities related.

The following scheme of reconstruction was agreed upon:

- (a) Two new companies Sunrise Ltd. and Khajana Ltd. are to be formed. The authorised capital of Sunrise Ltd. is to be Rs. 1,000 crores. The authorised capital of Khajana Ltd. is to be Rs. 500 crores.
- (b) Khajana Ltd. is to take over investments at Rs. 800 crores and unsecured loans at balance sheet value. It is to allot equity shares of Rs. 10 each at par to the members of Diverse Ltd. in satisfaction of the amount due under the arrangement.
- (c) Sunrise Ltd. is to take over the fixed assets and net working capital of the new project division along with the secured loans and obligation for capital commitments for which Diverse Ltd. is to continue to stand guarantee at book values. It is to allot one crore equity shares of Rs. 10 each as consideration to Diverse Ltd. Sunrise Ltd. made an issue of unsecured convertible debentures of Rs. 500 crores carrying interest at 15% per annum and having a right to convert into equity shares of Rs. 10 each at par on 31.3.2011. This issue was made to the members of Sunrise Ltd. as a right who grabbed the opportunity and subscribed in full.
- (d) Diverse Ltd. is to guarantee all liabilities transferred to the 2 companies.
- (e) Diverse Ltd. is to make a bonus issue of equity shares in the ratio of one equity share for every equity share held by making use of the revenue reserves.

Assume that the above scheme was duly approved by the Honourable High Court and that there are no other transactions. Ignore taxation.

You are asked to:

- (i) Pass journal entries in the books of Diverse Ltd., and
- (ii) Prepare the balance sheets of the three companies giving all the information required by

the Companies Act, 1956 in the manner so required to the extent of available information.

### Solution

#### Journal of Diverse Ltd.

(Rs. in crores)

|   |                                                                                                                                                                                                        | Dr.     | Cr. |
|---|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------|-----|
| 1 | Khajana Ltd. A/c                                                                                                                                                                                       | Dr. 800 |     |
|   | To Investments A/c                                                                                                                                                                                     |         | 400 |
|   | To Members A/c                                                                                                                                                                                         |         | 400 |
|   | (Being transfer of investments at agreed value of Rs. 800 crores under the scheme of reconstruction approved by the high court)                                                                        |         |     |
| 2 | Unsecured loans A/c                                                                                                                                                                                    | Dr. 600 |     |
|   | To Khajana Ltd.                                                                                                                                                                                        |         | 600 |
|   | (Being unsecured loans taken over by Khajana Ltd. under the scheme of reconstruction approved by the honourable high court)                                                                            |         |     |
| 3 | Members A/c                                                                                                                                                                                            | Dr. 200 |     |
|   | To Khajana Ltd.                                                                                                                                                                                        |         | 200 |
|   | (Being allotment by Khajana Ltd. of 20 crore equity shares of Rs. 10 each to the members of the company in the ratio of 4 equity shares of Khajana Ltd. for every 5 equity shares held in the company) |         |     |
| 4 | Members A/c                                                                                                                                                                                            | Dr. 200 |     |
|   | To Capital reserve                                                                                                                                                                                     |         | 200 |
|   | (Being balance in Members A/c transferred to capital reserve)                                                                                                                                          |         |     |
| 5 | Sunrise Ltd. A/c                                                                                                                                                                                       | Dr. 10  |     |
|   | Provision for depreciation A/c                                                                                                                                                                         | Dr. 30  |     |

#### 4.8 Financial Reporting

|   |                                                                                                                                                                                                                                                                                      |     |       |       |
|---|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----|-------|-------|
|   | Secured loans against fixed assets A/c                                                                                                                                                                                                                                               | Dr. | 300   |       |
|   | Secured loans against working capital A/c                                                                                                                                                                                                                                            | Dr. | 100   |       |
|   | Current liabilities A/c                                                                                                                                                                                                                                                              | Dr. | 1,700 |       |
|   | To Fixed assets A/c                                                                                                                                                                                                                                                                  |     |       | 600   |
|   | To Current assets A/c                                                                                                                                                                                                                                                                |     |       | 1,500 |
|   | To Capital reserve A/c                                                                                                                                                                                                                                                               |     |       | 40    |
|   | (Being assets and liabilities of new project division transferred to Sunrise Ltd. along with capital commitments of Rs. 700 crores, the difference between consideration and the book values at which transferred assets and liabilities appeared being credited to capital reserve) |     |       |       |
| 6 | Equity shares of Sunrise Ltd.                                                                                                                                                                                                                                                        | Dr. | 10    |       |
|   | To Sunrise Ltd.                                                                                                                                                                                                                                                                      |     |       | 10    |
|   | (Being the receipt of one crore equity shares of Rs. 10 each from Sunrise Ltd. in full discharge of consideration on transfer of assets and liabilities of the new project division)                                                                                                 |     |       |       |
| 7 | Investment in debentures A/c                                                                                                                                                                                                                                                         | Dr. | 500   |       |
|   | To Bank A/c                                                                                                                                                                                                                                                                          |     |       | 500   |
|   | (Being issue of unsecured convertible debentures by Sunrise Ltd., subscribed in full)                                                                                                                                                                                                |     |       |       |
| 8 | Revenue reserves A/c                                                                                                                                                                                                                                                                 | Dr. | 250   |       |
|   | To Equity share capital A/c                                                                                                                                                                                                                                                          |     |       | 250   |
|   | (Being allotment of 25 crores equity shares of Rs. 10 each as fully paid bonus shares to the members of the company by using revenue reserves in the ratio of one equity share for every equity share held)                                                                          |     |       |       |

**Diverse Ltd.****Balance Sheet after the scheme of arrangement**

|                                         | <i>Schedule<br/>No.</i> |              | <i>(Rs. in crores)</i> |
|-----------------------------------------|-------------------------|--------------|------------------------|
| <b>I SOURCES OF FUNDS</b>               |                         |              |                        |
| (1) Shareholders' funds:                |                         |              |                        |
| (a) Capital                             | A                       | 500          |                        |
| (b) Reserves and surplus                | B                       | <u>740</u>   | 1,240                  |
| (2) Loan funds:                         |                         |              |                        |
| (a) Secured against:                    |                         |              |                        |
| Fixed assets                            |                         | —            |                        |
| Working capital                         |                         | —            |                        |
| (b) Unsecured                           |                         | —            | <u>—</u>               |
| TOTAL                                   |                         |              | <u>1,240</u>           |
| <b>II APPLICATION OF FUNDS</b>          |                         |              |                        |
| (1) Fixed assets:                       | C                       |              |                        |
| Gross block                             |                         | 200          |                        |
| Less: Depreciation                      |                         | <u>170</u>   |                        |
| Net block                               |                         |              | 30                     |
| (2) Investments                         | D                       |              | 10                     |
| (3) Current assets                      |                         | 1,500        |                        |
| Less: Current liabilities               |                         | <u>300</u>   |                        |
| Net current assets                      |                         | <u>1,200</u> |                        |
| TOTAL                                   |                         |              | <u>1,240</u>           |
| 1. Capital commitments                  |                         |              | Nil                    |
| 2. Contingent Liability                 |                         |              |                        |
| Guarantee given in respect of:          |                         |              |                        |
| Capital commitments by Sunrise Ltd.     |                         | 700          |                        |
| Liabilities transferred to Sunrise Ltd. |                         | 2,100        |                        |
| Liabilities transferred to Khajana Ltd. |                         | 600          |                        |

#### 4.10 Financial Reporting

##### Schedules to Accounts

(Rs. in crores)

|   |                                                                         |            |              |
|---|-------------------------------------------------------------------------|------------|--------------|
| A | Share capital:                                                          |            |              |
|   | Issued, Subscribed and Paid-up:                                         |            |              |
|   | 100 crores Equity Shares of Rs. 10 each                                 |            | <u>1,000</u> |
|   | 50 crores Equity Shares of Rs. 10                                       |            |              |
|   | each fully paid-up                                                      |            | 500          |
|   | Of the above shares, 25 crores fully paid Equity Shares of Rs. 10 each  |            |              |
|   | have been issued as bonus shares by capitalization of revenue reserves. |            |              |
| B | Reserves and Surplus:                                                   |            |              |
|   | Capital Reserve on transfer of :                                        |            |              |
|   | Investments to Khajana Ltd.                                             |            | 200          |
|   | Business of new project division to Sunrise Ltd.                        |            | <u>40</u>    |
|   |                                                                         |            | 240          |
|   | Revenue Reserves:                                                       |            |              |
|   | As per last balance sheet                                               | 750        |              |
|   | Less: Used for issue of fully paid bonus shares                         | <u>250</u> | <u>500</u>   |
|   |                                                                         | <u>740</u> |              |
| C | Fixed assets:                                                           |            |              |
|   | Gross block:                                                            |            |              |
|   | As per last balance sheet                                               | 800        |              |
|   | Less: Transfer to Sunrise Ltd.                                          | <u>600</u> | 200          |
|   | Provision for depreciation:                                             |            |              |
|   | As per last balance sheet                                               | 200        |              |
|   | Less: In respect of assets transferred to Sunrise Ltd.                  | <u>30</u>  | <u>170</u>   |
|   |                                                                         |            | <u>30</u>    |
| D | Investments (at cost):                                                  |            |              |
|   | In wholly owned subsidiary Sunrise Ltd.                                 |            |              |
|   | (a) 1 crore equity shares of Rs. 10 each                                |            | 10           |
|   | (b) 15% unsecured convertible debentures                                |            | <u>500</u>   |
|   |                                                                         |            | <u>510</u>   |



**Balance Sheet of Sunrise Ltd. after the scheme of arrangement**

| Schedule No.                       |                      | (Rs. in crores) |            |
|------------------------------------|----------------------|-----------------|------------|
| I                                  | SOURCES OF FUNDS     |                 |            |
| (1) Shareholders' funds:           |                      |                 |            |
| (a) Capital                        | A                    | 10              |            |
| (b) Reserves and surplus           |                      | =               | 10         |
| (2) Loan funds :                   |                      |                 |            |
| (a) Secured loans                  | B                    | 400             |            |
| (b) Unsecured loans                | C                    | <u>500</u>      | <u>900</u> |
| TOTAL                              |                      |                 | <u>910</u> |
| II                                 | APPLICATION OF FUNDS |                 |            |
| (1) Fixed assets:                  |                      |                 |            |
| (a) Goodwill                       |                      | 40              |            |
| (b) Other fixed assets             |                      | <u>570</u>      | 610        |
| (2) Investments                    |                      |                 |            |
| (3) Current assets :               |                      |                 |            |
| (a) Bank balance                   | 500                  |                 |            |
| (b) Others                         | <u>1,500</u>         | 2,000           |            |
| Less: Current liabilities          |                      | <u>1,700</u>    | <u>300</u> |
| Total                              |                      |                 | <u>910</u> |
| 1. Capital commitments             |                      |                 |            |
| 2. Guarantee given by Diverse Ltd. |                      |                 |            |
| in respect of:                     |                      |                 |            |
| Capital commitments                |                      | 700             |            |
| Liabilities                        |                      | 2,100           | 2,800      |

**Schedules to Accounts**

(Rs. in crores)

|                                                    |              |
|----------------------------------------------------|--------------|
| <b>A Share Capital</b>                             |              |
| Authorised                                         |              |
| 100 crores Equity Shares of Rs. 10 each            | <u>1,000</u> |
| Issued, Subscribed and Paid-up                     |              |
| 1 crore Equity Shares of Rs. 10 each fully paid-up | 10           |

#### 4.12 Financial Reporting

All the above shares have been issued for consideration other than cash, on takeover of new project division from Diverse Ltd.

All the above shares are held by the holding company Diverse Ltd.

|     |                                                                      |            |
|-----|----------------------------------------------------------------------|------------|
| B   | Secured Loans                                                        |            |
| (a) | Against fixed assets                                                 | 300        |
| (b) | Against working capital                                              | <u>100</u> |
|     |                                                                      | <u>400</u> |
| C   | Unsecured Loans                                                      |            |
|     | 15% Unsecured convertible Debentures                                 | 500        |
|     | - Convertible into equity shares of Rs. 10 each at par. on 31.3.2011 |            |

#### Balance Sheet of Khajana Ltd. after the scheme of arrangement

|                      | Schedule No.                                                  |   | (Rs. in crores) |
|----------------------|---------------------------------------------------------------|---|-----------------|
| SOURCES OF FUNDS     |                                                               |   |                 |
| (1)                  | Shareholders' funds:                                          |   |                 |
| (a)                  | Capital                                                       | A | 200             |
| (b)                  | Reserves and surplus                                          |   | <u>200</u>      |
| (2)                  | Loan funds:                                                   |   |                 |
| (a)                  | Secured loans                                                 |   | —               |
| (b)                  | Unsecured loans                                               |   | <u>600</u>      |
|                      | TOTAL                                                         |   | <u>800</u>      |
| APPLICATION OF FUNDS |                                                               |   |                 |
|                      | Investments                                                   |   | <u>800</u>      |
|                      | TOTAL                                                         |   | <u>800</u>      |
|                      | Guarantee given by Diverse Ltd. in respect of unsecured loans |   | 600             |

#### Schedule to Accounts

|   | (Rs. in crores )                                                 |
|---|------------------------------------------------------------------|
| A | Share Capital                                                    |
|   | Authorised                                                       |
|   | 50 crores Equity Shares of Rs. 10 each                           |
|   | <u>500</u>                                                       |
|   | Issued, Subscribed and Paid-up                                   |
|   | 20 crores Equity Shares of Rs. 10 each fully paid-up             |
|   | 200                                                              |
|   | All the above shares have been issued to members of Diverse Ltd. |

## Accounting for Corporate Restructuring 4.13

for consideration other than cash, on acquisition of investments and taking over of liability for unsecured loans from Diverse Ltd.

### Working Notes :

|                                              | (Rs. in crores)                 |                                 |              |
|----------------------------------------------|---------------------------------|---------------------------------|--------------|
| 1.                                           | <i>Established<br/>division</i> | <i>New Project<br/>division</i> | <i>Total</i> |
| Fixed assets:                                |                                 |                                 |              |
| Gross block                                  | 200                             | 600                             | 800          |
| Less: Depreciation                           | <u>170</u>                      | <u>30</u>                       | <u>200</u>   |
|                                              | 30                              | 570                             | 600          |
| Current assets                               | 1,500                           | 1,500                           | 3,000        |
| Less: Current liabilities                    | <u>300</u>                      | <u>1,700</u>                    | <u>2,000</u> |
| Employment of funds                          | <u>1,200</u>                    | <u>(200)</u>                    | <u>1,000</u> |
| 2. Guarantee by Diverse Ltd. against:        |                                 |                                 |              |
| (a) (i) Capital commitments                  |                                 |                                 | 700          |
| (ii) Liabilities transferred to Sunrise Ltd. |                                 |                                 |              |
| Secured loans against fixed assets           |                                 | 300                             |              |
| Secured loans against working capital        |                                 | 100                             |              |
| Current liabilities                          |                                 | <u>1,700</u>                    | 2,100        |
| (b) Liabilities transferred to Khajana Ltd.  |                                 |                                 | 600          |

### Illustration 2

Enterprise Ltd. has 2 divisions A and B.

Division A has been making constant profits while division B has been invariably suffering losses.

On 31st March, 2006 the division-wise Balance Sheet was :

|                   | (Rupees in crores) |            |            |
|-------------------|--------------------|------------|------------|
|                   | A                  | B          | Total      |
| Fixed assets cost | 250                | 500        | 750        |
| Depreciation      | <u>225</u>         | <u>400</u> | <u>625</u> |
|                   | 25                 | 100        | 125        |

#### 4.14 Financial Reporting

|                              |            |             |            |
|------------------------------|------------|-------------|------------|
| Current assets:              | 200        | 500         | 700        |
| Less: Current liabilities    | <u>25</u>  | <u>400</u>  | <u>425</u> |
|                              | 175        | 100         | 275        |
|                              | <u>200</u> | <u>200</u>  | <u>400</u> |
| Financed by:                 |            |             |            |
| Loan funds                   | -          | 300         | 300        |
| Capital : Equity Rs. 10 each | 25         | -           | 25         |
| Surplus                      | <u>175</u> | <u>-100</u> | <u>75</u>  |
|                              | <u>200</u> | <u>200</u>  | <u>400</u> |

Division B along with its assets and liabilities was sold for Rs.25 crores to Turnaround Ltd. a new company, who allotted 1 crore equity shares of Rs. 10 each at a premium of Rs. 15 per share to the members of Enterprise Ltd. in full settlement of the consideration, in proportion to their shareholding in the company.

Assuming that there are no other transactions, you are asked to :

- Pass journal entries in the books of Enterprise Ltd.
- Prepare the Balance Sheet of Enterprise Ltd. after the entries in (i).
- Prepare the Balance Sheet of Turnaround Ltd.

#### Solution

##### Journal of Enterprise Ltd.

|                                                                                                    |                            | (Rs. in crores) |     |
|----------------------------------------------------------------------------------------------------|----------------------------|-----------------|-----|
|                                                                                                    |                            | Dr.             | Cr. |
|                                                                                                    |                            | Rs.             | Rs. |
| (1)                                                                                                | Turnaround Ltd.            | Dr. 25          |     |
|                                                                                                    | Loan Funds                 | Dr. 300         |     |
|                                                                                                    | Current Liabilities        | Dr. 400         |     |
|                                                                                                    | Provision for Depreciation | Dr. 400         |     |
|                                                                                                    | To Fixed Assets            |                 | 500 |
|                                                                                                    | To Current Assets          |                 | 500 |
|                                                                                                    | To Capital Reserve         |                 | 125 |
| (Being division B along with its assets and liabilities sold to Turnaround Ltd. for Rs. 25 crores) |                            |                 |     |

|                                                                                                                                                                               |     |    |    |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----|----|----|
| (2) Capital Reserve                                                                                                                                                           | Dr. | 25 |    |
| To Turnaround Ltd.                                                                                                                                                            |     |    | 25 |
| (Being allotment of 1 crore equity shares of<br>Rs. 10 each at a premium of Rs. 15 per share<br>to the members of Enterprise Ltd. in full settlement<br>of the consideration) |     |    |    |

**Notes :**

- (1) Any other alternative set of entries, with the same net effect on various accounts, may be given by the students.
- (2) Profit on sale of division may, alternatively, be credited to Profit and Loss Account instead of Capital Reserve, in accordance with the requirements of AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies.

**Enterprise Ltd.****Balance Sheet after reconstruction***(Rs. in crores)**Schedule*

|                           |   |            |            |
|---------------------------|---|------------|------------|
| I. SOURCES OF FUNDS       |   |            |            |
| (1) Shareholders' funds   |   |            |            |
| (a) Capital               |   | 25         |            |
| (b) Reserves and surplus  | A | <u>175</u> |            |
|                           |   |            | 200        |
| (2) Loan funds            |   |            | <u>—</u>   |
| TOTAL                     |   |            | <u>200</u> |
| II. APPLICATION OF FUNDS  |   |            |            |
| (1) Fixed assets          |   |            |            |
| (a) Gross block           |   | 250        |            |
| (b) Less: Depreciation    |   | <u>225</u> |            |
| (c) Net block             |   |            | 25         |
| (2) Investments           |   |            | —          |
| (3) Current assets        |   | 200        |            |
| Less: Current liabilities |   | <u>25</u>  |            |
| Net current assets        |   |            | <u>175</u> |
| TOTAL                     |   |            | <u>200</u> |

#### 4.16 Financial Reporting

##### Schedule to Balance Sheet

(Rs.in crores)

|   |                                        |            |
|---|----------------------------------------|------------|
| A | Reserves and Surplus                   | 75         |
|   | Add: Capital Reserve on reconstruction | <u>100</u> |
|   |                                        | <u>175</u> |

Note to Accounts : Consequent on transfer of Division B to newly incorporated company Turnaround Ltd., the members of the company have been allotted 1 crore equity shares of Rs. 10 each at a premium of Rs. 15 per share of Turnaround Ltd., in full settlement of the consideration in proportion to their shareholding in the company.

##### Balance Sheet of Turnaround Ltd.

(Rs. in crores)

| Schedule |                           |       |              |
|----------|---------------------------|-------|--------------|
| I.       | SOURCES OF FUNDS          |       |              |
|          | (1) Shareholders' funds   |       |              |
|          | (a) Capital               | A     | 10           |
|          | (b) Reserves and surplus  |       | <u>15</u> 25 |
|          | (2) Loan funds            |       | <u>300</u>   |
|          |                           | TOTAL | <u>325</u>   |
| II.      | APPLICATION OF FUNDS      |       |              |
|          | (1) Fixed assets          | B     | 225          |
|          | (2) Investments           |       | –            |
|          | (3) Current assets        |       | 500          |
|          | Less: Current liabilities |       | <u>400</u>   |
|          | Net current assets        |       | <u>100</u>   |
|          | TOTAL                     |       | <u>325</u>   |

##### Schedules to Balance Sheet

(Rs.in crores)

|    |                                                                                                                                                            |    |
|----|------------------------------------------------------------------------------------------------------------------------------------------------------------|----|
| A. | Share Capital:                                                                                                                                             |    |
|    | Issued and Paid-up:                                                                                                                                        |    |
|    | 1 crore Equity shares of Rs. 10 each fully paid up                                                                                                         | 10 |
|    | All the above shares have been issued for consideration other than cash, to the members of Enterprise Ltd. on take over of Division B from Enterprise Ltd. |    |

## B. Fixed Assets:

|                    |            |
|--------------------|------------|
| Goodwill           | 125        |
| Other fixed assets | <u>100</u> |
|                    | <u>225</u> |

**Illustration 3**

Kuber Ltd. furnishes you with the following Balance Sheet as at 31st March, 2006 :

Sources of funds : (Rs. in crores)

Share Capital :

Authorised 100

Issued:

12% redeemable preference shares of

Rs. 100 each fully paid 75

Equity shares of Rs. 10 each fully paid 25 100

Reserves and surplus:

Capital reserve 15

Share premium 25

Revenue reserves 260 300

400

Funds employed in:

Fixed assets : Cost 100

Less: Provision for depreciation 100 nil

Investments at cost (market value Rs.400 Cr.) 100

Current assets 340

Less: Current liabilities 40 300

400

The company redeemed preference shares on 1st April, 2006. It also bought back 50 lakh equity shares of Rs. 10 each at Rs. 50 per share. The payments for the above were made out of the huge bank balances, which appeared as part of current assets.

You are asked to :

- (i) Pass journal entries to record the above
- (ii) Prepare balance sheet
- (iii) Value equity share on net asset basis.

#### 4.18 Financial Reporting

##### Solution

##### Journal of Kuber Ltd.

|                                                                                                                                                       |     | (Rs. in Crores) |     |
|-------------------------------------------------------------------------------------------------------------------------------------------------------|-----|-----------------|-----|
|                                                                                                                                                       |     | Dr.             | Cr. |
|                                                                                                                                                       |     | Rs.             | Rs. |
| Redeemable preference share capital                                                                                                                   | Dr. | 75              |     |
| To Bank                                                                                                                                               |     |                 | 75  |
| (Being redemption of 12% preference shares pursuant to capital re-organisation)                                                                       |     |                 |     |
| Revenue reserves                                                                                                                                      | Dr. | 75              |     |
| To Capital redemption reserve                                                                                                                         |     |                 | 75  |
| (Being amount equal to par value of preference shares redeemed out of profits transferred to capital redemption reserve)                              |     |                 |     |
| Equity share capital                                                                                                                                  | Dr. | 5               |     |
| Revenue reserves                                                                                                                                      | Dr. | 20              |     |
| To Bank                                                                                                                                               |     |                 | 25  |
| (Being buyback of 50 lakh equity shares of Rs. 10 each from the members at a price of Rs. 50 per share, premium paid transferred to revenue reserves) |     |                 |     |
| Revenue reserves                                                                                                                                      | Dr. | 5               |     |
| To Capital redemption reserve                                                                                                                         |     |                 | 5   |
| (Being transfer to capital redemption reserve, as required by Section 77 AA, on buyback out of reserves)                                              |     |                 |     |

##### Kuber Ltd.

##### Balance Sheet (after reconstruction)

(Rs. in crores)

##### Schedule

##### I. SOURCES OF FUNDS

##### (1) Shareholders' funds

##### (a) Capital

A

20



## Accounting for Corporate Restructuring 4.19

|                                              |   |            |            |
|----------------------------------------------|---|------------|------------|
| (b) Reserves and Surplus                     | B | <u>280</u> | 300        |
| (2) Loan funds                               |   |            | <u>—</u>   |
| TOTAL                                        |   |            | <u>300</u> |
| II. APPLICATION OF FUNDS                     |   |            |            |
| (1) Fixed assets                             |   |            |            |
| (a) Gross block                              |   | 100        |            |
| (b) Less: Depreciation                       |   | <u>100</u> |            |
| (c) Net block                                |   |            | —          |
| (2) Investments (market value:Rs.400 crores) |   | 100        |            |
| (3) Current assets                           |   | 240        |            |
| Less: Current liabilities                    |   | <u>40</u>  |            |
| Net current assets                           |   |            | <u>200</u> |
| TOTAL                                        |   |            | <u>300</u> |

### Schedules to Balance Sheet

(Rs.in crores)

|                                                                                                                                                                                                                |  |           |            |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|-----------|------------|
| A. Share Capital                                                                                                                                                                                               |  |           |            |
| Authorised                                                                                                                                                                                                     |  |           | <u>100</u> |
| Issued, Subscribed and Paid-up                                                                                                                                                                                 |  |           |            |
| 200 lakhs Equity Shares of Rs. 10 each fully paid up                                                                                                                                                           |  |           | <u>20</u>  |
|                                                                                                                                                                                                                |  |           | <u>20</u>  |
| 50 lakhs Equity Shares of Rs. 10 each have been bought back out of reserves at Rs. 50 per share 12% 75 lakhs Redeemable Preference Shares of Rs. 100 each fully paid up, have been redeemed on 1st April, 2006 |  |           |            |
| B. Reserves and Surplus                                                                                                                                                                                        |  |           |            |
| (1) Capital Reserve                                                                                                                                                                                            |  |           | 15         |
| (2) Capital Redemption Reserve                                                                                                                                                                                 |  |           |            |
| As per last account                                                                                                                                                                                            |  | —         |            |
| Add: Transfer from                                                                                                                                                                                             |  |           |            |
| Revenue Reserves                                                                                                                                                                                               |  | <u>80</u> | 80         |
| (3) Share (Securities) Premium                                                                                                                                                                                 |  |           | 25         |
| (4) Revenue Reserves                                                                                                                                                                                           |  |           |            |
| As per last account                                                                                                                                                                                            |  | 260       |            |
| Less: Transfer to Capital                                                                                                                                                                                      |  |           |            |
| Redemption Reserve                                                                                                                                                                                             |  | <u>80</u> |            |
|                                                                                                                                                                                                                |  | 180       |            |
| Less: Premium on buyback                                                                                                                                                                                       |  | <u>20</u> | <u>160</u> |
|                                                                                                                                                                                                                |  |           | <u>280</u> |

## 4.20 Financial Reporting

### Net asset value of an equity share

(Rs. in crores)

|                                             |            |
|---------------------------------------------|------------|
| Investments (at market value)               | 400        |
| Net current assets                          | <u>200</u> |
| Net assets available to equity shareholders | <u>600</u> |

No. of equity shares : 2 crores

$$\begin{aligned}\text{Value of an equity share} &= \frac{600 \text{ crores}}{2 \text{ crores}} \\ &= \text{Rs. } 300\end{aligned}$$

**Note:** As regards treatment of loss (profit) on buyback, there is no authoritative pronouncement as to whether the difference between the nominal value and the amount paid should be treated as capital or revenue in nature. In the given case, the debit has been given to revenue reserves.

Also, in the absence of any other information, it has been assumed that shares have been bought back out of free reserves.

### Illustration 4

Maxi Mini Ltd. has 2 divisions - Maxi and Mini. The Balance Sheet as at 31st October, 2006 was as under:

|                                       | Maxi<br>division<br>Rs. | Mini<br>division<br>Rs. | Total<br>(in crores)<br>Rs. |
|---------------------------------------|-------------------------|-------------------------|-----------------------------|
| Fixed assets:                         |                         |                         |                             |
| Cost                                  | 600                     | 300                     | 900                         |
| Depreciation                          | <u>500</u>              | <u>100</u>              | <u>600</u>                  |
| W.D.V.                                | 100                     | 200                     | 300                         |
| Net current assets:                   |                         |                         |                             |
| Current assets                        | 400                     | 300                     | 700                         |
| Less: Current liabilities             | <u>100</u>              | <u>100</u>              | <u>200</u>                  |
|                                       | <u>300</u>              | <u>200</u>              | <u>500</u>                  |
| Total                                 | <u>400</u>              | <u>400</u>              | <u>800</u>                  |
| Financed by :                         |                         |                         |                             |
| Loan funds                            | —                       | 100                     | 100                         |
| (secured by a charge on fixed assets) |                         |                         |                             |

Own funds:

|                               |            |            |            |
|-------------------------------|------------|------------|------------|
| Equity capital                |            |            | 50         |
| (fully paid up Rs. 10 shares) |            |            |            |
| Reserves and surplus          |            |            | <u>650</u> |
|                               | <u>?</u>   | <u>?</u>   | <u>700</u> |
| Total                         | <u>400</u> | <u>400</u> | <u>800</u> |

It is decided to form a new company Mini Ltd. to take over the assets and liabilities of Mini division.

Accordingly Mini Ltd. was incorporated to take over at Balance Sheet figures the assets and liabilities of that division. Mini Ltd. is to allot 5 crores equity shares of Rs. 10 each in the company to the members of Maxi Mini Ltd. in full settlement of the consideration. The members of Maxi Mini Ltd. are therefore to become members of Mini Ltd. as well without having to make any further investment.

- You are asked to pass journal entries in relation to the above in the books of Maxi Mini Ltd. and Mini Ltd. Also show the Balance Sheets of the 2 companies as on the morning of 1st November, 2006, showing corresponding previous year's figures.
- The directors of the 2 companies ask you to find out the net asset value of equity shares pre and post demerger.
- Comment on the impact of demerger on "shareholders wealth".

### Solution

#### Journal of Maxi Mini Ltd.

|                                           |         |  | (Rs. in crores) |
|-------------------------------------------|---------|--|-----------------|
|                                           | Dr.     |  | Cr.             |
|                                           | Rs.     |  | Rs.             |
| Current liabilities A/c                   | Dr. 100 |  |                 |
| Loan fund (secured) A/c                   | Dr. 100 |  |                 |
| Provision for depreciation A/c            | Dr. 100 |  |                 |
| Loss on reconstruction (Balancing figure) | Dr. 300 |  |                 |
| To Fixed assets A/c                       |         |  | 300             |
| To Current assets A/c                     |         |  | 300             |

(Being the assets and liabilities of Mini division taken out of the books on transfer of the division to Mini Ltd., the consideration being allotment to the members of the company of one equity share of Rs. 10 each of that

## 4.22 Financial Reporting

company at par for every share held in the company  
vide scheme of reorganisation.)

Note : Any other alternatives set of entries, with the same net effect on various accounts, may be given by the students.

### Journal of Mini Ltd.

|                             |         |  | (Rs. in crores) |
|-----------------------------|---------|--|-----------------|
|                             | Dr.     |  | Cr.             |
|                             | Rs.     |  | Rs.             |
| Fixed assets (300-100) A/c  | Dr. 200 |  |                 |
| Current assets A/c          | Dr. 300 |  |                 |
| To Current liabilities A/c  |         |  | 100             |
| To Secured loan funds A/c   |         |  | 100             |
| To Equity share capital A/c |         |  | 50              |
| To Capital reserve          |         |  | 250             |

(Being the assets and liabilities of Mini division  
of Maxi Mini Ltd. taken over and allotment of  
5 crores equity shares of Rs. 10 each at par as  
fully paid up to the members of Maxi Mini Ltd.)

### Maxi Mini Ltd.

#### Balance Sheet as at 1st November, 2006

|                           |          |                         | (Rs. in crores)          |
|---------------------------|----------|-------------------------|--------------------------|
|                           | Schedule | After<br>reconstruction | Before<br>reconstruction |
| I. SOURCES OF FUNDS       |          |                         |                          |
| (1) Shareholder's funds : |          |                         |                          |
| (a) Capital               |          | 50                      | 50                       |
| (b) Reserves and Surplus  | A        | <u>350</u>              | <u>650</u>               |
|                           |          | 400                     | 700                      |
| (2) Loan funds :          |          |                         |                          |
| Secured loans             |          |                         |                          |
| TOTAL                     |          | <u>—</u>                | <u>100</u>               |
|                           |          | <u>400</u>              | <u>800</u>               |

## II. APPLICATION OF FUNDS

|                           |            |            |
|---------------------------|------------|------------|
| (1) Fixed assets :        |            |            |
| (a) Gross block           | 600        | 900        |
| (b) Less: Depreciation    | <u>500</u> | <u>600</u> |
| (c) Net block I           | <u>100</u> | <u>300</u> |
| (2) Investments           | —          | —          |
| (3) Current assets        | 400        | 700        |
| Less: Current liabilities | <u>100</u> | <u>200</u> |
| Net current assets II     | <u>300</u> | <u>500</u> |
| TOTAL (I + II)            | <u>400</u> | <u>800</u> |

## Schedule to Balance Sheet

|                              | <i>After<br/>reconstruction</i> | <i>Before<br/>reconstruction</i> |
|------------------------------|---------------------------------|----------------------------------|
| A. Reserves and Surplus      | 650                             | 650                              |
| Less: Loss on reconstruction | <u>300</u>                      | <u>—</u>                         |
|                              | <u>350</u>                      | <u>650</u>                       |

Note to Accounts : Consequent on reconstruction of the company and transfer of Mini division to newly incorporated company Mini Ltd., the members of the company have been allotted 5 crores equity shares of Rs. 10 each at part of Mini Ltd.

**Mini Ltd.**  
**Balance Sheet as at 1 November, 2006**

(Rs. in crores)

## Schedule

## I. SOURCES OF FUNDS

|                           |   |            |
|---------------------------|---|------------|
| (1) Shareholder's funds : |   |            |
| (a) Capital               | A | 50         |
| (b) Reserves and Surplus  |   | <u>250</u> |
|                           |   | 300        |
| (2) Loan funds :          |   |            |
| Secured loans             |   | <u>100</u> |
| TOTAL                     |   | <u>400</u> |

## II. APPLICATION OF FUNDS

|                    |   |     |
|--------------------|---|-----|
| (1) Fixed assets : |   | 200 |
| (2) Investments    | — |     |

#### 4.24 Financial Reporting

|                           |            |            |
|---------------------------|------------|------------|
| (3) Current assets        | 300        |            |
| Less: Current liabilities | <u>100</u> |            |
| Net current assets        |            | <u>200</u> |
| TOTAL                     |            | <u>400</u> |

#### Schedules to Balance Sheet

(Rs. in crores)

##### A. Share Capital :

Issued and paid up :

5 crores Equity shares of Rs. 10 each fully paid up 50

All the above shares have been issued for consideration other than cash, to the members of Maxi Mini Ltd., on take over of Mini division from Maxi Mini Ltd.

##### (b) Net asset value of an equity share

|                  | <i>Pre-demerger</i>                                                | <i>Post-demerger</i>                                             |
|------------------|--------------------------------------------------------------------|------------------------------------------------------------------|
| Maxi Mini Ltd. : | $\frac{\text{Rs. 700 crores}}{5 \text{ crores}} = \text{Rs. 1.40}$ | $\frac{\text{Rs. 400 crores}}{5 \text{ crores}} = \text{Rs. 80}$ |
| Mini Ltd.:       |                                                                    | $\frac{\text{Rs. 300 crores}}{5 \text{ crores}} = \text{Rs. 60}$ |

- (c) Demerger into two companies has had no impact on “net asset value” of shareholding. Pre-demerger, it was Rs. 140 per share. After demerger, it is Rs. 80 plus Rs. 60 i.e. Rs. 140 per original share.

It is only yield valuation that is expected to change because of separate focusing on two distinct businesses whereby profitability is likely to improve on account of demerger.

## 5. ACCOUNTING FOR AMALGAMATIONS

### 5.1 LEGAL POSITION

Chapter V of the Companies Act, 1956 deals with amalgamation and reconstruction. Under section 391, a company is entitled to make compromise or arrangement with creditors and members. The words used in this section are very wide. This section covers companies which are liable to be wound up but it is not necessary that they should be in actual winding up process. Provisions for section 394 facilitate reconstruction and amalgamation of companies. Where an application is made to the court under section 391 for the sanctioning of the compromise or arrangement proposed between a company and any such persons as are

mentioned in that section and it is shown to the court (a) that the compromise or arrangement has been proposed for the purposes of or in connection with a scheme for the reconstruction of the company or companies or the amalgamation of any two or more companies; and (b) that under the scheme, the whole or any part of the undertaking, property or liabilities of any company concerned in the scheme is to be transferred to another company; the court may order sanctioning the compromise or arrangement. Also the court may, by a subsequent order, make provisions for all or any of the following matters:

- (i) the transfer to the transferee company of the whole or any part of the undertaking, property or liabilities of any transferor company ;
- (ii) the allotment or appropriation by the transferee company of any shares, debentures, policies or other like interest in that company which, under the compromise or arrangement are to be allotted or appropriated by that company to or for any persons;
- (iii) the continuation by or against the transferee company of any legal proceedings pending by or against any transferor company;
- (iv) the dissolution, without winding up, of any transferor company;
- (v) the provision to be made for any persons who, within such time and in such a manner as the court directs, dissent from the compromise or the arrangement;
- (vi) such incidental, consequential and supplementary matters as are necessary to clear the reconstruction or amalgamation shall be fully or effectively carried out.

Where an order under section 394 provides for the transfer of any property or liabilities, then by virtue of the order that property shall be transferred and vested in and liabilities shall be transferred to and become the liabilities of the transferee company; and in the case of any property, if the order so directs, freed from any charge, which is, by virtue of the compromise or arrangement, to cease to have effect. However, the court has no jurisdiction to sanction an arrangement under section 391 which does not have the approval of the company either through the board or if appropriate by means of simple majority of the members in General Meeting. The compromise or arrangement should be within the powers of the company and not *ultra vires*. If it is beyond the company's objects or powers, the court will have no jurisdiction to sanction it. A contrary opinion is also there; the Calcutta High Court in *Marybong and Kyel Tea Estates Ltd. re 1977*, 47 *Company Cases* 802, observed that section 394 gives jurisdiction to the court to sanction an arrangement, even though there may be no power in company mentioned in the objects clause of its memorandum of association. It is argued that where there is a statutory provision dealing with the amalgamation of companies; no special power in Objects Clause of memorandum of association of the company is necessary for its amalgamation with another company.

## 4.26 Financial Reporting

### 5.2 MEANING OF RECONSTRUCTION AND AMALGAMATION

The terms amalgamation and reconstruction are not defined in the Companies Act. Generally the expression reconstruction", "reorganisation" or "scheme of arrangement" is used where only one company is involved and the rights of its shareholders and/or creditors are varied. The term amalgamation is used where two or more companies are involved or where one is merged with another or taken over by another. Neither reconstruction nor amalgamation has a precise meaning. Amalgamation is blending of two or more existing undertakings into one undertaking, the shareholders of each blending company becoming substantially the shareholders in the company which is to carry blended undertakings. There may be amalgamation either by the transfer of two or more undertakings to an existing company. The term amalgamation contemplates not only state of things in which two companies are so joined as to form a new company but also the absorption and blending of one by the other.

**5.2.1 Notice to the Registrar and Central Government :** Sub-section 3 of Section 394 makes it obligatory on the part of the company to file a certified copy of the order of the Court sanctioning arrangement or compromise with the Registrar of Companies within 30 days. Under Section 394 A, the Court shall give notice of every application made to it under sections 391 or 394 to the Central Government and shall take into consideration the representations made to it by that Government before passing any order under any of these sections.

**5.2.3 Dissenting Shareholders :** Dissenting shareholders include a shareholder who has not assented to the scheme or contract and any shareholder who has failed or refused to transfer his shares to the transferee company in accordance with the scheme or contract.

Where a scheme or contract involves transfer of shares or any class of shares of a transferee company to the transferor company, the transferee company has to make offer which should be approved by the holder of not less than nine-tenths in value of such shares on which transfer is involved within 4 months. After expiry of such 4 months period, and within two months time thereafter, the transferee company may give notice in the prescribed manner to any dissenting shareholder that it desires to acquire their shares. When such a notice is given, the transferee company shall, excepting the case where an application has been made by the dissenting shareholders within 1 month from the date on which the notice was given to the court and the court orders otherwise, be entitled and bound to acquire those shares. If there is no court order in response to the application made by the dissenting shareholder, the transferee company must transmit a copy of the notice to the transferor company together with an instrument of transfer executed on behalf of the shareholder by any person appointed by the transferor along with the amounts or other considerations representing price payable to the dissenting shareholders. Any such sum received by the transferee company representing the price of the shares of the dissenting shareholders shall be paid into a separate bank account. The price of shares will be at such rates which has been agreed upon as per the scheme of amalgamation and payable to the other shareholders.



### 5.3. PURCHASE CONSIDERATION

The consideration paid for the purpose of amalgamation is termed as Purchase Consideration (PC). PC includes anything benefit passed on to the members of the transferee company from the transferor company in any form i.e. Equity shares, Preference shares, Debentures, Cash etc. If PC is paid only in terms of equity shares, we classify that as amalgamation in nature merger but it involves other means of compensation also then we term it as amalgamation in nature of purchase. There no such restriction with the pricing of the securities issued, it can be at par, premium or at discount. Usually intrinsic value of share is taken into consideration for the said purpose.

Para 3 (g) of AS 14 on Accounting for Amalgamations (explained in para 4.5) issued by ICAI defines the term 'consideration' as 'the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. The consideration for the amalgamation should include any non-cash element at fair value. In case of issue of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the market value of the assets or if no market value information is available, the net book value of the assets should be considered as fair value.

In the problem information for PC will be available in two ways. Firstly, list of the various consideration paid is given, one should take care to add only those items paid to the members of the company and not to any outsider. Following are few such examples:

Case I: A Ltd. take over B Ltd. and discharges consideration for the business as follows:

- (i) Issued 42,000 fully paid equity shares of Rs. 10 each at par to the equity shareholders of B Ltd.
- (ii) Issued fully paid up 15% preference shares of Rs. 100 each to discharge the preference shareholders of B Ltd. at a premium of 10%.
- (iii) It is agreed that the debentures of B Ltd. will be converted into equal number and amount of 13% debentures of A Ltd.

In the above case our PC will be Rs. 4,20,000 + 110% of Preference Shares only.

**Case II:** Discharge the PC by allotment of 20,000 equity shares of Rs. 10 each at an agreed value of Rs. 12 each of X Ltd. and by the payment of the balance in cash.

Here, first calculate the value of net asset, from that figure deduct 2,40,000 for equity shares and the balance will be paid in cash.

**Case III:** P Ltd. agrees to take over Q Ltd. Find out the ratio of exchange of shares on the basis of the book values.

In the first step we calculate net worth of the business taken over on the revalued figure basis and then it is divided by the number of shares issued to get Intrinsic Value of Shares. PC is

#### 4.28 Financial Reporting

paid in the ratio of this value, and then at market price.

The same can also be explained with the help of an example given below:

##### Example

Given below is the Balance Sheet of AB Ltd. as on 31.12.2006 on which date its assets and liabilities are taken over by CD Ltd.

| <i>Liabilities</i>                         | <i>'000 Rs.</i> | <i>Assets</i>        | <i>'000 Rs.</i> |
|--------------------------------------------|-----------------|----------------------|-----------------|
| Share Capital                              |                 | Plant and Machinery  | 26,00           |
| Equity Shares of Rs. 10 each fully paid up | 52,00           | Furniture            | 12,00           |
| General Reserve                            | 12,50           | Stock                | 24,00           |
| 12% Debentures                             | 13,50           | Debtors              | 7,50            |
| Sundry Creditors and                       |                 | Cash                 | 10,00           |
| Other current Liabilities                  | <u>7,50</u>     | Preliminary Expenses | <u>6,00</u>     |
|                                            | <u>85,50</u>    |                      | <u>85,50</u>    |

CD Ltd. agreed to issue 12% Debentures to the debenture holders of AB Ltd. at par.

Let us see how purchase consideration should be determined.

##### (1) Assets and liabilities taken over at book values

If all the assets and liabilities are taken over at par then determination of purchase consideration is very simple.

|                                                     | <i>'000 Rs.</i> | <i>'000 Rs.</i> |
|-----------------------------------------------------|-----------------|-----------------|
| <i>Gross Assets taken over as per Balance Sheet</i> |                 |                 |
| Plant and Machinery                                 |                 | 26,00           |
| Furniture                                           |                 | 12,00           |
| Stock                                               |                 | 24,00           |
| Debtors                                             |                 | 7,50            |
| Cash                                                |                 | <u>10,00</u>    |
|                                                     |                 | 79,50           |
| <i>Less: Sundry Liabilities taken over</i>          |                 |                 |
| 12% Debentures                                      | 13,50           |                 |
| S/creditors and other current liabilities           | <u>7,50</u>     | <u>21,00</u>    |
| Value of net assets taken over                      |                 | <u>58,50</u>    |

Thus purchase consideration is Rs. 58,50 thousands.

**(2) Assets and liabilities taken over at valuation**

Suppose that CD Ltd. agreed to take over the asset of AB Ltd. at current values:

|                     |                  |
|---------------------|------------------|
| Plant and Machinery | 30% depreciation |
| Furniture           | 20% depreciation |
| Stock               | +20% revaluation |
| Debtors             | 10% discount     |

In this purchase consideration is to be determined as follows:

|                                             |              |
|---------------------------------------------|--------------|
|                                             | '000 Rs.     |
| <i>Value of assets taken over:</i>          |              |
| Plant and Machinery                         | 18,20        |
| Furniture                                   | 9,60         |
| Stock                                       | 28,80        |
| Debtors                                     | 6,75         |
| Cash                                        | <u>10,00</u> |
|                                             | 73,35        |
| <i>Less : Sundry liabilities taken over</i> | <u>21,00</u> |
| Purchase Consideration                      | 52,35        |

**(3) When payments are more or less than value of net assets :** Often the transferee pays more or less than the value of net assets taken over. Take for example, that CD Ltd. in case

(1) Issued 600 thousand equity shares of Rs. 10 each at par to the equity shareholders of the transferor company AB Ltd. Then purchase consideration is Rs. 60,00 thousand, not Rs. 58,50 thousand. The difference Rs. 150 thousand is goodwill paid by CD Ltd. It is purchased goodwill.

Also take for example that CD Ltd. issued 565 equity shares of Rs. 10 each to the equity shareholders of AB Ltd. Here purchase consideration becomes Rs. 56,50 thousand, not Rs. 60,00 thousand. The difference Rs. 200 thousand is capital reserve to CD Ltd.

Let us suppose that CD Ltd. agreed to discharge 12% Debentures @ 110 by issuing its own debentures and to issue 550 thousand equity shares to the equity shareholders at a premium of Rs. 2 per share.

|                                            |          |          |
|--------------------------------------------|----------|----------|
|                                            | '000 Rs. | '000 Rs. |
| <i>Value of assets taken over:</i>         |          |          |
| as per Balance Sheet value                 |          | 79,50    |
| <i>Less: Sundry liabilities taken over</i> |          |          |
| 12% Debentures                             | 14,85    |          |

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|                                                              |             |              |
|--------------------------------------------------------------|-------------|--------------|
| Sundry creditors and other Liabilities                       | <u>7.50</u> | <u>22.35</u> |
| Book Value of Net Assets                                     |             | 57,15        |
| Purchase Consideration :                                     |             |              |
| 550 thousand equity shares Rs. 10 each at a premium of Rs. 2 |             | <u>66.00</u> |
| Goodwill paid ('000 Rs.)                                     |             | <u>8.85</u>  |

(Alternatively, in some text books Purchase consideration is computed as Rs. 6600 thousand + Rs. 14,85 thousand i.e. Rs. 80,85 thousand which is not the value of net assets taken over in the true sense of the term. As per AS 14, consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the *shareholders* of the transferor company.

Therefore correct amount of purchase consideration is Rs. 66,00,000).

#### 5. 4 DISCHARGE OF PURCHASE CONSIDERATION

As discussed earlier in this unit, the purchase consideration in the case of amalgamation is payable to the shareholders, both preference and equity, of the transferor company. This may be discharged by issuing preference and/or equity shares of the transferee company and partly by cash. Often the transferee company discharges claims of the preference shareholders of the transferor company at a premium or at a discount by issuing preference shares. Similarly, claims of the equity shareholders of the transferor company may also be discharged by issuing equity shares of the transferee company either at par or at premium or at discount.

Given below is an example stating the computational procedure of determining number of shares of the transferee company to be issued in discharge of the purchase consideration.

##### Example 1

##### Balance Sheet of PX Ltd. as on 31.12.2006

| <i>Liabilities</i>                   | <i>Rs. in '000s</i> | <i>Assets</i>       | <i>Rs. in '000s</i> |
|--------------------------------------|---------------------|---------------------|---------------------|
| Share Capital:                       |                     | Sundry Fixed Assets | 50,00               |
| Equity shares of                     |                     | Stock               | 20,00               |
| Rs. 10 each                          | 50,50               | Debtors             | 10,00               |
| 8% Preference shares                 | 9,50                | Cash & Bank         | 5,00                |
| 12% Debentures                       | 15,00               |                     |                     |
| Sundry Creditors & Other Liabilities | <u>10,00</u>        |                     |                     |
|                                      | <u>85,00</u>        |                     | <u>85,00</u>        |

ZX Ltd. agreed to take over PX Ltd. by issuing requisite number of preference shares of Rs. 10 each at 5% discount to the preference shareholders of PX Ltd. and requisite number of

## Accounting for Corporate Restructuring 4.31

equity shares of Rs. 10 each at par to the equity shareholders of PX Ltd. Purchase consideration is settled as per book value of the assets and the debentures will be taken over by ZX Ltd. on the agreement that such will be paid off at 10% premium after one year. Debenture-holders of PX Ltd. will accept 12% debentures of ZX Ltd.

| <b>Purchase Consideration:</b>           | <i>Rs. in '000s</i> | <i>Rs. in '000s</i> |
|------------------------------------------|---------------------|---------------------|
| Book Value of assets taken over          |                     | 85,00               |
| Less : Liabilities taken-over:           |                     |                     |
| Debentures                               | 15,00               |                     |
| Add: Premium on redemption of debentures | <u>1,50</u>         |                     |
|                                          | 16,50               |                     |
| Sundry Creditors & Other Liabilities     | <u>10,00</u>        | <u>26,50</u>        |
| Purchase Consideration                   |                     | <u>58,50</u>        |

To be discharged by 8% preference shares of ZX Ltd. and equity shares.

### Computation of number of shares to be issued:

$$1) \text{ Preference shares to be issued : } \frac{\text{Rs. 950 thousand}}{\text{Rs. 9.5}} = 100 \text{ thousand}$$

Balance of purchase consideration: Rs. 58,50 thousand - Rs. 950 thousand = 49,00 thousand

$$2) \text{ Equity shares to be issued } \frac{\text{Rs. 49 thousand}}{\text{Rs. 10}} = 490 \text{ thousand}$$

### Example 2

Given below is the Balance Sheet of LMN Ltd. as on 31.12.2006 at which date the company was taken over by PQR Ltd.

| <i>Liabilities</i> | <i>Rs. in '000s</i> | <i>Assets</i>         | <i>Rs. in '000s</i> |
|--------------------|---------------------|-----------------------|---------------------|
| Share Capital      |                     | Sundry fixed assets   | 80,00               |
| Equity Shares      | 70,00               | Sundry current assets | 42,00               |
| Preference shares  | 12,00               |                       |                     |
| 12% Debentures     | 25,00               |                       |                     |
| Sundry Creditors   | <u>15,00</u>        |                       |                     |
|                    | <u>122,00</u>       |                       | <u>122,00</u>       |

Decided that sundry fixed assets of LMN Ltd. will be taken over at a valuation of Rs. 102,00 thousand. 8% preference shareholders of LMN Ltd. are to be discharged by issuing 8% preference shares of the transferee company to the extent of 50% and the balance in cash. Claims of the equity shareholders to be discharged by issuing equity shares of the transferee company to the extent of 60% and the balance in cash. The transferee company will issue

#### 4.32 Financial Reporting

preference shares at par but equity shares of Rs. 10 each at a premium of 20%

##### Purchase Consideration:

|                                      | Rs. in '000s  |
|--------------------------------------|---------------|
| <i>Value of assets taken over</i>    |               |
| Sundry fixed assets                  | 102,00        |
| Sundry current assets                | <u>42,00</u>  |
|                                      | 144,00        |
| Less: Sundry liabilities taken over: | <u>40,00</u>  |
| Purchase Consideration               | <u>104,00</u> |
| To be discharged by:                 |               |
| Preference shares                    | 6,00          |
| Equity shares                        | 55,20         |
| Cash                                 | <u>42,80</u>  |
|                                      | <u>104,00</u> |

##### Number of shares to be issued:

- 1) Preference shares of Rs. 10 each

$$\frac{\text{Rs. 600 thousand}}{\text{Rs.10}} = 60 \text{ thousand}$$

Balance of purchase consideration ('000 Rs.)

$$104,00 - 12,00 = 92,00$$

$$60\% \text{ thereof} = 55,20$$

- 2) Equity shares of Rs. 10 each at a premium of Rs. 2

$$\frac{\text{Rs. 55,20 thousand}}{\text{Rs.12}} = 460 \text{ thousand}$$

#### Example 3

Given below are Balance Sheets of A Ltd. & B Ltd. as on 31st Dec. 2006 at which date the companies were amalgamated and a new company C Ltd. was formed.

##### Balance Sheets of A Ltd. & B Ltd.

| Liabilities      | A Ltd. | B Ltd. | Assets                | A Ltd.        | B Ltd.        |
|------------------|--------|--------|-----------------------|---------------|---------------|
|                  |        |        |                       | (Rs in '000s) | (Rs in '000s) |
| Equity Shares of |        |        | Sundry Fixed Assets   | 85,00         | 70,00         |
| Rs. 10 each      | 70,00  | 60,00  | Sundry current assets | 20,00         | 30,00         |

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|                           |               |               |               |                             |
|---------------------------|---------------|---------------|---------------|-----------------------------|
| Reserve                   | 20,00         | 40,00         | Miscellaneous |                             |
| Sundry creditors &        |               |               | expenditure   | 10,00                       |
| other current liabilities | <u>15,00</u>  | <u>10,00</u>  |               |                             |
|                           | <u>105,00</u> | <u>110,00</u> |               | <u>105,00</u> <u>110,00</u> |

Agreed that sundry fixed assets of A Ltd. would be valued at Rs. 100,00 thousand and that of B Ltd. at Rs. 95,00 thousand. C Ltd. would issue requisite number of equity shares of Rs. 10 each at 10% premium to discharge claim of the equity shareholders of A Ltd. & B Ltd. Let us see how many shares of C Ltd. should be issued to take over the businesses of A Ltd. & B Ltd.

### Purchase Consideration :

|                                                | A Ltd.<br>Rs. in '000s | B Ltd.<br>Rs. in '000s |
|------------------------------------------------|------------------------|------------------------|
| <i>Value of assets taken over:</i>             |                        |                        |
| Sundry fixed assets                            | 100,00                 | 95,00                  |
| Sundry current assets                          | <u>20,00</u>           | <u>30,00</u>           |
|                                                | 120,00                 | 125,00                 |
| <i>Less: Liabilities taken over:</i>           | <u>15,00</u>           | <u>10,00</u>           |
| Purchase Consideration                         | <u>105,00</u>          | <u>115,00</u>          |
| Total Purchase Consideration                   | 220,00                 |                        |
| Number of equity shares to be issued by C Ltd. |                        |                        |

$$\frac{\text{Rs. 220,00 thousand}}{\text{Rs.11}} = 20,00 \text{ thousand}$$

So, C Ltd. will be formed with the paid up capital of Rs. 200,00 thousand and share premium of Rs. 20,00 thousand.

## 6. TYPES OF AMALGAMATION

The Institute has issued in October, 1994, AS 14 on 'Accounting for Amalgamations'. AS 14 is mandatory in nature and is applicable in respect of accounting periods commencing on or after 1/4/1995. AS 14 deals with accounting for amalgamations and the treatment of any resultant goodwill or reserve. Amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamated companies but also of the shareholders' interest and of the businesses of these companies. Such amalgamations are called 'amalgamations in the nature of merger'. The basic conditions of these amalgamations are:

- (a) All the assets and liabilities of the transferor company become, after amalgamation, the

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assets and liabilities of the transferee company.

- (b) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
- (c) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
- (d) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
- (e) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

In the second category are those amalgamations which are in effect a mode by which one company acquires another company and, as a consequence, the shareholders of the company which is acquired normally do not have a proportionate share in the equity of the combined company or the business of the company which is acquired is not intended to be continued. Such amalgamations are called 'amalgamations in the nature of purchase'. In short, those amalgamations which do not satisfy any one or more of the conditions specified in (a) through (e) above are known as amalgamations in the nature of purchase.

#### 6.1 METHODS OF ACCOUNTING FOR AMALGAMATION

There are two main methods of accounting for amalgamations:

- (a) The Pooling of Interests Methods and
- (b) The Purchase Method.

The first method is applied in case of amalgamation in the nature of merger and the second method in case of amalgamation in the nature of purchase.

- ◆ **The Pooling of Interests Method:** Under this method the assets, liabilities and all reserves of the transferor company are recorded by transferee company at their existing carrying amounts unless the carrying amounts are to be adjusted to follow a uniform set of accounting policies. The effects on the financial statements of the transferee company of any changes in accounting policies are to be reported in accordance with AS-5. The balance of the profit and loss account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to general reserve, if any.



The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of transferor company should be adjusted in reserves.

Thus neither 'goodwill' nor 'capital reserve' arises in case of amalgamations in the nature of merger.

- ◆ **The Purchase Method** : Here the assets and liabilities of the transferor company should be incorporated in the transferee company's financial statements in either of the following two ways:

- (i) at their existing carrying amounts; or
- (ii) the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.

The reserves of the transferor company, other than statutory reserves, should not be included in the financial statements of the transferee company. In case of statutory reserves (i.e., Development Allowance Reserve, Investment Allowance Reserve etc.) where the maintenance of such reserves for a specific period is required by statute, these should be recorded in the financial statements of the transferee company with the help of the following entry:

|                             |     |                           |
|-----------------------------|-----|---------------------------|
| Amalgamation Adjustment A/c | Dr. |                           |
|                             |     | To Statutory Reserves A/c |

The 'Amalgamation Adjustment A/c' should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet of the transferee company. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the adjustment account should be reversed.

Any excess of the amount of purchase consideration over the acquired net assets of the transferor company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. On the other hand if the amount of purchase consideration falls short of the value of net assets acquired, such shortfall should be recognised as capital reserve.

## 6.2 TREATMENT OF GOODWILL ARISING ON AMALGAMATION

Goodwill on amalgamation can arise only if 'The Purchase Method' is followed.

The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.

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### 6.3 AMALGAMATION AFTER THE BALANCE SHEET DATE

When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure is made in accordance with AS-4, 'Contingencies and Events Occurring after the Balance Sheet Date', but the amalgamation is not incorporated in the financial statements.

#### Illustration 5

AX Ltd. and BX Ltd. amalgamated on and from 1st January 2007. A new Company ABX Ltd. was formed to take over the businesses of the existing companies.

#### Balance Sheet as on 31-12-2006

|                       | <i>AX Ltd.</i>  | <i>BX Ltd.</i>  |               | <i>AX Ltd.</i>  | <i>BX Ltd.</i>  |
|-----------------------|-----------------|-----------------|---------------|-----------------|-----------------|
| <i>Liabilities</i>    | <i>'000 Rs.</i> | <i>'000 Rs.</i> | <i>Assets</i> | <i>'000 Rs.</i> | <i>'000 Rs.</i> |
| Share Capital         |                 |                 | Sundry Fixed  |                 |                 |
| Equity Shares of      |                 |                 | Assets        | 85,00           | 75,00           |
| Rs. 10 each           | 60,00           | 70,00           | Investment    | 10,50           | 5,50            |
| General Reserve       | 15,00           | 20,00           | Stock         | 12,50           | 27,50           |
| P & L A/c             | 10,00           | 5,00            | Debtors       | 18,00           | 40,00           |
| Investment Allowance  |                 |                 | Cash & Bank   | 4,50            | 4,00            |
| Reserve               | 5,00            | 1,00            |               |                 |                 |
| Export Profit Reserve | 50              | 1,00            |               |                 |                 |
| 12% Debentures        | 30,00           | 40,00           |               |                 |                 |
| Sundry Creditors      | <u>10,00</u>    | <u>15,00</u>    |               |                 |                 |
|                       | <u>130,50</u>   | <u>152,00</u>   |               | <u>130,50</u>   | <u>152,00</u>   |

ABX Ltd. issued requisite number of shares to discharge the claims of the equity shareholders of the transferor companies.

Prepare a note showing purchase consideration and discharge thereof and draft the Balance Sheet of ABX Ltd.

**Solution (Assumption : Amalgamation is in the nature of merger )**

#### Working Notes :

##### (1) Purchase Consideration

|                           | <i>AX Ltd.</i>  | <i>BX Ltd.</i>  |
|---------------------------|-----------------|-----------------|
|                           | <i>'000 Rs.</i> | <i>'000 Rs.</i> |
| <i>Assets taken over:</i> |                 |                 |
| Sundry fixed assets       | 85,00           | 75,00           |
| Investments               | 10,50           | 5,50            |

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|                                    |              |                |                |              |
|------------------------------------|--------------|----------------|----------------|--------------|
| Stock                              | 12,50        |                |                | 27,50        |
| Debtors                            | 18,00        |                |                | 40,00        |
| Cash & Bank                        | <u>4,50</u>  |                |                | <u>4,00</u>  |
|                                    | 130,50       |                |                | 152,00       |
| <i>Less : Sundry Liabilities</i>   |              |                |                |              |
| 12% Debentures                     | 30,00        |                | 40,00          |              |
| Sundry Creditors                   | <u>10,00</u> | <u>40,00</u>   | 15,00          | <u>55,00</u> |
| Net Assets taken over              |              | 90,50          |                | 97,00        |
| <i>Less: Reserves and Surplus:</i> |              |                |                |              |
| General Reserve                    | 15,00        |                | 20,00          |              |
| P & L A/c                          | 10,00        |                | 5,00           |              |
| Investment Allowance Reserve       | 5,00         |                | 1,00           |              |
| Export Profit Reserve              | <u>50</u>    | <u>30,50</u>   | <u>1,00</u>    | <u>27,00</u> |
| Purchase Consideration             |              | <u>60,00</u>   |                | <u>70,00</u> |
|                                    |              | <i>AX Ltd.</i> | <i>BX Ltd.</i> |              |
|                                    |              | '000           | '000 Rs.       |              |

Discharge of purchase Consideration:

$$130,00 \times \frac{90,50}{187,50} = 6,27,500 \text{ * Equity shares of Rs. 10 each} \quad 62,75$$

$$130,00 \times \frac{97,00}{187,50} = 6,72,500 \text{ Equity shares of Rs. 10 each} \quad 67,25$$

### Balance Sheet of ABX Ltd. as on 1.1.2007

| <i>Liabilities</i>           | <i>Amount</i> | <i>Assets</i>       | <i>Amount</i> |
|------------------------------|---------------|---------------------|---------------|
|                              | '000 Rs.      |                     | '000 Rs.      |
| Share Capital                |               | Sundry Fixed Assets | 160,00        |
| Equity Shares of Rs. 10 each | 130,00        | Investments         | 16,00         |
| General Reserve              | 35,00         | Stock               | 40,00         |
| P&L A/c                      | 15,00         | Debtors             | 58,00         |
| Investment Allowance Reserve | 6,00          | Cash & Bank         | 8,50          |
| Export Profit Reserve        | 1,50          |                     |               |
| 12% Debentures               | 70,00         |                     |               |

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\* The total purchase consideration is to be discharged by ABX Ltd. in such a way that the rights of the shareholders of AX Ltd. and BX Ltd. remain unaltered in the future profits of ABX Ltd.

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(Assumed that new debentures were issued in exchange of the old series)

|                  |               |               |
|------------------|---------------|---------------|
| Sundry Creditors | <u>25,00</u>  | <u>282,50</u> |
|                  | <u>282,50</u> | <u>282,50</u> |

**Assumption: Amalgamation is in the nature of Purchase**

##### Balance Sheet of ABX Ltd. as on 1.1.2007

| <i>Liabilities</i>           | <i>Amount</i>   | <i>Assets</i>                   | <i>Amount</i>   |
|------------------------------|-----------------|---------------------------------|-----------------|
|                              | <i>'000 Rs.</i> |                                 | <i>'000 Rs.</i> |
| Share Capital                |                 |                                 |                 |
| Equity shares of Rs. 10 each | 187,50          | Sundry Fixed Assets             | 160,00          |
| Investment Allowance Reserve | 6,00            | Investments                     | 16,00           |
| Export Project Reserve       | 1,50            | Stock                           | 40,00           |
| 12% Debentures               | 70,00           | Debtors                         | 58,00           |
| Sundry Creditors             | 25,00           | Cash & bank                     | 8,50            |
|                              |                 | Amalgamation Adjustment Account | <u>7,50</u>     |
|                              | <u>290,00</u>   |                                 | <u>290,00</u>   |

##### Note :

- (1) Shares are issued by ABX Ltd. on the basis of net assets acquired of AX Ltd. and BX Ltd. Hence there is no goodwill.
- (2) Discharge of Purchase consideration:

|                                     | <b>AX Ltd.</b>  | <b>BX Ltd.</b>  |
|-------------------------------------|-----------------|-----------------|
|                                     | <i>'000 Rs.</i> | <i>'000 Rs.</i> |
| 905,00 Equity Shares of Rs. 10 each | 90,50           |                 |
| 970,00 Equity Shares of Rs. 10 each |                 | 97,00           |

- (3) The statutory reserves of AX Ltd. and BX Ltd. are shown in the balance sheet of ABX Ltd. with a corresponding debit in Amalgamation Adjustment Account.

##### Illustration 6

Long Ltd. and Short Ltd. were amalgamated on and from 1st April, 2006. A new company Moderate Ltd. was formed to take over the businesses of the existing companies. The balance sheets of Long Ltd. and Short Ltd. as on 31st March, 2006 are given below:

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| (Rs. in lacs)                 |              |               |                              |              |               |
|-------------------------------|--------------|---------------|------------------------------|--------------|---------------|
| Liabilities                   | Long<br>Ltd. | Short<br>Ltd. | Assets                       | Long<br>Ltd. | Short<br>Ltd. |
| <b>Share Capital:</b>         |              |               |                              |              |               |
| Equity shares of Rs. 100 each | 850          | 725           | <b>Fixed Assets:</b>         |              |               |
| 14% Preference Shares         |              |               | Land & Building              | 460          | 275           |
| of Rs. 100 each               | 320          | 175           | Plant & Machinery            | 325          | 210           |
| <b>Reserves and Surplus:</b>  |              |               | <b>Investments</b>           | 75           | 50            |
| Revaluation reserve           | 125          | 80            | <b>Current Assets and</b>    |              |               |
| General Reserve               | 240          | 160           | <b>Loans &amp; Advances:</b> |              |               |
| Investment Allowance          | 50           | 30            | Stock                        | 325          | 269           |
| Reserve                       |              |               | Sundry Debtors               | 305          | 270           |
| P & L Account                 | 75           | 52            | Bills receivable             | 25           | —             |
| <b>Secured Loans:</b>         |              |               | Cash and Bank                | 385          | 251           |
| 13% Debentures                |              |               |                              |              |               |
| (Rs. 100 each)                | 50           | 28            |                              |              |               |
| <b>Unsecured Loan:</b>        |              |               |                              |              |               |
| Public deposits               | 25           | —             |                              |              |               |
| <b>Current Liabilities</b>    |              |               |                              |              |               |
| <b>and Provisions:</b>        |              |               |                              |              |               |
| Sundry creditors              | 145          | 75            |                              |              |               |
| Bills payable                 | <u>20</u>    | <u>—</u>      |                              |              |               |
|                               | <u>19,00</u> | <u>13,25</u>  |                              | <u>19,00</u> | <u>13,25</u>  |

### Other information

- (i) 13% Debenture holders of Long Ltd. and Short Ltd. are discharged by Moderate Ltd. by issuing such number of its 15% Debentures of Rs.100 each so as to maintain the same amount of interest.
- (ii) Preference Shareholders of the two companies are issued equivalent number of 15% preference shares of Moderate Ltd. at a price of Rs. 125 per share (face value Rs. 100)
- (iii) Moderate Ltd. will issue 4 equity shares for each equity share of Long Ltd. and 3 equity shares for each equity share of Short Ltd. The shares are to be issued @ Rs. 35 each, having a face value of Rs.10 per share.
- (iv) Investment allowance reserve is to be maintained for two more years.

#### 4.40 Financial Reporting

Prepare the balance sheet of Moderate Ltd. as on 1st April, 2006 after the amalgamation has been carried out on the basis of the following assumption:

- (a) Amalgamation is in the nature of merger.
- (b) Amalgamation is in the nature of purchase.

#### Solution

Para 3 (g) of AS-14 defines the term 'consideration' as the value of shares, other securities and any payment made in the form of cash or other assets by the transferee company to the shareholders of transferor company. Therefore, payments made to debenture holders should not be construed as part of consideration.

#### Computation of Purchase consideration

|                                                                                    | (Rs. in lacs)   |                |
|------------------------------------------------------------------------------------|-----------------|----------------|
|                                                                                    | <b>Long</b>     | <b>Short</b>   |
|                                                                                    | <b>Ltd.</b>     | <b>Ltd.</b>    |
| (1) Preference Shareholders:                                                       |                 |                |
| (Rs. in lacs) $320 \times \frac{125}{100} = 3,20,000 \text{ shares @ Rs.125 each}$ | 400             |                |
| (Rs. in lacs) $175 \times \frac{125}{100} = 1,75,000 \text{ shares @ Rs.125 each}$ |                 | 218.75         |
| (2) Equity Shareholders:                                                           |                 |                |
| $(4 \times 8,50,000) = 34,00,000 \text{ equity shares @ Rs.35 each}$               | 1190            |                |
| $(3 \times 7,25,000) = 21,75,000 \text{ equity shares @ Rs.35 each}$               | <u>        </u> | <u>761.25</u>  |
|                                                                                    | <u>15,90</u>    | <u>9,80.00</u> |

#### (a) Amalgamation in the nature of merger

#### Balance Sheet of Moderate Ltd.

As on 1st April, 2006

| (Rs. in lacs)                  |         | (Rs. in lacs)                |        |
|--------------------------------|---------|------------------------------|--------|
| Liabilities                    | Amount  | Assets                       | Amount |
| <b>Share Capital:</b>          |         | <b>Fixed Assets :</b>        |        |
| 55,75,000 equity shares        |         | Land and Building            | 735.00 |
| of Rs. 10 each                 | 557.50  | Plant & Machinery            | 535.00 |
| 4,95,000 15% Preference shares |         | <b>Investments</b>           | 125.00 |
| of Rs. 100 each                | 4,95.00 | <b>Current Assets, Loans</b> |        |

## Accounting for Corporate Restructuring 4.41

|                                             |                |                      |                |
|---------------------------------------------|----------------|----------------------|----------------|
| <b>Reserves and Surplus:</b>                |                | <b>and advances:</b> |                |
| Revaluation reserve                         | 2,05.00        | Stock                | 594.00         |
| General Reserve                             | —              | Sundry Debtors       | 575.00         |
| Share Premium                               | 15,17.50       | Bills receivable     | 25.00          |
| Investment Allowance Reserve                | 80.00          | Cash & Bank          | 636.00         |
| Profit & Loss Account                       | 37.40          |                      |                |
| <b>Secured Loan :</b>                       |                |                      |                |
| 15% Debentures (Rs. 100 each)               | 67.60          |                      |                |
| <b>Unsecured Loan :</b>                     |                |                      |                |
| Public Deposits                             | 25.00          |                      |                |
| <b>Current Liabilities and Provisions :</b> |                |                      |                |
| Sundry Creditors                            | 220.00         |                      |                |
| Bills Payable                               | <u>20.00</u>   |                      |                |
|                                             | <u>3225.00</u> |                      | <u>3225.00</u> |

### Working Notes:

1. (A) Amount of Share Capital of Transferor Companies:

|     |                                  |                      |                   |
|-----|----------------------------------|----------------------|-------------------|
|     |                                  | <i>(Rs. in lacs)</i> |                   |
|     |                                  | <b>Long Ltd.</b>     | <b>Short Ltd.</b> |
|     | Equity Share Capital             | 850                  | 725               |
|     | Preference Share Capital         | <u>320</u>           | <u>175</u>        |
|     |                                  | <u>1170</u>          | <u>900</u>        |
| (B) | Amount of Purchase consideration | <u>1590</u>          | <u>980</u>        |
| (C) | Difference (i.e. B–A)            | <u>420</u>           | <u>80</u>         |

The total difference of Rs. (in lacs) 500 should be adjusted in the balance sheet of Moderate Ltd. against reserves as below:

|                         |                    |            |                            |
|-------------------------|--------------------|------------|----------------------------|
|                         | Combined<br>Amount | Adjustment | Balance<br>Sheet<br>Amount |
| General Reserve         | 400                | 400        | Nil                        |
| Profit and Loss Account | 127                | 100        | 27                         |
|                         | <u>527</u>         | <u>500</u> | <u>(subject to note 2)</u> |
|                         |                    |            | <u>27</u>                  |

#### 4.42 Financial Reporting

2. Similarly, the difference between the amount of debentures of Long Ltd. and Short Ltd. taken over and the amount of debentures of Moderate Ltd. issued in exchange should also be adjusted against reserves. In this problem, the difference of Rs. (in lacs) 10.40 should be added to Profit and Loss Account balance (since general reserve has already become nil). Therefore, in the balance sheet of Moderate Ltd., Profit and Loss Account balance will be shown as Rs. (in lacs)  $(27 + 10.40) = 37.40$ .

**(b) Amalgamation in the nature of Purchase:**

|                                       | (Rs. in lacs)   |               |
|---------------------------------------|-----------------|---------------|
|                                       | Long Ltd.       | Short Ltd.    |
| <i>Assets taken over:</i>             |                 |               |
| Land and Building                     | 460             | 275           |
| Plant and Machinery                   | 325             | 210           |
| Investments                           | 75              | 50            |
| Stock                                 | 325             | 269           |
| Sundry Debtors                        | 305             | 270           |
| Bills receivable                      | 25              | —             |
| Cash and Bank                         | <u>385</u>      | <u>251</u>    |
|                                       | <u>19,00</u>    | <u>13,25</u>  |
| <i>Less : Liabilities taken over:</i> |                 |               |
| 13% Debentures                        | 43.33           | 24.27         |
| Public Deposits                       | 25.00           | —             |
| Sundry Creditors                      | 145.00          | 75.00         |
| Bills Payable                         | <u>20.00</u>    | <u>—</u>      |
|                                       | <u>233.33</u>   | <u>99.27</u>  |
| Net Assets taken over                 | 16,66.67        | 1225.73       |
| Purchase consideration                | <u>15,90.00</u> | <u>980.00</u> |
| Capital Reserves                      | <u>76.67</u>    | <u>245.73</u> |

**Balance Sheet of Moderate Ltd.**

**As on 1st April, 2006**

|                         | (Rs. in lacs) |                     | (Rs. in lacs) |
|-------------------------|---------------|---------------------|---------------|
| <i>Liabilities</i>      | <i>Amount</i> | <i>Assets</i>       | <i>Amount</i> |
| <b>Share Capital:</b>   |               | <b>Fixed Assets</b> |               |
| 55,75,000 Equity Shares |               | Land Building       | 735.00        |
| of Rs. 10 each          | 557.50        | Plant and Machinery | 535.00        |
| 4,95,000 Preference     |               | Investments         | 125.00        |



## Accounting for Corporate Restructuring 4.43

|                                             |                |                                             |                |
|---------------------------------------------|----------------|---------------------------------------------|----------------|
| Shares of Rs. 100 each                      | 495.00         | <b>Current Assets, Loans and Advances :</b> |                |
| <b>Reserves and Surplus:</b>                |                | Stock                                       | 594.00         |
| Share Premium                               | 1517.50        | Sundry Debtors                              | 575.00         |
| Capital Reserve                             | 322.40         | Bills Receivable                            | 25.00          |
| Investment Allowance                        |                | Cash & Bank                                 | 636.00         |
| Reserve                                     | 80.00          | <b>Misc. Expenditure:</b>                   |                |
| <b>Secured Loan :</b>                       |                | Amalgamation                                |                |
| 15% Debentures (Rs. 100 each)               | 67.60          | Adjustment Account                          | 80.00          |
| <b>Unsecured Loan</b>                       |                |                                             |                |
| Public Deposits                             | 25.00          |                                             |                |
| <b>Current Liabilities and Provisions :</b> |                |                                             |                |
| Sundry Creditors                            | 220.00         |                                             |                |
| Bills Payable                               | <u>20.00</u>   |                                             |                |
|                                             | <u>3305.00</u> |                                             | <u>3305.00</u> |

**Illustration 7:** The Massive Company Ltd. was incorporated on 1st July 2006 for the purpose of acquiring North Ltd., South Ltd., and West Ltd.

The balance sheets of these companies as on 30th June 2006 are as follows :

|                                                     | <b>North Ltd.</b> | <b>South Ltd.</b> | <b>West Ltd.</b> |
|-----------------------------------------------------|-------------------|-------------------|------------------|
|                                                     | <i>Rs.</i>        | <i>Rs.</i>        | <i>Rs.</i>       |
| <b>Assets</b>                                       |                   |                   |                  |
| Tangible fixed assets –at cost less depreciation    | 5,00,000          | 4,00,000          | 3,00,000         |
| Goodwill                                            |                   | 60,000            |                  |
| Other assets                                        | <u>2,00,000</u>   | <u>2,80,000</u>   | <u>85,000</u>    |
|                                                     | <u>7,00,000</u>   | <u>7,40,000</u>   | <u>3,85,000</u>  |
|                                                     | <b>North Ltd.</b> | <b>South Ltd.</b> | <b>West Ltd.</b> |
|                                                     | <i>Rs.</i>        | <i>Rs.</i>        | <i>Rs.</i>       |
| <b>Liabilities</b>                                  |                   |                   |                  |
| Issued ordinary share capital shares of Rs. 10 each | 4,00,000          | 5,00,000          | 2,50,000         |
| P & L A/c                                           | 1,50,000          | 1,10,000          | 60,000           |
| 10% Debentures                                      | 70,000            |                   | 40,000           |
| Sundry Creditors                                    | <u>80,000</u>     | <u>1,30,000</u>   | <u>35,000</u>    |
|                                                     | <u>7,00,000</u>   | <u>7,40,000</u>   | <u>3,85,000</u>  |

#### 4.44 Financial Reporting

|                                                        |          |          |          |
|--------------------------------------------------------|----------|----------|----------|
| Average annual profits before                          | Rs.      | Rs.      | Rs.      |
| Debentures interest (July 2006 to June 2006 inclusive) | 90,000   | 1,20,000 | 50,000   |
| Professional valuation of tangible assets on           |          |          |          |
| 30th June 2006                                         | 6,20,000 | 4,80,000 | 3,60,000 |

(1) The directors in their negotiations agreed that : (i) the recorded goodwill of South Ltd. is valueless; (ii) the "Other assets" of North Ltd. are worth Rs. 30,000; (iii) the valuation of 30th June 2006 in respect of tangible fixed assets should be accepted, (iv) these adjustments are to be made by the individual company before the completion of the acquisition.

(2) The acquisition agreement provides for the issue of 12 per cent unsecured Debentures to the value of the net assets of companies North Ltd., South Ltd., and West Ltd., and for the issuance of Rs. 10 nominal value ordinary shares for the capitalized average profit of each acquired company in excess of net assets contributed. The capitalisation rate is established at 10 per cent.

You are required to calculate purchase consideration and show the purchase consideration as discharged.

#### Solution

##### Statement showing Debentures and Shares to be issued

|                              | North Ltd.    |                 | South Ltd. |                 | West Ltd.     |                 |
|------------------------------|---------------|-----------------|------------|-----------------|---------------|-----------------|
|                              | Rs.           | Rs.             | Rs.        | Rs.             | Rs.           | Rs.             |
| Tangible Fixed assets        |               | 6,20,000        |            | 4,80,000        |               | 3,60,000        |
| Other Assets                 |               | <u>30,000</u>   |            | <u>2,80,000</u> |               | <u>85,000</u>   |
|                              |               | 6,50,000        |            | 7,60,000        |               | 4,45,000        |
| Less : Sundry Crs.           | 80,000        |                 | 1,30,000   |                 | 35,000        |                 |
| 10% Debenture                | <u>70,000</u> | <u>1,50,000</u> | <u>—</u>   | <u>1,30,000</u> | <u>40,000</u> | <u>75,000</u>   |
| Net assets                   |               | <u>5,00,000</u> |            | <u>6,30,000</u> |               | <u>3,70,000</u> |
|                              | North Ltd.    |                 | South Ltd. |                 | West Ltd.     |                 |
|                              | Rs.           |                 | Rs.        |                 | Rs.           |                 |
| Capitalised average profits* |               | 8,30,000        |            | 12,00,000       |               | 4,60,000        |
| Less: Net assets             |               | <u>5,00,000</u> |            | <u>6,30,000</u> |               | <u>3,70,000</u> |
| Excess                       |               | <u>3,30,000</u> |            | <u>5,70,000</u> |               | <u>90,000</u>   |
| Issue by Massive Ltd.        |               |                 |            |                 |               |                 |
| Equity shares                |               | 3,30,000        |            | 5,70,000        |               | 90,000          |
| 12% Debentures               |               | 5,00,000        |            | 6,30,000        |               | 3,70,000        |

\* Average annual profits of North Ltd., is Rs. 83,000 i.e. Rs. 90,000 less Debenture Interest Rs. 7,000; capitalised at the rate of 10% the amount is Rs. 8,30,000.

### Illustration 8

Given below Balance Sheets of AX Ltd. and TX Ltd. as on 31.12.2006. TX Ltd. was merged with AX Ltd. with effect from 1.1.2007 and the merger was in the nature of purchase.

#### Balance Sheets as on 31.12.2006

| <i>Liabilities</i>    | <i>AX Ltd.</i>   | <i>TX Ltd.</i>  | <i>Assets</i>    | <i>AX Ltd.</i>   | <i>TX Ltd.</i>  |
|-----------------------|------------------|-----------------|------------------|------------------|-----------------|
|                       | <i>Rs.</i>       | <i>Rs.</i>      |                  | <i>Rs.</i>       | <i>Rs.</i>      |
| Share Capital:        |                  |                 |                  |                  |                 |
| Equity Shares of      |                  |                 | Sundry Fixed     |                  |                 |
| Rs.10 each            | 7,00,000         | 2,50,000        | Assets           | 9,50,000         | 4,00,000        |
| General Reserve       | 3,50,000         | 1,20,000        | Investments      |                  |                 |
| P & L A/c             | 2,10,000         | 65,000          | (Non-trade)      | 2,00,000         | 50,000          |
| Export Profit Reserve | 70,000           | 40,000          | Stock            | 1,20,000         | 50,000          |
| 12 % Debentures       | 1,00,000         | 1,00,000        | Debtors          | 75,000           | 80,000          |
| Sundry Creditors      | 40,000           | 45,000          | Advance Tax      | 80,000           | 20,000          |
| Prov. for Taxation    | 1,00,000         | 60,000          | Cash & Bank      |                  |                 |
| Proposed Dividend     | 1,40,000         | 50,000          | Balances         | 2,75,000         | 1,30,000        |
|                       |                  |                 | Preliminary Exp. | <u>10,000</u>    | <u>—</u>        |
|                       | <u>17,10,000</u> | <u>7,30,000</u> |                  | <u>17,10,000</u> | <u>7,30,000</u> |

AX Ltd. would issue 12% Debentures to discharge the claims of the debenture holders of TX Ltd. at par. Non-trade investments of AX Ltd. fetched @25% while those of TX Ltd. fetched @18% Profit (pre- tax) by AX Ltd. and TX Ltd. during 2004, 2005 and 2006 and were as follows:

|      | <b>AX Ltd.</b> | <b>TX Ltd.</b> |
|------|----------------|----------------|
|      | <i>Rs.</i>     | <i>Rs.</i>     |
| 2004 | 5,00,000       | 1,50,000       |
| 2005 | 6,50,000       | 2,10,000       |
| 2006 | 5,75,000       | 1,80,000       |

Goodwill may be calculated on the basis of capitalisation method taking 20% as the pre-tax normal rate of return. Purchase consideration is discharged by AX Ltd. on the basis of intrinsic value per share. The company decided to cancel the proposed dividend. Prepare Balance Sheet of AX Ltd. after merger.

#### 4.46 Financial Reporting

##### Solution

##### (1) Valuation of Goodwill

##### (i) Capital Employed

|                                    |                 | AX Ltd.          |               | TX Ltd.         |
|------------------------------------|-----------------|------------------|---------------|-----------------|
|                                    | Rs.             | Rs.              | Rs.           | Rs.             |
| Sundry-Assets as per Balance Sheet |                 | 17,10,000        |               | 7,30,000        |
| Less: Preliminary Expenses         | 10,000          |                  | —             |                 |
| Non-trade Investment               | <u>2,00,000</u> | <u>2,10,000</u>  | <u>50,000</u> | <u>50,000</u>   |
|                                    |                 | 15,00,000        |               | 6,80,000        |
| Less : Sundry Liabilities          |                 |                  |               |                 |
| 12% Debentures                     | 1,00,000        |                  | 1,00,000      |                 |
| Sundry Creditors                   | 40,000          |                  | 45,000        |                 |
| Provision for Taxation             | <u>1,00,000</u> | <u>2,40,000</u>  | <u>60,000</u> | <u>2,05,000</u> |
|                                    |                 | <u>12,60,000</u> |               | <u>4,75,000</u> |

##### (ii) Average Pre-Tax Profit

|                           | AX Ltd.         | TX Ltd.         |
|---------------------------|-----------------|-----------------|
|                           | Rs.             | Rs.             |
| 2004                      | 5,00,000        | 1,50,000        |
| 2005                      | 6,50,000        | 2,10,000        |
| 2006                      | <u>5,75,000</u> | <u>1,80,000</u> |
|                           | 17,25,000       | 5,40,000        |
| Simple Average            | 5,75,000        | 1,80,000        |
| Less : Non-trading income | <u>50,000</u>   | <u>9,000</u>    |
|                           | <u>5,25,000</u> | <u>1,71,000</u> |

##### (iii) Goodwill

|                                                                         |                  |                                  |                 |
|-------------------------------------------------------------------------|------------------|----------------------------------|-----------------|
| Capitalisation Value of average profit $\frac{5,25,000}{20} \times 100$ | 26,25,000        | $\frac{1,71,000}{20} \times 100$ | 8,55,000        |
| Less : Capital Employed                                                 | <u>12,60,000</u> |                                  | <u>4,75,000</u> |
|                                                                         | <u>13,65,000</u> |                                  | <u>3,80,000</u> |

##### (2) Intrinsic Value per Share

|                                               | AX Ltd.          | TX Ltd.         |
|-----------------------------------------------|------------------|-----------------|
|                                               | Rs.              | Rs.             |
| Goodwill                                      | 13,65,000        | 3,80,000        |
| Sundry Other Assets less preliminary expenses | <u>17,00,000</u> | <u>7,30,000</u> |
|                                               | 30,65,000        | 11,10,000       |

## Accounting for Corporate Restructuring 4.47

### Less : Liabilities

|                           |                 |                  |                 |
|---------------------------|-----------------|------------------|-----------------|
| 12% Debentures            | 1,00,000        | 1,00,000         |                 |
| Sundry Creditors          | 40,000          | 45,000           |                 |
| Provision for Tax         | <u>1,00,000</u> | <u>2,40,000</u>  | <u>60,000</u>   |
|                           |                 | <u>28,25,000</u> | <u>9,05,000</u> |
| Intrinsic value per share |                 | <u>28,25,000</u> | <u>9,05,000</u> |
|                           |                 | 70,000           | 25,000          |
|                           |                 | = Rs. 40.40      | = Rs. 36.20     |

### (3) Purchase Consideration

|                                                                       |                     |
|-----------------------------------------------------------------------|---------------------|
| 25,000 Shares @ Rs. 36.20                                             | <u>Rs. 9,05,000</u> |
| To be discharged by 22,400                                            |                     |
| $\left[ 25,000 \times \frac{36.20}{40.40} \right]$ Shares @ Rs. 40.40 | Rs. 9,04,960        |
| Cash for fraction                                                     | Rs. 40              |

### Balance Sheet of AX Ltd.

#### (after merger with TX Ltd.)

| Liabilities               | Rs.             | Rs.      | Assets              | Rs.             | Rs.       |
|---------------------------|-----------------|----------|---------------------|-----------------|-----------|
|                           |                 |          | Goodwill            |                 | 3,80,000* |
| Share Capital             |                 |          | Sundry Fixed Assets |                 |           |
| 92,400 Equity Shares      |                 |          | Balance             | 9,50,000        |           |
| of Rs. 10 each            |                 | 9,24,000 | Add : Assets        |                 |           |
| (of which 22,400 shares   |                 |          | takenover           | <u>4,00,000</u> | 13,50,000 |
| were issued to the ven-   |                 |          | Investments         |                 |           |
| dors otherwise than cash) |                 |          | Balance             | 2,00,000        |           |
| General Reserve           |                 | 3,50,000 | Add : Investments   |                 |           |
| P&LA/c                    | 2,10,000        |          | Taken over          | <u>50,000</u>   | 2,50,000  |
| Add : Proposed            |                 |          | Stock Balance       | 1,20,000        |           |
| dividend written off      | <u>1,40,000</u> | 3,50,000 |                     |                 |           |
| Share Premium             |                 | 6,80,960 |                     |                 |           |

\* Goodwill = Purchase consideration – Net Assets acquired

Rs. 9,05,000 - Rs. 5,25,000 = Rs. 3,80,000

#### 4.48 Financial Reporting

|                               |                 |                  |                             |                 |                  |
|-------------------------------|-----------------|------------------|-----------------------------|-----------------|------------------|
| Export Profit Reserve         |                 |                  | Add : Stock                 |                 |                  |
| Balance                       | 70,000          |                  | Taken over                  | <u>50,000</u>   | 1,70,000         |
| Add : Balance of TX Ltd.      | <u>40,000</u>   | 1,10,000         | Debtors:Balance             | 75,000          |                  |
| 12% Debentures Balance        | 1,00,000        |                  | Add : Taken over            | <u>80,000</u>   | 1,55,000         |
| Add : 12% Debentures          |                 |                  | Advance Tax bal.            | 80,000          |                  |
| issued at par other than cash | <u>1,00,000</u> | 2,00,000         | Add : Bal. of TX Ltd.       | <u>20,000</u>   | 1,00,000         |
| Sundry creditors Balance      | 40,000          |                  | Cash & Bank                 |                 |                  |
| Add : liabilities taken over  | <u>45,000</u>   | 85,000           | Balance                     | 2,75,000        |                  |
| Provision for Taxation        | 1,00,000        |                  | Add: Balance of TX          |                 |                  |
| Add : Prov. for Taxation -    |                 |                  | Ltd. taken over             | <u>1,30,000</u> |                  |
| of TX Ltd.                    | <u>60,000</u>   | 1,60,000         |                             | 4,05,000        |                  |
|                               |                 |                  | Less: Purchase              |                 |                  |
|                               |                 |                  | Consideration               |                 |                  |
|                               |                 |                  | Discharged                  | <u>40</u>       | 4,04,960         |
|                               |                 |                  | Preliminary expenses        |                 | 10,000           |
|                               |                 |                  | Amalgamation Adjustment A/c | <u>40,000</u>   |                  |
|                               |                 | <u>28,59,960</u> |                             |                 | <u>28,59,960</u> |

#### Illustration 9

A Limited and B Limited both engaged in similar merchanting activities since 2005 decide to amalgamate their businesses. Holding Co. C Limited, would be formed on 1st January 2007 to acquire all the shares in both companies.

From the information given below you are required to

- calculate the amount of purchase consideration
- prepare the Balance Sheet of C Limited after the transactions have been completed.

The terms of the offer were :

- Rs. 100 12% Debentures for every Rs. 100 of net asset owned by each company on December 2006; 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 2005 and 2006, weights being 1 and 2 respectively.
- It was agreed that accounts of B Ltd. for the two years ended Dec. 31, 2006 be adjusted, where necessary, to confirm with accounting policies followed by A Ltd.

## Accounting for Corporate Restructuring 4.49

3. The pretax-profits, including investment income, of the two companies were as follows:

|        | 2005         | 2006         |
|--------|--------------|--------------|
| A Ltd. | Rs. 5,46,000 | Rs. 6,12,000 |
| B Ltd. | Rs. 5,96,100 | Rs. 8,58,000 |

4. A Ltd. values Stock on first-in-first-out basis while B Ltd. used different basis. To bring B Ltd.'s values in line with those of A Ltd. its value will require to be reduced by Rs. 12,000 at the end of 2005 and Rs. 34,000 at the end of 2006.
5. Both the companies use straight line method of depreciation.
6. B Ltd. deducts 1 % from trade debtors as a general provision against doubtful debts.
7. Prepaid expenses in B Ltd. include advertising expenditure carried forward of Rs. 60,000 in 2005 and Rs. 30,000 in 2006, being part of initial advertising in 2005 which is being written off over three years. Similar expenditure in A Ltd. has been fully written off in 2005.
8. To bring directors' remuneration on to a comparative basis, the profits of B Ltd. are to be reduced by Rs. 40,000 in 2005 and Rs. 60,000 in 2006, and the net assets are also to be adjusted accordingly.

Balance Sheets as on 31st December, 2005 and 2006 were as follows:

### A Ltd.

|                                | 2005<br>Rs.      | 2006<br>Rs.      |                                  | 2005<br>Rs.      | 2006<br>Rs.      |
|--------------------------------|------------------|------------------|----------------------------------|------------------|------------------|
| <i>Share Capital</i>           |                  |                  | <i>Fixed Assets</i>              |                  |                  |
| <i>Issued &amp; Subscribed</i> |                  |                  | <i>Furniture &amp; Fixtures:</i> |                  |                  |
| 4,000 shares of Rs. 100        |                  |                  | Cost                             | 2,30,000         | 2,30,000         |
| each fully paid                | 4,00,000         | 4,00,000         | Less : Depreciation              | <u>23,000</u>    | <u>46,000</u>    |
|                                |                  |                  |                                  | 2,07,000         | 1,84,000         |
|                                |                  |                  | <i>Investment</i>                |                  |                  |
| <i>Reserves &amp; Surplus</i>  |                  |                  | Quoted                           |                  |                  |
| Capital Reserve                | —                | 70,000           | Investments at                   |                  |                  |
| Revenue Reserve                | 2,66,100         | 5,58,000         | Market value                     | —                | 2,60,000         |
| <i>Current Liabilities</i>     |                  |                  | <i>Current Assets</i>            |                  |                  |
| <i>and provisions</i>          |                  |                  | Stock at Cost                    | 6,10,000         | 7,25,000         |
| Sundry Creditors               | 5,00,900         | 6,07,000         | Sundry Debtors                   | 6,00,000         | 7,40,000         |
| Provision for                  |                  |                  | Prepaid expenses                 | 10,000           | 14,000           |
| Taxation                       | <u>2,80,000</u>  | <u>3,20,000</u>  | Cash at Bank                     | <u>20,000</u>    | <u>32,000</u>    |
|                                | <u>14,47,000</u> | <u>19,55,000</u> |                                  | <u>14,47,000</u> | <u>19,55,000</u> |

### B Ltd.

#### 4.50 Financial Reporting

|                               | 2005             | 2006             |                              | 2005             | 2006             |
|-------------------------------|------------------|------------------|------------------------------|------------------|------------------|
|                               | Rs.              | Rs.              |                              | Rs.              | Rs.              |
| <i>Share Capital</i>          |                  |                  | <i>Fixed Assets</i>          |                  |                  |
| Issued & Subscribed           |                  |                  | Cost Less                    | 3,20,000         | 3,20,000         |
| 5,000 Equity Shares of        |                  |                  | Depreciation                 | <u>48,000</u>    | <u>96,000</u>    |
| Rs. 100 each fully paid       | 5,00,000         | 5,00,000         |                              | 2,72,000         | 2,24,000         |
| <i>Reserves &amp; Surplus</i> |                  |                  | <i>Investments</i>           |                  |                  |
| Revenue Reserve               | 2,86,000         | 7,14,000         | Quoted Investments           |                  |                  |
| <i>Current Liabilities</i>    |                  |                  | at cost (Market value        |                  |                  |
| <i>&amp; Provisions</i>       |                  |                  | 4,90,000)                    | —                | 4,00,000         |
| Sundry Creditors              | 4,90,000         | 4,94,000         | <i>Current Assets, Loans</i> |                  |                  |
| Bank Overdraft                | —                | 1,70,000         | <i>and Advances</i>          |                  |                  |
| Provision for Taxation        | 3,10,000         | 4,30,000         | Stock-in-trade               |                  |                  |
|                               |                  |                  | at cost                      | 5,97,000         | 7,42,000         |
|                               |                  |                  | Sundry Debtors               | 5,94,000         | 8,91,000         |
|                               |                  |                  | Prepaid Expenses             | 72,000           | 48,000           |
|                               |                  |                  | Cash at Bank                 | <u>51,000</u>    | <u>3,000</u>     |
|                               | <u>15,86,000</u> | <u>23,08,000</u> |                              | <u>15,86,000</u> | <u>23,08,000</u> |

#### Solution

##### (i) Statement of adjusted net profits of B Ltd :

|                             | 2005            | 2006            |
|-----------------------------|-----------------|-----------------|
|                             | Rs.             | Rs.             |
|                             | minus           | plus            |
| Reported net profit         | —               | 5,96,100        |
| Reduction in stock in trade | 12,000          | —               |
| Sundry Debtors              | —               | 6,000           |
| Advertising                 | 60,000          | —               |
| Directors' Remuneration     | 40,000          | —               |
| Depreciation                | —               | 16,000          |
| Appreciation in investments |                 | <u>90,000</u>   |
|                             | <u>1,12,000</u> | <u>6,18,100</u> |
| Adjusted                    | 5,06,100        | 9,21,000        |



## (ii) Issue of Equity Shares equal to two year's purchase of average profits:

| <i>A Ltd.</i>                |            |               | <i>B Ltd.</i>    |            |               |
|------------------------------|------------|---------------|------------------|------------|---------------|
| <i>Year</i>                  | <i>Rs.</i> | <i>Weight</i> | <i>Rs.</i>       | <i>Rs.</i> | <i>Weight</i> |
| 2005                         | 5,46,000   | 1             | 5,46,000         | 5,06,100   | 1             |
| 2006                         | 6,12,000   | 2             | <u>12,24,000</u> | 9,21,000   | 2             |
|                              |            |               | <u>17,70,000</u> |            |               |
| Average                      |            |               | <u>5,90,000</u>  |            |               |
| Two years purchase           |            |               | 11,80,000        |            |               |
| Net Assets as adjusted       |            |               | <u>10,28,000</u> |            |               |
| Total Purchase Consideration |            |               | <u>22,08,000</u> |            |               |

**Working Notes:**

- (i) Shares will be issued for goodwill and 12% debentures for net assets.  
(ii) Adjustment to net assets of B Ltd.

|                                       | <i>Rs.</i>      | <i>Rs.</i>       |
|---------------------------------------|-----------------|------------------|
| Furniture & Fixtures                  | 3,20,000        |                  |
| Less : Dep. @10% for 2 years          | <u>64,000</u>   |                  |
|                                       |                 | 2,56,000         |
| Quoted investments                    |                 | 4,90,000         |
| Stock (7,42,000 – 34,000)             |                 | 7,08,000         |
| Debtors (8,91,000 + 9,000)            |                 | 9,00,000         |
| Prepaid exp. (48,000 – 30,000)        |                 | 18,000           |
| Cash at Bank                          |                 | <u>3,000</u>     |
|                                       |                 | 23,75,000        |
| Less : Current Liabilities            | 10,94,000       |                  |
| Liability for directors' remuneration | <u>1,00,000</u> | <u>11,94,000</u> |
|                                       |                 | <u>11,81,000</u> |

**Balance Sheet of C Ltd. as on .....**

| <i>Liabilities</i>            | <i>Rs.</i> | <i>Assets</i>       | <i>Rs.</i> |
|-------------------------------|------------|---------------------|------------|
| Share Capital                 |            |                     |            |
| Issued & Subscribed           |            | Investments at cost |            |
| 27,454 shares of Rs. 100 each |            | Shares in A Ltd.    | 22,08,000  |

#### 4.52 Financial Reporting

|                            |                  |                  |                       |                  |                  |
|----------------------------|------------------|------------------|-----------------------|------------------|------------------|
| fully paid                 | 27,45,400        |                  | Shares in B Ltd.      | 27,46,400        |                  |
| <i>Current Liabilities</i> |                  |                  | <i>Current Assets</i> |                  |                  |
| <i>and provisions</i>      |                  |                  | Stock at Cost         | 6,10,000         | 7,25,000         |
| Sundry Creditors           | 5,00,900         | 6,07,000         | Sundry Debtors        | 6,00,000         | 7,40,000         |
| Provision for              |                  |                  | Prepaid expenses      | 10,000           | 14,000           |
| Taxation                   | <u>2,80,000</u>  | <u>3,20,000</u>  | Cash at Bank          | <u>20,000</u>    | <u>32,000</u>    |
|                            | <u>14,47,000</u> | <u>19,55,000</u> |                       | <u>14,47,000</u> | <u>19,55,000</u> |

#### B Ltd.

|                               | 2005             | 2006             |                              | 2005             | 2006             |
|-------------------------------|------------------|------------------|------------------------------|------------------|------------------|
|                               | Rs.              | Rs.              |                              |                  | Rs.              |
| <i>Share Capital</i>          |                  |                  | <i>Fixed Assets</i>          |                  |                  |
| Issued & Subscribed           |                  |                  | Cost Less                    | 3,20,000         | 3,20,000         |
| 5,000 Equity Shares of        |                  |                  | Depreciation                 | <u>48,000</u>    | <u>96,000</u>    |
| Rs. 100 each fully paid       | 5,00,000         | 5,00,000         |                              | <u>2,72,000</u>  | <u>2,24,000</u>  |
| <i>Reserves &amp; Surplus</i> |                  |                  | <i>Investments</i>           |                  |                  |
| Revenue Reserve               | 2,86,000         | 7,14,000         | Quoted Investments           |                  |                  |
| <i>Current Liabilities</i>    |                  |                  | at cost (Market value        |                  |                  |
| <i>&amp; Provisions</i>       |                  |                  | 4,90,000)                    | —                | 4,00,000         |
| Sundry Creditors              | 4,90,000         | 4,94,000         | <i>Current Assets, Loans</i> |                  |                  |
| Bank Overdraft                | —                | 1,70,000         | <i>and advances</i>          |                  |                  |
| Provision for Taxation        | 3,10,000         | 4,30,000         | Stock-in-trade at cost       | 5,97,000         | 7,42,000         |
|                               |                  |                  | Sundry Debtors               | 5,94,000         | 8,91,000         |
|                               |                  |                  | Prepaid Expenses             | 72,000           | 48,000           |
|                               |                  |                  | Cash at Bank                 | <u>51,000</u>    | <u>3,000</u>     |
|                               | <u>15,86,000</u> | <u>23,08,000</u> |                              | <u>15,86,000</u> | <u>23,08,000</u> |

#### Solution

##### (i) Statement of adjusted net profits of B Ltd.:

|                             |        | 2005     |        | 2006     |
|-----------------------------|--------|----------|--------|----------|
|                             | Rs.    | Rs.      | Rs.    | Rs.      |
|                             | minus  | plus     | minus  | plus     |
| Reported net profit         | —      | 5,96,100 | —      | 8,58,000 |
| Reduction in stock in trade | 12,000 | —        | 34,000 | 12,000   |
| Sundry Debtors              | —      | 6,000    | —      | 9,000    |

## Accounting for Corporate Restructuring 4.53

|                             |                 |                 |               |                  |
|-----------------------------|-----------------|-----------------|---------------|------------------|
| Advertising                 | 60,000          | —               | —             | 30,000           |
| Directors' Remuneration     | 40,000          | —               | 60,000        | —                |
| Depreciation                | —               | 16,000          | —             | 16,000           |
| Appreciation in investments | <u>—</u>        | <u>—</u>        | <u>—</u>      | <u>90,000</u>    |
|                             | <u>1,12,000</u> | <u>6,18,100</u> | <u>94,000</u> | <u>10,15,000</u> |
| Adjusted                    |                 | 5,06,100        |               | 9,21,000         |

### (ii) Issue of Equity Shares equal to two year's purchase of average profits:

| A Ltd.                       |          |        |                  | B Ltd.   |        |                  |
|------------------------------|----------|--------|------------------|----------|--------|------------------|
| Year                         | Rs.      | Weight | Rs.              | Rs.      | Weight | Rs.              |
| 2005                         | 5,46,000 | 1      | 5,46,000         | 5,06,100 | 1      | 5,06,100         |
| 2006                         | 6,12,000 | 2      | <u>12,24,000</u> | 9,21,000 | 2      | <u>18,42,000</u> |
|                              |          |        | <u>17,70,000</u> |          |        | <u>23,48,100</u> |
| Average                      |          |        | <u>5,90,000</u>  |          |        | <u>7,82,700</u>  |
| Two years purchase           |          |        | 11,80,000        |          |        | 15,65,400        |
| Net Assets as adjusted       |          |        | <u>10,28,000</u> |          |        | <u>11,81,000</u> |
| Total Purchase Consideration |          |        | <u>22,08,000</u> |          |        | <u>27,46,400</u> |

### Working Notes:

- (i) Shares will be issued for goodwill and 12% debentures for net assets:  
(ii) Adjustment to net assets of B Ltd.:

|                                       | Rs.             | Rs.              |
|---------------------------------------|-----------------|------------------|
| Furniture & Fixtures                  | 3,20,000        |                  |
| Less : Dep. @10% for 2 years          | <u>64,000</u>   | 2,56,000         |
| Quoted investments                    |                 | 4,90,000         |
| Stock (7,42,000 – 34,000)             |                 | 7,08,000         |
| Debtors (8,91,000 + 9,000)            |                 | 9,00,000         |
| Prepaid exp. (48,000 – 30,000)        |                 | 18,000           |
| Cash at Bank                          |                 | <u>3,000</u>     |
|                                       |                 | 23,75,000        |
| Less : Current Liabilities            | 10,94,000       |                  |
| Liability for directors' remuneration | <u>1,00,000</u> | <u>11,94,000</u> |
|                                       |                 | <u>11,81,000</u> |

#### 4.54 Financial Reporting

##### Balance Sheet of C Ltd. as on.....

|                                | Rs.              |                            | Rs.              |
|--------------------------------|------------------|----------------------------|------------------|
| <i>Liabilities</i>             |                  | <i>Assets</i>              |                  |
| Share Capital                  |                  |                            |                  |
| <i>Issued &amp; Subscribed</i> |                  | <i>Investments at cost</i> |                  |
| 27,454 shares of Rs. 100 each  |                  | Shares in A Ltd.           | 22,08,000        |
| fully paid                     | 27,45,400        | Shares in B Ltd.           | 27,46,400        |
| (Issued for consideration      |                  |                            |                  |
| other than cash)               |                  |                            |                  |
| Secured Loans                  |                  |                            |                  |
| 22,090 Debentures of Rs. 100   |                  |                            |                  |
| each fully paid                | <u>22,09,000</u> |                            |                  |
|                                | <u>49,54,400</u> |                            | <u>49,54,400</u> |

#### Illustration 10

AB Ltd. and CD Ltd. two private companies, decide to amalgamate their business into a new holding company EF Ltd., which was incorporated on 1st Nov. 2006 with an authorised capital of Rs. 40,00,000 in equity shares of Rs. 10 each. The new company plans to commence operations on 1st Jan. 2007.

From the information given below, and assuming that all transactions are completed by 30th June 2007, you are required to

- Project the balance sheet of EF Ltd. as on 30th June 2007.
- Project profit & loss account of EF Ltd. for the six months ending 30th June 2007.
- Show the computation of the number of shares to be issued to the former shareholders of AB Ltd. and CD Ltd.

#### Information

- EF Ltd. will acquire the whole of the Equity share capital of AB Ltd. and CD Ltd. by issuing its own shares fully paid.
- The number of shares to be issued is to be calculated by multiplying the future annual maintainable profits available to the Equity shareholders in each of the two companies by agreed price earning ratios.

The following information is relevant:

|                                            | AB Ltd.   | CD Ltd.  |
|--------------------------------------------|-----------|----------|
|                                            | Rs.       | Rs.      |
| Equity Shares of Rs. 10 each fully paid    | 10,00,000 | 4,00,000 |
| 8% Cum. Preference shares                  |           | 1,00,000 |
| 10% Debentures                             | 2,00,000  |          |
| Future annual maintainable                 |           |          |
| Pre tax profits (before interest/dividend) | 2,30,000  | 1,12,000 |
| Price Earning Ratio                        | 10 times  | 8 times  |

- (3) Shares in the holding company are to be issued to the shareholders in subsidiary companies at a premium of 20% and thereafter these shares will be marketed on the stock exchange.
- (4) It is expected that the Group profits of the new company in 2000 will be at least Rs. 4,50,000 but that will be required as additional working capital to facilitate expansion. Accordingly it is planned to make a further issue of Rs. 37,500 Equity shares to the public for cash at a premium of 30% on 1st May 2007. The new shares will not rank for interest/dividend to be paid on 30th June, 2007.
- (5) Out of the proceeds of the right issue EF Ltd. will advance Rs. 2,50,000 to AB Ltd. and Rs. 2,00,000 to CD Ltd. on 1st May 2007 for working capital. These advance will carry interest @15% p.a. to be paid monthly.
- (6) Preliminary expenses are estimated at Rs. 8,000 and administrative expenses for the half-year ended 30th June 2007 at Rs. 16,000 but this expenditure will be covered by temporary overdraft facility. It is estimated that bank over draft interest cost will be Rs. 1,600 in the first six months.
- (7) A provision for Rs. 7,500 should be made for directors fee for the half-year.
- (8) On 30th June, 2007, it is planned to pay interim dividend as follows:
- |           |      |
|-----------|------|
| Per share |      |
| AB Ltd    | 5%   |
| CD Ltd.   | 4.4% |
| EF Ltd.   | 4%   |
- (9) Income tax is to be taken at 50%.

#### 4.56 Financial Reporting

##### Solution

|                                                                                       | <i>AB Ltd.</i><br>Rs. | <i>CD Ltd.</i><br>Rs. |
|---------------------------------------------------------------------------------------|-----------------------|-----------------------|
| <b>(1) Valuation of shares in subsidiaries:</b>                                       |                       |                       |
| Future maintainable EBIT                                                              | 2,30,000              | 1,12,000              |
| Less : Deb. interest                                                                  | <u>20,000</u>         | <u>—</u>              |
|                                                                                       | 2,10,000              | 1,12,000              |
| Less : Income tax @50%                                                                | <u>1,05,000</u>       | <u>56,000</u>         |
| Profit after tax                                                                      | 1,05,000              | 56,000                |
| Less : Preference Dividend                                                            | <u>—</u>              | <u>8,000</u>          |
| Profit to Equity Shareholders                                                         | 1,05,000              | 48,000                |
| PE Ratio                                                                              | 10                    | 8                     |
| Capitalised earning                                                                   | 10,50,000             | 3,84,000              |
| Number of shares to be exchanged in EF Ltd.<br>@ Rs. 12 (including pre. of Rs.2 each) | 87,500                | 32,000                |
| <b>(2) Issued share Capital - 1,19,500 Shares of Rs. 10 each</b>                      |                       | 11,95,000             |
| Share Premium (1,19,500 x 2)                                                          |                       | <u>2,39,000</u>       |
| Gross                                                                                 |                       | <u>14,34,000</u>      |
| <b>(3) Proceeds of new issue and cash flow</b>                                        |                       | Rs.                   |
| 37,500 shares @ Rs. 10 each                                                           |                       | 3,75,000              |
| Share Premium @ 30%                                                                   |                       | 1,12,500              |
| Gross Proceeds                                                                        |                       | 4,87,500              |
| Less : Preliminary Expense                                                            | 8,000                 |                       |
| Adm. Expenses                                                                         | 16,000                |                       |
| Advance to AB Ltd.                                                                    | 2,50,000              |                       |
| Advance to CD Ltd.                                                                    | 2,00,000              |                       |
| Bank Interest                                                                         | <u>1,600</u>          | <u>4,75,600</u>       |
|                                                                                       |                       | 11,900                |
| Add : Interest Receivable                                                             |                       | 11,250                |
| Dividend Receivable AB Ltd.                                                           | 50,000                |                       |
| Dividend Receivable CD Ltd.                                                           | <u>17,600</u>         | <u>67,600</u>         |
|                                                                                       |                       | 90,750                |
| Less : Div. Payable (on Rs. 11,95,000 @ 4%)                                           |                       | <u>47,800</u>         |
|                                                                                       |                       | <u>42,950</u>         |

**Illustration 11**

Smith Ltd. is considering buying the business of B Ltd.; the final accounts of which for the last three years were as follows:

**Profit and Loss Accounts for the years ended 31st Dec.**

|                   | 2004            | 2005            | 2006            |
|-------------------|-----------------|-----------------|-----------------|
|                   | Rs.             | Rs.             | Rs.             |
| Sales             | <u>2,00,000</u> | <u>1,90,000</u> | <u>2,24,000</u> |
| Material consumed | 1,00,000        | 95,000          | 1,12,000        |
| Business expenses | 80,000          | 80,000          | 82,000          |
| Depreciation      | <u>12,000</u>   | <u>13,000</u>   | <u>14,000</u>   |
| Net Profit        | <u>8,000</u>    | <u>2,000</u>    | <u>16,000</u>   |

**Balance Sheets as at 31 st Dec.**

|                           | 2003            | 2004          | 2005            | 2006            |
|---------------------------|-----------------|---------------|-----------------|-----------------|
|                           | Rs.             | Rs.           | Rs.             | Rs.             |
| Fixed Assets, at cost     | 1,00,000        | 1,20,000      | 1,40,000        | 1,80,000        |
| Less : Depreciation       | <u>70,000</u>   | <u>82,000</u> | <u>95,000</u>   | <u>1,09,000</u> |
|                           | 30,000          | 38,000        | 45,000          | 71,000          |
| Stock-in-trade            | 16,000          | 17,000        | 18,500          | 21,000          |
| Sundry Debtors            | 21,000          | 24,000        | 26,000          | 28,000          |
| Cash in hand and at Bank  | 32,000          | 11,000        | 28,000          | 13,200          |
| Prepaid Expenses          | <u>1,000</u>    | <u>500</u>    | <u>2,000</u>    | <u>1,000</u>    |
|                           | <u>1,00,000</u> | <u>90,500</u> | <u>1,19,500</u> | <u>1,34,200</u> |
| Equity Capital            | 50,000          | 50,000        | 70,000          | 70,000          |
| Share Premium             | —               | —             | 5,000           | 5,000           |
| General Reserve           | 16,000          | 24,000        | 26,000          | 42,000          |
| Debentures                | 20,000          | —             | —               | —               |
| Sundry Creditors          | 11,000          | 13,000        | 14,000          | 14,000          |
| Accrued Business Expenses | <u>3,000</u>    | <u>3,500</u>  | <u>4,500</u>    | <u>3,200</u>    |
|                           | <u>1,00,000</u> | <u>90,500</u> | <u>1,19,500</u> | <u>1,34,200</u> |

Smith Ltd. wishes the offer to be based upon trading cash flows rather than book profits. By trading cash flow is meant cash received from debtors less cash paid to creditors and for business expenses (excluding depreciation), together with an allowance for average annual expenditure on fixed assets of Rs. 15,000 per year.

#### 4.58 Financial Reporting

The actual expenditure on fixed assets is to be ignored, as is any cash received or paid out on the issue or redemption of shares or debentures.

Smith Ltd. wishes the trading cashflow to be calculated for each of the years 2004, 2005 and 2006, and for these to be combined using weighting of 20% for 2004, 30% for 2005 and 50% for 2006 to give an average annual trading cashflow.

Smith Ltd. considers that the average annual trading cashflow should show a return of 10% on its investment.

You are required to calculate:

- the trading cashflow for each of the years 2004, 2005 and 2006;
- the weighted average annual trading cashflow
- the price which Smith Ltd. should offer for the business.

#### Solution

(a)

#### Trading Cash Flows of B Ltd.

|                                                           | 2004          | 2005          | 2006          |
|-----------------------------------------------------------|---------------|---------------|---------------|
|                                                           | Rs.           | Rs.           | Rs.           |
| Profit earned during the years                            | 8,000         | 2,000         | 16,000        |
| Depreciation                                              | 12,000        | 13,000        | 14,000        |
| Increase in Creditors                                     | 2,000         | 1,000         | —             |
| Increase in Accruals                                      | 500           | 1,000         | —             |
| Decrease in Prepaid Exp.                                  | 500           | —             | 1,000         |
| (A)                                                       | <u>23,000</u> | <u>17,000</u> | <u>31,000</u> |
| Less : Increase in Stock                                  | 1,000         | 1,500         | 2,500         |
| Increase in Debtors                                       | 3,000         | 2,000         | 2,000         |
| Increase in Pre-payment                                   | —             | 1,500         | —             |
| Decrease in Accruals                                      | —             | —             | 1,300         |
| (B)                                                       | <u>4,000</u>  | <u>5,000</u>  | <u>5,800</u>  |
| Gross Trading Cash flow (A)–(B)                           | 19,000        | 12,000        | 25,200        |
| Less : Adjustment for average investments in fixed assets | <u>15,000</u> | <u>15,000</u> | <u>15,000</u> |
|                                                           | <u>4,000</u>  | <u>–3,000</u> | <u>10,200</u> |

(b) Weighted average annual trading Cashflow

|      |                    | Rs.  |
|------|--------------------|------|
| 2003 | 20% of Rs. 4,000   | 800  |
| 2004 | 30% of (–Rs.3,000) | –900 |



|      |                   |              |
|------|-------------------|--------------|
| 2005 | 50% of Rs. 10,200 | <u>5,100</u> |
|      |                   | <u>5,000</u> |

(c) Price Smith Ltd. should offer for the business =  $\frac{\text{Rs. } 5,000}{0.10} = \text{Rs. } 50,000$

### Illustration 12

Batliboi & Co. Ltd. carried on manufacturing business. Its products were sold to wholesalers and the company had its own retail shop. Adhikary & Co., Private Ltd. carried on similar manufacturing business, but all goods produced were sold through the company's own retail shops.

The summarised balance sheets of the two companies as at 31st March, 2006 were as follows:

|                        | Batliboi & Adhikary &<br>Co. Ltd. Co. (P) Ltd. |                 |                         | Batliboi & Adhikary &<br>Co. Ltd. Co. (P) Ltd. |                 |
|------------------------|------------------------------------------------|-----------------|-------------------------|------------------------------------------------|-----------------|
|                        | Rs.                                            | Rs.             |                         | Rs.                                            | Rs.             |
| <i>Share Capital</i>   |                                                |                 | <i>Fixed Assets :</i>   |                                                |                 |
| Authorised Equity      |                                                |                 | Freehold Properties     |                                                |                 |
| Shares of Rs. 10       | <u>40,00,000</u>                               | <u>6,00,000</u> | at cost                 | 10,00,000                                      | 2,50,000        |
| Issued & fully paid up | 25,00,000                                      | 6,00,000        | Plant & Machinery at    |                                                |                 |
| P & L A/c              | 3,40,000                                       | 90,000          | cost less depreciation  | <u>13,00,000</u>                               | <u>1,00,000</u> |
| Creditors              | 4,20,000                                       | 70,000          |                         | 23,00,000                                      | 3,50,000        |
|                        |                                                |                 | <i>Current Assets :</i> |                                                |                 |
|                        |                                                |                 | Stock                   | 4,80,000                                       | 1,20,000        |
|                        |                                                |                 | Debtors                 | 2,30,000                                       | 80,000          |
|                        |                                                |                 | Bank                    | <u>2,50,000</u>                                | <u>2,10,000</u> |
|                        | <u>32,60,000</u>                               | <u>7,60,000</u> |                         | <u>32,60,000</u>                               | <u>7,60,000</u> |

The original cost of Plant and Machinery was:

|                         |               |
|-------------------------|---------------|
| Batliboi & Co. Ltd.     | Rs, 26,00,000 |
| Adhikary & Co. (P) Ltd. | Rs. 2,00,000  |

The following arrangements were made and carried out on April 1, 2006:

- (1) Batliboi & Co. Ltd purchased from the shareholders of Adhikary & Co. (P) Ltd. all the issued shares @ Rs. 14 per share.
- (2) The shareholders of Adhikary & Co. (P) Ltd. took over one of the freehold properties of Adhikary & Co. (Private) Ltd. for Rs. 60,000, at the book value of the same. It was agreed

#### 4.60 Financial Reporting

that the amount should be set off against the amount due to them under (I) above and the balance due to them to be satisfied by the issue of an appropriate number of equity shares in Batliboi & Co. Ltd. at Rs. 19.50 per share

The necessary transfer in regard to the setting off the price of the property taken over by the shareholders against the amount due to them from Batliboi & Co. Ltd. were made in the books of the two companies.

- (3) All manufacturing was to be carried on by Batliboi and Co. Ltd. and all retail business is to be carried on by Adhikary & Co. (Private) Ltd. in this connection.
  - (i) Batliboi & Co. Ltd. purchased the whole of Adhikary & Co. (P) Ltd.'s plant and machinery for Rs. 1,50,000 and certain of their free-hold property (cost Rs. 1,00,000) at Rs. 1,20,000.
  - (ii) Adhikary & Co. (P) Ltd. purchased Batliboi & Co. Ltd.'s freehold retail shop buildings (cost to Batliboi & Co. Ltd, Rs. 75,000) at Rs. 60,000 and took over the retail stock at Rs. 80,000 at the book value.
- (4) Batliboi & Co. Ltd. drew a cheque in favour of Adhikary & Co. (P) Ltd. for the net amount due, taking into account all the matters mentioned above.
- (5) Immediately after the transfer of shares in (1) above, Adhikary & Co. (P) Ltd. declared and paid a dividend of Rs. 60,000 (ignore income-tax).

You are required to prepare the Balance Sheets of Batliboi & Co. Ltd. and Adhikary & Co. (P) Ltd. immediately after the completion of the above transaction.

#### Solution

##### Balance Sheet of Batliboi & Co as on 31st March, 2006

| <i>Liabilities</i>                      | <i>Rs.</i> | <i>Assets</i>              | <i>Rs.</i>      |
|-----------------------------------------|------------|----------------------------|-----------------|
| <i>Share Capital</i>                    |            | <i>Fixed Assets</i>        |                 |
| <i>Authorised</i>                       |            | Freehold properties        |                 |
| 4,00,000 shares of Rs. 10 each          | 40,00,000  | As per last Balance Sheet  | 10,00,000       |
| <i>Issued, Subscribed &amp; Paid-up</i> |            | Addition during the year   | <u>1,20,000</u> |
| 2,90,000 shares of Rs. 10 each          |            |                            | 11,20,000       |
| fully paid of which 40,000              |            | Less: Sold during the year | <u>75,000</u>   |
| shares were issued pursuant             |            |                            | 10,45,000       |
| to a contract without payment           |            |                            |                 |
| being received in cash                  | 29,00,000  | Plant and Machinery:       |                 |
| <i>Reserves &amp; Surplus</i>           |            | As per last Balance Sheet  | 26,00,000       |
| Share Premium A/c                       | 3,80,000   | Addition during the year   | <u>1,50,000</u> |

## Accounting for Corporate Restructuring 4.61

|                                               |                            |                                              |
|-----------------------------------------------|----------------------------|----------------------------------------------|
| Profit & Loss A/c                             | 3,25,000                   | 27,50,000                                    |
| <i>Current Liabilities &amp; Provisions :</i> | <i>Less : Depreciation</i> | <u>13,00,000</u> 14,50,000                   |
| Sundry Creditors                              | 4,20,000                   | <i>Investments</i>                           |
|                                               |                            | Shares in subsidiary company                 |
|                                               |                            | 7,80,000                                     |
|                                               |                            | <i>Current, Assets, Loans &amp; Advances</i> |
|                                               |                            | Stock in trade                               |
|                                               |                            | 4,00,000                                     |
|                                               |                            | Sundry debtors                               |
|                                               |                            | 2,30,000                                     |
|                                               |                            | Cash at Bank                                 |
|                                               |                            | <u>1,20,000</u>                              |
|                                               | <u>40,25,000</u>           | <u>40,25,000</u>                             |

### Working Notes :

- (1) Value of shares in Adhikary & Co. (P) Ltd. Rs.

|                                   |                 |
|-----------------------------------|-----------------|
| 60,000 shares @ Rs. 14 per share  | 8,40,000        |
| Less : Value of freehold property | <u>60,000</u>   |
| Net amount due                    | <u>7,80,000</u> |

No of shares issued  $7,80,000 / Rs. 19.5 = 40,000$

|                                  |                 |
|----------------------------------|-----------------|
| Amount credited to Share Capital | 4,00,000        |
| Amount credited to Share Premium | <u>3,80,000</u> |
|                                  | <u>7,80,000</u> |
- (2) Rs. 15,000 loss on the sale of Building to Adhikary & Co. (P) Ltd., has been debited to the Profit & Loss Account.
- (3) Investment A/c has been credited by dividend received Rs.60,000 out of pre-acquisition profit.
- (4) Amount payable to Adhikary & Co. (P) Ltd. Rs.

|                                                                                  |                 |
|----------------------------------------------------------------------------------|-----------------|
| Value of assets purchased from Adhikary & Co. (P) Ltd.                           | 2,70,000        |
| Less : Value of assets sold                                                      | <u>1,40,000</u> |
|                                                                                  | 1,30,000        |
| Value of freehold property taken over by shareholders of Adhikary & Co. (P) Ltd. | <u>60,000</u>   |
|                                                                                  | 1,90,000        |

#### 4.62 Financial Reporting

(5) Cash Balance:

|                                                                |                 |
|----------------------------------------------------------------|-----------------|
| As given                                                       | 2,50,000        |
| Add : Dividend received                                        | <u>60,000</u>   |
| Less : Paid to Adhikary & Co. Ltd. including                   | 3,10,000        |
| Rs. 60,000 for assets taken over by its erstwhile shareholders | <u>1,90,000</u> |
|                                                                | <u>1,20,000</u> |

#### Balance Sheet of Adhikary & Co. (P) Ltd. as on 31st March, 2006

| Liabilities                                | Rs.             | Assets                                     | Rs.             |
|--------------------------------------------|-----------------|--------------------------------------------|-----------------|
| <i>Share Capital</i>                       |                 | <i>Fixed Assets</i>                        |                 |
| <i>Authorised</i>                          |                 | Freehold properties:                       |                 |
| 60,000 shares of Rs. 10 each               | <u>6,00,000</u> | As per last Balance Sheet                  | 2,50,000        |
| <i>Issued, Subscribed &amp; Paid-up :</i>  |                 | Addition during the                        | <u>60,000</u>   |
| 60,000 shares of Rs. 10                    |                 | Less :                                     | 3,10,000        |
| each fully paid                            | 6,00,000        | Sold during the Year                       | <u>1,60,000</u> |
| <i>Reserves and Surplus</i>                |                 | Plant & Machinery:                         |                 |
| Profit & Loss Account                      | 1,00,000        | Cost                                       | 2,00,000        |
| <i>Current Liabilities &amp; Provision</i> |                 | Less : Sold (Cost)                         | <u>2,00,000</u> |
| Sundry Creditors                           | 70,000          |                                            | nil             |
|                                            |                 | <i>Current Assets, Loan &amp; Advances</i> |                 |
|                                            |                 | Stock in trade                             | 2,00,000        |
|                                            |                 | Sundry debtors                             | 80,000          |
|                                            |                 | Cash at Bank                               | <u>3,40,000</u> |
|                                            | <u>7,70,000</u> |                                            | <u>7,70,000</u> |

#### Working Notes:

|                                                                                                                                                                |                 |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------|
|                                                                                                                                                                | Rs.             |
| (1) Profit & Loss Account (given)                                                                                                                              | 90,000          |
| Add : Profit on sale of machinery and freehold property                                                                                                        | <u>70,000</u>   |
|                                                                                                                                                                | 1,60,000        |
| Less: Dividend paid                                                                                                                                            | <u>60,000</u>   |
|                                                                                                                                                                | <u>1,00,000</u> |
| (2) Freehold properties have been reduced by Rs. 1,00,000 transferred to Batliboi & Co. & Rs. 60,000 taken over by the shareholders of Adhikari & Co. (P) Ltd. |                 |

|                                  |                 |
|----------------------------------|-----------------|
| (3) Cash at Bank :               | Rs.             |
| Balance as given.                | 2,10,000        |
| Add: Received from Batliboi & Co | <u>1,90,000</u> |
|                                  | 4,00,000        |
| Less : Dividend Paid             | <u>60,000</u>   |
|                                  | <u>3,40,000</u> |

**Illustration 13**

Rich Ltd. and Poor Ltd. decided to amalgamate their business with a view to a public share issue. A holding company, Mix Ltd., is to be incorporated on 1st May 2006 with all authorised capital of Rs. 60,000,000 in Rs. 10 ordinary shares. The company will acquire the entire ordinary share capital of Rich Ltd. and of Poor Ltd. in exchange for an issue of its own shares.

The consideration for the acquisition is to be ascertained by multiplying the estimated profits available to the ordinary shareholders by agreed price earnings ratio. The following relevant figures are given:

|                                                            | <i>Rich Ltd.</i> | <i>Poor Ltd.</i> |
|------------------------------------------------------------|------------------|------------------|
|                                                            | <i>Rs.</i>       | <i>Rs.</i>       |
| Issued share capital                                       |                  |                  |
| Ordinary shares of Rs. 10 each                             | 30,00,000        | 12,00,000        |
| 6% Cumulative Preference shares of Rs. 100 each            | —                | 10,00,000        |
| 5% Debentures, redeemable in 2010                          |                  | 8,00,000         |
| Estimated annual maintainable profits, before deduction of |                  |                  |
| debenture interest & taxation                              | 6,00,000         | 2,40,000         |
| Price/earning ratio                                        | 15               | 10               |

The shares in the holding company are to be issued to members of the subsidiaries on 1st June 2006, at a premium of Rs. 2.50 a share and thereafter these shares will be marketable on the Stock Exchange.

It is anticipated that the merger will achieve significant economics but will necessitate additional working capital. Accordingly, it is planned that on 31st December 2006, Mix Ltd. will make a further issue of 60,000 ordinary shares the public for cash at the premium of Rs. 3.75 a share. These shares will not rank for dividends until 31st December 2006.

In the period ending 31st December 2006, bank overdraft facilities will provide funds for the payment by Mix Ltd. of preliminary expenses estimated at Rs. 50,000 and management etc. expenses estimated at Rs. 6,000.

It is further assumed that interim dividends on ordinary shares, relating to the period from 1st

#### 4.64 Financial Reporting

June to 31st December 2006 will be paid on 31st December 2006 by Mix Ltd. at 3½ % by Rich Ltd. at 5% and by Poor Ltd. at 2%.

You are required to project, as on 31st December 2006 for Mix Ltd., (a) the Balance Sheet as it would appear immediately after fully subscribed share issue, and (b) the Profit and Loss Account for the Period ending 31st December 2006.

Assume the rate of corporation tax to be 40% you can make any other assumption you consider relevant.

#### Solution

##### Projected Balance Sheet of Mix Ltd. as on December 31, 2006

| <i>Liabilities</i>                                        | <i>Rs.</i>    | <i>Rs.</i>       | <i>Assets</i>         | <i>Rs.</i>       |
|-----------------------------------------------------------|---------------|------------------|-----------------------|------------------|
| <i>Share Capital</i>                                      |               |                  | <i>Investments</i>    |                  |
| Authorised : 6,00,000 equity shares of Rs. 10 each        | 60,00,000     |                  | Subsidiary Companies  |                  |
| Issued : 5,40,000 equity shares of Rs. 10 each fully paid | 54,00,000     |                  | Shares at cost        | 60,00,000        |
| <i>Reserves</i>                                           |               |                  | <i>Current Assets</i> |                  |
| Share Premium Account                                     | 14,25,000     |                  | Balance at Bank       | 7,75,000         |
| Less : Preliminary Expenses written off                   | <u>50,000</u> | <u>13,75,000</u> |                       |                  |
|                                                           |               | <u>67,75,000</u> |                       | <u>67,75,000</u> |

##### Projected Profit and Loss Account for the Period ending December 31, 2006

|                                                                         |                 |
|-------------------------------------------------------------------------|-----------------|
|                                                                         | <i>Rs.</i>      |
| Dividends received from subsidiaries Rs. (1,50,000 + 24,000)            | 1,74,000        |
| Less : Management etc. expenses                                         | <u>6,000</u>    |
| Net Profit                                                              | 1,68,000        |
| Deduct Dividend (3/2 percent on Rs. 48,00,000) paid on December 31,2006 | <u>1,68,000</u> |
| Balance                                                                 | <u>Nil</u>      |

#### Working Notes :

##### (1) Computation of shares issued to former shareholders in

|                                                                                           | <b>Rich Ltd.</b> | <b>Poor Ltd.</b> |
|-------------------------------------------------------------------------------------------|------------------|------------------|
| Estimated annual maintainable profits before deduction of debenture interest and taxation | Rs.<br>6,00,000  | Rs.<br>2,40,000  |

## Accounting for Corporate Restructuring 4.65

|                                           |                     |                          |                 |
|-------------------------------------------|---------------------|--------------------------|-----------------|
| Deduct Debenture interest                 | <u>          </u>   | <u>40,000</u>            |                 |
|                                           | 6,00,000            | 2,00,000                 |                 |
| Deduct Corporation tax 40 percent         | <u>2,40,000</u>     | <u>80,000</u>            |                 |
|                                           | 3,60,000            | 1,20,000                 |                 |
| Deduct Preference dividend                | <u>—</u>            | <u>60,000</u>            |                 |
| Profit for equity shareholders            | <u>3,60,000</u>     | <u>60,000</u>            |                 |
| P/E Ratio                                 | <u>15</u>           | <u>10</u>                |                 |
| Total consideration (Profit x P.E. Ratio) | <u>54,00,000</u>    | <u>6,00,000</u>          |                 |
| Share capital                             | 43,20,000           | 4,80,000                 |                 |
| Share premium                             | <u>10,80,000</u>    | <u>1,20,000</u>          |                 |
| (2)                                       | <b>Bank Account</b> |                          |                 |
|                                           | Rs.                 | Rs.                      |                 |
| To Share issue Dec.31.,2006               |                     | By Preliminary expenses* | 50,000          |
| 60,000 shares at Rs. 13.75 each           | 8,25,000            | " Management etc.        |                 |
| Dividends received:                       |                     | expenses                 | 6,000           |
| Rich Ltd.                                 | 1,50,000            | " Dividend paid          | 1,68,000        |
| Poor Ltd.                                 | <u>24,000</u>       | " Balance c/d            | <u>7,75,000</u> |
|                                           | 9,99,000            |                          | 9,99,000        |

### Illustration 14

A Ltd. agreed to absorb B Ltd. on 31st March 2006, whose balance sheet stood as follows

| <i>Liabilities</i>                          | Rs.              | <i>Assets</i>               | Rs.              |
|---------------------------------------------|------------------|-----------------------------|------------------|
| <i>Share Capital</i>                        |                  |                             |                  |
| 80,000 shares of                            |                  | <i>Fixed Assets</i>         | 7,00,000         |
| Rs. 10 each fully paid                      | 8,00,000         | <i>Investments</i>          | —                |
| <i>Reserves &amp; Surplus</i>               |                  | <i>Current Assets</i>       |                  |
| General Reserve                             | 1,00,000         | <i>Loans &amp; Advances</i> |                  |
| <i>Secured Loan</i>                         | —                | Stock in trade              | 1,00,000         |
| <i>Unsecured Loan</i>                       | —                | Sundry Debtors              | 2,00,000         |
| <i>Current Liabilities &amp; Provisions</i> |                  |                             |                  |
| Sundry Creditors                            | <u>1,00,000</u>  |                             |                  |
|                                             | <u>10,00,000</u> |                             | <u>10,00,000</u> |

\***Note:** It is assumed that preliminary expenses are to be written off against share premium account.

#### 4.66 Financial Reporting

The consideration was agreed to be paid as follows:

- (a) A payment in cash of Rs. 5 per share in B Ltd. and
- (b) The issue of shares of Rs. 10 each in A Ltd., on the basis of 2 Equity Shares (valued at Rs. 15) and one 10% cum. preference share (valued at Rs. 10) for every five shares held in B Ltd.

The whole of the share capital consists of shareholdings in exact multiple of five except the following holding.

|                   |            |                                        |
|-------------------|------------|----------------------------------------|
| Chopra            | 116        |                                        |
| Karki             | 76         |                                        |
| Amar Singh        | 72         |                                        |
| Malhotra          | 28         |                                        |
| Other individuals | <u>8</u>   | (eight members holding one share each) |
|                   | <u>300</u> |                                        |

It was agreed that A Ltd. will pay in cash for fractional shares equivalent at agreed value of shares in B Ltd. i.e. Rs. 65 for five shares of Rs. 50 paid.

Prepare a statement showing the purchase consideration receivable in shares and cash.

#### Solution

##### (a) Schedule of Fraction

|           | Holding of Shares | Exchangeable<br>in multiple of<br>five | Exchange<br>in equity | Preference<br>Exchangeable | Non       |
|-----------|-------------------|----------------------------------------|-----------------------|----------------------------|-----------|
| Chopra    | 116               | 115                                    | 46                    | 23                         | 1         |
| Karki     | 76                | 75                                     | 30                    | 15                         | 1         |
| Amarsingh | 72                | 70                                     | 28                    | 14                         | 2         |
| Malhotra  | 28                | 25                                     | 10                    | 5                          | 3         |
| Others    | <u>8</u>          | —                                      | —                     | —                          | <u>8</u>  |
|           | <u>300</u>        | <u>285</u>                             | <u>114</u>            | <u>57</u>                  | <u>15</u> |

##### (b) Shares Exchangeable : Equity Shares in A Ltd.

|     |            | No.           |              | No.           |
|-----|------------|---------------|--------------|---------------|
| (i) | 80,000–300 | 79,700        | 2/5 there of | 31,880        |
|     | 300-15     | <u>285</u>    | 2/5 there of | <u>114</u>    |
|     |            | <u>79,985</u> |              | <u>31,994</u> |



**Shares Exchangeable : Preference Shares in A Ltd.**

Shares held

|              |               |              |               |
|--------------|---------------|--------------|---------------|
| as in b (i)  | 79,700        | 1/5 there of | 15,940        |
| as in b (ii) | <u>285</u>    | 1/5 there of | <u>57</u>     |
|              | <u>79,985</u> |              | <u>15,997</u> |

- (c) There are 15 shares in B Ltd. which are not capable of exchange into equity and preference shares of A Ltd. they will be paid  $150 \times \frac{65}{50} = \text{Rs.}195$

|                                       |                  |
|---------------------------------------|------------------|
| Purchase Consideration                | Rs.              |
| 31,994 Equity Shares @ Rs. 15 each    | 4,79,910         |
| 15,997 Preference shares @Rs. 10 each | 1,59,970         |
| Cash on 79, 20055 @ Rs. 5 each        | <u>3,99,925</u>  |
|                                       | 10,39,805        |
| Add: Cash for 15 shares               | <u>195</u>       |
|                                       | <u>10,40,000</u> |

**Illustration 15**

The Balance Sheets of Big Ltd. and Small Ltd. as on 31.03.2005 were as follows:

**Balance Sheet as on 31.03.2005**

|                                        | Big Ltd.<br>(Rs.) | Small Ltd.<br>(Rs.) |                                              | Big Ltd.<br>(Rs.) | Small Ltd.<br>(Rs.) |
|----------------------------------------|-------------------|---------------------|----------------------------------------------|-------------------|---------------------|
| Equity Share Capital (Rs. 10)          | 8,00,000          | 3,00,000            | Building                                     | 2,00,000          | 1,00,000            |
| 10% Preference Share Capital (Rs. 100) | —                 | 2,00,000            | Machinery                                    | 5,00,000          | 3,00,000            |
| General reserve                        | 3,00,000          | 1,00,000            | Furniture                                    | 1,00,000          | 60,000              |
| Profit and Loss Account                | 2,00,000          | 1,00,000            | Investment:<br>6,000 shares<br>of Small Ltd. | 60,000            | —                   |
| Creditors                              | 2,00,000          | 3,00,000            | Stock                                        | 1,50,000          | 1,90,000            |
|                                        |                   |                     | Debtors                                      | 3,50,000          | 2,50,000            |
|                                        |                   |                     | Cash and<br>Bank                             | 90,000            | 70,000              |
|                                        |                   |                     | Preliminary<br>Expenses                      | <u>50,000</u>     | <u>30,000</u>       |
|                                        | <u>15,00,000</u>  | <u>10,00,000</u>    |                                              | <u>15,00,000</u>  | <u>10,00,000</u>    |

#### 4.68 Financial Reporting

Big Ltd. has taken over the entire undertaking of Small Ltd. on 30.09.2005, on which date the position of current assets except Cash and Bank balances and Current Liabilities were as under:

|           | Big Ltd.<br>(Rs.) | Small Ltd.<br>(Rs.) |
|-----------|-------------------|---------------------|
| Stock     | 1,20,000          | 1,50,000            |
| Debtors   | 3,80,000          | 2,50,000            |
| Creditors | 1,80,000          | 2,10,000            |

Profits earned for the half year ended on 30.09.2005 after charging depreciation at 5% on building, 15% on machinery and 10% on furniture, are:

|            |              |
|------------|--------------|
| Big Ltd.   | Rs. 1,02,500 |
| Small Ltd. | Rs. 54,000   |

On 30.08.1995 both Companies have declared 15% dividend for 2004-2005.

Goodwill of Small Ltd. has been valued at Rs. 50,000 and other Fixed assets at 10% above their book values on 31.03.2005. Preference shareholders of Small Ltd. are to be allotted 10% Preference Shares of Big Ltd. and equity shareholders of Small Ltd. are to receive requisite number of equity shares of Big Ltd. valued at Rs. 15 per share in satisfaction of their claims.

Show the Balance Sheet of Big Ltd. as of 30.09.2005 assuming absorption is through by that date.

#### Solution

##### Balance Sheet of Big Ltd. as at 30th September, 2005

| Liabilities                                                                                                                           | Amount<br>(Rs.) | Assets             | Amount<br>(Rs.) |
|---------------------------------------------------------------------------------------------------------------------------------------|-----------------|--------------------|-----------------|
| SHARE CAPITAL                                                                                                                         |                 | FIXED ASSETS       |                 |
| 1,09,600 Equity shares of Rs.10 each                                                                                                  | 10,96,000       | Building           | 2,00,000        |
| 10% Preference shares                                                                                                                 | 2,00,000        | Less: Depreciation | <u>5,000</u>    |
| (Of the above shares, 29,600 equity shares and all preference shares are allotted as fully paid-up for consideration other than cash) |                 |                    | 1,95,000        |
|                                                                                                                                       |                 | Add: Taken over    | <u>1,07,500</u> |
|                                                                                                                                       |                 | Machinery          | 5,00,000        |
|                                                                                                                                       |                 | Less: Depreciation | <u>37,500</u>   |
|                                                                                                                                       |                 |                    | 4,62,500        |
| RESERVES AND SURPLUS                                                                                                                  |                 | Add: Taken over    | <u>3,07,500</u> |

## Accounting for Corporate Restructuring 4.69

|                                    |                  |                                             |               |                  |
|------------------------------------|------------------|---------------------------------------------|---------------|------------------|
| Capital Reserve                    | 1,000            |                                             |               | 7,70,000         |
| Securities Premium Account         | 1,48,000         | Furniture                                   | 1,00,000      |                  |
| General Reserve                    | 3,00,000         | Less: Depreciation                          | <u>5,000</u>  |                  |
| Profit and Loss Account            | 1,91,500         |                                             | 95,000        |                  |
| SECURED LOANS                      | —                | Add: Taken over                             | <u>63,000</u> |                  |
| UNSECURED LOANS                    | —                |                                             |               | 1,58,000         |
| CURRENT LIABILITIES AND PROVISIONS |                  | INVESTMENTS                                 |               |                  |
|                                    |                  | CURRENT ASSETS, LOANS AND ADVANCES          |               |                  |
| Sundry Creditors                   | 3,90,000         | Current Assets                              |               |                  |
|                                    |                  | Stock                                       |               | 2,70,000         |
|                                    |                  | Sundry Debtors                              |               | 6,30,000         |
|                                    |                  | Cash and Bank                               |               | 1,46,000         |
|                                    |                  | MISCELLANEOUS EXPENDITURE                   |               |                  |
|                                    |                  | (to the extent not written off or adjusted) |               |                  |
|                                    |                  | Preliminary Expenses                        |               | <u>50,000</u>    |
|                                    | <u>23,26,500</u> |                                             |               | <u>23,26,500</u> |

### Working Notes:

#### 1. Ascertainment of Cash and Bank Balances as on 30th September, 2005

#### Balance Sheets as at 30th September, 2005

| Liabilities                  | Big Ltd.<br>(Rs.) | Small Ltd.<br>(Rs.) | Assets               | Big Ltd.<br>(Rs.) | Small Ltd.<br>(Rs.) |
|------------------------------|-------------------|---------------------|----------------------|-------------------|---------------------|
| Equity Share Capital         | 8,00,000          | 3,00,000            | Building**           | 1,95,000          | 97,500              |
| 10% Preference Share Capital | —                 | 2,00,000            | Machinery**          | 4,62,500          | 2,77,500            |
| General reserve              | 3,00,000          | 1,00,000            | Furniture**          | 95,000            | 57,000              |
| Profit and Loss Account*     | 1,91,500          | 89,000              | Investment           | 60,000            | —                   |
| Creditors                    | 1,80,000          | 2,10,000            | Stock                | 1,20,000          | 1,50,000            |
|                              |                   |                     | Debtors              | 3,80,000          | 2,50,000            |
|                              |                   |                     | Cash and Bank        | 1,09,000          | 37,000              |
|                              |                   |                     | (Balancing figure)   |                   |                     |
|                              |                   |                     | Preliminary Expenses | <u>50,000</u>     | <u>30,000</u>       |
|                              | <u>14,71,500</u>  | <u>8,99,000</u>     |                      | <u>14,71,500</u>  | <u>8,99,000</u>     |

#### 4.70 Financial Reporting

\*Balance of Profit and Loss Account on 30th September, 2005.

|                                                                   | <i>Big Ltd.</i><br>(Rs.) | <i>Small Ltd.</i><br>(Rs.) |
|-------------------------------------------------------------------|--------------------------|----------------------------|
| Net profit (for the first half)                                   | 1,02,500                 | 54,000                     |
| Balance brought forward                                           | <u>2,00,000</u>          | <u>1,00,000</u>            |
|                                                                   | 3,02,500                 | 1,54,000                   |
| Less: Dividend on Equity Share Capital Paid                       | <u>1,20,000</u>          | <u>45,000</u>              |
|                                                                   | 1,82,500                 | 1,09,000                   |
| Less: Dividend on Preference Share Capital Paid                   | <u>—</u>                 | <u>20,000</u>              |
|                                                                   | 1,82,500                 | 89,000                     |
| Add: Dividend received $\left[ \frac{1}{5} \times 45,000 \right]$ | <u>9,000</u>             | <u>—</u>                   |
|                                                                   | <u>1,91,500</u>          | <u>89,000</u>              |

\*\*Fixed Assets on 30th September, 2005 (Before absorption)

|                               | <i>Big Ltd.</i><br>(Rs.) | <i>Small Ltd.</i><br>(Rs.) |
|-------------------------------|--------------------------|----------------------------|
| (1) Building                  |                          |                            |
| As on 1.4.2005                | 2,00,000                 | 1,00,000                   |
| Less: Depreciation (5% p.a.)  | <u>5,000</u>             | <u>2,500</u>               |
|                               | <u>1,95,000</u>          | <u>97,500</u>              |
| (2) Machinery                 |                          |                            |
| As on 1.4.2005                | 5,00,000                 | 3,00,000                   |
| Less: Depreciation (15% p.a.) | <u>37,500</u>            | <u>22,500</u>              |
|                               | <u>4,62,500</u>          | <u>2,77,500</u>            |
| (3) Furniture                 |                          |                            |
| As on 1.4.2005                | 1,00,000                 | 60,000                     |
| Less: Depreciation (10% p.a.) | <u>5,000</u>             | <u>3,000</u>               |
|                               | <u>95,000</u>            | <u>57,000</u>              |

#### 2. Calculation of Shares Allotted

|                    |          |
|--------------------|----------|
| Assets taken over: | Rs.      |
| Goodwill           | 50,000   |
| Building           | 1,00,000 |

## Accounting for Corporate Restructuring 4.71

|                                                                                |                 |                   |
|--------------------------------------------------------------------------------|-----------------|-------------------|
| Add: 10%                                                                       | <u>10,000</u>   |                   |
|                                                                                | 1,10,000        |                   |
| Less: Depreciation                                                             | <u>2,500</u>    |                   |
|                                                                                |                 | 1,07,500          |
| Machinery                                                                      | 3,00,000        |                   |
| Add: 10%                                                                       | <u>30,000</u>   |                   |
|                                                                                | 3,30,000        |                   |
| Less: Depreciation                                                             | <u>22,500</u>   |                   |
|                                                                                |                 | 3,07,500          |
| Furniture                                                                      | 60,000          |                   |
| Add: 10%                                                                       | <u>6,000</u>    |                   |
|                                                                                | 66,000          |                   |
| Less: Depreciation                                                             | <u>3,000</u>    |                   |
|                                                                                |                 | 63,000            |
| Stock                                                                          |                 | 1,50,000          |
| Debtors                                                                        |                 | 2,50,000          |
| Cash and Bank                                                                  |                 | <u>37,000</u>     |
|                                                                                |                 | 9,65,000          |
| Less: Liabilities taken over:                                                  |                 |                   |
| Creditors                                                                      |                 | <u>2,10,000</u>   |
| Net assets taken over                                                          |                 | 7,55,000          |
| Less: Allotment of 10% Preference Shares                                       |                 |                   |
| to preference shareholders of Small Ltd.                                       |                 | <u>2,00,000</u>   |
|                                                                                |                 | 5,55,000          |
| Less: Belonging to Big Ltd.***                                                 |                 | 1,11,000          |
|                                                                                |                 |                   |
| $\left[ \frac{1}{5} \times 5,55,000 \right]$                                   |                 | <u>          </u> |
| Payable to other Equity Shareholders                                           |                 | <u>4,44,000</u>   |
| Number of equity shares of Rs. 10 each to<br>be Issued (valued at Rs. 15 each) | <u>4,44,000</u> |                   |
|                                                                                | 15              |                   |
|                                                                                | = 29,600        |                   |

[\*\*\* 6,000 shares out of 30,000 shares of Small Ltd. are already with Big Ltd.]

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##### 3. Ascertainment of Goodwill / Capital Reserve

|     |                                             | Rs.             |
|-----|---------------------------------------------|-----------------|
| (A) | Net Assets taken over                       | 7,55,000        |
| (B) | Preference shares allotted                  | 2,00,000        |
|     | Payable to other equity shareholders        | 4,44,000        |
|     | Cost of investments                         | <u>60,000</u>   |
|     |                                             | <u>7,04,000</u> |
| (C) | Capital Reserve [(A) – (B)]                 | 51,000          |
| (D) | Goodwill taken over                         | 50,000          |
| (E) | Final figure of Capital Reserve [(C) – (D)] | 1,000           |

##### Self- examination Questions

1. Describe the conditions must be fulfilled for an amalgamation in the nature of merger ?
2. Explain the term consideration in the context of corporate amalgamations.
3. Alpha Limited and Beta Limited were amalgamated on and from 1st April, 2006. A new Company Gamma Limited was formed to takeover the business of the existing companies. The Balance Sheets of Alpha Limited and Beta Limited as on 31st March, 2006 are given below :

| (Rs. in Lakhs)                        |               |              |                                    |               |              |
|---------------------------------------|---------------|--------------|------------------------------------|---------------|--------------|
| Liabilities                           | Alpha Limited | Beta Limited | Assets                             | Alpha Limited | Beta Limited |
| Share Capital                         |               |              | Fixed Assets                       | 1,200         | 1,000        |
| Equity shares of Rs. 100 each         | 1,000         | 800          | Current Assets, Loans and Advances | 880           | 565          |
| 15% Preference shares of Rs. 100 each | 400           | 300          |                                    |               |              |
| Reserve & Surplus                     |               |              |                                    |               |              |
| Revaluation Reserve                   | 100           | 80           |                                    |               |              |
| General Reserve                       | 200           | 150          |                                    |               |              |
| P & L Account                         | 80            | 60           |                                    |               |              |
| Secured Loan                          |               |              |                                    |               |              |
| 12% Debentures of Rs. 100 each        | 96            | 80           |                                    |               |              |
| Current Liabilities & Provisions      | <u>204</u>    | <u>95</u>    |                                    |               |              |
|                                       | <u>2,080</u>  | <u>1,565</u> |                                    | <u>2,080</u>  | <u>1,565</u> |

Other informations :

## Accounting for Corporate Restructuring 4.73

- (1) 12% Debenture holders of Alpha Limited and Beta Limited are discharged by Gamma Limited by issuing adequate number of 16% Debentures of Rs. 100 each to ensure that they continue to receive the same amount of interest.
- (2) Preference shareholders of Alpha Limited and Beta Limited have received same number of 15% Preference shares of Rs. 100 each of Gamma Limited.
- (3) Gamma Limited has issued 1.5 equity shares for each equity share of Alpha Limited and 1 equity share for each equity share of Beta Limited. The face value of shares issued by Gamma Limited is Rs. 100 each.

Required :

Prepare the Balance Sheet of Gamma Limited as on 1st April, 2006 after the amalgamation has been carried out using the 'pooling of interest method'.

4. The Balance Sheets of O Ltd. and P Ltd. as on 31st March, 2006 are as under:

| (Rs. in lakhs)              |               |              |                           |               |              |
|-----------------------------|---------------|--------------|---------------------------|---------------|--------------|
| <i>Liabilities</i>          | <i>O</i>      | <i>P</i>     | <i>Assets</i>             | <i>O</i>      | <i>P</i>     |
|                             | <i>Rs.</i>    | <i>Rs.</i>   |                           | <i>Rs.</i>    | <i>Rs.</i>   |
| Equity Shares of Rs.10 each | 25.00         | 50.00        | Fixed Assets              | 110.00        | 50.00        |
| Reserves                    | 131.00        | 29.25        | Investments               | 16.25         | 25.00        |
| 12% Debentures              | 11.00         | 5.50         | Current Assets            | 40.25         | 3.25         |
| Creditors                   | 8.00          | 2.75         | Miscellaneous Expenditure | 8.50          | 9.25         |
|                             | <u>175.00</u> | <u>87.50</u> |                           | <u>175.00</u> | <u>87.50</u> |

Investments of O Ltd. represent 1,25,000 shares of P Ltd. Investments of P Ltd. are considered worth Rs. 30 lakhs.

P Ltd. is taken over by O Ltd. on the basis of the intrinsic value of shares in their respective books of account.

Prepare a statement showing the number of shares to be allotted by O Ltd. to P Ltd. and the Balance Sheet of O Ltd. after absorption of P Ltd.

5. A Ltd. agreed to take over B Ltd. as on 1st October, 2006. No Balance Sheet of B was prepared on that date:

Balance Sheets of A and B as at 31st March, 2006 were as follows:

|                       |           | <i>A</i>   | <i>B</i>   |                 |           | <i>A</i>   | <i>B</i>   |
|-----------------------|-----------|------------|------------|-----------------|-----------|------------|------------|
|                       |           | <i>Rs.</i> | <i>Rs.</i> |                 |           | <i>Rs.</i> | <i>Rs.</i> |
| Share Capital : In    |           |            |            | Fixed Assets    | 12,50,000 | 8,75,000   |            |
| equity shares of Rs.  |           |            |            | Current Assets: |           |            |            |
| 10 each fully paid up | 15,00,000 | 10,00,000  |            | Stock           | 2,37,500  | 1,87,500   |            |

#### 4.74 Financial Reporting

|                       |                  |                  |               |                  |                  |
|-----------------------|------------------|------------------|---------------|------------------|------------------|
| Reserves and Surplus: |                  |                  | Debtors       | 3,90,000         | 2,56,000         |
| Reserve               | 4,15,000         | 2,56,000         | Bank          | 2,93,750         | 1,50,000         |
| Profit and Loss       | 1,87,500         | 1,50,000         | Miscellaneous |                  |                  |
| Creditors             | 93,750           | 75,000           | Expenditure:  |                  |                  |
|                       |                  |                  | Preliminary   |                  |                  |
|                       |                  |                  | Expenses      | <u>25,000</u>    | <u>12,500</u>    |
|                       | <u>21,96,250</u> | <u>14,81,000</u> |               | <u>21,96,250</u> | <u>14,81,000</u> |

Additional information available:

- (i) For the six months period from 1st April, 2006, A made a profit of Rs. 4,20,000 after writing off depreciation at 10% per annum on its fixed assets.
- (ii) For the same period, B made a net profit of Rs. 2,04,000 after writing off depreciation at 10% p.a. on its fixed assets.
- (iii) Both the companies paid on 1st August, 2006, equity dividends of 15%. Tax at 10% on such payments was also paid by each of them.
- (iv) Goodwill of B was valued at Rs. 1,20,000 on the date of take-over; stock of B, subject to an abnormal item of Rs. 7,500 to be fully written off, would be appreciated by 25% for purpose of take-over:
- (v) A to issue to B's shareholders fully paid equity shares of Rs. 10 each, on the basis of the comparative intrinsic values of the shares on the take-over date.

Draft the Balance Sheet of A after absorption of B. All workings are to form part of your answer.



# 5

## CONSOLIDATED FINANCIAL STATEMENTS OF GROUP COMPANIES

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### UNIT 1

#### 1.1 CONCEPT OF GROUP, HOLDING COMPANY AND SUBSIDIARY COMPANY

It is an era of business growth. Many organization are growing into large corporations by the process of acquisition, mergers, gaining control by one company over the other company, restructuring etc. Acquisition and mergers ultimately leads to either cost reduction or controlling the market or sharing the material supplies or product diversification or availing tax benefits or synergy. Whatever the motto behind these ventures is, the ultimate result is the large scale corporation. Formation of holding company is the most popular device for achieving these objectives.

Many a times, company expands by keeping intact their separate corporate identity. In this situation, a company (holding company) gains control over the other company (subsidiary company). This significant control is exercised by one company over the other either by purchasing specified number of shares or by exercising control over the board of directors or on voting power of that company. Unit of companies connected in these ways is collectively called a **group of companies**. Consolidated statements are specifically meant to present the state of affairs of the group as a whole treating the group as single entity.

A holding company may be defined as one, which has one or more subsidiary companies and enjoys control over them. Legally a holding company and its subsidiaries are distinct and separate entities. However, in substance holding and subsidiary companies work as a **group**. Accordingly, users of holding company accounts need financial information of subsidiaries to understand the performance and financial position of the holding company.

According to Section 4(1) of the Companies Act, 1956, a company shall be deemed to be a subsidiary of another if and only if, –

- (a) that other controls the composition of its Board of directors; or

## **5.2 Financial Reporting**

- (b) that other –
  - (i) where the first-mentioned company is an existing company in respect of which the holders of preference shares issued before the commencement of this Act have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company;
  - (ii) where the first-mentioned company is any other company, holds more than half in nominal value of its equity share capital; or
- (c) the first-mentioned company is a subsidiary of any company which is that other's subsidiary.

For example, if A Ltd. is a subsidiary of B Ltd., which is subsidiary of C Ltd., then A Ltd. would also be the subsidiary of C Ltd. by virtue of clause (c) above.

Section 42(l) prohibits a subsidiary company from holding shares in the holding company but a subsidiary may continue to be a member of its holding company if it was a member thereof at the commencement of the Act or before becoming a subsidiary of the holding company; but, in such a case, the subsidiary shall not have any voting rights in respect of the shares held. A subsidiary may also hold shares in the holding company as the legal representative of a deceased member of the holding company or as trustee (unless the holding company or any subsidiary thereof is beneficially interested under the trust concerned).

### **1.2 WHOLLY OWNED AND PARTLY OWNED SUBSIDIARIES**

A wholly owned subsidiary company is one in which all the shares with voting rights of 100% are owned by the holding company whereas in a partly owned subsidiary, all the shares of subsidiary company are not acquired by the holding company i.e. only the majority of shares (i.e., more than 50%) are owned by the holding company. In a wholly owned subsidiary, there is no minority interest because all the shares with voting rights are held by the holding company. On the other hand, in a partly owned subsidiary company, there is a minority interest because less than 50% shares with voting rights are held by outsiders other than the holding company.

### **1.3 PURPOSE OF PREPARING THE CONSOLIDATED FINANCIAL STATEMENTS**

Consolidated financial statements are the financial statements of a 'group' presented as those of a single enterprise, where a 'group' refers to a parent and all its subsidiaries. Parent company needs to inform the users about the financial position and results of operations of not only of their enterprise itself but also of the group as a whole. For this purpose, consolidated financial statements are prepared and presented by a parent/holding enterprise to provide financial information about a parent and its subsidiary(ies) as a single economic entity. Consolidated Financial Statements are intended to show the financial position of the group as a whole by showing the economic resources controlled by them, the obligations of the group and the results the group achieves with its resources. Thus, the information need of users is served by providing them alongwith the separate financial statements of the parent, consolidated financial statements, which present financial information about the group

as that of a single enterprise.

In some countries a holding company is required to prepare consolidated financial statements by inclusion of the financial statements of its subsidiaries with its own financial statements. In some other countries including India, holding companies are not required to prepare consolidated financial statements. However, Accounting Standard (AS) 21 has now been issued by the Council of the Institute which lays down principles and procedures for preparation and presentation of consolidated financial statements. (For full text of AS 21, refer to Appendix I Study Material – Vol. II)

The International Accounting Standard 27 "*Consolidated Financial Statements and Accounting for Investments in Subsidiaries*" provides the basic framework for the preparation and presentation of consolidated statements as well as accounting for investments in subsidiaries in a parent's separate financial statements.

#### **1.4 LEGAL REQUIREMENTS FOR PRESENTATION OF INFORMATION TO MEMBERS OF THE HOLDING COMPANY**

A holding company is required, under Section 212, to attach to its balance sheet the following documents in respect of each of its subsidiaries:

- (a) a copy of the balance sheet of the subsidiary;
- (b) a copy of its profit and loss account;
- (c) a copy of the report of its Board of Directors;
- (d) a copy of the report of its auditors;
- (e) a statement of the holding company's interest in the subsidiary as specified in sub-section (3) of Section 212;
- (f) the statement, if any, referred to in sub-section (5) of Section 212; and
- (g) the report, if any, referred to in sub-section (6) of Section 212.

The financial year of the subsidiary company must not have ended on a date more than six months prior to the date of the closing of accounts of the holding company. The Central Government has the power to issue necessary instructions for this purpose in case the interval between the closing of the financial year of the subsidiary company and that of the holding company is longer than six months [Section 213(2)].

The statement referred to in (e) above should contain the undermentioned information:

- (a) the extent of the holding company's interest in the subsidiary as at the end of the financial year of the subsidiary company;
- (b) the net aggregate amount, so far as it concerns members of the holding company, but not yet dealt with in that company's account of the subsidiary's profits after deducting its losses.
  - (i) for the financial year of the subsidiary covered by the balance sheet and the profit and loss account; and

## 5.4 Financial Reporting

- (ii) for the previous financial years of the subsidiary since it became the holding company's subsidiary;
- (c) the net aggregate amount of the profits of the subsidiary after deducting its losses:
  - (i) for the financial year under report; and
  - (ii) for the previous financial year of the subsidiary since it became the holding company's subsidiary.

so far as these profits or losses have been dealt with in the holding company is accounts.

**Note:** *Profits and losses mentioned in paragraph (b) and (c) are only such amounts as may be treated by the holding company as revenue profits or losses. In other words, distinction must be made from the point of view of the holding company, between revenue and capital profit of the subsidiary. In the absence of information, profits of a year may be treated as accruing from day to day [sub-section (4) of Section 212].*

Sub-section (5) of Section 212 requires that where the financial year of the holding and subsidiary companies do not coincide, a statement containing the following particulars should also be attached to the balance sheet of the holding company:

- (a) the change and the extent thereof, in the holding company's interest in the subsidiary after the close of the financial year of the subsidiary till the date of the balance sheet; and
- (b) details of any material changes which have occurred in the same period in respect of:
  - (i) the subsidiary's fixed assets; (ii) its investments; (iii) the moneys lent by it; and
  - (iv) the moneys borrowed by it for any purpose other than that of meeting current liabilities.

If, for any reason, the Board of Directors of the holding company is unable to obtain information on any of the matters required to be specified under sub-section (4) i.e., for making a distinction between capital and revenue profits, a report in writing to that effect should be attached to the balance sheet of the holding company. [Sub-section (6) of Section 212]. Also the Central Government may, on the application or with the consent of the Board of Directors of the company, direct that in relation to any subsidiary, the provisions of Section 212 shall not apply at all or shall apply to a limited extent [sub-section (8) of Section 212].

### Illustration 1

A Ltd., B Ltd. and C Ltd. are subsidiaries of H Ltd.

H Ltd.'s accounts for the year ending on 31st March, 2006 have been prepared. In respect of the income from the subsidiaries H Ltd. accounts only for dividend, if any, received from them.

**Consolidated Financial Statements of Group Companies      5.5**

Particulars in respect of the subsidiaries are:

|                                    | A Ltd.<br>Rs. | B Ltd.<br>Rs. | C Ltd.<br>Rs. |
|------------------------------------|---------------|---------------|---------------|
| Equity Share Capital of            |               |               |               |
| Rs. 100 each on date of            |               |               |               |
| Respective Balance Sheets          | 10,00,000     | 15,00,000     | 20,00,000     |
| Financial year ends on             | 31st March    | 31st Dec.     | 31st Oct.     |
| Shares held by H Ltd. on 31.3.2006 | 8,000         | 9,000         | 12,000        |
| Shares purchased by H Ltd.         |               |               |               |
| from 1.4.2005 to 31.3.2006         | Nil           | Nil           | Nil           |
| Dividend received in 2005-2006     |               |               |               |
| by H Ltd. in respect of            |               |               |               |
| last year from                     | —             | —             | 1,80,000      |
| Dividend received in 2005-2006     |               |               |               |
| by H Ltd. in respect of            |               |               |               |
| earlier years                      | 1,60,000      | —             | —             |
| Total divisible profit for         |               |               |               |
| the last year                      | 3,00,000      | 4,00,000      | 5,00,000      |
| Total undistributed profits        |               |               |               |
| for earlier years since they       |               |               |               |
| became subsidiaries of H Ltd.      | 8,00,000      | 9,00,000      | 15,00,000     |

B Ltd. purchased fixed assets for Rs. 2,00,000 and lent an amount of Rs. 1,00,000 upto 31.3.2006 since the last closing.

C Ltd. purchased investments for Rs. 1,25,000 and borrowed Rs. 1,00,000 upto 31.3.2006 since the last closing.

Prepare the statement pursuant to Section 212 of the Companies Act, 1956 to be furnished along with the accounts of H Ltd., for the year ending on 31st March, 2006.

**Solution**

**Annexure to the Account of H. Ltd.  
Statement pursuant to Section 212 of the Companies Act, 1956  
relating to the subsidiary companies.**

|                                               | A Ltd.<br>Rs.   | B Ltd.<br>Rs.  | C Ltd.<br>Rs. |
|-----------------------------------------------|-----------------|----------------|---------------|
| 1. Financial year of the Subsidiary Companies | 31st March 2006 | 31st Dec. 2005 | 31st Oct 2005 |

## 5.6 Financial Reporting

|    |      |                                                                                                                 |          |              |              |
|----|------|-----------------------------------------------------------------------------------------------------------------|----------|--------------|--------------|
| 2. | (a)  | Nos. of shares held at the end of the financial year of the subsidiary                                          | 8,000    | 9,000        | 12,000       |
|    | (b)  | Extent of holding                                                                                               | 80%      | 60%          | 60%          |
| 3. |      | Net aggregate profit/loss of the subsidiary so far as it concerns to the members of H Ltd.                      |          |              |              |
|    | (a)  | not dealt with in the accounts of H Ltd. for the year ended 31st March, 2006                                    |          |              |              |
|    | (i)  | for subsidiary's financial year ending as above in (1)                                                          | 2,40,000 | 2,40,000     | 1,20,000*    |
|    | (ii) | for previous financial years of the subsidiary since it became subsidiary of H Ltd.                             | 4,80,000 | 5,40,000     | 9,00,000     |
|    | (b)  | dealt with in the accounts of H Ltd. for the year ended 31st March, 2006                                        |          |              |              |
|    | (i)  | for the subsidiary's financial year as in (1) above                                                             | —        | —            | 1,80,000     |
|    | (ii) | for the previous financial years of the subsidiary since it become subsidiary of H Ltd.                         | 1,60,000 | —            | —            |
| 4. |      | Changes in the interest of H Ltd.; between the end of the financial year of the subsidiary and 31st March, 2006 |          |              |              |
|    | (a)  | Nos. of shares                                                                                                  | Nil      | Nil          | Nil          |
|    | (b)  | Extent of holding                                                                                               | Nil      | Nil          | Nil          |
| 5. |      | Material changes between the end of the financial year of the subsidiary and 31.3.2006                          |          |              |              |
|    | (a)  | Fixed Assets                                                                                                    | —        | (+) 2,00,000 | —            |
|    | (b)  | Investments                                                                                                     | —        | —            | (+) 1,25,000 |
|    | (c)  | Moneys lent by subsidiary                                                                                       | —        | 1,00,000     | —            |
|    | (d)  | Moneys borrowed by subsidiary                                                                                   |          |              |              |

for any purpose other than that of

|                             |   |   |          |
|-----------------------------|---|---|----------|
| meeting current liabilities | — | — | 1,00,000 |
|-----------------------------|---|---|----------|

\*60% of Rs. 2,00,000 i.e., Rs. 5,00,000 Less Dividend Rs. 3,00,000.

Let us now take one more illustration to discuss the technique of preparation of a statement covering certain financial information of subsidiaries.

### **Illustration 2**

X Ltd., Y Ltd. and Z Ltd. are subsidiaries of H Ltd.

H Ltd.'s accounts for the year ended 31st March, 2006 have been prepared. In respect of the income from the subsidiaries H Ltd. accounts only for dividend, if any, received from them.

Particulars in respect of the subsidiaries are:

|                                                                                        | X Ltd.<br>Rs. | Y Ltd.<br>Rs. | Z Ltd.<br>Rs. |
|----------------------------------------------------------------------------------------|---------------|---------------|---------------|
| Equity share capital of Rs. 100 each on the date of respective Balance sheets          | 50,00,000     | 80,00,000     | 1,20,00,000   |
| 12% Cumulative Preference share capital of Rs. 100 each                                | 5,00,000      | —             | 10,00,000     |
| Financial year ends on                                                                 | 31st March    | 31st Dec.     | 31st Oct.     |
| Equity dividend received in 2005-2006 by H Ltd. in respect of last year from           | —             | —             | 14,00,000     |
| Equity dividend received in 2005-2006 by H Ltd. in respect of earlier years from       | 7,50,000      | —             | —             |
| Total divisible profit for the last year                                               | 15,00,000     | 18,00,000     | 25,00,000     |
| Total undistributed profits for earlier years since they became subsidiaries of H Ltd. | 32,00,000     | 40,00,000     | 60,00,000     |

Y Ltd. purchased fixed assets for Rs. 6,00,000 and lent an amount of Rs. 4,00,000 upto 31st March, 2006 since the last closing. Z Ltd. purchased investments for Rs. 7,20,000 and borrowed Rs. 3,50,000 upto 31st March, 2006 since the last closing.

H Ltd.'s schedule of investments as on 31st March, 2006 includes, *inter alia*, the following:

|                                                          | Rs.       |
|----------------------------------------------------------|-----------|
| 1. 40,000 Equity shares of X Ltd.<br>@ Rs. 120 per share | 48,00,000 |
| 2. 72,000 Equity shares of Y Ltd.<br>@ Rs. 110 per share | 79,20,000 |

## 5.8 Financial Reporting

|     |                                                                    |                    |
|-----|--------------------------------------------------------------------|--------------------|
| 3 . | 84,000 Equity shares of Z Ltd.<br>@ Rs. 150 per share              | 1,26,00,000        |
| 4.  | 3,000 12% Cumulative Preference shares<br>of X Ltd. @ Rs. 100 each | 3,00,000           |
| 5 . | 7,000 12% Cumulative Preference shares<br>of Z Ltd. @ Rs. 100 each | <u>7,00,000</u>    |
|     |                                                                    | <u>2,63,20,000</u> |

Prepare the statement pursuant to Section 212 of the Companies Act, 1956 to be furnished along with the accounts of H Ltd. for the year ended 31st March, 2006.

### Solution

**Annexure to the Accounts of H Ltd.  
Statement pursuant to Section 212 of the Companies Act, 1956  
relating to Subsidiary Companies**

|                                                                                                                                                | X Ltd.           | Y Ltd.         | Z Ltd.         |
|------------------------------------------------------------------------------------------------------------------------------------------------|------------------|----------------|----------------|
| 1. Financial year of the subsidiary<br>ended on                                                                                                | 31st March '2006 | 31st Dec.'2005 | 31st Oct.'2005 |
| 2. (a) No. of equity shares of subsidiary<br>company held at the end of the<br>financial year                                                  | 40,000           | 72,000         | 84,000         |
| Extent of holding                                                                                                                              | 80%              | 90%            | 70%            |
| (b) No. of preference shares of<br>subsidiary company held at<br>the end of the financial year                                                 | 3,000            | —              | 7,000          |
| Extent of holding                                                                                                                              | 60%              | —              | 70%            |
| 3. Net aggregate amounts of profits<br>less losses of the subsidiary for<br>the year as above so far as it<br>concerns members of H Ltd.       |                  |                |                |
| (a) Dealt with in the accounts of H Ltd.                                                                                                       | 36,000           | —              | 14,84,000      |
| (b) Not dealt with in the accounts of H Ltd                                                                                                    | 11,52,000        | 16,20,000      | 2,66,000       |
| 4. Net aggregate amount of profits<br>less losses for previous financial<br>years of the subsidiary since it<br>became subsidiary so far as it |                  |                |                |



concerns the members of H Ltd.

|                                                                                                                               |           |            |            |
|-------------------------------------------------------------------------------------------------------------------------------|-----------|------------|------------|
| (a) Dealt with in the accounts of H Ltd                                                                                       | 7,50,000  | —          | —          |
| (b) Not dealt with in the accounts of H Ltd                                                                                   | 18,10,000 | 36,00,000  | 42,00,000  |
| 5. Changes of interest of H Ltd. in the subsidiary between the end of the financial year of the subsidiary and that of H Ltd. | —         | —          | —          |
| 6. Material changes between the end of the financial year of the subsidiary and that of H Ltd.                                |           |            |            |
| (a) Fixed Assets                                                                                                              | —         | + 6,00,000 | —          |
| (b) Investments                                                                                                               | —         | —          | + 7,20,000 |
| (c) Moneys lent by subsidiary                                                                                                 | —         | + 4,00,000 | —          |
| (d) Moneys borrowed by Subsidiary for any purpose other than that of meeting current liabilities                              | —         | —          | + 3,50,000 |

**Note:** While calculating the amounts for 3(a) above, preference dividends have also been considered. In the 4(a) & (b) above, preference dividend could not be considered because of lack of specific information about the number of earlier years covered.

### Self-examination Questions

1. Briefly discuss the requirements of Section 212 of the Companies Act with respect to disclosure of information regarding investment in subsidiaries.
2. Do you think that the legal requirements in India regarding disclosure of financial information in the investment in subsidiaries by holding company is adequate from the view point of transparent reporting?
3. H Ltd. acquired 1,50,000 shares of Rs. 10 each out of 2,00,000 in the equity shares of S Ltd. on 1st January, 2006. On that date, S Ltd. had a balance in general reserve of Rs.1,00,000 and a balance in the Profit and Loss Account Rs. 50,000. During 2006, S Ltd. earned Profit of Rs. 2 lacs after charging depreciation and providing for Income tax. During 2006, S Ltd. declared and paid dividend @ 20%. S Ltd. had also made a provision for proposed dividend @ 20% for the year 2006.

You are required to prepare a statement pursuant to Section 212 of the Companies Act, 1956 showing the required disclosures about investments in subsidiaries by H Ltd.

## UNIT 2

### CONSOLIDATED FINANCIAL STATEMENTS

As per AS 21, "Consolidated financial statements are the financial statements of a group presented as those of a single enterprise". In many developed countries like U.S.A., U.K., Germany, France and Japan the consolidation of financial statement of holding company with its subsidiary is required. Preparation of consolidated financial statements has certain specific advantages.

The main advantages of consolidation are given below:

- (i) **Single Source Document:** From the consolidated financial statements, the users of accounts can get an overall picture of the holding company and its subsidiaries. Consolidated Profit and Loss Account gives the overall profitability of the group after adjustment of unrealised profit involved in mutual transactions and decomposition of profit of the subsidiaries into capital and revenue. Similarly, Consolidated Balance Sheet shows the unified state of affairs of the group after adjustment of mutual indebtedness and putting separately the minority interest.
- (ii) **Intrinsic value of share:** Intrinsic share value of the holding company can be calculated directly from the Consolidated Balance Sheet.
- (iii) **Return on Investments in Subsidiaries:** The holding company controls its subsidiary. So its return on investments in subsidiaries should not be measured in terms of dividend alone. Consolidated Financial Statements provide information for identifying revenue profit for determining return on investment.
- (iv) **Acquisition of Subsidiary:** The Minority Interest data of the Consolidated Financial Statement indicates the amount payable to the outside shareholders of the subsidiary company at book value which is used as the starting point of bargaining at the time of acquisition of a subsidiary by the holding company.
- (v) **Evaluation of Holding Company in the market:** The overall financial health of the holding company can be judged using Consolidated Financial Statements. Those who want to invest in the shares of the holding company or acquire it, need such consolidated statement for evaluation.

#### 2.1 REQUIREMENTS OF ACCOUNTING STANDARD 21

Accounting Standard (AS) 21, 'Consolidated Financial Statements', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2001. An enterprise that presents consolidated financial statements should prepare and present these statements in accordance with this Standard

This Statement should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.

As per AS 21, consolidated financial statements normally include

- ◆ Consolidated Balance Sheet
- ◆ Consolidated Statement of Profit and Loss Account
- ◆ Consolidated Cash Flow Statement (in case parent presents cash flow statement)
- ◆ Notes and statements and explanatory schedules that form the integral part thereof.

The consolidated financial statements are presented to the extent possible in the same format as that adopted by the parent for its separate financial statements.

## **2.2     CONSOLIDATION PROCEDURES**

In preparing the consolidated financial statements, firstly, the financial statements of the parent and its subsidiaries are combined on a line by line basis by adding together like items of assets, liabilities, equity, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single enterprise, the following steps are then taken:

1. the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary are eliminated. In case cost of acquisition exceeds or is less than the acquirer's interest, goodwill or capital reserve is calculated retrospectively.
2. intragroup transactions, including sales, expenses and dividends, are eliminated, in full;
3. unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full;
4. unrealised losses resulting from intragroup transactions that are deducted in arriving at the carrying amount of assets are also eliminated unless cost cannot be recovered;
5. minority interest in the net income of consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and
6. minority interests in the net assets of consolidated subsidiaries are identified and presented in the consolidated balance sheet separately from liabilities and the parent shareholders' equity.

## **2.3     TREATMENT OF DIFFERENTIAL i.e., COST OF CONTROL**

Any excess of the cost to the parent of its subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as goodwill to be recognised as an asset in the considered financial statements. When the cost to the parent of its investment in a subsidiary is less than the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, the difference should be treated as a capital reserve in the consolidated financial statements. For the purpose of all these computations, where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.

## 5.12 Financial Reporting

However, International Accounting Standard 22 (Revised) "*Business Combinations*" suggests that such negative differential should be allocated over individual depreciable, non-monetary assets acquired in proportion to their share valuations or treated as deferred income. It may be mentioned that positive or negative differential is separately recognised only in purchase method. This differential calculated as cost of control is shown in the consolidated balance sheet.

For example, H Ltd. acquires 70% of the equity shares of S Ltd. on 1st January, 2006. On that date, paid up capital of S Ltd. was 10,000 equity shares of Rs.10 each; accumulated reserve balance was Rs. 1,00,000. H Ltd. paid Rs. 1,60,000 to acquire 70% interest in the S Ltd. Assets of S Ltd. were revalued on 1.1.2006 and a revaluation loss of Rs. 20,000 was ascertained. The book value of shares of S Ltd. is calculated as shown below:

|                                              | Rs.             |
|----------------------------------------------|-----------------|
| 70% of the Equity Share Capital Rs. 1,00,000 | 70,000          |
| 70% of Accumulated Reserve Rs. 1,00,000      | 70,000          |
| 70% of Revaluation Loss Rs. 20,000           | <u>(14,000)</u> |
|                                              | <u>1,26,000</u> |

So, H Ltd. paid a positive differential of Rs. 34,000 i.e. (Rs. 1,60,000 – 1,26,000). This differential is also called goodwill and is shown in the balance sheet under the head intangibles.

Let us take another example:

A Ltd. acquired 70% interest in B Ltd. on 1.1.2006. On that date, B Ltd. had paid-up capital of Rs. 1,00,000 consisting of 10,000 equity shares of Rs. 10 each and accumulated balance in reserve and surplus of Rs. 1,00,000. On that date, assets and liabilities of B Ltd. were also revalued and revaluation profit of Rs. 20,000 were calculated. A Ltd. paid Rs.1,30,000 to purchase the said interest.

In this case, the book value of Shares of B Ltd. is calculated as shown below:

|                                              | Rs.             |
|----------------------------------------------|-----------------|
| 70% of the Equity Share Capital Rs. 1,00,000 | 70,000          |
| 70% of Reserves and Surplus Rs. 1,00,000     | 70,000          |
| 70% of Revaluation Profit Rs. 20,000         | <u>14,000</u>   |
|                                              | <u>1,54,000</u> |

So, H Ltd. enjoyed negative differential of Rs. 24,000 i.e. (1,54,000 – 1,30,000).

### Illustration 4

Exe Ltd. acquires 70% of equity shares of Zed Ltd. as on 31st March, 2006 at a cost of Rs. 70 lakhs. The following information is available from the balance sheet of Zed Ltd. as on 31st March, 2006:

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|                     | <i>Rs. in lakhs</i> |
|---------------------|---------------------|
| Fixed Assets        | 120                 |
| Investments         | 55                  |
| Current Assets      | 70                  |
| Loans & Advances    | 15                  |
| 15% Debentures      | 90                  |
| Current Liabilities | 50                  |

The following revaluations have been agreed upon (not included in the above figures):

|              |             |
|--------------|-------------|
| Fixed Assets | Up by 20%   |
| Investments  | Down by 10% |

Zed Ltd. declared and paid dividend @ 20% on its equity shares as on 31st March, 2006.  
Exe Ltd. purchased the shares of Zed Ltd. @ Rs. 20 per share.

Calculate the amount of goodwill/capital reserve on acquisition of shares of Zed Ltd.

### Solution

Revalued net assets of Zed Ltd. as on 31st March, 2006

|                                                                                     | <i>Rs. in lakhs</i> | <i>Rs. in lakhs</i> |
|-------------------------------------------------------------------------------------|---------------------|---------------------|
| Fixed Assets                                                                        |                     | 144.0               |
| Investments                                                                         |                     | 49.5                |
| Current Assets                                                                      |                     | 70.0                |
| Loans and Advances                                                                  |                     | <u>15.0</u>         |
|                                                                                     |                     | 278.5               |
| Less: 15% Debentures                                                                | 90.0                |                     |
| Current Liabilities                                                                 | <u>50.0</u>         | <u>140.0</u>        |
|                                                                                     |                     | <u>138.5</u>        |
| Exe Ltd.'s share of net assets (70%)                                                |                     | 96.95               |
| Exe Ltd.'s cost of acquisition of shares of Zed Ltd.<br>(Rs. 70 lakhs – Rs.7 lakhs) |                     | <u>63.00</u>        |
| Capital reserve                                                                     |                     | <u>33.95</u>        |

### Illustration 5

Variety Ltd. holds 46% of the paid-up share capital of VR Ltd. The shares were acquired at a market price of Rs. 17 per share. The balance of shares of VR Ltd. are held by a foreign collaborating company. A memorandum of understanding has been entered into with the foreign company providing for the following:

- (a) The shares held by the foreign company will be sold to Variety Ltd. The price per share

## 5.14 Financial Reporting

will be calculated by capitalising the yield at 15%. Yield, for this purpose, would mean 40% of the average of pre-tax profits for the last 3 years, which were Rs.30 lakhs, Rs. 40 lakhs and Rs. 65 lakhs.

- (b) The actual cost of the shares to the foreign company was Rs. 5,40,000 only. The profit that would accrue to them would be taxable at an average rate of 30%. The tax payable will be deducted from the proceeds and Variety Ltd. will pay it to the Government.
- (c) Out of the net consideration, 50% would be remitted to the foreign company immediately and the balance will be an unsecured loan repayable after two years.

The above agreement was approved by all concerned for being given effect to on 1.4.2005. The total assets of VR Ltd. as on 31st March, 2005 was Rs. 1,00,00,000. It was decided to write down fixed assets by Rs. 1,75,000. Current liabilities of VR Ltd. as on the same date were Rs. 20,00,000. The paid-up share capital of VR Ltd. was Rs. 20,00,000 divided into 2,00,000 equity shares of Rs. 10 each.

Find out goodwill/capital reserve to Variety Ltd. on acquiring wholly the shares of VR Ltd.

### Solution

#### (1) Computation of purchase consideration:

$$(a) \text{ Y Ltd. of VR Ltd.: } \left[ \frac{40}{100} \times \frac{30 + 40 + 65}{3} \right] \quad \text{Rs.18 Lakhs}$$

(b) Price per share of VR Ltd.

$$\text{Capitalised yield } \left[ \frac{\text{Rs.18 lakhs}}{0.15} \right] \quad \text{Rs.120 lakhs}$$

Number of shares 2,00,000

Price per share Rs.60

(c) Purchase consideration for 54% shares in VR Ltd.:

$$2,00,000 \times \frac{54}{100} \times \text{Rs. 60} \quad \text{Rs. 64.80 lakhs}$$

(d) Discharge of purchase consideration:

$$\text{Tax deducted at source (Rs. 64.80 lakhs - Rs.5.40 lakhs)} \times \frac{30}{100} \quad \text{Rs. 17.82 lakhs}$$

50% of purchase consideration (net of tax) in cash

$$\text{Rs. (64.80 - 17.82) } \times 50\% \quad \text{Rs. 23.49 lakhs}$$

$$\text{Balance - Unsecured Loan} \quad \text{Rs. 23.49 lakhs}$$

|                                                      |              |                     |
|------------------------------------------------------|--------------|---------------------|
| <b>(2) Goodwill/Capital Reserve to Variety Ltd.:</b> |              | <i>Rs. in lakhs</i> |
| Total Assets                                         |              | 100.00              |
| Less: Reduction in value of Fixed Assets             |              | <u>1.75</u>         |
|                                                      |              | 98.25               |
| Less: Current Liabilities                            |              | <u>20.00</u>        |
| Net Assets                                           |              | 78.25               |
| Purchase consideration                               | 64.80        |                     |
| Investments                                          | <u>15.64</u> | <u>80.44</u>        |
| Goodwill                                             |              | <u>2.19</u>         |

## **2.4 MINORITY INTERESTS**

Minority interest represents that part of the net results of operations and of net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiaries, by the holding (parent) company. In short, minority interest represents the claims of the outside shareholders of a subsidiary. Minority interests in the net income of consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income attributable to the shareholders of the holding company.

Minority interest in the income of the group should be separately presented. The losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. The excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the minority has a binding obligation to, and is able to make good the losses. If the subsidiary subsequently reports profit, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered.

As per para 13(e) of AS 21, minority interest in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interest in the net assets consist of :

- (i) the amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and
- (ii) the minorities share of movements in equity since the date the parent-subsidiary relationship and into existence.

## **2.5 PROFIT OR LOSS OF SUBSIDIARY COMPANY**

For the purpose of consolidated balance sheet preparation all reserves and profits (or losses) of subsidiary company should be classified into pre and post acquisition reserves and profits (or losses). Profits (or losses) earned (or incurred) by subsidiary company upto the date of acquisition of the shares by the holding company are pre acquisition or capital profits (or loss). Similarly, all reserves of subsidiary company upto the date of acquisition are capital reserves from the view point of holding company. If the holding interest in subsidiary is

## 5.16 Financial Reporting

acquired during the middle or some other period of the current year, pre-acquisition profit should be calculated accordingly.

In addition profit or loss on revaluation of fixed assets of subsidiary should also be treated as capital profit or loss. But if the fall in the value of the asset occurs after the date of acquisition, the loss should be treated as revenue loss. Adjustment for depreciation would be made in the profit and loss account of the subsidiary.

The minority interest in the reserves and profits (or losses) of subsidiary company should be transferred to minority interest account which will also include share capital of subsidiary company held by outsiders / minority shareholders. The holding company's interest in the pre acquisition reserves and profits (or losses) should be adjusted against cost of control to find out goodwill or capital reserve on consolidation. The balance of reserves and profits (or loss) of subsidiary company, representing holding company's interest in post acquisition or revenue reserves and profits (or losses), should be added to the balances of reserves and profits (or losses) of holding company.

## 2.6 DIVIDEND RECEIVED FROM SUBSIDIARY COMPANIES

The holding company, when it receives a dividend from a subsidiary company, must distinguish between the part received out of capital profits and that out of revenue profits - the former is credited to Investment Account, it being a capital receipt, and the latter is adjusted as revenue income for being credited to the Profit & Loss Account. It must be understood that the term 'capital profit', in this context, apart from the generic meaning of the term, connotes profit earned by the subsidiary company till the date of acquisition. As a result, profits which may be of revenue nature for the subsidiary company, may be capital profits so far as the holding company is concerned. If the controlling interest was acquired during the course of a year, profit for that year must be apportioned into the pre-acquisition and post-acquisition portions, on the basis of time in the absence of information on the point.

### Illustration 6

H Ltd. acquired 3,000 shares in S Ltd., at a cost of Rs. 4,80,000 on 1st August, 2006. The capital of S Ltd. consisted of 5,000 shares of Rs. 100 each fully paid. The Profit & Loss Account of this company for 2006 showed an opening balance of Rs. 1,25,000 and profit for the year of Rs. 3,00,000. At the end of the year, it declared a dividend of 40%. Record the entry in the books of H Ltd., in respect of the dividend.

### Solution

The profits of S Ltd., have to be divided between capital and revenue profits from the point of view of the holding company.

|                                     | <i>Capital Profit</i><br>Rs.    | <i>Revenue Profit</i><br>Rs. |
|-------------------------------------|---------------------------------|------------------------------|
| Balance on 1.1.2006                 | 1,25,000                        | —                            |
| Profit for 2006 (3,00,000 × 7/12)   | <u>1,75,000</u> (3,00,000×5/12) | <u>1,25,000</u>              |
| Total                               | 3,00,000                        | 1,25,000                     |
| Proportionate share of H Ltd. (3/5) | <u>1,80,000</u>                 | <u>75,000</u>                |



The treatment of the dividend of Rs. 1,20,000 received by H Ltd., will depend on the character of profits which have been utilised by S Ltd., to pay the dividend. There are four possibilities:

(1) Earlier profits, included in the profit brought forward from the previous year have been used up first. In that case, the dividend of Rs.1,20,000 would be paid wholly out of capital or pre-acquisition profits. The entry in that case will be:

|                       |     |          |          |
|-----------------------|-----|----------|----------|
|                       |     | Rs.      | Rs.      |
| Bank Account          | Dr. | 1,20,000 |          |
| To Investment Account |     |          | 1,20,000 |

(2) The profit for 2006 alone has been utilised to pay the dividend, and no part of the profit brought forward has been utilised for the purpose. The share of H Ltd., in profit for the first seven months of S Ltd., is Rs. 1,05,000 i.e., Rs. 1,75,000 × 3/5 and that the profit for the remaining five months is Rs. 75,000. The dividend of Rs. 1,20,000 will be adjusted in this ratio: Rs. 70,000 out of profits up to the 1st August and Rs. 50,000 out of profits after that date. The dividend out of profits subsequent to August 1st will be revenue income and that out of earlier profits capital receipt. Hence the entry.

|                            |     |          |        |
|----------------------------|-----|----------|--------|
|                            |     | Rs.      | Rs.    |
| Bank                       | Dr. | 1,20,000 |        |
| To Investment Account      |     |          | 70,000 |
| To Profit and Loss Account |     |          | 50,000 |

(3) Later profits have been utilised first and then pre- acquisition profits. In such a case, the whole of Rs. 75,000 (share of H Ltd. in profits of S Ltd., after 1st August) would be received and treated as revenue income; the remaining dividend, Rs. 45,000 (Rs. 1,20,000 less Rs. 75,000) would be capital receipt. The entry would be:

|                          |     |          |        |
|--------------------------|-----|----------|--------|
|                          |     | Rs.      | Rs.    |
| Bank                     | Dr. | 1,20,000 |        |
| To Investment Account    |     |          | 45,000 |
| To Profit & Loss Account |     |          | 75,000 |

(4) The two profits, pre-and post-acquisition, have been used up proportionally. The ratio would be Rs. 1,80,000 : 75,000;  $1,20,000 \times \frac{75,000}{2,55,000}$  would be revenue receipt and the remaining capital. The entry would be:

|                          |     |          |        |
|--------------------------|-----|----------|--------|
|                          |     | Rs.      | Rs.    |
| Bank                     | Dr. | 1,20,000 |        |
| To Investment Account    |     |          | 84,706 |
| To Profit & Loss Account |     |          | 35,294 |

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### Notes:

- (1) Points (3) and (4) above can arise only if there is definite information about the profits utilised; in practice such treatment is rare.
- (2) The treatment outlined above in fact is not peculiar to holding companies-dividends received out of profits earned before purchase of investments normally also are credited to the Investment Account. For instance, if shares in X Ltd., are purchased in January, 2006 and in April X Ltd., declares a dividend in respect of 2005, the dividend received by the holder of the shares correctly should not be treated as income but as capital receipt, and credited to Investment Account.
- (3) The holding company, like other holders, records no entry on issue of bonus shares by the subsidiary company - only the number of shares held is increased.

### Illustration 7

(a) From the following data, determine in each case:

- (1) Minority interest at the date of acquisition and the date of consolidation.
- (2) Goodwill or Capital Reserve.
- (3) Amount of holding company's profit in the consolidated Balance Sheet assuming holding company's own Profit & Loss Account to be Rs. 2,00,000 in each case.

| Company<br>& % shares owned |   |      | Cost<br><br>Rs. | Subsidiary Company              |                             |                                  |                             |
|-----------------------------|---|------|-----------------|---------------------------------|-----------------------------|----------------------------------|-----------------------------|
|                             |   |      |                 | Date of acquisition<br>1.1.2006 |                             | Consolidation Date<br>31.12.2006 |                             |
|                             |   |      |                 | Share<br>Capital                | Profit &<br>Loss<br>Account | Share<br>Capital                 | Profit &<br>Loss<br>Account |
|                             |   |      |                 | Rs.                             | Rs.                         | Rs.                              | Rs.                         |
| Case 1                      | A | 90%  | 1,40,000        | 1,00,000                        | 50,000                      | 1,00,000                         | 70,000                      |
| Case 2                      | B | 85%  | 1,04,000        | 1,00,000                        | 30,000                      | 1,00,000                         | 20,000                      |
| Case 3                      | C | 80%  | 56,000          | 50,000                          | 20,000                      | 50,000                           | 20,000                      |
| Case 4                      | D | 100% | 1,00,000        | 50,000                          | 40,000                      | 50,000                           | 55,000                      |

(b) XYZ Ltd. purchased 80% shares of ABC Ltd. on 1st January, 2006 for Rs. 1,40,000. The issued capital of ABC Ltd., on 1st January, 2006 was Rs. 1,00,000 and the balance in the Profit & Loss Account was Rs. 60,000.

For the year ending on 31st December, 2006 ABC Ltd. has earned a profit of Rs. 20,000 and, at the same time, declared and paid a dividend of Rs. 30,000.

Show by an entry how the dividend should be recorded in the books of XYZ Ltd.

What is the amount of minority interest as on 1st January, 2006 and 31st December, 2006?

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(c) The following balances appear in the books of a holding Co. and its subsidiary on the dates stated:

|                                                                      | <i>Jan. 1</i> | <i>Dec. 31</i> | <i>Dec. 31</i> | <i>Dec. 31</i> |
|----------------------------------------------------------------------|---------------|----------------|----------------|----------------|
|                                                                      | <i>2004</i>   | <i>2004</i>    | <i>2005</i>    | <i>2006</i>    |
|                                                                      | <i>Rs.</i>    | <i>Rs.</i>     | <i>Rs.</i>     | <i>Rs.</i>     |
| <i>Holding Company</i>                                               |               |                |                |                |
| Investments in Subsidiary                                            | 1,28,000      | 1,28,000       | 1,19,000       | 1,40,000       |
| Profit & Loss Account<br>(Balance)                                   | 1,35,000      | 1,60,000       | 1,48,000       | 1,55,000       |
| <i>Subsidiary Company</i>                                            |               |                |                |                |
| Share Capital                                                        | 1,00,000      | 1,00,000       | 1,00,000       | 1,00,000       |
| Profit & Loss Account<br>(Balance before providing<br>for dividend ) | 50,000        | 62,000         | 70,000         | 80,000         |

Subsidiary's issued capital consisted of 1,000 equity shares of Rs. 100 each. The holding Co. purchased 800 shares on 1st January, 2004. It sold 50 shares on 1st January, 2005 and purchased 100 shares on 1st January, 2006. The Investment Account was debited with the cost of shares purchased and credited with the sale proceeds. The holding Co. has made no other entries in the Investment Account and credited all dividends received to the Profit & Loss Account. The subsidiary company paid a dividend of 15% in March each year in respect of the previous year.

Prepare a statement showing the amount of goodwill/cost of control and minority interest at the end of each year.

**Solution**

| <b>(a)</b> | <b>(1)</b>   | <i>Minority interest<br/>as at the date of<br/>acquisition</i> | <i>Minority interest<br/>as at the date of<br/>consolidation</i> |
|------------|--------------|----------------------------------------------------------------|------------------------------------------------------------------|
|            |              | <i>Rs.</i>                                                     | <i>Rs.</i>                                                       |
|            | Case 1 (10%) | 15,000                                                         | 17,000                                                           |
|            | Case 2 (15%) | 19,500                                                         | 18,000                                                           |
|            | Case 3 (20%) | 14,000                                                         | 14,000                                                           |
|            | Case 4 Nil   | Nil                                                            | Nil                                                              |

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| (2)    | <i>Goodwill</i> | <i>Capital Reserve</i> |
|--------|-----------------|------------------------|
|        | <i>Rs.</i>      | <i>Rs.</i>             |
| Case 1 | 5,000           | —                      |
| Case 2 | —               | 6,500                  |
| Case 3 | Nil             | Nil                    |
| Case 4 | 10,000          | —                      |

- (3) The balance in the Profit & Loss Account on the date of acquisition (1.1.2006) is Capital Profit, as such the balance of Consolidated Profit & Loss Account shall be equal to holding Co.'s Profit.

On 31.12.2006 in each case the following amount shall be added or deducted from the balance of holding Co.'s Profit & Loss Accounts.

| <b>Case 1</b> | <b>Case 2</b> | <b>Case 3</b> | <b>Case 4</b> |
|---------------|---------------|---------------|---------------|
| Rs. 18,000    | – Rs. 8,500   | Nil           | Rs. 15,000    |

(b)

### Book of XYZ Ltd.

|                                                                                               |     |               |                 |
|-----------------------------------------------------------------------------------------------|-----|---------------|-----------------|
|                                                                                               |     | <i>Rs.</i>    | <i>Rs.</i>      |
| Bank A/c                                                                                      | Dr. | 24,000        |                 |
| To Profit & Loss A/c                                                                          |     |               | 16,000          |
| To Investments in ABC Ltd.                                                                    |     | 8,000         |                 |
| (Dividend received from ABC Ltd. 1/3 credited to investment A/c being out of capital profits) |     |               |                 |
| <i>Goodwill on Consolidation:</i>                                                             |     |               |                 |
|                                                                                               |     | <i>Rs.</i>    | <i>Rs.</i>      |
| Cost of shares less dividend out of capital profits                                           |     |               | 1,32,000        |
| Less: Face value                                                                              |     | 80,000        |                 |
| Add: Share of capital profits                                                                 |     | <u>40,000</u> | <u>1,20,000</u> |
|                                                                                               |     |               | <u>12,000</u>   |
| Minority interest on: 1st January, 2006: 20% of Rs. 1,60,000                                  |     |               | 32,000          |
| 31st December, 2006: 20% of Rs. 1,50,000                                                      |     |               | 30,000          |

| (c) Statement showing Goodwill or Cost of Control as on |                          |                          |                          |
|---------------------------------------------------------|--------------------------|--------------------------|--------------------------|
|                                                         | 31st Dec.<br>2004<br>Rs. | 31st Dec.<br>2005<br>Rs. | 31st Dec.<br>2006<br>Rs. |
| Cost of investment                                      | 1,28,000                 |                          |                          |
| Less: Dividend out of Capital Profit                    | <u>12,000</u>            |                          |                          |
|                                                         | 1,16,000                 | 1,16,000                 |                          |
| Less: Cost of investment sold                           |                          |                          |                          |
| $\left[ \frac{50}{800} \times 1,16,000 \right]$         | —                        | 7,250                    | 1,08,750                 |
| Add: Cost of investment purchased                       |                          |                          | 21,000                   |
| Less: Capital Dividend                                  |                          |                          | <u>1,500*</u>            |
| (A)                                                     | <u>1,16,000</u>          | <u>1,08,750</u>          | <u>1,28,250</u>          |
| Nominal Value of Shares                                 | 80,000                   | 75,000                   | 85,000                   |
| Capital Profit                                          | <u>28,000</u>            | <u>26,250</u>            | <u>31,750**</u>          |
| (B)                                                     | <u>1,08,000</u>          | <u>1,01,250</u>          | <u>1,16,750</u>          |
| Goodwill (A-B)                                          | <u>8,000</u>             | <u>7,500</u>             | <u>11,500</u>            |

**Note:** In 2006, Rs. 21,000 must have been spent since by that amount the book value of investment has gone up.

| Minority interest |     | Capital + Profits |        |          |
|-------------------|-----|-------------------|--------|----------|
|                   |     | Rs.               | Rs.    | Rs.      |
| 31st Dec. 2004    | 20% | 20,000            | 12,400 | = 32,400 |
| 31st Dec. 2005    | 25% | 25,000            | 17,500 | = 42,500 |
| 31st Dec. 2006    | 15% | 15,000            | 12,000 | = 27,000 |

In a particular situation it may so happen that the losses applicable to the minority in a consolidated subsidiary exceed the minority interest in the equity of the subsidiary. Such excess and any further losses should be charged against majority interest. If the subsidiary company subsequently reports profits, such profits should be allocated to majority interest unless the minority's share of losses previously absorbed has been recovered.

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\* Dividend out of Capital Profits

\*\* 10% of 20,000 i.e. profit earned and not yet distributed after Jan., 2004 till 31<sup>st</sup> dec. 2005 (55,000-35,000) plus 85% of Rs. 35,000 profit remaining undistributed out of profits as on 1.1.2004.

## 5.22 Financial Reporting

### Illustration 8

A Ltd. acquired 70% of equity shares of B Ltd. as on 1st January, 2000 at a cost of Rs.10,00,000 when B Ltd. had an equity share capital of Rs. 10,00,000 and reserves and surplus of Rs. 80,000. Both the companies follow calendar year as the accounting year. In the four consecutive years B Ltd. fared badly and suffered losses of Rs. 2,50,000, 4,00,000, Rs.5,00,000 and Rs. 1,20,000 respectively. Thereafter in 2004 B Ltd. experienced turnaround and registered an annual profit of Rs. 50,000. In the next two years i.e. 2005 and 2006 B Ltd. recorded annual profits of Rs. 1,00,000 and Rs. 1,50,000 respectively.

Show the minority interests and cost of control at the end of each year for the purpose of consolidation.

### Solution

|                                                                  | Minority<br>Interest (30%)<br>Rs. | Holding<br>Interest (70%)<br>Rs. |
|------------------------------------------------------------------|-----------------------------------|----------------------------------|
| Share of net assets of B Ltd. as on 1.1.2000                     | 3,24,000                          | 7,56,000                         |
| Cost of acquisition                                              | —                                 | <u>10,00,000</u>                 |
|                                                                  | 3,24,000                          | <u>2,44,000</u> (goodwill)       |
| Minority's share of losses of B Ltd:<br>year ended 31.12.2000    | <u>75,000</u>                     |                                  |
| Minority interest as on 31.12.2000                               | 2,49,000                          |                                  |
| Minority's share of losses of B Ltd.:<br>year ended 31.12.2001   | <u>1,20,000</u>                   |                                  |
| Minority interest as on 31.12.2001                               | 1,29,000                          |                                  |
| Minority's share of losses of B Ltd.<br>year ended 31.12.2002    | <u>1,29,000*</u>                  |                                  |
| Minority interest as on 31.12.2002                               | Nil                               |                                  |
| Minority's share of losses for 2003                              | <u>Nil</u>                        |                                  |
| Minority's share of profits of B Ltd. for 2004                   | <u>Nil</u>                        |                                  |
| Minority's share of profit for 2005                              | <u>Nil</u>                        |                                  |
| Minority's share of profit for 2006<br>(Rs. 45,000 – Rs. 12,000) | 33,000*                           |                                  |
| Minority interest as on 31.12.2006                               | <u>33,000</u>                     |                                  |

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\* In the year 2002, the minority's share of losses actually comes to Rs.1,50,000. But since minority interest as on 31.12.2001 was less than the share of loss, the excess of loss of Rs.21,000 is to be added to A Ltd.'s share of losses. Similarly for the year 2003, the entire loss of B Ltd. is to be adjusted against A Ltd.'s profits for the purpose of consolidation. Therefore, upto 2003, the minority's share of B Ltd.'s losses of Rs.57,000 are to be borne by A Ltd. Thereafter, the entire profits of B Ltd. will be allocated to A Ltd. unless the minority's share of losses previously absorbed (Rs.57,000) has been recovered. Such recovery is fully made in 2006 and therefore minority interest of Rs. 33,000 is shown after adjusting fully the share of losses of minority previously absorbed by A Ltd.

## 2.7 PREPARATION OF CONSOLIDATED BALANCE SHEET

While preparing the consolidated balance sheet, assets and outside liabilities of the subsidiary company are merged with those of the holding company. Share capital and reserves and surplus of subsidiary company are apportioned between holding company and minority shareholders. These items, along with investments of holding company in shares of subsidiary company are not separately shown in consolidated balance sheet. The net amounts resulting from various computations on these items, shown as (a) minority interest (b) cost of control (c) holding company's share in post-acquisition profits of the subsidiary company (added to appropriate concerned account of the holding company) are entered in consolidated balance sheet. The method of calculation of these items with detailed treatment of other relevant issues has been dealt with in various paras separately.

As per para 15 of AS 21, if an enterprise makes two or more investments in another enterprise at different dates and eventually obtain control of the other enterprise the consolidated financial statements are presented only from the date on which holding-subsidiary relationship comes in existence. If two or more investments are made over a period of time, the equity of the subsidiary at the date of investment for the purposes of paragraph 13 of AS 21, is generally determined on a step-by-step basis; however, if small investments are made over a period of time and then an investment is made that results in control, the date of the latest investment, as a practicable measure, may be considered as the date of investment.

### Illustration 9

From the following balance sheets of H Ltd. and its subsidiary S Ltd. drawn up at 31st March, 2006, prepare a consolidated balance sheet as at that date, having regard to the following :

- (i) Reserves and Profit and Loss Account of S Ltd. stood at Rs. 25,000 and Rs. 15,000 respectively on the date of acquisition of its 80% shares by H Ltd. on 1st April, 2005.
- (ii) Machinery (Book-value Rs. 1,00,000) and Furniture (Book value Rs. 20,000) of S Ltd. were revalued at Rs. 1,50,000 and Rs. 15,000 respectively on 1.4.2005 for the purpose of fixing the price of its shares. [Rates of depreciation : Machinery 10%, Furniture 15%.]

#### Balance Sheet of H Ltd. as on 31st March, 2006

| <i>Liabilities</i> | <b>H Ltd.</b>    | <b>S. Ltd.</b>  | <i>Assets</i> | <b>H Ltd.</b>    | <b>S Ltd.</b>   |
|--------------------|------------------|-----------------|---------------|------------------|-----------------|
|                    | <i>Rs.</i>       | <i>Rs.</i>      |               | <i>Rs.</i>       | <i>Rs.</i>      |
| Share Capital      |                  |                 | Machinery     | 3,00,000         | 90,000          |
| Shares of          |                  |                 | Furniture     | 1,50,000         | 17,000          |
| Rs. 100 each       | 6,00,000         | 1,00,000        | Other assets  | 4,40,000         | 1,50,000        |
| Reserves           | 2,00,000         | 75,000          | Shares in     |                  |                 |
| Profit and Loss    |                  |                 | S Ltd.:       |                  |                 |
| Account            | 1,00,000         | 25,000          | 800 shares at |                  |                 |
| Creditors          | <u>1,50,000</u>  | <u>57,000</u>   | Rs. 200 each  | <u>1,60,000</u>  | <u>—</u>        |
|                    | <u>10,50,000</u> | <u>2,57,000</u> |               | <u>10,50,000</u> | <u>2,57,000</u> |

## 5.24 Financial Reporting

### Solution

#### Working Notes:

##### 1. Pre-acquisition profits and reserves of S Ltd.

|                                                 | Rs.           |
|-------------------------------------------------|---------------|
| Reserves                                        | 25,000        |
| Profit and Loss Account                         | <u>15,000</u> |
|                                                 | <u>40,000</u> |
| H Ltd.'s $= \frac{4}{5} \times 40,000$          | 32,000        |
| Minority Interest $= \frac{1}{5} \times 40,000$ | <u>8,000</u>  |

##### 2. Profit on revaluation of assets of S Ltd.

|                                               |                           |               |
|-----------------------------------------------|---------------------------|---------------|
| Profit on Machinery                           | Rs. (1,50,000 – 1,00,000) | 50,000        |
| Less : Loss on Furniture                      | Rs. (20,000 – 15,000)     | <u>5,000</u>  |
| Net Profit on revaluation                     |                           | <u>45,000</u> |
| H Ltd.'s share $\frac{4}{5} \times 45,000$    |                           | 36,000        |
| Minority Interest $\frac{1}{5} \times 45,000$ |                           | <u>9,000</u>  |

##### 3. Post-acquisition reserves of S Ltd.

|                                                   |               |
|---------------------------------------------------|---------------|
| Post acquisition reserves = Rs. (75,000 – 25,000) | <u>50,000</u> |
| H Ltd.'s share $\frac{4}{5} \times 50,000$        | 40,000        |
| Minority interest $\frac{1}{5} \times 50,000$     | <u>10,000</u> |

##### 4. Post -acquisition profits of S Ltd.

|                                                                                         |              |
|-----------------------------------------------------------------------------------------|--------------|
| Post-acquisition profits Rs. (25,000 – 15,000)                                          | 10,000       |
| Add: Excess depreciation charged furniture @ 15%<br>on Rs. 5,000 i.e. (20,000 – 15,000) | <u>750</u>   |
|                                                                                         | 10,750       |
| Less: Under depreciation on machinery @ 10%<br>on Rs. 50,000 i.e. (1,50,000 – 1,00,000) | <u>5,000</u> |
| Adjusted post-acquisition profits                                                       | <u>5,750</u> |
| H Ltd.'s share $\frac{4}{5} \times 5,750$                                               | 4,600        |
| Minority Interest $\frac{1}{5} \times 5,750$                                            | <u>1,150</u> |

##### 5. Minority Interest

|                                                                                     |        |
|-------------------------------------------------------------------------------------|--------|
| Paid-up value of (1,000 – 800) = 200 shares<br>held by outsiders i.e. 200 × Rs. 100 | 20,000 |
| Add: 1/5th share of pre-acquisition profits and reserves                            | 8,000  |



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|                                          |               |
|------------------------------------------|---------------|
| 1/5th share of profit on revaluation     | 9,000         |
| 1/5th share of post-acquisition reserves | 10,000        |
| 1/5th share of post-acquisition profit   | <u>1,150</u>  |
|                                          | <u>48,150</u> |

**6. Cost of Control or Goodwill**

|                                                                              |                 |
|------------------------------------------------------------------------------|-----------------|
| Paid-up value of 800 shares held by H Ltd. i.e. $800 \times \text{Rs. } 100$ | 80,000          |
| Add: 4/5th share of pre-acquisition profits and reserves                     | 32,000          |
| 4/5th share of profit on the revaluation                                     | <u>36,000</u>   |
| Intrinsic value of shares on the date of acquisition                         | <u>1,48,000</u> |
| Price paid up by H Ltd. for 800 shares                                       | 1,60,000        |
| Less : Intrinsic value of the shares                                         | <u>1,48,000</u> |
| Cost of control or Goodwill                                                  | 12,000          |

**Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd.  
as at 31st March, 2006**

| <i>Liabilities</i>           | <i>Rs.</i>       | <i>Assets</i>      | <i>Rs.</i>       |
|------------------------------|------------------|--------------------|------------------|
| Share Capital                |                  | Goodwill           | 12,000           |
| Shares of                    | 6,00,000         | Machinery          |                  |
| Rs. 100 each                 |                  | H Ltd.             | 3,00,000         |
| Reserves                     | 2,00,000         | S Ltd.             | 1,00,000         |
| Add: 4/5th share of S Ltd.'s |                  | Add: Appreciation  | <u>50,000</u>    |
| post-acquisition reserves    | <u>40,000</u>    |                    | 1,50,000         |
| Profit and Loss Account      | 1,00,000         | Less: Depreciation | <u>15,000</u>    |
| Add: 4/5th share of S Ltd.'s |                  |                    | <u>1,35,000</u>  |
| post-acquisition profits     | <u>4,600</u>     |                    | 4,35,000         |
| Creditors                    |                  | Furniture          |                  |
| H Ltd.                       | 1,50,000         | H. Ltd.            | 1,50,000         |
| S Ltd.                       | <u>57,000</u>    | S Ltd.             | 20,000           |
| Minority Interest            | 48,150           | Less: Decrease     |                  |
|                              |                  | in value           | <u>5,000</u>     |
|                              |                  |                    | 15,000           |
|                              |                  | Less: Depreciation | <u>2,250</u>     |
|                              |                  |                    | <u>12,750</u>    |
|                              |                  | Other Assets       |                  |
|                              |                  | H Ltd.             | 4,40,000         |
|                              |                  | S Ltd.             | <u>1,50,000</u>  |
|                              | <u>11,99,750</u> |                    | <u>5,90,000</u>  |
|                              |                  |                    | <u>11,99,750</u> |

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### 2.8 ELIMINATION OF INTRA-GROUP BALANCES AND INTRA-GROUP TRANSACTIONS

Intragroup balances should be eliminated from both sides of the consolidated Balance Sheet. Similarly intragroup transactions (e.g. sales, expenses, dividends etc. are also to be eliminated in full in the consolidated profit and loss account. Suppose A Ltd. is a holding company of B Ltd. Bills payable of B Ltd. include Rs. 4,000 issued to A Ltd. out of which A Ltd. had discounted Rs.1,000 and that debtors of A Ltd. include Rs.10,000 owings by B Ltd. In this situation, Bills of Rs. 3,000 still held by A Ltd. would be eliminated both from Bills Receivable and Bills Payable in the consolidated balance sheet. Also both sundry debtors and creditors would get reduced by Rs. 10,000. Consider another example if S Ltd. (a subsidiary of H Ltd.) has paid Rs. 12,000 as interest out of which Rs. 6,000 has been received by H Ltd., in the consolidated profit and loss account interest paid should be shown only at, Rs.6,000, intragroup interest being eliminated in full.

**2.8.1 Unrealised profit on inter-company transactions:** It is natural for a company to sell goods to its subsidiary or subsidiaries and *vice versa*, usually goods are sold at normal selling price. For the purpose of consolidation of financial statements, profit on goods received from the other company of the same group but sold away before the balance sheet date raises no problem. But in respect of such goods not yet sold, the unrealised profits are to be eliminated in full as per para 16 of AS 21. This may be done by creating a reserve in respect of total unrealised profit which has not yet been realised. Suppose A Ltd. supplies goods of the invoice value of Rs. 20,000 to B Ltd. (a subsidiary of A Ltd.) of which goods valued at Rs. 8,000 were still in stock of B Ltd. and invoice value was cost plus 25%. The total unrealised profit in the unsold stock of Rs. 8,000 will be Rs. 1,600. Also, unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

Here, the point to be noted is that one has to see whether the intragroup transaction is "upstream" or "down stream". **Upstream transaction** is a transaction in which the subsidiary company sells goods to holding company. While in the **downstream transaction** holding company is the seller and subsidiary company is the buyer. In the case of upstream transaction, goods are sold by the subsidiary to holding company; profit is made by the subsidiary company, which is ultimately shared by the holding company and the minority shareholders. In such a transaction, if some goods remain unsold at the balance sheet date, the unrealized profit on such goods should be eliminated from minority interest as well as from consolidated profit on the basis of their share holding besides deducting the same from unsold stock. But in the case of downstream transaction the whole profit is earned by the holding company, therefore whole unrealized profit should be adjusted from unsold stock account and consolidated profit and loss account only.

### 2.9 PREPARATION OF CONSOLIDATED PROFIT AND LOSS ACCOUNT

Preparation of Consolidated Profit and Loss Account of holding company and its subsidiaries is not very difficult. All the revenue items are to be added on line by line basis and from the consolidated revenue items inter-company transactions should be eliminated.

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For example, a holding company may sell goods or services to its subsidiary, receives consultancy fees, commission, royalty etc. These items are included in sales and other income of the holding company and in the expense items of the subsidiary. Alternatively, the subsidiary may also sell goods or services to the holding company. These inter-company transactions are to be eliminated in full.

If there remains any unrealised profit in the stock of good, of any of the Group Company, such unrealised profit is to be eliminated from the value of stock to arrive at the consolidated profit.

Also it is necessary to eliminate the share of holding company in the proposed dividend of the subsidiary. See Illustrations 10, 11 to understand the technique of preparation of the consolidated profit and loss account.

### Illustration 10

Given below are the Profit & Loss Account of H Ltd. and its subsidiary Ltd. for the year ended 31st March, 2006.

|                                   | H Ltd.<br>(Rs. in lacs) | S Ltd.<br>(Rs. in lacs) |
|-----------------------------------|-------------------------|-------------------------|
| <i>Incomes:</i>                   |                         |                         |
| Sales and other income            | 5,000                   | 1,000                   |
| Increase in stock                 | <u>1,000</u>            | <u>200</u>              |
|                                   | <u>6,000</u>            | <u>1,200</u>            |
| <i>Expenses:</i>                  |                         |                         |
| Raw material consumed             | 800                     | 200                     |
| Wages and Salaries                | 800                     | 150                     |
| Production expenses               | 200                     | 100                     |
| Administrative Expenses           | 200                     | 100                     |
| Selling and Distribution Expenses | 200                     | 50                      |
| Interest                          | 100                     | 50                      |
| Depreciation                      | <u>100</u>              | <u>50</u>               |
|                                   | <u>2,400</u>            | <u>700</u>              |
| Profit before tax                 | 3,600                   | 500                     |
| Provision for tax                 | <u>1,200</u>            | <u>200</u>              |
| Profit after tax                  | 2,400                   | 300                     |
| Proposed dividend                 | <u>1,200</u>            | <u>150</u>              |
| Balance of Profit                 | 1,200                   | 150                     |

### Other Information:

H Ltd. sold goods to S Ltd. of Rs. 120 lacs at cost plus 20%. Stock of S Ltd. includes such

## 5.28 Financial Reporting

goods valuing Rs. 24 lacs. Administrative Expenses of S Ltd. include Rs. 5 lacs paid to H Ltd. as consultancy fees. Selling and Distribution expenses of H Ltd. include Rs.10 lacs paid to S Ltd. as commission.

H Ltd. holds 80% of equity share capital of Rs. 1,000 lacs in S Ltd. H Ltd. took credit to its Profit and Loss Account, the proportionate amount of dividend declared and paid by S Ltd. for the year 2004-2005.

### Solution

#### Consolidated Profit & Loss Account of H Ltd. and its subsidiary S Ltd. for the year ended on 31st March, 2006

|                                                              | <i>Rs. in Lacs</i> | <i>Rs. in Lacs</i> |
|--------------------------------------------------------------|--------------------|--------------------|
| <b>Income</b>                                                |                    |                    |
| Sales and other income                                       |                    |                    |
| H Ltd.                                                       | 5,000              |                    |
| S Ltd.                                                       | <u>1,000</u>       |                    |
|                                                              | 6,000              |                    |
| Less: Inter-company Sales                                    | (120)              |                    |
| Consultancy fees received by H Ltd. from S Ltd.              | (5)                |                    |
| Commission received by S Ltd. from H Ltd.                    | <u>(10)</u>        | 5,865              |
| Increase in Stock                                            |                    |                    |
| H Ltd.                                                       | 1,000              |                    |
| S Ltd.                                                       | <u>200</u>         |                    |
|                                                              | 1,200              |                    |
| Less: Unrealised profits Rs. 24 lacs $\times \frac{20}{120}$ | <u>(4)</u>         | <u>1,196</u>       |
|                                                              |                    | 7,061              |
| <b>Expenses</b>                                              |                    |                    |
| Raw Material:                                                |                    |                    |
| H Ltd.                                                       | 800                |                    |
| S Ltd.                                                       | <u>200</u>         |                    |
|                                                              | 1,000              |                    |
| Less: Purchases by S Ltd. from H Ltd.                        | <u>(120)</u>       | 880                |
| Wages and Salaries:                                          |                    |                    |
| H Ltd.                                                       | 800                |                    |
| S Ltd.                                                       | <u>150</u>         | 950                |

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|                                                                      |              |              |
|----------------------------------------------------------------------|--------------|--------------|
| Direct Expenses                                                      |              |              |
| H Ltd.                                                               | 200          |              |
| S Ltd.                                                               | <u>100</u>   | 300          |
| Administrative Expenses                                              |              |              |
| H Ltd.                                                               | 200          |              |
| S Ltd.                                                               | <u>100</u>   |              |
|                                                                      | 300          |              |
| Less: Consultancy fees received by H Ltd. from S Ltd.                | <u>(5)</u>   | 295          |
| Selling and Distribution Expenses:                                   |              |              |
| H Ltd.                                                               | 200          |              |
| S Ltd.                                                               | <u>50</u>    |              |
|                                                                      | 250          |              |
| Less: Commission received from S Ltd. from H Ltd.                    | <u>(10)</u>  | 240          |
| Interest:                                                            |              |              |
| H Ltd.                                                               | 100          |              |
| S Ltd.                                                               | <u>50</u>    | 150          |
| Depreciation:                                                        |              |              |
| H Ltd.                                                               | 100          |              |
| S Ltd.                                                               | <u>50</u>    | <u>150</u>   |
|                                                                      |              | <u>2,965</u> |
| Profit before tax                                                    |              | 4,096        |
| Provision for tax                                                    |              |              |
| H Ltd.                                                               | 1,200        |              |
| S. Ltd.                                                              | <u>200</u>   | <u>1,400</u> |
| Profit after tax                                                     |              | 2,696        |
| Proposed dividend                                                    |              |              |
| H Ltd.                                                               | 1,200        |              |
| S Ltd.                                                               | <u>150</u>   |              |
|                                                                      | 1,350        |              |
| Less: Share of H Ltd. in proposed dividend of S Ltd.                 |              |              |
| 80% of Rs. 150 lacs                                                  | <u>(120)</u> | <u>1,230</u> |
| Profit to be transferred to consolidated balance sheet               |              | <u>1,466</u> |
| It is assumed that H Ltd. acquired shares in S Ltd. before 2004-2005 |              |              |

### 5.30 Financial Reporting

**Note:** Since the amount of dividend received by H Ltd. for the year 2004-2005 is not given, it has not been deducted from 'sales and other income' in consolidated profit and loss account and not added to consolidated opening retained earnings (which is also not given).

#### Illustration 11

The Trial Balances of H Ltd. and S Ltd. as on 31st December 2005 were as under:

|                             | H Ltd.           |                   | S Ltd.           |                   |
|-----------------------------|------------------|-------------------|------------------|-------------------|
|                             | Dr.              | Cr.               | Dr.              | Cr.               |
|                             | Rs.              | Rs                | Rs.              | Rs.               |
| Equity Share Capital        |                  |                   |                  |                   |
| (Share of Rs. 100 each)     |                  | 10,00,000         |                  | 2,00,000          |
| 7% Preference Share Capital |                  |                   |                  |                   |
| (Share of Rs. 100 each)     |                  | —                 |                  | 2,00,000          |
| Reserves                    |                  | 3,00,000          |                  | 1,00,000          |
| 6% Debentures               |                  | 2,00,000          |                  | 2,00,000          |
| Sundry Debtors/Creditors    | 80,000           | 90,000            | 50,000           | 60,000            |
| P&L A/c balance             |                  | 20,000            |                  | 15,000            |
| Purchases/Sales             | 5,00,000         | 9,00,000          | 6,00,000         | 9,50,000          |
| Wages & Salaries            | 1,00,000         | —                 | 1,50,000         |                   |
| Debenture Interest          | 12,000           |                   | 12,000           |                   |
| General Expenses            | 80,000           |                   | 60,000           |                   |
| Preference-Dividend         |                  |                   |                  |                   |
| up to 30.6.2005             |                  | 3,500             | 7,000            |                   |
| Stock (31.12.2005)          | 1,00,000         |                   | 50,000           |                   |
| Cash at Bank                | 13,500           |                   | 6,000            |                   |
| Investment in S Ltd.        | 5,28,000         |                   | —                |                   |
| Fixed Assets                | <u>11,00,000</u> | <u>          </u> | <u>7,90,000</u>  | <u>          </u> |
|                             | <u>25,13,500</u> | <u>25,13,500</u>  | <u>17,25,000</u> | <u>17,25,000</u>  |

Investment in S Ltd. were acquired on 1.4.2005 and consisted of 80% of Equity Capital and 50% of Preference Capital. Depreciation on fixed assets is written off @ 10% p.a. After acquiring control over S Ltd., H Ltd. supplied to it goods at cost plus 20%, the total invoice value of such goods being Rs. 60,000; 1/4 of such goods was still in stock at the end of the year.

Prepare the Consolidated Profit and Loss Account for the year ended on 31st December, 2005.

**Solution**

**Consolidated Profit and Loss Account of H Ltd. and S Ltd.  
for the year ended 31st December, 2005**

|                                                                          | H Ltd.<br>Rs.   | S Ltd.<br>Rs.   | Adjustments<br>Rs. | Total<br>Rs.     |
|--------------------------------------------------------------------------|-----------------|-----------------|--------------------|------------------|
| <i>Credit Side</i>                                                       |                 |                 |                    |                  |
| By Sales                                                                 | 9,00,000        | 9,50,000        | 60,000             | 17,90,000        |
| By Dividend                                                              | 3,500           | —               | 3,500              | —                |
| By Dividend Receivable                                                   | <u>3,500</u>    | <u>—</u>        | <u>3,500</u>       | <u>—</u>         |
|                                                                          | <u>9,07,000</u> | <u>9,50,000</u> | <u>67,000</u>      | <u>17,90,000</u> |
| <i>Debit Side</i>                                                        |                 |                 |                    |                  |
| To Purchases (Adjusted)                                                  | 5,00,000        | 6,00,000        | 60,000             | 10,40,000        |
| To Wages and Salaries                                                    | 1,00,000        | 1,50,000        | —                  | 2,50,000         |
| To Debenture Interest                                                    | 12,000          | 12,000          | —                  | 24,000           |
| To General Expenses                                                      | 80,000          | 60,000          | —                  | 1,40,000         |
| To Depreciation                                                          | 1,10,000        | 79,000          | —                  | 1,89,000         |
| To Preference Dividend                                                   | —               | 7,000           | 3,500              | 3,500            |
| To Preference Dividend Payable                                           | —               | 7,000           | 3,500              | 3,500            |
| To Net Profit                                                            | <u>1,05,000</u> | <u>35,000</u>   | <u>—</u>           | <u>1,40,000</u>  |
|                                                                          | <u>9,07,000</u> | <u>9,50,000</u> | <u>67,000</u>      | <u>17,90,000</u> |
| To Minority Interest 1/5 of Rs. 35,000                                   |                 | 7,000           |                    | 7,000            |
| To Capital Reserve*                                                      |                 | 7,000           |                    | 7,000            |
| To Investment A/c- dividend<br>for 3 months (prior to<br>acquisition)    | 1,750           |                 |                    | 1,750            |
| To Stock Reserve $\left[ \frac{60,000}{4} \times \frac{20}{120} \right]$ | 2,500           |                 |                    | 2,500            |
| To Profit for the year                                                   | <u>1,00,750</u> | <u>21,000</u>   |                    | <u>1,21,750</u>  |
|                                                                          | <u>1,05,000</u> | <u>35,000</u>   |                    | <u>1,40,000</u>  |

**2.10 PREPARATION OF CONSOLIDATED CASH FLOW STATEMENT**

A holding company has to prepare a consolidated cash flow statement if it is required to prepare cash flow statement. Even when a holding company is preparing cash flow statement for the first time, it is required to prepare consolidated cash flow statement. Same as

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\* Capital Reserve is made up of 3 month's profit upto 1.4.2005 i.e.  $\frac{1}{4} \times 35,000 \times 80/100$ .

### 5.32 Financial Reporting

Consolidated Profit and Loss account, the preparation of consolidated Cash flow statement is also not difficult. All the items of Cash flow from operating activities, investing activities and financing activities are to be added on line by line basis and from the consolidated items, inter-company transactions should be eliminated. Below given is the Consolidated Cash Flow Statement with hypothetical figures:

| <b>Consolidated Cash Flow Statement</b>        |                         |                  |              |
|------------------------------------------------|-------------------------|------------------|--------------|
|                                                | <i>(Rs. in million)</i> |                  |              |
|                                                | <i>A Company</i>        | <i>B Company</i> | <i>Total</i> |
| <b>Cash Flow From Operating Activities</b>     |                         |                  |              |
| Change in Reserve                              | 8                       | 2                | 10           |
| Change in P & L A/c                            | 0                       | 1                | 1            |
| Proposed Dividend                              | 22                      |                  | 22           |
| Tax Provision                                  | 20                      | 1                | 21           |
| Depreciation                                   | 10                      | 5                | 15           |
| Interest                                       | <u>-10</u>              | <u>10</u>        | <u>0</u>     |
|                                                | 50                      | 19               | 69           |
| Less: Tax payment                              | <u>-20</u>              | <u>-1</u>        | <u>-21</u>   |
|                                                | 30                      | 18               | 48           |
| Working Capital Adjustment                     | <u>-13</u>              | <u>12</u>        | <u>-1</u>    |
| (A)                                            | <u>17</u>               | <u>30</u>        | <u>47</u>    |
| <b>Cash Flow from Investment Activities</b>    |                         |                  |              |
| Sale of fixed assets                           | 30                      | 0                | 30           |
| Purchase of fixed assets                       | <u>-30</u>              | <u>-20</u>       | <u>-50</u>   |
| (B)                                            | <u>0</u>                | <u>-20</u>       | <u>-20</u>   |
| <b>Cash Flow from Financing Activities (C)</b> | <u>-22</u>              | <u>-10</u>       | <u>-32</u>   |
| Net cash flows (A+B+C)                         | <u>-5</u>               | <u>0</u>         | <u>-5</u>    |

### 2.11 ACQUISITION OF INTEREST IN SUBSIDIARY AT DIFFERENT DATES

Often a holding company acquires a subsidiary in steps. As per para 15 of AS 21, "If an enterprise makes two or more investments in another enterprise at different dates and eventually obtains control of the other enterprise, the consolidated financial statements are presented only from the date on which holding-subsidiary relationship comes in existence. If two or more investments are made over a period of time, the equity of the subsidiary at the date of investment, is generally determined on a step-by-step basis; however, if small investments are made over a period of time and then an investment is made that results in control, the date of the latest investment, as a practicable measure, may be considered as



the date of investment.

### Illustration 12

H Ltd. acquired 20% shares in S Ltd. on 1-7-2005 for Rs.50 million, then another 20% on 1-10-2005 for Rs.60 million and finally, another 20% on 1-11-2005 for Rs.80 million. S Ltd. became subsidiary of H Ltd. on and from 1-1-2005. Balance of Reserve of S Ltd. as on 1-4-2005 (Rs. in million) 60.

### Balance Sheets of H Ltd. and S Ltd. as on 31-3-2006

|                                | <i>Rs. in Million</i> |                   |
|--------------------------------|-----------------------|-------------------|
|                                | <b>H Ltd.</b>         | <b>S Ltd.</b>     |
| Equity Share Capital           | 500                   | 200               |
| General Reserve                | 400                   | 120               |
| Profit & Loss A/c              | <u>10</u>             | <u>12</u>         |
| <b>Sources</b>                 | <b><u>910</u></b>     | <b><u>332</u></b> |
| Fixed Assets                   |                       |                   |
| Gross Block                    | 800                   | 350               |
| Less: Accumulated Depreciation | <u>100</u>            | <u>30</u>         |
| Net Block                      | 700                   | 320               |
| Investments                    | 190                   |                   |
| Net Current Assets             | <u>20</u>             | <u>12</u>         |
| <b>Applications</b>            | <b><u>910</u></b>     | <b><u>332</u></b> |

### Solution

In this case goodwill paid in acquiring cost of control should be computed step by step basis:

| <b>Goodwill</b>                     | <b>1-7-2005</b>       | <b>1-10-2005</b> | <b>1-11-2005</b> | <b>Total</b> | <b>Minority Interest</b> |
|-------------------------------------|-----------------------|------------------|------------------|--------------|--------------------------|
|                                     | <i>Rs. In million</i> |                  |                  |              |                          |
| Cost of investments (A)             | <u>50</u>             | <u>60</u>        | <u>80</u>        | <u>190</u>   |                          |
| Book Value of Investments:          |                       |                  |                  |              |                          |
| Equity Share Capital                | 40                    | 40               | 40               | 120.00       | 80                       |
| General Reserve 1-4-2005            | 12                    | 12               | 12               | 36.00        | 24                       |
| Pre-acquisition profit of 2005-2006 | <u>3.6</u>            | <u>7.2</u>       | <u>8.40</u>      | <u>19.20</u> |                          |

### 5.34 Financial Reporting

|                                            |              |             |              |               |
|--------------------------------------------|--------------|-------------|--------------|---------------|
| (B)                                        | <u>55.6</u>  | <u>59.2</u> | <u>60.40</u> | <u>175.20</u> |
| Cost of Control (A-B)                      | <u>-5.60</u> | <u>0.80</u> | <u>19.60</u> | <u>14.80</u>  |
| 20% of post-acquisition reserve and profit |              |             |              | <u>28.80</u>  |
|                                            |              |             |              | <u>132.80</u> |

(Rs. in million)

|                                |           |
|--------------------------------|-----------|
| Consolidated Profit & Loss a/c |           |
| Balance of P & L A/c of H Ltd. | 10        |
| Share of current reserve       | <u>24</u> |
|                                | <u>34</u> |

#### Consolidated Balance Sheet

Rs. in Million

|                                |               |
|--------------------------------|---------------|
| Equity Share Capital           | 500.0         |
| General Reserve                | 400.0         |
| Profit & Loss A/c              | 34.0          |
| Minority Interest              | <u>132.8</u>  |
| Sources                        | <u>1066.8</u> |
| Fixed Assets                   |               |
| Gross Block                    | 1150.0        |
| Less: Accumulated Depreciation | <u>130.0</u>  |
| Net Block                      | 1020.0        |
| Consolidation Goodwill         | 14.8          |
| Net Current Assets             | <u>32.0</u>   |
| Applications                   | <u>1066.8</u> |

Another situation may be that a parent company increases or decreases its stake in the subsidiary. For example, H Ltd. Acquired 70% of the equity shares in S Ltd. It further acquires 10% of the equity shares subsequently or sells 10% of the equity shares. In both the cases step by step method should be followed for measuring goodwill/capital reserve.

#### Illustration 13

H Ltd. acquired 70% shares in S Ltd. on 1-4-2005 for Rs.200 million, then acquired another 20% on 1-10-2005 for Rs.60 million S Ltd. became subsidiary of H Ltd. on and from 1-4-2005. Balance of Reserve of S Ltd. as on 1-4-2005 Rs.60 million.

**Balance Sheets of H Ltd. and S Ltd. as on 31-3-2006**

|                          | <i>Rs. in Million</i> |                   |
|--------------------------|-----------------------|-------------------|
|                          | <b>H Ltd.</b>         | <b>S. Ltd.</b>    |
| Equity Share Capital     | 500                   | 200               |
| General Reserve          | 400                   | 120               |
| Profit & Loss A/c        | <u>10</u>             | <u>12</u>         |
| <b>Sources</b>           | <b><u>910</u></b>     | <b><u>332</u></b> |
| Fixed Assets             |                       |                   |
| Gross Block              | 800                   | 350               |
| Accumulated Depreciation | <u>100</u>            | <u>30</u>         |
| Net Block                | 700                   | 320               |
| Investments              | 190                   |                   |
| Net Current Assets       | <u>20</u>             | <u>12</u>         |
| <b>Applications</b>      | <b><u>910</u></b>     | <b><u>332</u></b> |

**Solution:**

|                                             | <b>1-4-2005</b>       | <b>1-10-2005</b> | <b>Total</b> | <b>Minority Interest</b> |
|---------------------------------------------|-----------------------|------------------|--------------|--------------------------|
|                                             | <i>Rs. in million</i> |                  |              |                          |
| <b>Goodwill</b>                             |                       |                  |              |                          |
| Cost of investments (A)                     | <u>200</u>            | <u>60</u>        | <u>260</u>   |                          |
| Book Value of Investments:                  |                       |                  |              |                          |
| Equity Share Capital                        | 140                   | 40               | 180          | 20                       |
| General Reserve 1-4-2005                    | 42                    | 12               | 54           | 6                        |
| Pre-acquisition profit for 2005-2006        | <u>0</u>              | <u>7.2</u>       | <u>7.2</u>   | <u>7.2</u>               |
| (B)                                         | <u>182</u>            | <u>59.2</u>      | <u>241.2</u> | <u>33.20</u>             |
| Goodwill (A-B)                              |                       |                  | 18.8         |                          |
| Post acquisition profit (Rs. in Million)    |                       |                  |              |                          |
| Balance of H Ltd.                           |                       |                  |              | 10.0                     |
| Share of Profit of S Ltd.                   |                       |                  |              | <u>57.6</u>              |
|                                             |                       |                  |              | <u>67.6</u>              |
| Consolidated Balance Sheet (Rs. in Million) |                       |                  |              |                          |
| Equity Share Capital                        |                       |                  |              | 500.0                    |
| General Reserve                             |                       |                  |              | 400.0                    |
| Profit & Loss a/c                           |                       |                  |              | 67.6                     |
| Minority Interest                           |                       |                  |              | <u>33.2</u>              |

### 5.36 Financial Reporting

|                          |               |
|--------------------------|---------------|
| <b>Sources</b>           | <u>1000.8</u> |
| Fixed Assets             |               |
| Gross Block              | 950.0         |
| Accumulated Depreciation | <u>130.0</u>  |
| Net Block                | 820.0         |
| Consolidation Goodwill   | 18.8          |
| Net Current Assets       | <u>162.0</u>  |
| Applications             | <u>1000.8</u> |

### 2.12 UNIFORM ACCOUNTING POLICIES

Consolidation should be done using uniform accounting policies. If any company in the same group uses accounting policies other than those adopted in consolidated financial statements for like transactions and events in similar circumstances, necessary adjustments should be made. However where such adjustments cannot be made, the fact should be disclosed together with the proportions of items to which different accounting policies have been applied. For example, if the subsidiary company follows LIFO method for valuation of inventories and the holding company follows FIFO method, the financial statement of subsidiary company should be restated by adjusting the value of inventories to bring the same in line with the valuation procedure adopted by the holding company. Then only consolidation can be considered.

#### Illustration 12

Consider the following balance sheets of subsidiary B Ltd.:

|                               | 2004             | 2005             |                        | 2004             | 2005             |
|-------------------------------|------------------|------------------|------------------------|------------------|------------------|
|                               | Rs.              | Rs.              |                        | Rs.              | Rs.              |
| Share-Capital                 |                  |                  | <i>Fixed Assets</i>    |                  |                  |
| Issued & subscribed           |                  |                  | Cost                   | 3,20,000         | 3,20,000         |
| 5,000 equity shares           |                  |                  | Less: Accumulated      |                  |                  |
| of Rs. 100 each               | 5,00,000         | 5,00,000         | depreciation           | <u>48,000</u>    | <u>96,000</u>    |
| <i>Reserves &amp; Surplus</i> |                  |                  |                        | 2,72,000         | 2,24,000         |
| Revenue reserves              | 2,86,000         | 7,14,000         | <i>Investments</i>     |                  |                  |
| Current Liabilities &         |                  |                  | at cost                | —                | 4,00,000         |
| Provisions:                   |                  |                  | <i>Current Assets:</i> |                  |                  |
| Sundry Creditors              | 4,90,000         | 4,94,000         | Stock                  | 5,97,000         | 7,42,000         |
| Bank overdraft                | —                | 1,70,000         | Sundry Debtors         | 5,94,000         | 8,91,000         |
| Provision for taxation        | 3,10,000         | 4,30,000         | Prepaid Expenses       | 72,000           | 48,000           |
|                               |                  |                  | Cash at Bank           | <u>51,000</u>    | <u>3,000</u>     |
|                               | <u>15,86,000</u> | <u>23,08,000</u> |                        | <u>15,86,000</u> | <u>23,08,000</u> |

Consider also the following information:

- (a) B Ltd. is a subsidiary of A Ltd. Both the companies follow calendar year as the accounting year.

- (b) A Ltd. values stocks on LIFO basis while B Ltd. used FIFO basis. To bring B Ltd.'s values in line with those of A Ltd. its value of stock is required to be reduced by Rs. 12,000 at the end of 2004 and Rs. 34,000 at the end of 2005.
- (c) Both the companies use straight-line method of depreciation. However A Ltd. charges depreciation @ 10%.
- (d) B Ltd. deducts 1% from sundry debtors as a general provision against doubtful debts.
- (e) Prepaid expenses in B Ltd. include advertising expenditure carried forward of Rs. 60,000 in 2004 and Rs. 30,000 in 2005, being part of initial advertising expenditure of Rs. 90,000 in 2004 which is being written off over three years. Similar amount of advertising expenditure of A Ltd. has been fully written off in 2004.

Restate the balance sheet of B Ltd. as on 31st December, 2005 after considering the above information for the purpose of consolidation. Such restatement is necessary to make the accounting policies adopted by A Ltd. and B Ltd. uniform:

**Solution**

**Adjusted revenue reserves of B Ltd.:**

|                                                 | Rs.           | Rs.             |
|-------------------------------------------------|---------------|-----------------|
| Revenue reserves as given                       |               | 7,14,000        |
| Add: Depreciation over charged (Rs. 16,000 × 2) | 32,000        | —               |
| Provision for doubtful debts                    | <u>9,000</u>  | <u>41,000</u>   |
|                                                 |               | 7,55,000        |
| Less: Reduction in stock-in-trade               | 34,000        |                 |
| Advertising expenditure to be written off       | <u>30,000</u> | <u>64,000</u>   |
| Adjusted revenue reserve                        |               | <u>6,91,000</u> |

**Restated Balance Sheet of B Ltd.**

**As on 31st December, 2005**

|                              | Rs.      |                        | Rs.           |
|------------------------------|----------|------------------------|---------------|
| <i>Share Capital</i>         |          | <i>Fixed Assets</i>    |               |
| 5,000 Equity Shares          |          | Cost                   | 3,20,000      |
| of Rs. 100 each              | 5,00,000 | Less: Depreciation     |               |
| <i>Reserves and surplus:</i> |          | to date                | <u>64,000</u> |
| Revenue reserves             | 6,91,000 |                        | 2,56,000      |
| <i>Current Liabilities</i>   |          | <i>Investments</i>     | 4,00,000      |
| <i>and provisions:</i>       |          | <i>Current Assets:</i> |               |
| Sundry Creditors             | 4,94,000 | Stock                  | 7,08,000      |
| Bank overdraft               | 1,70,000 | Sundry Debtors         | 9,00,000      |

### 5.38 Financial Reporting

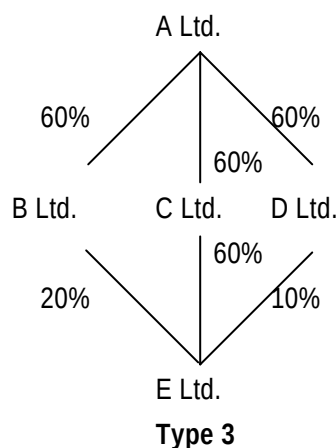
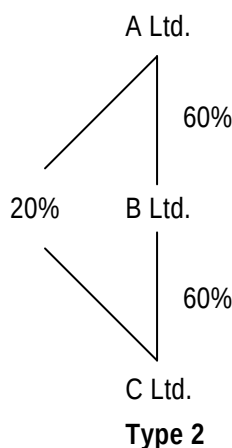
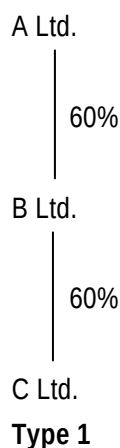
|                        |                   |                  |                  |
|------------------------|-------------------|------------------|------------------|
| Provision for taxation | 4,30,000          | Prepaid expenses | 18,000           |
|                        | <u>          </u> | Cash at Bank     | <u>3,000</u>     |
|                        | <u>22,85,000</u>  |                  | <u>22,85,000</u> |

### 2.13 CHAIN HOLDING

Suppose that Company B is subsidiary of Company A and Company C is subsidiary of Company B.

By virtue of Section 4(1)(c) of the Companies Act, 1956 C becomes subsidiary of Company A. Popularly, Company C is called sub-subsidiary of Company A and the type of holding mentioned in Section 4(l)(c) is called chain holding. Chain holding may take various forms.

In Type 1 the parent company does not hold any share in the sub-subsidiary. In Type 2 both the parent and subsidiary hold shares of sub-subsidiary. In Type 3 more than one subsidiaries of the parent company hold shares in the sub-subsidiary. There may be different other types of chain holding.



#### 2.13.1 Treatment of Capital Profit of Sub-subsidiary in the Consolidation Process:

There are two approaches, namely, direct method and indirect method. Capital Profit of the sub-subsidiary should be firstly apportioned between minority interest and group interest. The group interest should be taken directly for calculation of goodwill/capital reserve. This is called direct method.

Let us take an example. A Ltd.; holds 60% shares of B Ltd. and 20% shares of C Ltd.; B Ltd. holds 60% shares of C Ltd. Total profit of C Ltd. is Rs. 1,00,000 of which pre-acquisition profit is Rs. 40,000.

As per direct method capital profit (i.e., pre-acquisition profit in this case) should be apportioned as follows:

$$\text{Rs. } 40,000 \times \frac{20}{100} = \text{Rs. } 8,000 \text{ to minorities of C Ltd.}$$

$\text{Rs. } 40,000 \times \frac{80}{100} = \text{Rs. } 32,000$  to the group which is to be considered for calculating goodwill or capital reserve.

For computation of goodwill / capital reserve for the purpose of consolidation, cost of group investments is compared to their face value. Cost of investments should be arrived at after adjusting pre-acquisition profit/loss relating to such investments. So direct approach appears to be more logical.

In the indirect approach, pre-acquisition profit/loss is apportioned among minorities of the sub-subsidiaries and to the respective group companies. From the shares of respective group companies, their minority interests are deducted and the parent company gets its indirect shares. In the example given above A Ltd.'s direct shares to C Ltd.; is to the extent of 20% and indirect through B Ltd. is 60% of 60% i.e. 36%. So while computing goodwill or capital reserve for the purpose of consolidation (only 20% + 36%) i.e. 56% of the capital profit of C Ltd. is considered. In other words, the calculation will be as follows:

$$\text{Rs. } 40,000 \times \frac{20}{100} = \text{Rs. } 8,000 \text{ to minorities of C Ltd.}$$

$$\text{Rs. } 40,000 \times \frac{20}{100} = \text{Rs. } 8,000 \text{ to A Ltd.}$$

$$\text{Rs. } 40,000 \times \frac{60}{100} = \text{Rs. } 24,000 \text{ to B Ltd.}$$

Out of B Ltd.'s share of Rs.24,000 A Ltd. will get 60%. This means A Ltd.'s indirect share in capital profit of C Ltd. is  $\text{Rs. } 24,000 \times 60\%$  i.e. Rs.14,400. In total Rs.22,400 (14,400 + 8,000) is to be taken for computation for goodwill/capital reserve. This comes to 56% of Rs.40,000.

### Illustration 13

Prepare the Consolidated Balance Sheet as on December 31, 2006 of group of companies A Ltd., B Ltd. and C Ltd. Their balance sheets on that date are given below:

| <i>Liabilities</i>                    | <b>A Ltd.</b>          | <b>B Ltd.</b>          | <b>C Ltd.</b>        |
|---------------------------------------|------------------------|------------------------|----------------------|
|                                       | <i>Rs.</i>             | <i>Rs.</i>             | <i>Rs.</i>           |
| Share Capital (share of Rs. 100 each) | 1,25,000               | 1,00,000               | 60,000               |
| Reserves                              | 18,000                 | 10,000                 | 7,200                |
| Profit & Loss A/c                     | 16,000                 | 4,000                  | 5,000                |
| Sundry Creditors                      | 7,000                  | 3,000                  | —                    |
| A Ltd.                                | —                      | 7,000                  | —                    |
| C Ltd.                                | 3,300                  | —                      | —                    |
| <b>Total</b>                          | <b><u>1,69,300</u></b> | <b><u>1,24,000</u></b> | <b><u>72,200</u></b> |

## 5.40 Financial Reporting

### Assets

|                        |                 |                 |               |
|------------------------|-----------------|-----------------|---------------|
| Fixed Assets           | 28,000          | 55,000          | 37,400        |
| Investments in shares- |                 |                 |               |
| B Ltd.                 | 85,000          | —               | —             |
| C Ltd.                 | —               | 53,000          | —             |
| Stocks                 | 22,000          | 6,000           | —             |
| B Ltd.                 | 8,000           | —               | —             |
| Debtors                | 26,300          | 10,000          | 31,500        |
| A Ltd.                 | —               | —               | 3,300         |
| Total                  | <u>1,69,300</u> | <u>1,24,000</u> | <u>72,200</u> |

### Other information:

- (i) A Ltd. holds 750 shares in B Ltd. and B Ltd. holds 400 shares in C Ltd. These holdings were acquired on 30th June, 2006.
- (ii) On 1st January, 2006 the following balances stood in the books of B Ltd. and C Ltd.

|               | B Ltd. | C Ltd. |
|---------------|--------|--------|
|               | Rs.    | Rs.    |
| Reserves      | 8,000  | 6,000  |
| P & L Account | 1,000  | 1,000  |

- (iii) C Ltd., sold goods costing Rs. 2,500 to B Ltd. for Rs. 3,100. These goods still remain unsold.

### Solution

#### Workings Notes:

#### (1) Analysis of Profits:

| C Ltd.                             | Capital Profit | Revenue Reserve | Revenue Profit |
|------------------------------------|----------------|-----------------|----------------|
|                                    | Rs.            | Rs.             | Rs.            |
| Reserve on 1.1.2006                | 6,000          | —               | —              |
| Additional Reserve created in 2006 | 600            | 600             | —              |
| P & L A/c, Balance on 1.1.2006     | 1,000          | —               | —              |
| Profit for 2006                    | <u>2,000</u>   | <u>—</u>        | <u>2,000</u>   |
|                                    | 9,600          | 600             | 2,000          |
| Due to outsiders, 1/3              | <u>3,200</u>   | <u>200</u>      | <u>667</u>     |
| Share of B Ltd. (2/3)              | <u>6,400</u>   | <u>400</u>      | <u>1,333</u>   |



**Consolidated Financial Statements of Group Companies      5.41**

**B Ltd.**

|                                    |               |               |               |
|------------------------------------|---------------|---------------|---------------|
| From C Ltd.                        | 6,400*        | 400           | 1,333         |
| Reserve on 1.1.2006                | 8,000         | —             | —             |
| Additional Reserve created in 2006 | 1,000         | 1,000         | —             |
| Profit and Loss A/c:               |               |               |               |
| Balance on 1.1.2006                | 1000          | —             | —             |
| Profit during 2006                 | <u>1,500</u>  | —             | <u>1,500</u>  |
|                                    | 17,900        | 1,400         | 2,833         |
| Due to outsiders (1/4)             | <u>4,475</u>  | 350           | <u>708</u>    |
| Share of A Ltd.                    | <u>13,425</u> | 1,050         | 2,125         |
| <b>A Ltd.</b>                      |               | 18,000        | <u>16,000</u> |
|                                    |               |               | 18,125        |
| Less: Stock Reserve                |               |               | <u>600</u>    |
|                                    |               | <u>19,050</u> | <u>17,525</u> |

**Notes:**

- (i) During 2006 Rs.1,200 has been added to the Reserves of C Ltd., and Rs.2,000 to the Reserves of B Ltd. The profit must have been earned during the whole of the year; hence, half of these figures (i.e., up to 30.6.2006) must be considered as capital pre-acquisition and the remaining revenue.
- (ii) Total unrealised profit is Rs. 600, i.e., Rs. 3,100 less Rs. 2,500.
- (2) Minority Interest:

|                           | <b>B Ltd.</b> | <b>C Ltd.</b> |
|---------------------------|---------------|---------------|
|                           | <i>Rs.</i>    | <i>Rs.</i>    |
| Share Capital             | 25,000        | 20,000        |
| Share of Capital Profits  | 4,475         | 3,200         |
| Share of Revenue Reserves | 350           | 200           |
| Share of Revenue Profits  | <u>708</u>    | <u>667</u>    |
| Total                     | <u>30,533</u> | <u>24,067</u> |
| Grand Total               |               | <u>54,600</u> |

**(3) Cost of Control:**

Amount paid:

|        |               |          |
|--------|---------------|----------|
| A Ltd. | 85,000        |          |
| B Ltd. | <u>53,000</u> | 1,38,000 |

Less: Par value of shares in:

## 5.42 Financial Reporting

|                             |               |                 |
|-----------------------------|---------------|-----------------|
| B Ltd.                      | 75,000        |                 |
| C Ltd.                      | 40,000        |                 |
| Capital Profits*            | <u>13,425</u> | <u>1,28,425</u> |
| Cost of Control* / Goodwill |               | <u>9,575</u>    |

- (4) Since X Ltd. shows Rs. 8,000 against B Ltd. whereas B Ltd., shows only Rs. 7,000 in favour of A Ltd., it must be assumed that B Ltd., has remitted Rs. 1,000 to A Ltd.; not yet received by A Ltd. The amount is in transit.
- (5) If capital profit is increased by Rs. 1,600 cost of control will be Rs. 7,975\*.

### Consolidated Balance Sheet of A Ltd. and its subsidiaries B Ltd. and C Ltd., as on 31st December, 2006

| <i>Liabilities</i>                                | <i>Rs.</i>      | <i>Assets</i>       | <i>Rs.</i>      |
|---------------------------------------------------|-----------------|---------------------|-----------------|
| Share Capital (fully paid shares of Rs. 100 each) | 1,25,000        | Goodwill            | 9,575           |
| Reserves                                          | 19,050          | Fixed Assets        | 1,20,400        |
| Profit and Loss Account                           | 17,525          | Stock               | 28,000          |
| Sundry Creditors                                  | 10,000          | Less: Stock Reserve | <u>600</u>      |
| Minority Interest                                 | <u>54,600</u>   | Debtors             | 67,800          |
|                                                   | <u>2,26,175</u> | Cash in Transit     | <u>1,000</u>    |
|                                                   |                 |                     | <u>2,26,175</u> |

## 2.14 TREATMENT OF SUBSIDIARY COMPANY HAVING PREFERENCE SHARE CAPITAL

If the holding company has some investments in the preference shares of subsidiary, the carrying amount of such investments along with carrying amount of investments in equity shares of subsidiary company should be set off against the holding company's share in the equity of such subsidiary. The difference is treated as goodwill or deferred income. The interest of minority shareholders of the subsidiary company will then include such portion of preference share capital of the subsidiary company which is not held by holding company.

However, if a subsidiary company has cumulative preference shares which are partly held outside the group, the holding company should compute its share of profits or losses of subsidiary after adjusting for the subsidiary's preference dividend attributable to minority

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\* The whole of this amount may preferably be adjusted against cost of control, instead of being added to the profits of B Ltd. Consequently capital profits will increase by Rs. 1,600 with a corresponding reduction in Minority interest. This problem has been solved by following 'indirect approach' as discussed in para 3.11.1. All subsequent illustrations are solved by the following 'direct approach'.

shareholders, whether or not such dividends have been declared.

### 2.15 INTER-COMPANY HOLDINGS

It is possible that the subsidiary company may also hold shares in the holding company the law would permit this only if the subsidiary company had already required the shares when the Companies Act of 1956 came into force or before the holding company acquired the shares in the subsidiary. However the subsidiary company would have no voting rights at a meeting of its holding company.

In such a situation, the calculation of the minority interest would have to be based on the fact that the subsidiary also has a claim on the profits of the holding company. The calculation will have to be made separately for revenue and capital profits since, otherwise, cost of control cannot be ascertained correctly. For the purpose, such profits of the holding company as existed when the subsidiary company acquired the shares should be treated as capital profits. The calculation of the minority interest would involve an algebraical equation shown below.

#### Illustration 14

You are given below the balance sheets of two companies A Ltd. and B Ltd.

Prepare their consolidated Balance Sheet.

| <i>Liabilities</i> | <b>A Ltd.</b>   | <b>B Ltd.</b> | <i>Assets</i> | <b>A Ltd.</b>   | <b>B Ltd.</b>   |
|--------------------|-----------------|---------------|---------------|-----------------|-----------------|
|                    | <i>Rs.</i>      | <i>Rs.</i>    |               | <i>Rs.</i>      | <i>Rs.</i>      |
| Share Capital:     |                 |               | Investment:   |                 |                 |
| (Rs. 100 each)     | 5,00,000        | 2,00,000      | 1,600 shares  |                 |                 |
| Profits:           |                 |               | in B Ltd.     | 2,20,000        |                 |
| Capital profit     | 1,00,000        | 80,000        | 1,000 shares  |                 |                 |
| Revenue profit     | 3,00,000        | 50,000        | in A Ltd.     |                 | 1,50,000        |
| Creditors          | <u>1,50,000</u> | <u>60,000</u> | Sundry Assets | <u>8,30,000</u> | <u>2,40,000</u> |
|                    | 10,50,000       | 3,90,000      |               | 10,50,000       | 3,90,000        |

#### Solution

Suppose:

A = Revenue Profits of A Ltd., and

B = Revenue Profits of B Ltd.

Then,

$$A = 3,00,000 + \frac{4}{5} B$$

#### 5.44 Financial Reporting

$$B = 50,000 + \frac{1}{5} A$$

$$B = 50,000 + \frac{1}{5} (3,00,000 + \frac{4}{5} B) \text{ [Substituting for A]}$$

$$B = 50,000 + 60,000 + \frac{4}{25} B$$

$$B = 1,10,000 + \frac{4}{25} B$$

$$25B = 27,50,000 + 4B$$

$$21B = 27,50,000$$

$$B = 1,30,952$$

Minority interest in Revenue profits is 1/5 of Rs. 1,30,952 or Rs. 26,190. Total revenue profits being Rs. 3,50,000 for A Ltd. and B Ltd together, Rs. 3,23,810 remains for the group.

#### Capital Profits:

$$A = 1,00,000 + \frac{4}{5} B$$

$$B = 80,000 + \frac{1}{5} A$$

$$B = 80,000 + \frac{1}{5} (1,00,000 + \frac{4}{5} B)$$

$$B = 80,000 + 20,000 + \frac{4}{25} B$$

$$B = 1,00,000 + \frac{4}{25} B$$

$$25B = 25,00,000 + 4B$$

$$21B = 25,00,000$$

$$B = 1,19,048$$

Minority Interest @1/5 would be Rs. 23,810.

Total being Rs. 1,80,000 for the group it would be Rs.1,56,190

**Total Minority interest:**

|                          |               |
|--------------------------|---------------|
|                          | Rs.           |
| Shares held by outsiders | 40,000        |
| Revenue Profit           | 26,190        |
| Capital                  | <u>23,810</u> |
|                          | <u>90,000</u> |

**Cost of control :**

|                                         |               |                 |
|-----------------------------------------|---------------|-----------------|
| Amount paid by both companies           |               | 3,70,000        |
| Less : Face Value:                      | Rs.           |                 |
| Shares in B Ltd.                        | 1,60,000      |                 |
| Shares in A Ltd.                        | 1,00,000      |                 |
| Capital Profits (Rs. 1,19,048 – 23,810) | <u>95,238</u> | <u>3,55,238</u> |
| Cost of Control                         |               | <u>14,762</u>   |

*Alternative working note:*

|                                                       | A Ltd.          | B Ltd.          |
|-------------------------------------------------------|-----------------|-----------------|
|                                                       | Rs.             | Rs.             |
| Capital Profits                                       | 1,00,000        | 80,000          |
| Less: Transfer to make B's Capital Profit Rs.1,19,048 | <u>-39,048</u>  | <u>+39,048</u>  |
|                                                       | <u>60,952</u>   | 1,19,048        |
| Minority Interest                                     |                 | <u>23,810</u>   |
| Share of A Ltd.                                       |                 | <u>95,238</u>   |
| Revenue Profits                                       | 3,00,000        | 50,000          |
| Less: Transfer to make B's Profit Rs.1,30,952         | <u>-80,952</u>  | <u>+80,952</u>  |
|                                                       | 2,19,048        | 1,30,952        |
| Less: Minority Interest                               |                 | 26,190          |
| Share of A Ltd.                                       | <u>1,04,762</u> | <u>1,04,762</u> |
|                                                       | <u>3,23,810</u> | <u>1,04,762</u> |

**Consolidated Balance Sheet of A Ltd. and its subsidiary B Ltd.**

**as on 31st December, 2006**

| <i>Liabilities</i>        | Rs. | Rs.      | <i>Assets</i>   | Rs.             | Rs.       |
|---------------------------|-----|----------|-----------------|-----------------|-----------|
| Share Capital (less 1,000 |     |          | Sundry Assets   |                 |           |
| shares held by B Ltd.)    |     | 4,00,000 | A Ltd.          | 8,30,000        |           |
| Capital Profit            |     | 60,952   | B Ltd.          | <u>2,40,000</u> | 10,70,000 |
| Revenue Profit            |     | 3,23,810 | Cost of Control |                 | 14,762    |

## 5.46 Financial Reporting

Creditors

|                   |               |                  |                  |
|-------------------|---------------|------------------|------------------|
| A Ltd.            | 1,50,000      |                  |                  |
| B Ltd.            | <u>60,000</u> | 2,10,000         |                  |
| Minority Interest |               | <u>90,000</u>    |                  |
|                   |               | <u>10,84,762</u> | <u>10,84,762</u> |

## 2.16 DIFFERENT REPORTING DATES

A situation may arise in which the reporting dates of holding company and its subsidiaries are different. In that situation, the subsidiaries often prepare, for consolidation purpose, financial statements as at the same date as the holding company. When such statements cannot be prepared, financial statements drawn upto different reporting dates may be used provided the difference is not greater than six months (para 18 of AS 21). However, adjustments are required to be made for the effects of any significant event or intragroup transactions that occur between those dates and the date of consolidation.

### Illustration 16

Consider the following balance sheets:

|                                          | <b>A Ltd.</b>        | <b>B Ltd.</b>         |                  | <b>A Ltd.</b>        | <b>B Ltd.</b>         |
|------------------------------------------|----------------------|-----------------------|------------------|----------------------|-----------------------|
|                                          | (As on<br>31.3.2006) | (As on<br>31.12.2005) |                  | (As on<br>31.3.2006) | (As on<br>31.12.2005) |
|                                          | Rs.                  | Rs.                   |                  | Rs.                  | Rs.                   |
| Share Capital (Shares<br>of Rs. 10 each) | 10,00,000            | 5,00,000              | Fixed Assets     | 6,50,000             | 4,05,000              |
| Reserves and Surplus                     | 4,50,000             | 2,05,000              | Investment:      |                      |                       |
| Secured Loan:                            |                      |                       | 40,000 Shares    |                      |                       |
| 13% Debentures                           |                      |                       | in B Ltd.        | 8,00,000             | —                     |
| (Rs. 100 each)                           | —                    | 3,00,000              | 1,000 Debentures |                      |                       |
| Current Liabilities:                     |                      |                       | in B Ltd.        | 1,50,000             | —                     |
| Creditors                                | 3,80,000             | 80,000                | Current Assets:  |                      |                       |
| Other liabilities                        | 2,00,000             | 40,000                | Stock            | 2,00,000             | 3,50,000              |
|                                          |                      |                       | Debtors          | 1,50,000             | 2,65,000              |
|                                          |                      |                       | Cash and Bank    | <u>80,000</u>        | <u>1,05,000</u>       |
|                                          | <u>20,30,000</u>     | <u>11,25,000</u>      |                  | <u>20,30,000</u>     | <u>11,25,000</u>      |

On 5th January 2006, certain stocks of B Ltd. costing Rs. 20,000 were completely destroyed by fire. The insurance company paid 75% of the claim. On 20th January, 2006, A Ltd. sold goods to B Ltd. costing Rs. 1,50,000 at an invoice price of cost plus 20%. 50% of those goods were resold by B Ltd. to A Ltd. within 31st March, 2006 (these were then sold by A Ltd.

to a third party before 31st March, 2006). As on 31st March, 2006, B Ltd. owes Rs. 60,000 to A Ltd. in respect of those goods. Pre-acquisition profits of B Ltd. were Rs.75,000.

Prepare consolidated balance sheet as on 31st March, 2006 after making necessary adjustments in the balance sheet of B Ltd.

**Solution**

**(i) Adjustments to be made in the balance sheet items of B Ltd.:**

*Assets side*

|                                                       |                 |
|-------------------------------------------------------|-----------------|
| Stocks:                                               | Rs.             |
| As given on 31.12.2005                                | 3,50,000        |
| Add : Unsold stock out of goods purchased from A Ltd. | <u>90,000</u>   |
|                                                       | 4,40,000        |
| Less: Loss of stock by fire                           | <u>20,000</u>   |
|                                                       | <u>4,20,000</u> |
| Cash & Bank balance:                                  |                 |
| As given on 31.12.2005                                | 1,05,000        |
| Add: Insurance claim received                         | <u>15,000</u>   |
|                                                       | <u>1,20,000</u> |

*Liabilities side:*

|                                                      |                 |
|------------------------------------------------------|-----------------|
| Creditors:                                           |                 |
| As given on 31.12.2005                               | 80,000          |
| Add: Owings to A Ltd. on 31.3.2006                   | <u>60,000</u>   |
|                                                      | <u>1,40,000</u> |
| Reserves and Surplus:                                |                 |
| As given on 31.12.2005                               | 2,05,000        |
| Less: Abnormal Loss on goods destroyed               | <u>5,000</u>    |
|                                                      | 2,00,000        |
| Add: Profit from sale of goods purchased from A Ltd. | <u>30,000</u>   |
|                                                      | <u>2,30,000</u> |

**(ii) Goodwill / capital reserve on consolidation :**

|                                                      |                 |                 |
|------------------------------------------------------|-----------------|-----------------|
|                                                      | Rs.             | Rs.             |
| Amount paid for 40,000 Shares                        | 8,00,000        |                 |
| Amount paid for 1,000 Debentures                     | <u>1,50,000</u> | 9,50,000        |
| Less: Nominal value of proportionate share capital   | 4,00,000        |                 |
| Nominal value of proportionate 13% debentures        | 1,00,000        |                 |
| Share of pre-acquisition profits (80% of Rs. 75,000) | <u>60,000</u>   | <u>5,60,000</u> |
| Goodwill                                             |                 | <u>3,90,000</u> |

## 5.48 Financial Reporting

### (iii) Minority Interest:

|                                                                 |                 |
|-----------------------------------------------------------------|-----------------|
|                                                                 | Rs.             |
| Paid up value of 10,000 shares                                  | 1,00,000        |
| Add : 20% of Reserves & Surplus of B Ltd. (20% of Rs. 2,30,000) | <u>46,000</u>   |
|                                                                 | <u>1,46,000</u> |

### (iv) Reserves and Surplus of A Ltd.:

|                                                                    |                 |
|--------------------------------------------------------------------|-----------------|
| Balance as on 31.3.2006                                            | 4,50,000        |
| Add : Share of revenue reserves of B Ltd.<br>(80% of Rs. 1,55,000) | <u>1,24,000</u> |
|                                                                    | 5,74,000        |

|                                                                                         |               |
|-----------------------------------------------------------------------------------------|---------------|
| Less: Unrealised profit on stock $\left[ \frac{1}{6} \times \text{Rs. } 90,000 \right]$ | <u>15,000</u> |
|-----------------------------------------------------------------------------------------|---------------|

5,59,000

### Consolidated Balance Sheet of A Ltd. and its subsidiary B Ltd.

As on 31st March, 2006

| Liabilities                              | Rs.           | Rs.              | Assets                       | Rs.           | Rs.              |
|------------------------------------------|---------------|------------------|------------------------------|---------------|------------------|
| Share capital<br>(Shares of Rs. 10 each) |               | 10,00,000        | Goodwill                     |               | 3,90,000         |
| Reserves and Surplus                     |               | 5,59,000         | Other Fixed Assets           |               | 10,55,000        |
| Secured Loan:                            |               |                  | Current Assets:              |               |                  |
| 13% Debentures (Rs. 100 each)            |               | 2,00,000         | Stock                        | 6,20,000      |                  |
| Current Liabilities:                     |               |                  | Less: Unrealised<br>profit   | <u>15,000</u> | 6,05,000         |
| Creditors                                | 5,20,000      |                  | Debtors                      | 4,15,000      |                  |
| Less: Mutual<br>indebtedness             | <u>60,000</u> | 4,60,000         | Less: Mutual<br>indebtedness | <u>60,000</u> | 3,55,000         |
| Other liabilities                        |               | 2,40,000         | Cash & Bank                  |               | <u>2,00,000</u>  |
| Minority Interest                        |               | <u>1,46,000</u>  |                              |               | <u>26,05,000</u> |
|                                          |               | <u>26,05,000</u> |                              |               |                  |

## 2.17 MISCELLANEOUS ILLUSTRATIONS

### Illustration 17

A Ltd. acquired 1,600 ordinary shares of Rs.100 each of B Ltd. on 1st July 2006. On December 31, 2006 the Balance Sheets of the two companies were as given below:

| Liabilities                         | A Ltd.<br>Rs. | B Ltd.<br>Rs. | Assets            | A Ltd.<br>Rs. | B Ltd.<br>Rs. |
|-------------------------------------|---------------|---------------|-------------------|---------------|---------------|
| Capital (Shares of<br>Rs. 100 each) |               |               | Land & Buildings  | 1,50,000      | 1,80,000      |
|                                     |               |               | Plant & Machinery | 2,40,000      | 1,35,000      |



## Consolidated Financial Statements of Group Companies 5.49

|                   |                 |                 |                      |                 |                 |
|-------------------|-----------------|-----------------|----------------------|-----------------|-----------------|
| fully paid)       | 5,00,000        | 2,00,000        | Investment in B Ltd. |                 |                 |
| Reserves          | 2,40,000        | 1,00,000        | at cost              | 3,40,000        | —               |
| Profit & Loss A/c | 57,200          | 82,000          | Stock                | 1,20,000        | 36,400          |
| Bank Overdraft    | 80,000          | —               | Sundry Debtors       | 44,000          | 40,000          |
| Bills Payable     | —               | 8,400           | Bills Receivable     | 15,800          | —               |
| Creditors         | <u>47,100</u>   | <u>9,000</u>    | Cash                 | <u>14,500</u>   | <u>8,000</u>    |
|                   | <u>9,24,300</u> | <u>3,99,400</u> |                      | <u>9,24,300</u> | <u>3,99,400</u> |

The Profit & Loss Account of B Ltd. showed a credit balance of Rs. 30,000 on 1st January, 2006 out of which a dividend of 10% was paid on 1st August; A Ltd. has credited the dividend received to its Profit & Loss Account. The Plant & Machinery which stood at Rs. 1,50,000 on 1st January, 2006 was considered as worth Rs. 1,80,000 on 1st July, 2006; this figure is to be considered while consolidating the Balance Sheets.

Prepare consolidated Balance Sheet as on December 31, 2006.

### Solution

- (1) The dividend @ 10% on 1,600 shares, Rs. 16,000 received by A Ltd. should have been credited to the investment A/c, being out of pre-acquisition profits. A Ltd., must pass a correcting entry, viz.

|                       |                |
|-----------------------|----------------|
| Profit & Loss Account | Dr. Rs. 16,000 |
| To investment         | Rs. 16,000     |

- (2) The Plant & Machinery of B Ltd. would stand in the books at Rs. 1,42,500 on 1st July, 2006, considering only six months' depreciation on Rs. 1,50,000 total depreciation being Rs. 15,000. The value put on the assets being Rs. 1,80,000 there is an appreciation to the extent of Rs. 37,500.
- (3) *Capital profits of B Ltd.*

|                                            |               |                 |
|--------------------------------------------|---------------|-----------------|
|                                            | Rs.           | Rs.             |
| Reserve on 1.1.2006                        |               | 1,00,000        |
| Profit & Loss Account Balance on 1.1.2006  | 30,000        |                 |
| Less: Dividend paid                        | <u>20,000</u> | 10,000          |
| Profit for 2006: Total Rs. 82,000 less     |               |                 |
| Rs. 10,000 i.e. Rs. 72,000; upto 1.7.2006  |               | 36,000          |
| Appreciation in value of Plant & Machinery |               | <u>37,500</u>   |
|                                            |               | 1,83,500        |
| Less : 20% due to outsiders                |               | <u>36,700</u>   |
| Holding company's share                    |               | <u>1,46,800</u> |

## 5.50 Financial Reporting

### (4) Revenue profits of B Ltd.:

|                                                                                            |               |               |
|--------------------------------------------------------------------------------------------|---------------|---------------|
| Profit after 1.7.2006                                                                      | 36,000        |               |
| Less: 10% depreciation on Rs. 37,500 (increase in value of plant & machinery) for 6 months | <u>1,875*</u> |               |
|                                                                                            |               | 34,125        |
| Less: 1/5 due to outsiders                                                                 | <u>6,825</u>  |               |
| Share of A Ltd.                                                                            |               | <u>27,300</u> |

### (5) Minority interest:

|                          |              |               |
|--------------------------|--------------|---------------|
| Par value of 400 shares  | 40,000       |               |
| Add: 1/5 Capital Profits | 36,700       |               |
| 1/5 Revenue Profits      | <u>6,825</u> |               |
|                          |              | <u>83,525</u> |

### (6) Cost of Control:

|                                               |                 |                 |
|-----------------------------------------------|-----------------|-----------------|
| Amount paid for 1,600 shares                  | 3,40,000        |                 |
| Less: Dividend out of pre-acquisition profits | <u>16,000</u>   |                 |
|                                               |                 | 3,24,000        |
| Less: Par value of shares                     | 1,60,000        |                 |
| Capital Profits –share of A Ltd.              | <u>1,46,800</u> | <u>3,06,800</u> |
| Cost of Control or Goodwill                   |                 | <u>17,200</u>   |

### (7) Value of plant & Machinery:

|                                               |               |                 |
|-----------------------------------------------|---------------|-----------------|
| A Ltd.                                        |               | 2,40,000        |
| B Ltd.                                        | 1,35,000      |                 |
| Add: Appreciation on 1.7.2006                 | <u>37,500</u> |                 |
|                                               | 1,72,500      |                 |
| Less: Depreciation on Rs. 37,500 for 6 months | <u>1,875</u>  | <u>1,70,625</u> |
|                                               |               | <u>4,10,625</u> |

### (8) Profit & Loss Account (Consolidated):

|                                              |               |               |
|----------------------------------------------|---------------|---------------|
| A Ltd. as given                              | 57,200        |               |
| Less: Profit transferred to Investment A/c   | <u>16,000</u> |               |
|                                              |               | 41,200        |
| Share of A Ltd. in revenue profits of B Ltd. | <u>27,300</u> |               |
|                                              |               | <u>68,500</u> |

**Consolidated Balance Sheet of A Ltd. and its subsidiary, B Ltd.  
as on 31st December, 2006**

| <i>Liabilities</i>                          | <i>Rs.</i>       | <i>Assets</i>     | <i>Rs.</i>       |
|---------------------------------------------|------------------|-------------------|------------------|
| Capital (fully paid shares of Rs. 100 each) | 5,00,000         | Goodwill          | 17,200           |
| Reserves                                    | 2,40,000         | Land and Building | 3,30,000         |
| Profit & Loss Account                       | 68,500           | Plant & Machinery | 4,10,625         |
| Bank Overdraft                              | 80,000           | Stock             | 1,56,400         |
| Bills Payable                               | 8,400            | Sundry Debtors    | 84,000           |
| Creditors                                   | 56,100           | Bills Receivable  | 15,800           |
| Minority Interest                           | <u>83,525</u>    | Cash              | 22,500           |
|                                             | <u>10,36,525</u> |                   | <u>10,36,525</u> |

**Illustration 18**

The balance sheets of three companies, A Ltd., B Ltd., C Ltd., as on 31st December, 2006 are given below:

| <i>Liabilities:</i>                    | <b>A Ltd.</b>   | <b>B Ltd.</b>   | <b>C Ltd.</b>   |
|----------------------------------------|-----------------|-----------------|-----------------|
|                                        | <i>Rs.</i>      | <i>Rs.</i>      | <i>Rs.</i>      |
| Share Capital (shares of Rs. 100 each) | 1,50,000        | 1,00,000        | 60,000          |
| Reserves                               | 20,000          | 10,000          | 7,500           |
| Profit & Loss A/c                      | 50,000          | 30,000          | 25,000          |
| Sundry Creditors                       | 20,000          | 25,000          | 15,000          |
| A Ltd.                                 | <u>—</u>        | <u>10,000</u>   | <u>8,000</u>    |
|                                        | <u>2,40,000</u> | <u>1,75,000</u> | <u>1,15,500</u> |
| <b>Assets</b>                          | <b>A Ltd.</b>   | <b>B Ltd.</b>   | <b>C Ltd.</b>   |
|                                        | <i>Rs.</i>      | <i>Rs.</i>      | <i>Rs.</i>      |
| Goodwill                               | 20,000          | 15,000          | 10,000          |
| Fixed Assets                           | 70,000          | 50,000          | 60,000          |
| Shares in B Ltd. (750 shares)          | 90,000          | —               | —               |
| In C Ltd. (100 shares)                 | 15,000          | —               | —               |
| In C Ltd. (350 shares)                 | —               | 52,000          | —               |
| Due from: B Ltd.                       | 12,000          |                 |                 |
| C Ltd.                                 | 8,000           |                 |                 |
| Current Assets                         | <u>25,000</u>   | <u>58,000</u>   | <u>45,500</u>   |
|                                        | <u>2,40,000</u> | <u>1,75,000</u> | <u>1,15,500</u> |

## 5.52 Financial Reporting

All shares were acquired on 1st July, 2006. On 1st Jan., 2006, the balances were:

|                   | A Ltd. | B Ltd.     | C Ltd. |
|-------------------|--------|------------|--------|
| Reserves          | 10,000 | 10,000     | 5,000  |
| Profit & Loss A/c | 5,000  | 5,000(Dr.) | 3,000  |

Profits during 2006 were earned evenly over the year.

In August, 2006 each company declared and paid an interim dividend of 10% p.a. for six months. A Ltd. and B Ltd., have credited their Profit & Loss Account with the dividends received. During 2006, C Ltd. fabricated a machine costing Rs. 10,000 which it sold to B Ltd. for Rs. 12,000, B Ltd. then sold the machine to A Ltd., for Rs. 13,000, the transactions being completed on 31st December, 2006.

Prepare the consolidated Balance Sheet of the group as on 31st December, 2006.

### Solution

#### Consolidated Balance Sheet of A Ltd. and its Subsidiaries B Ltd. & C Ltd., as on 31st December, 2006

| <i>Liabilities</i>      |               | Rs.      | <i>Assets</i>    |               | Rs.             |
|-------------------------|---------------|----------|------------------|---------------|-----------------|
| Share Capital           |               |          | Goodwill         | 45,000        |                 |
| Issued & Subscribed     |               |          | Addition on con- |               |                 |
| 1,500 shares of Rs. 100 |               |          | solidation       | <u>2,593</u>  | 47,593          |
| each fully paid         |               | 1,50,000 | Fixed Assets:    |               |                 |
| Reserves: A Ltd.        | 20,000        |          | A Ltd.           | 70,000        |                 |
| Share in C Ltd.         | 208           |          | B Ltd.           | 50,000        |                 |
| Share in B Ltd.         | <u>548</u>    | 20,756   | C Ltd.           | <u>60,000</u> |                 |
| Profit & Loss Account   |               | 64,646   |                  | 1,80,000      |                 |
| Sundry Creditors        |               |          | Less: Unrea-     |               |                 |
| A Ltd.                  | 20,000        |          | lised profit     | <u>3,000</u>  | 1,77,000        |
| B Ltd.                  | 25,000        |          |                  |               |                 |
| C Ltd.                  | <u>15,000</u> | 60,000   | Current Assets   |               |                 |
| Minority Interest       |               |          | A Ltd.           | 25,000        |                 |
| B Ltd.                  |               | 36,567   | B Ltd.           | 58,000        |                 |
| C Ltd.                  |               | 23,124   | C Ltd.           | <u>45,500</u> | 1,28,500        |
|                         |               |          | Cash in Transit  |               | <u>2,000</u>    |
|                         |               |          |                  |               | <u>3,55,093</u> |
|                         |               |          |                  |               | <u>3,55,093</u> |

**Working notes:**

(i) *Analysis of Profits of C Ltd.*

|                               |              | Capital<br>Profit | Revenue<br>Reserve | Revenue<br>Profit |
|-------------------------------|--------------|-------------------|--------------------|-------------------|
|                               | Rs.          | Rs.               | Rs.                | Rs.               |
| General Reserve on 1.1.2006   |              | 5,000             |                    |                   |
| Profit & Loss A/c on 1.1.2006 |              | 3,000             |                    |                   |
| Increase in Reserve           |              | 1,250             | 1,250              |                   |
| Profit for the year           | 12,500       |                   |                    |                   |
| Less: Interim Dividend        | <u>3,000</u> | <u>9,500</u>      | <u>      </u>      | <u>12,500</u>     |
|                               |              | 18,750            | 1,250              | 12,500            |
| Less: Minority Interest 3/12  |              | <u>4,687</u>      | <u>312</u>         | <u>3,125</u>      |
| Brought Forward               |              | 14,063            | 938                | 9,375             |
| Share of A Ltd. 2/12          |              | <u>3,125</u>      | <u>208</u>         | <u>2,083</u>      |
| Share of B Ltd.               |              | <u>10,938</u>     | <u>730</u>         | <u>7,292</u>      |

(ii) *Analysis of Profits of B Ltd.*

|                                     |               |               |            |               |
|-------------------------------------|---------------|---------------|------------|---------------|
| Reserve on 1.1.2006                 |               | 10,000        |            |               |
| Profit & Loss on 1.1.2006           |               | -5,000        |            |               |
| Profit for the year                 | 40,000        |               |            |               |
| Less: Interim dividend<br>of C Ltd. | <u>1,750</u>  |               |            |               |
|                                     | <u>38,250</u> | 19,125        |            | 19,125        |
| Less: Interim Div.                  | <u>5,000</u>  | 14,125        |            |               |
| Share in C Ltd.                     |               | <u>      </u> | <u>730</u> | <u>7,292</u>  |
|                                     |               | 19,125        | 730        | 26,417        |
| Minority Interest 1/4               |               | <u>4,781</u>  | <u>182</u> | <u>6,604</u>  |
|                                     |               | <u>14,344</u> | <u>548</u> | <u>19,813</u> |

(iii) *Cost of Control / Capital Reserve*

|                       |  |               |
|-----------------------|--|---------------|
| Investments in B Ltd. |  |               |
| (90,000 – 3,750)      |  | 86,250        |
| Investments in C Ltd. |  |               |
| (15,000 – 500)        |  | 14,500        |
| (52,000 – 1,750)      |  | <u>50,250</u> |
|                       |  | 1,51,000      |

## 5.54 Financial Reporting

|                                    |               |                 |
|------------------------------------|---------------|-----------------|
| Less: Paid up Value of Investments |               |                 |
| in B Ltd.                          | 75,000        |                 |
| in C Ltd.                          | 45,000        |                 |
| Capital Profit in B Ltd.           | 14,344        |                 |
| Capital Profit in C Ltd.           | <u>14,063</u> | <u>1,48,407</u> |
|                                    |               | <u>2,593</u>    |

### (iv) Minority Interest

|                 | B Ltd.        | C Ltd.        |
|-----------------|---------------|---------------|
|                 | Rs.           | Rs.           |
| Share Capital   | 25,000        | 15,000        |
| Capital Profits | 4,781         | 4,687         |
| Revenue Reserve | 182           | 312           |
| Revenue Profits | <u>6,604</u>  | <u>3,125</u>  |
|                 | <u>36,567</u> | <u>23,124</u> |

### (v) Profit and Loss Account - A Ltd.

|                                                   |  |               |
|---------------------------------------------------|--|---------------|
| Balance                                           |  | 50,000        |
| Less: Dividend credited to Investment (3,750+500) |  | <u>4,250</u>  |
|                                                   |  | 45,750        |
| Share in B Ltd.                                   |  | 19,813        |
| Share in C Ltd.                                   |  | <u>2,083</u>  |
|                                                   |  | 67,646        |
| Less: Profit on Plant                             |  | <u>3,000</u>  |
|                                                   |  | <u>64,646</u> |

## Illustration 19

The following information was extracted from the books of A Limited group as on 31st December, 2006:

|                                                                                                                                      | A Ltd.        | B Ltd.        | C Ltd.        |
|--------------------------------------------------------------------------------------------------------------------------------------|---------------|---------------|---------------|
|                                                                                                                                      | Rs.           | Rs.           | Rs.           |
| <i>Profit and Loss Account:</i>                                                                                                      |               |               |               |
| Balance on 31st December, 2004 after provision for dividends of 10% in respect of calendar year 2004 but excluding dividend received | 50,000        | 36,000        | 26,000        |
| Net trading profit earned in 2005                                                                                                    | <u>60,000</u> | <u>42,000</u> | <u>28,000</u> |
|                                                                                                                                      | 1,10,000      | 78,000        | 54,000        |

**Consolidated Financial Statements of Group Companies     5.55**

|                                                                                                                                      |                 |                 |                 |
|--------------------------------------------------------------------------------------------------------------------------------------|-----------------|-----------------|-----------------|
| Less: Dividends of 10 per cent (received in 2006) in respect of calendar year 2005                                                   | <u>40,000</u>   | <u>30,000</u>   | <u>20,000</u>   |
|                                                                                                                                      | 70,000          | 48,000          | 34,000          |
| Net trading profit earned in 2006<br>(before taking into account proposed dividends of 10 per cent in respect of calendar year 2006) | <u>50,000</u>   | <u>50,000</u>   | <u>30,000</u>   |
|                                                                                                                                      | 1,20,000        | 98,000          | 64,000          |
| <i>Dividends Received:</i>                                                                                                           |                 |                 |                 |
| From B Limited in 2005                                                                                                               | 20,000          |                 |                 |
| From B Limited in 2006                                                                                                               | 25,000          |                 |                 |
| From C Limited in 2006                                                                                                               |                 | 15,000          |                 |
| Share Capital Authorised and Fully paid - Equity Shares of Re 1 each                                                                 | 4,00,000        | 3,00,000        | 2,00,000        |
| Sundry Creditors                                                                                                                     | <u>20,000</u>   | <u>5,000</u>    | <u>17,000</u>   |
|                                                                                                                                      | <u>5,85,000</u> | <u>4,18,000</u> | <u>2,81,000</u> |
| Fixed Assets at cost less Depreciation                                                                                               | 2,10,000        | 1,88,000        | 2,61,000        |
| Current Assets                                                                                                                       | 60,000          | 30,000          | 20,000          |
| Investment at cost:                                                                                                                  |                 |                 |                 |
| 2,00,000 Equity Shares in B Ltd.<br>bought on December 31, 2004                                                                      | 2,50,000        |                 |                 |
| 50,000 Equity Shares in B Ltd.<br>bought on December 31, 2005                                                                        | 65,000          |                 |                 |
| 1,50,000 Equity Shares in C Ltd.<br>bought on December 31, 2005                                                                      |                 | 2,00,000        |                 |
|                                                                                                                                      | <u>5,85,000</u> | <u>4,18,000</u> | <u>2,81,000</u> |

All the companies pay dividends of 10 per cent on Paid-up share capital in March following the end of the accounting year. The receiving companies enter the dividends in their books when dividends are received.

You are required to prepare:

- (a) Consolidated Balance Sheet as on 31st December, 2006.
- (b) Statements showing the composition of :
  - (i) Consolidated Profit and Loss Account.
  - (ii) Minority Interest, and
  - (iii) Cost of Control, Goodwill.

Ignore taxation.

## 5.56 Financial Reporting

### Solution

**(a) Consolidated Balance Sheet of A Ltd., and subsidiaries B Ltd. and C Ltd. as on 31st December, 2006**

| <i>Liabilities</i>                        | <i>Rs.</i>      | <i>Assets</i>                              | <i>Rs.</i>      |
|-------------------------------------------|-----------------|--------------------------------------------|-----------------|
| <i>Share Capital</i>                      |                 | <i>Fixed Assets</i>                        |                 |
| Authorised Issued & Subscribed            |                 | Goodwill on consolidation                  | 17,500          |
| 4,00,000 Shares of Re. 1 each fully paid  | 4,00,000        | Other Fixed Assets, cost less depreciation | 6,59,000        |
| <i>Reserves &amp; Surplus</i>             |                 | <i>Investments</i>                         | —               |
| Profit & Loss Account                     | 1,68,417        | <i>Current Assets</i>                      |                 |
| <i>Secured Loans</i>                      | —               | <i>Loans &amp; Advances</i>                |                 |
| <i>Unsecured Loans</i>                    | —               | Current Assets                             | 1,10,000        |
| <i>Current Liabilities and Provisions</i> |                 |                                            |                 |
| Sundry Creditors                          | 42,000          |                                            |                 |
| Proposed Dividend                         |                 |                                            |                 |
| A Ltd.                                    | 40,000          |                                            |                 |
| Minority Interest in subsidiaries         | <u>10,000*</u>  |                                            |                 |
| Minority Interest                         | <u>1,26,083</u> |                                            |                 |
|                                           | <u>7,86,500</u> |                                            | <u>7,86,500</u> |

**(b) (i) Consolidated Profit and Loss Account of A Ltd. and its subsidiaries, B Ltd. and C Ltd., for the year ended on 31st December, 2006.**

|                       | <i>Rs.</i>   | <i>Rs.</i> | <i>Rs.</i>                               | <i>Rs.</i>    |
|-----------------------|--------------|------------|------------------------------------------|---------------|
| To Dividend for 2005* |              |            | By Balance b/d                           |               |
| A Ltd.                | 40,000       |            | A Ltd.                                   | 1,10,000      |
| B Ltd. (Net)          | 5,000        |            | B Ltd.                                   | 78,000        |
| C Ltd. (Net)          | <u>5,000</u> | 50,000     | C Ltd.                                   | <u>54,000</u> |
| To Minority Interest: |              |            | By Dividend received in 2005 (for 2004)* | 2,42,000      |
|                       |              |            |                                          | 20,000        |

\* Alternatively, this can be shown as a part of Minority Interest. However, the better disclosure is to show such proposed dividend separately because a distinction is always necessary between immediate liability of dividend payment and an artificial liability towards minorities.



**Consolidated Financial Statements of Group Companies    5.57**

|                         |               |                 |                         |               |                 |
|-------------------------|---------------|-----------------|-------------------------|---------------|-----------------|
| B Ltd.                  | 20,083        |                 | By Profit for the year: |               |                 |
| C Ltd.                  | <u>16,000</u> | 36,083          | A Ltd.                  | 50,000        |                 |
| To Capital Receipts**   |               | 40,000          | B Ltd.                  | 50,000        |                 |
| To Capital Profits      |               |                 | C Ltd.                  | <u>30,000</u> | 1,30,000        |
| B Ltd.                  | 32,000        |                 |                         |               |                 |
| C Ltd.                  | <u>25,500</u> | 57,500          |                         |               |                 |
| To Proposed Dividend-99 |               | 40,000          |                         |               |                 |
| To Balance c/d          |               | <u>1,68,417</u> |                         |               |                 |
|                         |               | <u>3,92,000</u> |                         |               | <u>3,92,000</u> |

\*Net Amount (Rs.)

(after eliminating intragroup dividend)

| For  | Dividend Paid |        | Dividend Received |        | Dividend Paid | Dividend Received |
|------|---------------|--------|-------------------|--------|---------------|-------------------|
|      | By            | Rs.    | By                | Rs.    | Rs.           | Rs.               |
| 2004 |               |        | A Ltd.            | 20,000 |               | 20,000            |
|      |               |        | (from B Ltd.)     |        |               | (By A Ltd.)       |
| 2005 | A Ltd.        | 40,000 |                   |        | 40,000        |                   |
|      |               |        |                   |        | (By A Ltd.)   |                   |
| 2005 | B Ltd.        | 30,000 | A Ltd.            | 25,000 | 5,000         |                   |
|      |               |        | (from B Ltd.)     |        | (By B Ltd.)   |                   |
| 2005 | C Ltd.        | 20,000 | B Ltd.            | 15,000 | 5,000         |                   |
|      |               |        | (from C Ltd.)     |        | (By C Ltd.)   |                   |
|      |               |        |                   |        | <u>50,000</u> | <u>20,000</u>     |

\*\* To be credited to Investments in subsidiaries Rs. 25,000 from B Ltd. [Rs. 20,000 dividend received in 2005 (for 2004) + Rs. 5,000 dividend received in 2006 (for 2005)] and Rs. 15,000 from C Ltd.

**(ii) Minority Interest :**

|                                  | B Ltd.        | C Ltd.          |
|----------------------------------|---------------|-----------------|
|                                  | Rs.           | Rs.             |
| Share Capital                    | 50,000        | 50,000          |
| Capital Profits                  | 6,000         | 8,500           |
| Revenue Profits                  | <u>14,083</u> | <u>7,500</u>    |
|                                  | <u>70,083</u> | <u>66,000</u>   |
| Total                            |               | 1,36,083        |
| Less: Shown as proposed dividend |               | <u>10,000</u>   |
|                                  |               | <u>1,26,083</u> |

## 5.58 Financial Reporting

### (iii) Cost of control/Goodwill

|                                                                                   |               |                 |
|-----------------------------------------------------------------------------------|---------------|-----------------|
| Cost of Investment in B Ltd. – 2,00,000                                           | Rs.           | Rs.             |
| Shares (Rs. 2,50,000 less Dividend,<br>Rs. 20,000 received in 2005)               |               | 2,30,000        |
| Cost of Investments in B Ltd. – 50,000<br>Shares (less dividend received in 2006) |               | 60,000          |
| Cost of Investment in C Ltd. held by B Ltd.<br>(less dividend received in 2006)   |               | <u>1,85,000</u> |
|                                                                                   |               | 4,75,000        |
| Paid-up value of Shares in B Ltd.                                                 | 2,50,000      |                 |
| Paid-up value of Shares in C Ltd.                                                 | 1,50,000      |                 |
| Capital Profits in B Ltd.                                                         | 32,000        |                 |
| Capital Profits in C Ltd.                                                         | <u>25,500</u> | <u>4,57,500</u> |
| Goodwill                                                                          |               | <u>17,500</u>   |

### Working notes:

#### Analysis of Profits:

|                                                                                    | Capital Profit<br>Rs. | Revenue Profit<br>Rs. |
|------------------------------------------------------------------------------------|-----------------------|-----------------------|
| <b>C Ltd.</b>                                                                      |                       |                       |
| Balance on 31st Dec. 2005, after dividend                                          | 34,000                |                       |
| Profit for the year ending on 31st Dec., 2006<br>before proposed dividend for 2006 |                       | <u>30,000</u>         |
|                                                                                    | 34,000                | 30,000                |
| Minority Interest (1/4)                                                            | <u>8,500</u>          | <u>7,500</u>          |
|                                                                                    | <u>25,500</u>         | <u>22,500</u>         |
| <b>B Ltd.</b>                                                                      | Rs.                   | Rs.                   |
| Balance on 31st Dec., 2004                                                         | 36,000                | —                     |
| Profit in 2005 after dividend for 2005                                             | —                     | 12,000                |
| Profit for 2006 (before dividend),                                                 | —                     | 50,000                |
| Revenue Profit from C Ltd.                                                         | <u>—</u>              | <u>22,500</u>         |
|                                                                                    | 36,000                | 84,500                |
| Minority Interest (1/6)                                                            | <u>6,000</u>          | <u>14,083</u>         |
|                                                                                    | 30,000                | 70,417                |
| 1/6 of retained profit for 2005 treated                                            |                       |                       |

|                                                                      |                |               |
|----------------------------------------------------------------------|----------------|---------------|
| as Capital profit on purchase of 50,000<br>shares on 31st Dec., 2005 | <u>+ 2,000</u> | <u>-2,000</u> |
|                                                                      | <u>32,000</u>  | <u>68,417</u> |

**Illustration 20**

The summarised Balance Sheets of the following three companies are given below:

|                                                                    | <b>Eagle<br/>Ltd.</b>                            | <b>Garuda<br/>Ltd.</b> | <b>Bird<br/>Ltd.</b> |
|--------------------------------------------------------------------|--------------------------------------------------|------------------------|----------------------|
|                                                                    | <i>As on 31st March, 2006<br/>(Rs. in lakhs)</i> |                        |                      |
| <i>Liabilities</i>                                                 |                                                  |                        |                      |
| Equity Shares (Rs. 10 each, fully paid up)                         | 60                                               | 48                     | 40                   |
| 7½% Cumulative Preference Shares<br>(Rs. 100 each fully paid up)   | 15                                               | 12                     | 10                   |
| Capital Reserve on Revaluation of Land,<br>Buildings and Machinery | 120                                              |                        |                      |
| General Reserve                                                    | 25                                               | 15                     | 10                   |
| 8% 2,500 Mortgage Debenture Bonds of<br>Rs. 1,000 each             | 25                                               |                        |                      |
| Secured Loans and Advances from Banks                              | 153                                              | 71                     | 52                   |
| Unsecured Loans:                                                   |                                                  |                        |                      |
| (i) From Garuda Ltd.                                               | —                                                | —                      | 12                   |
| (ii) From Bird Ltd.                                                | 15                                               | —                      | —                    |
| (iii) Deposits from Public                                         | 18                                               | 12                     | 3                    |
| Current Liabilities and Provisions:                                |                                                  |                        |                      |
| (i) Inter-Company Balances                                         | 9                                                | —                      | —                    |
| (ii) Other liabilities and provisions                              | <u>314</u>                                       | <u>125</u>             | <u>72</u>            |
| Total                                                              | <u>754</u>                                       | <u>283</u>             | <u>199</u>           |
| <i>Assets</i>                                                      |                                                  |                        |                      |
| Fixed Assets (Net)                                                 | 272                                              | 104                    | 42                   |
| Investments (at Cost)                                              |                                                  |                        |                      |
| 2,50,000 Equity Shares of Garuda Ltd.                              | 25                                               |                        |                      |
| 80,000 Equity Shares of Bird Ltd.                                  | 8                                                |                        |                      |
| 1,60,000 Equity Shares of Bird Ltd.                                |                                                  | 20                     |                      |

## 5.60 Financial Reporting

|                                                   |            |            |            |
|---------------------------------------------------|------------|------------|------------|
| 10,000 Cumulative Preference Shares of Eagle Ltd. |            |            | 10         |
| 1,500 Mortgage Debentures of Eagle Ltd.           |            |            | 14         |
| Current Assets                                    | 353        | 123        | 112        |
| Profit and Loss Account                           | <u>96</u>  | <u>36</u>  | <u>21</u>  |
| Total                                             | <u>754</u> | <u>283</u> | <u>199</u> |

- (i) Eagle Ltd. subscribed for the shares of Garuda Ltd. and Bird Ltd. at par at the time of first issue of shares by the latter companies.
- (ii) Garuda Ltd., subscribed for 80,000 shares of Bird Ltd. at par at the time of first issue and latter acquired by purchase in the market 80,000 shares of Bird Ltd. at Rs. 15 each when Reserves and Surplus of Bird Ltd. stood at Rs. 5 lakhs.
- (iii) Current Assets of Garuda Ltd. and Bird Ltd. included Rs. 4 lakhs and Rs. 6 lakhs respectively being the current accounts balance against Eagle Ltd. These accounts remained unreconciled.
- (iv) Preference dividends were in arrears for:  
8 years in the case of Eagle Ltd. and 4 years in the case of other two companies.

Prepare the Consolidated Balance Sheet.

### Solution

#### Consolidated Balance Sheet of Eagle Ltd., and its subsidiaries Garuda Ltd., and Bird Ltd. as on 31st March, 2006

| <i>Liabilities</i>          | <i>Rs.</i>        | <i>Assets</i>                    | <i>Rs.</i>        |
|-----------------------------|-------------------|----------------------------------|-------------------|
|                             | <i>(in lakhs)</i> |                                  | <i>(in lakhs)</i> |
| <i>Share Capital</i>        |                   | <i>Fixed Assets (Net)</i>        | 418.00            |
| 6,00,000 Equity Shares of   |                   | Goodwill (on consolidation)      | 1.00              |
| Rs. 10 each fully paid      | 60.00             | <i>Current Assets</i>            | 552.00            |
| 5,000 7-1/2% Cum Preference |                   | <i>Profit &amp; Loss Account</i> | 88.06             |
| Share of Rs. 100 each       | 5.00              |                                  |                   |
| <i>Minority Interest</i>    |                   |                                  |                   |
| Garuda                      | 23.00             |                                  |                   |
| Bird                        | <u>16.00</u>      |                                  |                   |
|                             | 39.00             |                                  |                   |
| Loss in Subsidiaries        | <u>16.94</u>      |                                  |                   |
|                             | 22.06             |                                  |                   |
| Preference Shares           | <u>22.00</u>      | 44.06                            |                   |

## Consolidated Financial Statements of Group Companies 5.61

|                                           |               |                 |
|-------------------------------------------|---------------|-----------------|
| <i>Reserves &amp; Surplus</i>             |               |                 |
| Capital Reserve                           | 120.00        |                 |
| <i>Secured Loans</i>                      |               |                 |
| 8% Mortgage Debentures                    | 10.00         |                 |
| Loans and Advances                        |               |                 |
| from Banks                                | 276.00        |                 |
| <i>Unsecured Loans</i>                    |               |                 |
| Public Deposits                           | 33.00         |                 |
| <i>Current Liabilities and Provisions</i> |               |                 |
| Sundry liabilities and                    |               |                 |
| Provisions                                | <u>511.00</u> |                 |
|                                           | 1,059.06      | <u>1,059.06</u> |

**Note:** Arrears of Preference Dividends for eight years in Eagle Ltd. and four years in subsidiaries is

### Working Notes :

**(i) Analysis of Profits of Bird Ltd.**

(Rs. in lakhs)

|                                                                    |                |                |
|--------------------------------------------------------------------|----------------|----------------|
| Loss after adjusting Reserve and Profit on Debenture in Eagle Ltd. |                | <u>10</u>      |
|                                                                    | <i>Capital</i> | <i>Revenue</i> |
|                                                                    | <i>Profit</i>  | <i>Loss</i>    |
| Share of Eagle Ltd.                                                | 1              | 3              |
| Share of Garuda Ltd.                                               | 2              | 6              |
| Share of Minority                                                  | <u>2</u>       | <u>6</u>       |
|                                                                    | 5              | <u>15</u>      |

(ii) **Analysis of Garuda Ltd.**

|                           |           |
|---------------------------|-----------|
| Loss, less Reserve        | 21        |
| Add : Loss in Bird Ltd.   | <u>6</u>  |
|                           | <u>27</u> |
| Share of Eagle Ltd. 25/48 | 14.06     |
| Share of Minority         | 12.94     |

## 5.62 Financial Reporting

### (iii) Profit & Loss A/c Eagle Ltd.

|                     |             |              |
|---------------------|-------------|--------------|
| Loss, less Reserve  |             | 71.00        |
| Loss in Garuda Ltd. | 14.06       |              |
| Loss in Bird Ltd.   | <u>3.00</u> | <u>17.06</u> |
|                     |             | <u>88.06</u> |

### (iv) Cost of Control

|                                    |          |           |
|------------------------------------|----------|-----------|
| Cost of Investments in Garuda Ltd. |          | 25        |
| Cost of Investments in Bird Ltd.   |          | <u>28</u> |
|                                    |          | 53        |
| Paid up value of shares in:        |          |           |
| Garuda Ltd.                        | 25       |           |
| Bird Ltd.                          | 24       |           |
| Capital profit in Bird Ltd.        | <u>3</u> | <u>52</u> |
|                                    |          | <u>1</u>  |

**Note:** In accordance with para 15 of AS 21, the consolidated financial statements have been presented from the date on which holding subsidiary relationship comes in existence.

### Illustration 21

On 1st January, 2006, Investments Ltd. a new company, raised its first Capital of Rs. 3,00,000 from the issue of 30,000 shares of Rs. 10 each at par, and on that date acquired the following shareholdings:

A Ltd. – 3,000 shares of Rs. 10 each fully paid for Rs. 35,000

B Ltd. – 10,000 shares of Rs. 10 each fully paid for Rs. 72,000

C Ltd. – 8,000 shares of Rs. 10 each fully paid for Rs. 92,000.

Apart from these transactions and those detailed below, investments Ltd. neither paid nor received other monies during 2006.

The following are the summarised Balance Sheets of the Subsidiary Companies on 31st December, 2006 :

|                   | A Ltd. | B Ltd. | C Ltd. |
|-------------------|--------|--------|--------|
|                   | Rs.    | Rs.    | Rs.    |
| Goodwill          | 4,000  | —      | 15,000 |
| Freehold Property | 18,000 | 41,000 | 50,000 |
| Plant             | 16,000 | 30,000 | 12,000 |
| Stock             | 11,000 | 32,000 | 21,000 |
| Debtors           | 4,000  | 8,000  | 17,000 |

**Consolidated Financial Statements of Group Companies     5.63**

|                           |               |                 |                 |
|---------------------------|---------------|-----------------|-----------------|
| Cash at Bank              | 1,000         | 2,000           | 11,500          |
| Profit, and Loss Account  | <u>—</u>      | <u>18,000</u>   | <u>—</u>        |
|                           | <u>54,000</u> | <u>1,31,000</u> | <u>1,26,500</u> |
| Share Capital             | 40,000        | 1,20,000        | 1,00,000        |
| Reserves (as on 1.1.2006) | 3,000         | —               | 7,500           |
| Profit and Loss Account   | 6,000         | —               | 15,000          |
| Creditors                 | <u>5,000</u>  | <u>11,000</u>   | <u>4,000</u>    |
|                           | <u>54,000</u> | <u>1,31,000</u> | <u>1,26,500</u> |

*Other relevant information:*

- (1) The freehold property of C Ltd. is to be revalued at Rs. 65,000 as on 1.1.2006.
- (2) Additional depreciation for the year 2006 of Rs. 3,000 on the plant of B Ltd is to be provided.
- (3) The stock of A Ltd. as on 31st December, 2006 has been undervalued by Rs. 2,000 and is to be adjusted.
- (4) As on 31st December, 2006 Investments Ltd. owed A Ltd. Rs. 3,500 and is owed Rs. 6,000 by B Ltd. C Ltd. is owed Rs. 1,000 by A Ltd. and Rs. 2,000 by B Ltd.
- (5) The balances on Profit and Loss Accounts as on 31st December, 2005 were: A Ltd. Rs. 2,000 (credit); B Ltd Rs. 12,000 (debit); and C Ltd. Rs. 4,000 (credit).  
The credit balances of A Ltd. and C Ltd. were wholly distributed as dividends in March, 2006.
- (6) During 2006, A Ltd. and C Ltd. declared and paid interim dividends of 8% and 10% respectively.

You are required to prepare the Consolidated Balance Sheet of investments Ltd. and its subsidiary companies as on 31st December, 2006, ignore taxation.

**Solution**

**Consolidated Balance Sheet of Investments Ltd. and its subsidiaries A Ltd., B Ltd. and C Ltd. as on 31st December, 2006**

| <i>Liabilities</i>           | <i>Rs.</i> | <i>Assets</i>               | <i>Rs.</i> |
|------------------------------|------------|-----------------------------|------------|
| <i>Share Capital</i>         |            | <i>Fixed Assets</i>         |            |
| Issued & Subscribed          |            | Goodwill                    | 19,000     |
| 30,000 shares of Rs. 10      |            | Freehold Property           | 1,24,000   |
| each fully paid              | 3,00,000   | Plant                       | 55,000     |
| <i>Reserve &amp; Surplus</i> |            | <i>Investments</i>          | —          |
| Reserve on Consolidation     | 25,950     | <i>Current Assets</i>       |            |
| Profits & Loss A/c           | 20,900*    | <i>Loans &amp; Advances</i> |            |

## 5.64 Financial Reporting

|                     |                 |                |                 |
|---------------------|-----------------|----------------|-----------------|
| Secured Loans       | —               | Stock in trade | 66,000          |
| Unsecured Loans     | —               | Sundry Debtors | 35,000          |
| Current Liabilities |                 | Less: Inter-   |                 |
| & Provisions        |                 | Co. Debts      | <u>12,500</u>   |
| Sundry Creditors    | 23,500          |                | 22,500          |
| Less: Inter Co.     | <u>12,500</u>   | Cash at Bank   | 1,28,100        |
| Minority Interest   | <u>56,750</u>   |                |                 |
|                     | <u>4,14,600</u> |                | <u>4,14,600</u> |

### Analysis of Profits:

|                                                           | Capital Profit<br>Rs. | Revenue Profit<br>Rs. |
|-----------------------------------------------------------|-----------------------|-----------------------|
| <b>(i) C Ltd.</b>                                         |                       |                       |
| Profit & Loss Account on 1.1.2006 less Div. (4000 – 4000) | —                     |                       |
| Reserve on 1st Jan., 2006                                 | 7,500                 |                       |
| Appreciation in the value of Freehold Property            | 15,000                |                       |
| Profit for the year after interim dividend                | <u>22,500</u>         | <u>15,000</u>         |
| Minority Interest 20%                                     | <u>4,500</u>          | <u>3,000</u>          |
| Share of Investments Ltd.                                 | <u>18,000</u>         | <u>12,000</u>         |
| <b>(ii) B Ltd.</b>                                        |                       |                       |
| Loss on the date of acquisition                           | -12,000               |                       |
| Loss suffered during the year<br>(21,000 – 12,000)        | <u>-12,000</u>        | <u>-9,000</u>         |
| Minority Interest (1/6)                                   | <u>2,000</u>          | <u>1,500</u>          |
| Share of Investment Ltd.                                  | <u>-10,000</u>        | <u>-7,500</u>         |
| *Revenue Profit of C Ltd.                                 | Rs.12,000             |                       |
| Revenue Profit of B Ltd.                                  | – Rs. 7,500           |                       |
| Revenue Profit of A Ltd.                                  | <u>Rs. 6,000</u>      |                       |
|                                                           | Rs. 10,500            |                       |
| Add: Interim dividend received                            | <u>Rs. 10,400</u>     | <u>Rs. 20,900</u>     |



(iii) A Ltd.

|                                                                  |                   |              |
|------------------------------------------------------------------|-------------------|--------------|
| Reserve on 1.1.2006                                              | 3,000             |              |
| Profit on 1.1.2006 less Dividend (2,000 – 2,000)                 | —                 | —            |
| Profit earned during the year (after interim dividend Rs. 3,200) | <u>          </u> | <u>8,000</u> |
|                                                                  | 3,000             | 8,000        |
| Minority Interest (1/4)                                          | <u>750</u>        | <u>2,000</u> |
|                                                                  | <u>2,250</u>      | <u>6,000</u> |

(iv)

**Cost of Control / Capital Reserve**

|                                                              |               |                 |
|--------------------------------------------------------------|---------------|-----------------|
| Cost of Investments in A Ltd. less Dividend (35,000 – 1,500) |               | 33,500          |
| Cost of Investments in B Ltd.                                |               | 72,000          |
| Cost of Investments in C Ltd. less Dividend (92,000 – 3,200) |               | <u>88,800</u>   |
|                                                              |               | 1,94,300        |
| Paid up value of Shares held in A Ltd.                       | 30,000        |                 |
| Paid up value of Shares held in B Ltd.                       | 1,00,000      |                 |
| Paid up value of Shares held in C Ltd.                       | 80,000        |                 |
| Capital Profits in A Ltd.                                    | 2,250         |                 |
| Capital Profits in B Ltd.                                    | –10,000       |                 |
| Capital Profits in C Ltd.                                    | <u>18,000</u> | <u>2,20,250</u> |
| Capital Reserve                                              |               | <u>25,950</u>   |

(v) **Minority Interest**

|                 | <b>A Ltd.</b> | <b>B Ltd.</b> | <b>C Ltd.</b> |
|-----------------|---------------|---------------|---------------|
|                 | <i>Rs.</i>    | <i>Rs.</i>    | <i>Rs.</i>    |
| Share Capital   | 10,000        | 20,000        | 20,000        |
| Capital Profits | 750           | –2,000        | 4,500         |
| Revenue Profits | <u>2,000</u>  | <u>–1,500</u> | <u>3,000</u>  |
|                 | <u>12,750</u> | <u>16,500</u> | <u>27,500</u> |
|                 |               |               | 56,750        |

(vi)

**Bank A/c - Investments Ltd.**

|                          | <i>Rs.</i> |                          | <i>Rs.</i> |
|--------------------------|------------|--------------------------|------------|
| To Share Capital         | 3,00,000   | By Investments in A Ltd. | 35,000     |
| To Investments in A Ltd. | 1,500      | By Investments in B Ltd. | 72,000     |
| To Investments in C Ltd. | 3,200      | By Investments in C Ltd. | 92,000     |
| To Dividends-A Ltd.      | 2,400      | By B Ltd. (indebtedness) | 6,000      |

## 5.66 Financial Reporting

|           |                 |                |                 |
|-----------|-----------------|----------------|-----------------|
| C Ltd.    | 8,000           | By Balance c/d | 1,13,600        |
| To A Ltd. | <u>3,500</u>    |                |                 |
|           | <u>3,18,600</u> |                | <u>3,18,600</u> |

### (vii) Sundry Assets

|                        | <i>Freehold<br/>Property</i> | <i>Plant</i>  | <i>Stock</i>  | <i>Debtors</i> | <i>Cash at<br/>Bank</i> |
|------------------------|------------------------------|---------------|---------------|----------------|-------------------------|
|                        | <i>Rs.</i>                   | <i>Rs.</i>    | <i>Rs.</i>    | <i>Rs.</i>     | <i>Rs.</i>              |
| (a) Investments Ltd.   | —                            | —             | —             | 6,000          | 1,13,600                |
| (b) A Ltd.             | 18,000                       | 16,000        | 13,000        | 4,000          | 1,000                   |
| (c) B Ltd              | 41,000                       | 27,000        | 32,000        | 8,000          | 2,000                   |
| (d) CLtd.              | <u>65,000</u>                | <u>12,000</u> | <u>21,000</u> | <u>17,000</u>  | <u>11,500</u>           |
|                        | 1,24,000                     | 55,000        | 66,000        | 35,000         | 1,28,100                |
| Less : Inter Co. debts |                              |               |               | <u>12,500</u>  |                         |
|                        |                              |               |               | <u>22,500</u>  |                         |

### Illustration 22

The following condensed balance sheets of H Ltd. and S Ltd. were prepared as on 31st December, 2006:

| Assets                          | H Ltd.          | S Ltd.          |
|---------------------------------|-----------------|-----------------|
|                                 | <i>Rs.</i>      | <i>Rs.</i>      |
| Goodwill                        | 1,12,000        | 40,000          |
| Plant & Machinery               | 95,000          | 50,400          |
| Furniture                       | 7,000           | 4,600           |
| 9,000 ordinary shares in S Ltd. | 1,20,000        | —               |
| 2,000 ordinary shares in H Ltd. | —               | 24,000          |
| Stock-in-trade                  | 48,000          | 1,14,000        |
| Sundry debtors                  | 70,000          | 45,000          |
| Cash at Bank                    | <u>17,000</u>   | <u>13,000</u>   |
|                                 | <u>4,69,000</u> | <u>2,91,000</u> |
| <i>Liabilities</i>              |                 |                 |
| Share Capital                   |                 |                 |
| Ordinary shares of 10 each      | 1,80,000        | 1,00,000        |
| 7½% Pref shares of Rs. 10 each  | 1,50,000        | 80,000          |
| Premium on ordinary shares      | 36,000          | —               |
| Reserves                        | 26,000          | 30,000          |

## Consolidated Financial Statements of Group Companies 5.67

|                       |                 |                 |
|-----------------------|-----------------|-----------------|
| Sundry Creditors      | 17,000          | 61,000          |
| Profit & Loss Account | <u>60,000</u>   | <u>20,000</u>   |
|                       | <u>4,69,000</u> | <u>2,91,000</u> |

Sundry creditors of H Ltd. include Rs. 15,000 due to S Ltd. for goods supplied since the acquisition of the shares. These goods are charged at 10% above cost. The stock of H Ltd. include goods costing Rs. 33,000 purchased from S Ltd.

H Ltd. acquired the shares of S Ltd. on 1st July, 2006. As at the date of last preceding balance sheet of S Ltd., viz., 31st Dec., 2005; the plant and machinery stood in the books

at Rs. 56,000, the reserve at Rs. 30,000 and the profit and loss account at Rs. 8,000. The plant was revalued by H Ltd. on the date of acquisition of the share of S Ltd. at Rs. 60,000 but no adjustments were made in the books of S Ltd. On 31st Dec., 2005, the debit balance of profit and, loss account was Rs. 22,750 in the books of H Ltd.

Both the companies have provided depreciation on all their fixed assets at 10% per annum. You are required to prepare a consolidated balance sheet on 31st Dec., 2006 and supporting schedule for computation.

### Solution

#### Working notes:

|                                                               |                   |                |
|---------------------------------------------------------------|-------------------|----------------|
| <b>(i) (a) Analysis of profits of S Ltd. (Pre-allocation)</b> | <i>Capital</i>    | <i>Revenue</i> |
|                                                               | <i>Profit</i>     | <i>Profit</i>  |
|                                                               | <i>Rs.</i>        | <i>Rs.</i>     |
| Reserves                                                      | 30,000            |                |
| Profit and Loss Account 1.1.2006                              | 8,000             |                |
| Profit for the year after                                     |                   |                |
| Pref. Div. (12,000 – 6,000)                                   | 3,000             | 3,000          |
| Profit on Revaluation                                         |                   |                |
| (60,000 – 53,200)                                             | 6,800             |                |
| Additional Depreciation                                       | <u>          </u> | <u>(200)</u>   |
|                                                               | <u>47,800</u>     | <u>2,800</u>   |

#### **(b) Analysis of Profits of H Ltd.**

|                                                                          |                |                |
|--------------------------------------------------------------------------|----------------|----------------|
|                                                                          | <i>Capital</i> | <i>Revenue</i> |
|                                                                          | <i>Profit</i>  | <i>Profit</i>  |
|                                                                          | <i>Rs.</i>     | <i>Rs.</i>     |
| Reserves                                                                 | 13,000         | 13,000         |
| Profit and Loss Account on 1.1.2006                                      | (22,750)       |                |
| Profit for the year after preference dividend (82,750 – 11,250 = 71,500) | <u>35,750</u>  | <u>35,750</u>  |
|                                                                          | <u>26,000</u>  | <u>48,750</u>  |

## 5.68 Financial Reporting

### (ii) Capital profits of H Ltd. & S Ltd. (post allocation)

Suppose capital profits of H Ltd. =  $a$

and capital profits of S Ltd. =  $b$

$$\text{Total Capital profits of H Ltd.} = 26,000 + \frac{9}{10}b$$

$$\text{Total Capital profits of S Ltd.} = 47,800 + \frac{1}{9}a$$

$$a = 26,000 + \frac{9}{10} \left[ 47,800 + \frac{1}{9}a \right]$$

$$a = 76,689$$

$$b = 47,800 + \frac{1}{9}(76,689)$$

$$b = 56,321$$

Minority Interest in Capital profits of S Ltd.

Rs.

5,632

Share of holding Co. H Ltd.

50,689

56,321

### (iii) Revenue profits of H Ltd. and S Ltd. (post allocation)

Assume revenue profits of H Ltd. =  $x$

and revenue profits of S Ltd. =  $y$

$$\text{Total Revenue profits of H Ltd.} = 48,750 + \frac{9}{10}y$$

$$\text{Total Revenue profits of S Ltd.} = 2,800 + \frac{1}{9}x$$

$$\text{or } x = 48,750 + \frac{9}{10} \left( 2,800 + \frac{1}{9}x \right)$$

$$\text{or } \frac{81}{90}x = 51,270$$

or  $x = 56,967$

$$y = 2,800 + \frac{1}{9} (56,967)$$

$= 9,130$

|                                  | H Ltd.<br>Rs.   | S Ltd.<br>Rs.   |
|----------------------------------|-----------------|-----------------|
| <b>(iv) Capital Profits</b>      |                 |                 |
| As per Working Note 1            | 26,000          | 47,800          |
| Adjustment as per equation       | <u>(-)8,521</u> | <u>8,521</u>    |
|                                  | <u>17,479</u>   | 56,321          |
| Minority Interest 10%            |                 | <u>5,632</u>    |
| Share of H Ltd.                  |                 | <u>50,689</u>   |
| <b>(v) Revenue Profits</b>       |                 |                 |
| (60,000 – 11,250 Pref. Dividend) | 48,750          | 2,800           |
| Adjustment 6330                  | <u>-6,330</u>   | <u>+6,330</u>   |
|                                  | 42,420          | 9,130           |
| Minority interest                |                 | <u>913</u>      |
| Share of H Ltd.                  | <u>8,217</u>    | <u>8,217</u>    |
|                                  | <u>50,637</u>   |                 |
| <b>(vi) Cost of Control</b>      |                 |                 |
| H Ltd. in S Ltd.                 |                 |                 |
| Cost of Investments              |                 | 1,20,000        |
| Paid up value                    | 90,000          |                 |
| Capital Profits                  | <u>50,689</u>   | <u>1,40,689</u> |
| Capital Reserve                  |                 | <u>20,689</u>   |
| Cost of Investments              |                 | 24,000          |
| Paid up value                    |                 | <u>20,000</u>   |
| Goodwill                         |                 | 4,000           |

**Consolidated Balance Sheet of H Ltd., and its subsidiary S Ltd.,  
as on 31st December, 2006**

| Liabilities             | Rs.      | Assets   | Rs.      |
|-------------------------|----------|----------|----------|
| Share Capital           |          | Goodwill | 1,12,000 |
| 18,000 shares of Rs. 10 |          | H Ltd.   |          |
| each fully paid         | 1,80,000 | S Ltd.   | 40,000   |

## 5.70 Financial Reporting

|                           |               |                 |                        |                 |                 |
|---------------------------|---------------|-----------------|------------------------|-----------------|-----------------|
| Less: Held by S Ltd.      | <u>20,000</u> | 1,60,000        | On consolidation of    |                 |                 |
| 15,000 7½% Pref. shares   |               |                 | S Ltd. in H Ltd.       | <u>4,000</u>    |                 |
| of Rs. 10 each fully paid |               | 1,50,000        |                        | 1,56,000        |                 |
|                           |               |                 | Less : Capital Reserve | <u>20,689</u>   | 1,35,311        |
| Reserve & Surplus:        |               |                 | Plant & Machinery:     |                 |                 |
| Reserve                   |               | 17,479          | H Ltd.                 | 95,000          |                 |
| Profit & Loss A/c         | 50,637        |                 | S Ltd.                 |                 |                 |
| Less: Stock Res.          | <u>3,000</u>  | 47,637          | (50,400 + 6,800 – 200) | <u>57,000</u>   | 1,52,000        |
| Share Premium             |               | 36,000          | Furniture:             |                 |                 |
|                           |               |                 | H Ltd.                 | 7,000           |                 |
| Current Liabilities &     |               |                 | S Ltd.                 | <u>4,600</u>    | 11,600          |
| Provisions:               |               |                 |                        |                 |                 |
| H Ltd.                    | 17,000        |                 | Stock in trade:        |                 |                 |
| S Ltd.                    | <u>61,000</u> |                 | H Ltd.                 | 48,000          |                 |
|                           | 78,000        |                 | S Ltd.                 | <u>1,14,000</u> |                 |
| Less: Interco.            | <u>15,000</u> | 63,000          |                        | 1,62,000        |                 |
| Provision for Pref.       |               |                 | Less : Stock Res.      | <u>3,000</u>    | 1,59,000        |
| Div. H Ltd.               |               | 11,250          |                        |                 |                 |
| Minority Interest         |               |                 | Sundry Debtors:        |                 |                 |
| Pref. shares              | 80,000        |                 | H Ltd.                 | 70,000          |                 |
| Dividend                  | 6,000         |                 | S Ltd.                 | <u>45,000</u>   |                 |
| Equity shares             | 10,000        |                 |                        | 1,15,000        |                 |
| Capital Profit            | 5,632         |                 | Less : Inter Co.       | <u>15,000</u>   | 1,00,000        |
| Revenue Profits           | <u>913</u>    | 1,02,545        | Cash at Bank:          |                 |                 |
|                           |               |                 | H Ltd.                 | 17,000          |                 |
|                           |               |                 | S Ltd.                 | <u>13,000</u>   | <u>30,000</u>   |
|                           |               | <u>5,87,911</u> |                        |                 | <u>5,87,911</u> |

### Illustration 23

Able Ltd. made an offer to acquire all the shares of Baker Ltd. at a price of Rs. 25 per share, to be satisfied by the allotment of five shares in Able Ltd. for every four shares in Baker Ltd.

By the date of expiration of the offer, which was on 1st January, 2006, share-holders owning 75% of the shares in Baker Ltd. accepted the offer and the acquisition was effective from that date.

The accounting date of Baker Ltd. was on 31st March in each year, but to conform with Able Ltd. accounts were prepared to 30th June, 2006, covering the fifteen months to the date.

**Consolidated Financial Statements of Group Companies     5.71**

The draft summarised accounts of the companies on 30th June, 2006 which do not include any entries regarding the acquisition of shares in Baker Ltd., were as follows:

**Balance Sheet as on 30th June, 2006**

| <i>Liabilities</i>           |               | <b>Able Ltd.</b> |              | <b>Baker Ltd.</b> |
|------------------------------|---------------|------------------|--------------|-------------------|
|                              | <i>Rs.</i>    | <i>Rs.</i>       | <i>Rs.</i>   | <i>Rs.</i>        |
| Share Capital –              |               |                  |              |                   |
| Equity shares of Rs. 10 each |               |                  |              |                   |
| Authorised :                 |               | <u>3,00,000</u>  |              | <u>75,000</u>     |
| Issued & fully paid:         |               | 1,50,000         |              | 60,000            |
| Reserves & Surplus:          |               |                  |              |                   |
| General Reserve              | 55,000        |                  |              |                   |
| Profit & Loss Account        | <u>62,000</u> | 1,17,000         |              | 20,000            |
| Current liabilities          |               | 27,000           |              | 7,000             |
| Provision for taxation       |               | <u>33,000</u>    |              | <u>6,000</u>      |
|                              |               | <u>3,27,000</u>  |              | <u>93,000</u>     |
| <br><i>Assets</i>            |               |                  |              |                   |
| Freehold property, at cost   |               | 2,00,000         |              | 38,000            |
| Plant & Machinery at cost    | 50,000        |                  | 12,000       |                   |
| Less: Depreciation           | <u>18,000</u> | 32,000           | <u>3,000</u> | 9,000             |
| Quoted Investment at Cost    |               | 7,000            |              | —                 |
| Stock at Cost                |               | 32,000           |              | 21,000            |
| Debtors                      |               | 41,000           |              | 17,000            |
| Balance at Bank              |               | <u>15,000</u>    |              | <u>8,000</u>      |
|                              |               | <u>3,27,000</u>  |              | <u>93,000</u>     |

**Profit & Loss Account for the period ended on 30th June, 2006**

|                                        | <b>Able Ltd.</b> | <b>Baker Ltd.</b> |
|----------------------------------------|------------------|-------------------|
|                                        | <i>One Year</i>  | <i>15 months</i>  |
|                                        | <i>Rs.</i>       | <i>Rs.</i>        |
| Balance brought forward                | 14,000           | 12,000            |
| Profit for the period                  | <u>80,000</u>    | <u>18,000</u>     |
|                                        | <u>94,000</u>    | <u>30,000</u>     |
| Taxation for the period                | 32,000           | 6,000             |
| Interim Dividend paid, 30th Nov., 2005 | —                | 4,000             |
| Balance carried forward                | <u>62,000</u>    | <u>20,000</u>     |
|                                        | <u>94,000</u>    | <u>30,000</u>     |

## 5.72 Financial Reporting

The Directors of Able Ltd. recommended a final dividend of 20% to the shareholders on register as on 30th June, 2006. The Directors of Baker Ltd., proposed a final dividend of 12½% payable on 30th September, 2006.

You are required to prepare the consolidated Balance Sheet of Able Ltd. and Baker Ltd. on 30th June, 2006.

### Solution

#### Consolidated Balance Sheet of Able Ltd. and its subsidiary Baker Ltd. as on 30th June, 2006

| <i>Liabilities</i>     | <i>Rs.</i>      | <i>Rs.</i>      | <i>Assets</i>        | <i>Rs.</i>    | <i>Rs.</i>      |
|------------------------|-----------------|-----------------|----------------------|---------------|-----------------|
| Share Capital          |                 |                 | Goodwill             |               | 56,100          |
| (Equity shares of      |                 |                 | Freehold Property:   |               |                 |
| Rs. 10 each)           |                 |                 | Able Ltd.            | 2,00,000      |                 |
| Authorised :           | <u>3,00,000</u> |                 | Baker Ltd.           | <u>38,000</u> | 2,38,000        |
| Issued & fully paid    | 2,06,250        |                 |                      |               |                 |
| Share premium A/c      | 56,250          |                 | Plant and Machinery: |               |                 |
| General Reserve        | 55,000          |                 | At cost less Dep.    |               |                 |
| Profit & Loss A/c      | 24,350          |                 | Able Ltd.            | 32,000        |                 |
| Minority Interest      | 18,125          |                 | Baker Ltd.           | <u>9,000</u>  | 41,000          |
| Provision for taxation | 39,000          |                 |                      |               |                 |
| Current Liabilities:   |                 |                 | Quoted investments:  |               |                 |
| Able Ltd.              | 27,000          |                 | Able Ltd.            |               | 7,000           |
| Baker Ltd.             | <u>7,000</u>    | 34,000          | Able Ltd.            | 41,000        |                 |
|                        |                 |                 | Baker Ltd.           | <u>17,000</u> | 58,000          |
| Proposed Dividend:     |                 |                 |                      |               |                 |
| Minority Interest      | 1,875           |                 | Stock:               |               |                 |
| Own Shareholders       | <u>41,250</u>   | 43,125          | Able Ltd.            | 32,000        |                 |
|                        |                 |                 | Baker Ltd.           | <u>21,000</u> | 53,000          |
|                        |                 |                 | Bank:                |               |                 |
|                        |                 |                 | Able Ltd.            | 15,000        |                 |
|                        |                 |                 | Baker Ltd.           | <u>8,000</u>  | <u>23,000</u>   |
|                        |                 | <u>4,76,100</u> |                      |               | <u>4,76,100</u> |



**Working Notes:**

|                                                                   | Rs.           | Rs.           |
|-------------------------------------------------------------------|---------------|---------------|
| (i) <i>Number of shares to be issued :</i>                        |               |               |
| 75% of shares of Bakers Ltd.                                      | 4,500         |               |
| No. of shares of Able Ltd. $4,500 \times 5/4$                     | 5,625         |               |
| Value of 4,500 Shares @Rs. 25                                     |               | 1,12,500      |
| Face value of 5,625 Shares @ Rs. 10                               |               | <u>56,250</u> |
| Share Premium                                                     |               | <u>56,250</u> |
| (ii) <i>Cost of Control :</i>                                     |               |               |
| Cost of Shares in Baker Ltd.                                      |               |               |
| Share Capital                                                     | 56,250        |               |
| Share Premium                                                     | <u>56,250</u> | 1,12,500      |
| Less: Face value of shares acquired                               | 45,000        |               |
| Pre-acquisition profits                                           | <u>11,400</u> | <u>56,400</u> |
| Goodwill on consolidation                                         |               | <u>56,100</u> |
| (iii) <i>Minority Interest:</i>                                   |               |               |
| Share Capital A/c, 1/4                                            |               | 15,000        |
| Profit & Loss A/c, 1/4                                            |               | <u>5,000</u>  |
|                                                                   |               | 20,000        |
| Less: Proposed Dividend, 12½% on<br>Rs. 15,000 (shown separately) |               | <u>1,875</u>  |
|                                                                   |               | <u>18,125</u> |
| (iv) <i>Pre-acquisition profit of Baker Ltd.:</i>                 |               |               |
| Profit & Loss A/c as per Balance Sheet                            |               | 20,000        |
| Less: Post-acquisition profit, 6/15 of Rs. 18,000                 | 7,200         |               |
| Less: Taxation thereon 6/15 of Rs. 6,000                          | <u>2,400</u>  | <u>4,800</u>  |
|                                                                   |               | <u>15,200</u> |
| 3/4 thereof                                                       |               | <u>11,400</u> |
| (v) <i>Profit &amp; Loss A/c – Able Ltd.</i>                      |               |               |
| Balance as per P & L A/c                                          |               | 62,000        |
| Less: Proposed Dividend<br>(20% on Rs. 2,06,250)                  |               | <u>41,250</u> |
| Balance to Consolidated P & L A/c                                 |               | <u>20,750</u> |

## 5.74 Financial Reporting

(vi) *Profit and Loss A/c - Baker Ltd.*

|                                    |               |               |
|------------------------------------|---------------|---------------|
| Balance as per Profit and Loss A/c |               | 20,000        |
| Less : Minority Interest           | 5,000         |               |
| Pre-acquisition profit             | <u>11,400</u> | <u>16,400</u> |
| Balance in Consolidated P & L A/c  |               | <u>3,600</u>  |
| Total of (v) and (vi)              |               | <u>24,350</u> |

**Note:** It is assumed that whole of the dividend of Rs. 41,250 proposed by Able Ltd. will be appropriated from revenue, although part of that dividend is due to the ex-shareholders of Baker Ltd.

### Illustration 24

In preparing the consolidated balance sheet of H Ltd. as on 31st December, 2006 you are required to show clearly what amount, if any, you would include in respect of W Ltd. with regard to:

- (a) Cost of control/reserve;
- (b) Profit or loss; and
- (c) Minority interest.

under each of the following assumptions :

- (i) 48,000 of the shares then in issue of W Ltd. were acquired at a cost of Rs. 75,000 on 1st March, 2004 H Ltd. participated in the proposed dividend of Rs. 8,000.
- (ii) 40,000 of the shares then in issue of W Ltd. were acquired at a cost of Rs. 60,000 on 31st Dec., 2004; H Ltd. participated in the bonus issue but not in the proposed dividend of Rs. 9,000.
- (iii) 60,000 of the shares then in issue of W Ltd. were acquired at a cost of Rs. 80,000 on 1st July, 2006; H Ltd. did not participate in the proposed dividend of Rs. 6,000.

The balance sheet of W Ltd. as on 31st December, 2006 showed:

|                                                  |        |
|--------------------------------------------------|--------|
|                                                  | Rs.    |
| Share Capital, Authorised & Issued of Re. 1 each | 80,000 |
| Undistributed profits                            | 24,000 |
| 7% Debentures                                    | 40,000 |

The Profit & Loss Appropriation Accounts, for four years ended 31st December, 2006 were as follows:

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|                                      | 2003          | 2004          | 2005          | 2006          |
|--------------------------------------|---------------|---------------|---------------|---------------|
|                                      | Rs.           | Rs.           | Rs.           | Rs.           |
| Balance at the beginning of the year | 16,000        | 22,000        | 43,000        | 28,000        |
| Bonus issue of one for four          |               |               |               |               |
| - 1st January, 2005                  |               |               | <u>16,000</u> |               |
|                                      |               |               | 27,000        |               |
| Profit for the year(loss)            | <u>14,000</u> | <u>30,000</u> | <u>7,000</u>  | <u>4,000</u>  |
|                                      | 30,000        | 52,000        | 34,000        | 24,000        |
| Proposed Dividends                   | <u>8,000</u>  | <u>9,000</u>  | <u>6,000</u>  | <u>Nil</u>    |
| Balance carried forward              | <u>22,000</u> | <u>43,000</u> | <u>28,000</u> | <u>24,000</u> |

**Solution**

Amounts to be included in the Consolidated Balance Sheet of H Limited as on 31st December, 2006 in respect of W Limited:

(i) (a) Goodwill / Cost of Control:

|                                                                          | Rs.           | Rs.           |
|--------------------------------------------------------------------------|---------------|---------------|
| Cost of 48,000 shares on 1st March, 2004                                 |               | 75,000        |
| Less: Dividends from pre-acquisition profits:                            |               |               |
| $\frac{48}{64} \times 8,000$                                             | 6,000         |               |
| $\frac{48}{64} \times \frac{2}{12} \times 9,000$                         | <u>1,125</u>  | <u>7,125</u>  |
|                                                                          |               | <u>67,875</u> |
| Nominal value of shares                                                  |               | 48,000        |
| Proportion of pre-acquisition profit as at 31st December, 2003           | 22,000        |               |
| Earned in 2004 less dividend $\left[ \frac{2}{12} \times 21,000 \right]$ | <u>3,500</u>  |               |
|                                                                          | <u>25,500</u> |               |
| H Ltd.'s share Rs. $25,500 \times \frac{48}{64}$                         |               | <u>19,125</u> |
|                                                                          |               | <u>67,125</u> |

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\* Total Number of shares before the bonus issue was 80,000 less 1/5 or 64,000

## 5.76 Financial Reporting

|                                                  |               |               |
|--------------------------------------------------|---------------|---------------|
| Goodwill, Rs. 67,875 – 67,125                    |               | <u>750</u>    |
|                                                  | Rs.           | Rs.           |
| (b) Consolidated Profit & Loss balance           |               |               |
| Profit & Loss Account as per Balance Sheet       |               | 24,000        |
| Minority Interest: $\frac{20}{80} \times 24,000$ | 6,000         |               |
| Capital Profit :                                 |               |               |
| Pre-acquisition profit                           | 25,500        |               |
| Less: Capitalised for bonus issue                | <u>16,000</u> |               |
|                                                  | <u>9,500</u>  |               |
| Share of H Ltd.: $\frac{60}{80} \times 9,500$    | <u>7,125</u>  | <u>13,125</u> |
| Balances for Consolidation                       |               | <u>10,875</u> |
| (c) Minority Interest                            |               |               |
| Share Capital (1/4)                              |               | 20,000        |
| Profit & Loss Account                            |               | <u>6,000</u>  |
|                                                  |               | <u>26,000</u> |

This answer assumes that 2/12th of the proposed dividends for 2004 and capitalisation for the bonus issue both came from pre-acquisition profits.

|                                                                      |               |               |
|----------------------------------------------------------------------|---------------|---------------|
|                                                                      | Rs.           | Rs.           |
| (ii) (a) Cost of Control / Goodwill.                                 |               |               |
| Cost of 40,000 shares - 31st December, 2004                          |               | 60,000        |
| Nominal value of shares purchased                                    | 40,000        |               |
| Pre-acquisition profits $\frac{40}{64} \times 43,000$                | <u>26,875</u> | <u>66,875</u> |
| Capital Reserve                                                      |               | <u>6,875</u>  |
| Shares held by the holding company after bonus issue will be 50,000. |               |               |
| (b) Profits & Loss Account - as per Balance Sheet                    |               | <u>24,000</u> |
| Minority Interest: $\frac{30}{80} \times 24,000$                     |               | 9,000         |
| Pre-acquisition Profit: $\frac{50}{80} \times (43,000 - 16,000)$     |               | <u>16,875</u> |
|                                                                      |               | <u>25,875</u> |

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|                                                                     |                  |
|---------------------------------------------------------------------|------------------|
| Balance for Consolidation $\left[ 3,000 \times \frac{5}{8} \right]$ | <u>Dr. 1,875</u> |
| (c) <i>Minority Interest</i> : $\frac{30}{80} \times 1,04,000$      | <u>39,000</u>    |
| <b>(iii) Cost of Control/Goodwill</b>                               |                  |
| (a) <i>Cost of 60,000 shares - 1st July, 2006</i>                   | <u>80,000</u>    |
| Nominal value of shares when purchased                              | 60,000           |
| Pre-acquisition profit:                                             |                  |
| at 31st December, 2005                                              | 28,000           |
| Less: $\frac{6}{12} \times 4,000$                                   | <u>2,000</u>     |
|                                                                     | <u>26,000</u>    |
| H Ltd.'s shares : $\frac{60}{80} \times 26,000$                     | <u>19,500</u>    |
|                                                                     | <u>79,500</u>    |
| Goodwill (80,000 – 79,500)                                          | <u>500</u>       |
| (b) <i>Profit and Loss Account- as per Balance sheet</i>            | <u>24,000</u>    |
| Minority Interest : $\frac{20}{80} \times 24,000$                   | 6,000            |
| Pre-acquisition Profit                                              | <u>19,500</u>    |
|                                                                     | 25,500           |
| Balance for Consolidation                                           | <u>Dr. 1,500</u> |
| (c) <i>Minority Interest</i> : $\frac{20}{80} \times 1,04,000$      | <u>26,000</u>    |

**Illustration 25**

The Balance Sheet of A Ltd. and C Ltd. on 31st December, 2006 contained the following items relating to the profits and losses of the companies:

|                               | A Ltd.       | B Ltd.       | C Ltd.              |
|-------------------------------|--------------|--------------|---------------------|
|                               | Rs.          | Rs.          | Rs.                 |
| Non Profit (or loss) for year | 800          | 1,800        | Dr. 480             |
| Add : Balance forward         | <u>1,500</u> | Loss 800     | Profit <u>1,920</u> |
|                               | <u>2,300</u> | <u>1,000</u> | <u>1,440</u>        |

## 5.78 Financial Reporting

A Ltd. acquired 10% of the share capital of B Ltd. on 1st August, 2005. B Ltd. was incorporated on 1st Jan., 2005.

A Ltd. acquired 75% of the share capital of C Ltd. on 1st December, 2006.

B Ltd. acquired 80% of the share capital of C Ltd. on 1st September, 2006.

Prepare draft schedule of consolidated profit and loss account of the group showing the amount to be transferred to other essential accounts to be included in the consolidated balance sheet, i.e., the credit total of Rs. 4,740.

### Solution

#### (i) Analysis of profit of C Ltd.

|                                         | Capital Profit | Revenue Profit |
|-----------------------------------------|----------------|----------------|
|                                         | Rs.            | Rs.            |
| Balance brought forward                 | 1,920          |                |
| Profit/Loss for the year pre-post 8 : 4 | <u>-320</u>    | <u>-160</u>    |
|                                         | 1,600          | -160           |
| Shares of Minority Interest (10%)       | <u>160</u>     | <u>16</u>      |
| Balance                                 | 1,440          | -144           |
| Share of A Ltd.                         | <u>160</u>     | <u>16*</u>     |
| Share of B Ltd.                         | <u>1,280</u>   | <u>-128</u>    |

#### (ii) Analysis of profit of B Ltd.

|                              | Capital Profit | Revenue Profit |
|------------------------------|----------------|----------------|
|                              | Rs.            | Rs.            |
| Balance brought forward      |                |                |
| divided in the ratio of 7:5  |                |                |
| i.e., Capital upto 31st July |                |                |
| and Revenue from August      | - 467          | -333           |
| Revenue loss from C Ltd.     |                | <u>-128</u>    |
|                              |                | -461           |
| Profit for the year          | <u>      </u>  | <u>1,800</u>   |
|                              | -467           | 1,339          |
| Minority Interest (1/4)      | <u>-117</u>    | <u>335</u>     |

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\* For A Ltd. this represents loss for Sept., Oct., Nov. & Dec. Loss upto 1st Dec. is capital loss for A Ltd. Hence only Rs. 4 is Revenue loss; net capital profit for A Ltd. is Rs. 148.

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|                                                |             |              |
|------------------------------------------------|-------------|--------------|
| Share of A Ltd.                                | <u>-350</u> | <u>+1004</u> |
| (iii) <i>Capital Profits for Consolidation</i> |             |              |
| B Ltd. in C Ltd.                               |             | 1,280        |
| A Ltd. in C Ltd. (160 – 12)                    |             | <u>148</u>   |
|                                                |             | 1,428        |
| A Ltd. in B Ltd.                               |             | <u>-350</u>  |
|                                                |             | <u>1,078</u> |
| (iv) <i>Minority Interest C Ltd.</i>           |             |              |
| in Capital Profit                              |             | +160         |
| in Revenue Profit                              |             | <u>-16</u>   |
|                                                |             | 144          |
| in B Ltd.: Capital Profit                      |             | <u>-117</u>  |
|                                                |             | 27           |
| Revenue Profit                                 |             | <u>335</u>   |
|                                                |             | <u>362</u>   |
| (v) <i>Revenue Profit</i>                      |             |              |
| A Ltd. in B Ltd.                               |             | 1,004        |
| Less: A Ltd. in C Ltd. (Loss of Dec.)          |             | <u>4</u>     |
|                                                |             | <u>1,000</u> |

**Illustration 26**

As on 30th June, 2006 the draft balance sheets of the companies showed, the following position:

|                            | <b>Rock Ltd.</b> | <b>King Ltd.</b> | <b>Chair Ltd.</b> |
|----------------------------|------------------|------------------|-------------------|
|                            | <i>Rs.</i>       | <i>Rs.</i>       | <i>Rs.</i>        |
| Fixed assets               | 1,35,000         | 60,000           | 70,000            |
| Investments at cost        | <u>1,60,000</u>  | <u>1,50,000</u>  | <u>10,000</u>     |
|                            | <u>2,95,000</u>  | <u>2,10,000</u>  | <u>80,000</u>     |
| Current assets:            |                  |                  |                   |
| Stock                      | 55,240           | 36,840           | 61,760            |
| Debtors                    | 1,10,070         | 69,120           | 93,880            |
| Balances at bank           | <u>1,31,290</u>  | <u>16,540</u>    | <u>52,610</u>     |
|                            | <u>2,96,600</u>  | <u>1,22,500</u>  | <u>2,08,250</u>   |
| Less: Current liabilities: |                  |                  |                   |

## 5.80 Financial Reporting

|                                      |                 |                 |                 |
|--------------------------------------|-----------------|-----------------|-----------------|
| Creditors                            | 1,12,060        | 73,130          | 78,190          |
| Taxation                             | 30,000          | —               | 22,000          |
| Proposed dividends                   | <u>1,00,000</u> | <u>60,000</u>   | <u>40,000</u>   |
|                                      | <u>2,42,060</u> | <u>1,33,130</u> | <u>1,40,190</u> |
| Net current assets / (liabilities)   | <u>54,540</u>   | <u>(10,630)</u> | <u>68,060</u>   |
|                                      | <u>3,49,540</u> | <u>1,99,370</u> | <u>1,48,060</u> |
| Financed by:                         |                 |                 |                 |
| Issued ordinary shares of Rs.10 each | 2,00,000        | 1,50,000        | 80,000          |
| Capital reserve                      | 50,000          | —               | 23,000          |
| Revenue reserve                      | <u>99,540</u>   | <u>49,370</u>   | <u>45,060</u>   |
|                                      | <u>3,49,540</u> | <u>1,99,370</u> | <u>1,48,060</u> |

You also obtain the following information:

- (1) King Ltd. acquired 6,800 shares in Chair Ltd. at Rs. 22 per share in 2003 when the balance on capital reserve was Rs. 15,000 and on revenue reserve Rs. 30,500 consolidated.
- (2) Rock Ltd. purchased 8,000 shares in King Ltd. in 2003 when the balance on the revenue reserve was Rs. 40,000. Rock Ltd. purchased a further 4,000 shares in King Ltd. in 2004 when the balance on the revenue reserve was Rs. 45,000. Rock Ltd. held no other investments on 30th June, 2006.
- (3) Proposed dividends from subsidiary companies are included in the figure for debtors in the accounts of the parent companies.

Prepare the consolidated balance sheet of Rock Ltd. and its subsidiaries in vertical form as on 30th June, 2006, together with the consolidation schedules.

### Solution

| Rock Limited                                     |                 |     |               |
|--------------------------------------------------|-----------------|-----|---------------|
| Consolidated Balance Sheet as on 30th June, 2006 |                 |     |               |
|                                                  | Rs.             | Rs. | Rs.           |
| Goodwill                                         |                 |     | 49,592        |
| Fixed assets (1,35,000 + 60,000 + 70,000)        |                 |     | 2,65,000      |
| Investments at cost [W.N. (v)]                   |                 |     | <u>10,400</u> |
|                                                  |                 |     | 3,24,992      |
| Current Assets:                                  |                 |     |               |
| Stock                                            | 1,53,840        |     |               |
| Debtors [W.N. (vi)]                              | 1,91,070        |     |               |
| Balance at bank                                  | <u>2,00,440</u> |     |               |



**Consolidated Financial Statements of Group Companies     5.81**

|                                       |               |                 |                 |
|---------------------------------------|---------------|-----------------|-----------------|
|                                       |               | 5,45,350        |                 |
| Current liabilities:                  |               |                 |                 |
| Creditors                             | 2,63,380      |                 |                 |
| Taxation                              | 52,000        |                 |                 |
| Proposed dividends:                   |               |                 |                 |
| Holding company                       | 1,00,000      |                 |                 |
| Minority shareholders                 | <u>18,000</u> | <u>4,33,380</u> | <u>1,11,970</u> |
|                                       |               |                 | <u>4,36,962</u> |
| Financed by :                         |               |                 |                 |
| Issued ordinary shares of Rs. 10 each |               |                 | 2,00,000        |
| Capital reserve (50,000 + 5,440)      |               |                 | 55,440          |
| Revenue reserve (99,540+16,064)       |               |                 | <u>1,15,604</u> |
|                                       |               |                 | 3,71,044        |
| Minority interest                     |               |                 | <u>65,918</u>   |
|                                       |               |                 | <u>4,36,962</u> |

**Working Notes:**

*Analysis of profit*

(i) *Chair Ltd.*

|                             | <i>Capital<br/>Profit<br/>Rs.</i> | <i>Capital<br/>Reserve<br/>Rs.</i> | <i>Revenue<br/>Reserve<br/>Rs.</i> |
|-----------------------------|-----------------------------------|------------------------------------|------------------------------------|
| Capital Reserve in 2003     | 15,000                            |                                    |                                    |
| Increase in Capital Reserve |                                   | 8,000                              |                                    |
| Revenue Reserve in 2003     | 30,500                            |                                    |                                    |
| Increase in Revenue Reserve |                                   |                                    | <u>14,560</u>                      |
|                             | 45,500                            | 8,000                              | 14,560                             |
| Minority Interest 15%       | <u>6,825</u>                      | <u>1,200</u>                       | <u>2,184</u>                       |
| Share of King               | <u>38,675</u>                     | <u>6,800</u>                       | <u>12,376</u>                      |

(ii) *King Ltd.*

|                             |        |              |               |
|-----------------------------|--------|--------------|---------------|
| Revenue Reserve in 2003     | 40,000 |              |               |
| Increase in Revenue Reserve |        |              | 9,370         |
| Share in Chair Ltd.         |        | <u>6,800</u> | <u>12,376</u> |
|                             | 40,000 | 6,800        | 21,746        |

## 5.82 Financial Reporting

|                                                |                  |                   |                 |
|------------------------------------------------|------------------|-------------------|-----------------|
| Minority interest (20%)                        | <u>8,000</u>     | <u>1,360</u>      | <u>4,349</u>    |
|                                                | 32,000           | <u>5,440</u>      | 17,397          |
| Less: $(5,000 \times \frac{4}{15})$ for second |                  |                   |                 |
| acquisition treated as capital                 | <u>+1,333</u>    |                   | <u>-1,333</u>   |
|                                                | <u>33,333</u>    |                   | <u>16,064</u>   |
| (iii) <i>Cost of Control / Goodwill</i>        |                  |                   |                 |
| Cost of Investment in Chair                    |                  |                   | 1,49,600        |
| Cost of Investment in king                     |                  |                   | <u>1,60,000</u> |
|                                                |                  |                   | 3,09,600        |
| Paid up value of shares                        |                  |                   |                 |
| in Chair                                       |                  | 68,000            |                 |
| in King                                        |                  | 1,20,000          |                 |
| Capital profits in                             |                  |                   |                 |
| Chair                                          |                  | 38,675            |                 |
| King                                           |                  | <u>33,333</u>     |                 |
|                                                |                  |                   | <u>2,60,008</u> |
| Goodwill                                       |                  |                   | <u>49,592</u>   |
| (iv) <i>Minority Interest</i>                  |                  |                   |                 |
|                                                | (20%)            | (15%)             |                 |
|                                                | <b>King Ltd.</b> | <b>Chair Ltd.</b> |                 |
| Capital                                        | 30,000           | 12,000            |                 |
| Capital Reserve                                | 1,360            | 1,200             |                 |
| Revenue Reserve                                | 4,349            | 2,184             |                 |
| Capital Profit                                 | <u>8,000</u>     | <u>6,825</u>      |                 |
|                                                | <u>43,709</u>    | <u>22,209</u>     |                 |
| (v) <i>Investment</i>                          |                  |                   |                 |
| King Limited                                   |                  |                   | 1,50,000        |
| Less: Cost of Chair Limited (6,800 × Rs. 22)   |                  |                   | <u>1,49,600</u> |
|                                                |                  |                   | 400             |
| Chair Limited                                  |                  |                   | <u>10,000</u>   |
|                                                |                  |                   | <u>10,400</u>   |

## (vi) Debtors

|                                   |               |                 |
|-----------------------------------|---------------|-----------------|
| Rock Limited                      |               | 1,10,070        |
| Less: Dividend from King Limited  |               | <u>48,000</u>   |
|                                   |               | 62,070          |
| King Limited                      | 69,120        |                 |
| Less: Dividend from Chair Limited | <u>34,000</u> | 35,120          |
| Chair Limited                     |               | <u>93,880</u>   |
|                                   |               | <u>1,91,070</u> |

**2.18 DISPOSAL OF SHARES**

When a holding company disposes off a part of its holding in the subsidiary company and the subsidiary remains a subsidiary after some of the shares have been sold, cost of control and minority interest will be calculated on the basis of shares held by the holding company on the date of consolidation. The profit or loss on disposal should be transferred to Profit and Loss Account of holding company.

The results of operations of a subsidiary are included in the consolidated financial statements as from the date on which parent-subsidiary relationship came in existence. The results of operations of a subsidiary with which parent-subsidiary relationship ceases to exist are included in the consolidated statement of profit and loss until the date of cessation of the relationship. The difference between the proceeds from the disposal of investment in a subsidiary and the carrying amount of its assets less liabilities as of the date of disposal is recognised in the consolidated statement of profit and loss as the profit or loss on the disposal of the investment in the subsidiary. In order to ensure the comparability of the financial statements from one accounting period to the next, supplementary information is often provided about the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date and the results for the reporting period on the corresponding amounts for the period.

An investment in an enterprise should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments, from the date the enterprise ceases to be a subsidiary and does not become an associate\*.

The carrying amount of the investment at the date it ceases to be a subsidiary is regarded as cost thereafter.

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\* Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', which came into effect in respect of accounting periods commencing on or after 1.4.2002, defines the term 'associate' and specifies the requirements relating to accounting for investments in associates in Consolidated Financial Statements.

## 5.84 Financial Reporting

### Illustration 27

From the following Summarised Balance Sheets of A Ltd. and its subsidiary B Ltd., prepare a consolidated Balance Sheet as on 31st December, 2006.

| <i>Liabilities</i>  | <b>A Ltd.</b>   | <b>B Ltd.</b> | <i>Assets</i>    | <b>A Ltd.</b>   | <b>B Ltd.</b> |
|---------------------|-----------------|---------------|------------------|-----------------|---------------|
|                     | <i>Rs.</i>      | <i>Rs.</i>    |                  | <i>Rs.</i>      | <i>Rs.</i>    |
| Share Capital       |                 |               | Sundry Assets    | 93,000          | 32,000        |
| Equity Shares       |                 |               | Shares in B Ltd. |                 |               |
| of Rs. 10 each      | 1,00,000        | 20,000        | 1,200 shares at  |                 |               |
| Profit on sale of   |                 |               | Rs. 15 each      | 18,000          |               |
| shares              | 3,000           |               |                  |                 |               |
| Profit and Loss A/c |                 |               |                  |                 |               |
| Brought forward     | 6,000           | 7,200         |                  |                 |               |
| For the year        | <u>2,000</u>    | <u>4,800</u>  |                  |                 |               |
|                     | <u>1,11,000</u> | <u>32,000</u> |                  | <u>1,11,000</u> | <u>32,000</u> |

A Ltd. bought in earlier year 1,600 equity shares in B Ltd. @ 15 when the Profit and Loss Account balance in B Ltd. was Rs. 4,400. A sold 400 shares @ Rs. 22.50, credited the difference between the sale proceeds and cost to "Profit on sale of investment account" on 30 June, 2006 and crediting the balance to the investment account. Profit during the year accrued uniformly.

### Solution

#### Consolidated Balance Sheet of A Ltd., and its subsidiary B Ltd. as at 31st December, 2006

| <i>Liabilities</i>          | <i>Rs</i>       | <i>Assets</i>             | <i>Rs.</i>      |
|-----------------------------|-----------------|---------------------------|-----------------|
| Share Capital               |                 | Fixed Assets              |                 |
| 10,000 Equity Shares of Rs. | 1,00,000        | Goodwill on Consolidation | 3,360           |
| 10 each fully paid          |                 | Sundry Assets             | 1,25,000        |
| Reserves & Surplus          |                 |                           |                 |
| Profit And Loss Account     | 15,560          |                           |                 |
| Secured Loans               | —               |                           |                 |
| Unsecured Loans             | —               |                           |                 |
| Current Liabilities and     |                 |                           |                 |
| Provisions                  |                 |                           |                 |
| Minority Interest           | <u>12,800</u>   |                           |                 |
|                             | <u>1,28,360</u> |                           | <u>1,28,360</u> |

**Working Notes :**

(i) *Analysis of Profit of B Ltd.*

| <i>Capital</i>                             | <i>Revenue</i> |              |
|--------------------------------------------|----------------|--------------|
| <i>Profit</i>                              | <i>Profit</i>  |              |
|                                            | <i>Rs.</i>     | <i>Rs.</i>   |
| P/L A/c Balance on the date of acquisition | 4,400          |              |
| Increase in the balance after acquisition  |                | 2,800        |
| Profit for the year                        | <u>4,400</u>   | <u>4,800</u> |
|                                            | 4,400          | 7,600        |
| Less : Minority Interest (40 per cent)     | <u>1,760</u>   | <u>3,040</u> |
| Share of A Ltd                             | <u>2,640</u>   | <u>4,560</u> |

(ii) *Cost of Control*

|                                |              |               |
|--------------------------------|--------------|---------------|
| Cost of Investments            |              | 18,000        |
| Less : Paid-up value of shares | 12,000       |               |
| Share of Capital Profits       | <u>2,640</u> | <u>14,640</u> |
| Goodwill                       |              | <u>3,360</u>  |

(iii) *Minority Interest (40 per cent)*

|                              |               |
|------------------------------|---------------|
| Paid-up value of shares held | 8,000         |
| Share of Capital Profits     | 1,760         |
| Share of Revenue Profits     | <u>3,040</u>  |
|                              | <u>12,800</u> |

(iv) *Consolidated Revenue Profit*

|                                              |               |
|----------------------------------------------|---------------|
| Balance as per Profit and Loss A/c of A Ltd. | 8,000         |
| Add: Profit on sale of shares                | <u>3,000</u>  |
|                                              | 11,000        |
| Share in Revenue Profit of B Ltd.            | <u>4,560</u>  |
|                                              | <u>15,560</u> |

(v) **Investments in B Ltd.**

| <i>Particulars</i> | <i>Rs.</i>    | <i>Particulars</i> | <i>Rs.</i>    |
|--------------------|---------------|--------------------|---------------|
| To Balance b/d     | 24,000        | By Bank            | 9,000         |
| To Profit on Sale  | <u>3,000</u>  | By Balance c/d     | <u>18,000</u> |
|                    | <u>27,000</u> |                    | <u>27,000</u> |

## 5.86 Financial Reporting

### Illustration 28

H Ltd. purchased on 1.4.96 8,000 equity shares of Rs. 100 each in S Ltd. when S Ltd. had Rs. 10,00,000 share capital.

It sold 500 such shares on 1.4.97 and purchased 1,000 shares on 1.4.98.

S Ltd. paid 15% dividend each year in September and there was no change in Share Capital Account upto 31.3.99. Profit and Loss Account balances in S Ltd. and Investments of H Ltd. in S Ltd. on different dates were as under :

|                  | Profit and Loss Account<br>balance of S Ltd.<br>Rs. | Investments of H Ltd.<br>in S Ltd.<br>Rs. |
|------------------|-----------------------------------------------------|-------------------------------------------|
| 1st April, 2003  | 5,00,000                                            | 12,80,000                                 |
| 31st March, 2004 | 6,20,000                                            | 12,80,000                                 |
| 31st March, 2005 | 7,00,000                                            | 11,90,000                                 |
| 31st March, 2006 | 8,00,000                                            | 14,00,000                                 |

The amounts shown as investments represent cost price as reduced by sales and increased by further purchase without making any adjustment for profit or loss on sale for dividend.

Prepare statements to show the relevant figures as on 31st March, 2004, 2005 and 2006 for preparation of Consolidated Accounts in respect of :

- Goodwill or Cost of Control
- Revenue Profit.

### Solution

#### Working Notes:

- Calculation of correct cost of investments

| Investment in Shares in S Ltd. Account |                  |          |                          |
|----------------------------------------|------------------|----------|--------------------------|
| 2003                                   | Rs.              | 2004     | Rs.                      |
| April 1 To Bank (8,000 shares)         | 12,80,000        | March 31 | By Profit & Loss Account |
|                                        |                  |          | Rectification regarding  |
|                                        |                  |          | pre-acquisition          |
|                                        |                  |          | dividend – Rs. 8,00,000  |
|                                        |                  |          | × 15/100                 |
|                                        |                  |          | 1,20,000                 |
|                                        |                  |          | By Balance c/d           |
|                                        |                  |          | (8,000 shares)           |
|                                        |                  |          | <u>11,60,000</u>         |
|                                        | <u>12,80,000</u> |          | <u>12,80,000</u>         |

**Consolidated Financial Statements of Group Companies      5.87**

| 2004                                                    | Rs.              | 2004                                                                                | Rs.              |
|---------------------------------------------------------|------------------|-------------------------------------------------------------------------------------|------------------|
| April 1 To Balance b/d<br>(8,000 shares)                | 11,60,000        | April 1 By Bank (Sale proceeds of<br>500 shares = Rs. 12,80,000 –<br>Rs. 11,90,000) | 90,000           |
| April 1 To Profit and Loss<br>Account                   |                  | 2005                                                                                |                  |
| Profit on sale: Rs. 90,000 –<br>(11,60,000 × 500/8,000) | <u>17,500</u>    | March 31 By Balance c/d<br>(7,500 shares)                                           | 10,87,500        |
|                                                         | <u>11,77,500</u> |                                                                                     | <u>11,77,500</u> |

| 2005                                     | Rs.              | 2006                                                                                                         | Rs.              |
|------------------------------------------|------------------|--------------------------------------------------------------------------------------------------------------|------------------|
| April 1 To Balance b/d<br>(7,500 shares) | 10,87,500        | March 31 By Profit & Loss Account–<br>Rectification regarding pre<br>acquisition dividend on<br>1,000 shares | 15,000           |
| To Bank (1,000<br>shares purchased)      | 2,10,000         | By Balance c/d<br>(8,500 shares)                                                                             | 12,82,500        |
|                                          | <u>12,97,500</u> |                                                                                                              | <u>12,97,500</u> |
| 2006                                     |                  |                                                                                                              |                  |
| April 1 To Balance b/d                   | 12,82,500        |                                                                                                              |                  |

|                                                  |                 |
|--------------------------------------------------|-----------------|
| (ii) Capital Profits :                           |                 |
| 31st March 2004:                                 | Rs.             |
| Balance of Profit & Loss Account as on 31.3.2003 | 5,00,000        |
| Less: Dividend on Rs. 10,00,000 @15%             | <u>1,50,000</u> |
|                                                  | <u>3,50,000</u> |

$$\text{H Ltd.'s share} = \text{Rs. } 3,50,000 \times \frac{8,000}{10,000} = 2,80,000$$

31st March, 2005 :

As H Ltd. has sold 500 shares, its share of capital profits is reduced.

$$\text{H Ltd.'s share} = \frac{\text{Rs. } 3,50,000 \times 7,500}{10,000} = \text{Rs. } 2,62,500$$

## 5.88 Financial Reporting

31st March, 2006 :

|                                                  |                 |
|--------------------------------------------------|-----------------|
| Balance of Profit & Loss Account as on 31.3.2005 | 7,00,000        |
| Less: Dividend on Rs. 10,00,000 @ 15%            | <u>1,50,000</u> |
|                                                  | <u>5,50,000</u> |

H Ltd.'s share in respect of 1,000 shares purchased on 1.4.2005

$$= \frac{\text{Rs. } 5,50,000 \times 1,000}{10,000} \quad 55,000$$

H Ltd.'s share of capital profits in respect of 7,500 shares purchased on 31.3.2003 as calculated above

2,62,500

Total 3,17,500

(a) Goodwill or Cost of Control:

|                                                                       | 31.3.2004<br>Rs. | 31.3.2005<br>Rs. | 31.3.2006<br>Rs. |
|-----------------------------------------------------------------------|------------------|------------------|------------------|
| Correct Cost of Investment as per Working Note no. (i)                | 11,60,000        | 10,87,500        | 12,82,500        |
| Less : Paid up value of shares in hand                                | <u>8,00,000</u>  | <u>7,50,000</u>  | <u>8,50,000</u>  |
|                                                                       | 3,60,000         | 3,37,500         | 4,32,500         |
| Less : H Ltd.'s share of capital profits as per working Notes no (ii) | <u>2,80,000</u>  | <u>2,62,500</u>  | <u>3,17,500</u>  |
| Goodwill or Cost of Control                                           | <u>80,000</u>    | <u>75,000</u>    | <u>1,15,000</u>  |

(b) Revenue Profit

|                                                                                                             | 31.3.2004<br>Rs. | 31.3.2005<br>Rs. |
|-------------------------------------------------------------------------------------------------------------|------------------|------------------|
| Balance of Profit & Loss Account                                                                            | 6,20,000         | 7,00,000         |
| Less : Capital Profits                                                                                      |                  |                  |
| Balance of Profit & Loss Account as on 1st April, 2003 after deducting dividend for the year 2002-2003 @15% | <u>3,50,000</u>  | <u>3,50,000</u>  |
|                                                                                                             | 2,70,000         | 3,50,000         |
| Less : Minority Interest                                                                                    |                  |                  |
| 20% on 31.3.2004                                                                                            | 54,000           |                  |
| 25% on 31.3.2005                                                                                            |                  | <u>87,500</u>    |
| H Ltd.'s share                                                                                              | <u>2,16,000</u>  | <u>2,62,500</u>  |



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|                                                                                 |                 |
|---------------------------------------------------------------------------------|-----------------|
|                                                                                 | Rs.             |
| Balance of Profit & Loss Account on 31.3.2006                                   | 8,00,000        |
| Less : Capital Profits as mentioned above                                       | <u>3,50,000</u> |
|                                                                                 | 4,50,000        |
| Less : Minority Interest @ 15%                                                  | <u>67,500</u>   |
|                                                                                 | 3,82,500        |
| But for 10% shares acquired on 1.4.2005<br>there are additional Capital Profits |                 |
| Balance of Profit & Loss Account<br>as on 31.3.2005                             | 7,00,000        |
| Less: Dividend for the year ended<br>31.3.2005 @ 15%                            | <u>1,50,000</u> |
|                                                                                 | 5,50,000        |
| Less : Capital Profit already taken<br>into account above                       | <u>3,50,000</u> |
| Additional Capital Profit                                                       | 2,00,000        |
| H Ltd.'s share = Rs. 2,00,000 × 10/100                                          | <u>20,000</u>   |
|                                                                                 | <u>3,62,500</u> |

### 2.19 FOREIGN SUBSIDIARIES

For consolidating foreign subsidiaries, the first step is to convert the figures of foreign subsidiary into reporting currency on the basis of rules as prescribed by AS 11 (revised 2003), "The Effects of Changes in Foreign Exchange Rates". The amount of exchange difference is calculated as the balancing figure, which is accounted for as post-acquisition profit/loss. After such conversion, the consolidation is done in usual manner.

## UNIT 3

### TREATMENT OF INVESTMENT IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS

#### 3.1 MEANING OF ASSOCIATES

An associate is an enterprise in which an investor has significant influence and which is neither a subsidiary nor a joint venture. Here, 'Significant influence' means the power to participate in the financial and operating decisions of the investee, but the investor does not have control over it.

If an investor holds directly or indirectly through its subsidiaries 20% or more of the voting power of the investee, it should be presumed that investor enjoys significant influence on the investee, and so the investee is considered as an associate of the investor.

An enterprise that presents consolidated financial statements should account for investments in associates in the consolidated financial statements in accordance with the Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements". This Standard does not deal with accounting for investments in associates in the preparation and presentation of separate financial statements by an investor.

#### 3.2 ACCOUNTING METHOD FOR ASSOCIATES

AS 23 suggests equity method of accounting for investments in associates. Under equity method of accounting investment is initially recorded at cost, identifying any goodwill/ capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post-acquisition change in investor's share of net assets in the investee. Distributions received from the investee reduce the carrying amount of the investment. The investor's share in the operational result of the investee is reflected in the consolidated statement of profit and loss.

The following procedure should be followed:

- Investment is initially recorded at cost. Subsequently, the carrying amount is increased on the basis of share of profit or decreased on the basis of share of loss in the associate.
- Step (1): Find out value of investments on the basis of proportionate value of net assets of the investee;
- Step (2): Find out goodwill or capital reserve arising out of the purchase consideration. If the purchase price is above the value of investments determined in step (1) then there is goodwill and if the purchase price is less than the value of the investments determined in step (1) then there is capital reserve.

- Step (3): Goodwill or capital reserve as determined in step (2) should be included in the carrying amount of the investments with a separate disclosure. On the contrary, investments are recognised at purchase price as per AS 13 without disclosing goodwill/capital reserve.

Goodwill/capital reserve can be disclosed within bracket below the "Investments in Associates" in the following style and accumulated income which was not earlier recognized should be added to value of investments for first time consolidation with corresponding credit to consolidated reserve.

## **INVESTMENTS**

### **Long Term Investments**

In Associates – at original cost  
[including Rs.....goodwill/capital reserve (previous year Rs.....)  
arising on acquisition of associates]

*Add:* Accumulated income from Associates.

- Unrealised profit or loss resulting from transactions between the investor (and its consolidated subsidiary) and the associate should be eliminated to the extent of interest of the investor in the associate.
- The carrying amount of investment in an associate is reduced to recognise decline in the value of investments computed in terms of proportionate net assets of the investee.
- Applying the logic of consolidation unrealized profit arising out of intra-group transactions should be eliminated.

In case an associate has made a provision for proposed dividend in its financial statements, the investor's share of the results of operations of the associate should be computed without taking into consideration the proposed dividend [ASI-16]. The investor may account for its share of proposed dividend in its profit and loss account. In that case this approach helps to reflect correct application of equity method. But if the investor has not accounted for its proportionate share of proposed dividend, consolidated financial statement will not reflect fair position.

### **Illustration 1**

A Ltd. acquired 25% of shares in B Ltd. as on 31.3.2005 for Rs. 3 lakhs. The Balance Sheet of B Ltd. as on 31.3.2005 is given below:

|                      | Rs.             |
|----------------------|-----------------|
| Share Capital        | 5,00,000        |
| Reserves and Surplus | <u>5,00,000</u> |

## 5.92 Financial Reporting

|                |                  |
|----------------|------------------|
|                | <u>10,00,000</u> |
| Fixed Assets   | 5,00,000         |
| Investments    | 2,00,000         |
| Current Assets | <u>3,00,000</u>  |
|                | <u>10,00,000</u> |

During the year ended 31.3.2006 the following are the additional information available:

- (i) A Ltd. received dividend from B Ltd., for the year ended 31.3.2005 at 40% from the Reserves.
- (ii) B Ltd., made a profit after tax of Rs. 7 lakhs for the year ended 31.3.2006.
- (iii) B Ltd., declared a dividend @ 50% for the year ended 31.3.2006 on 30.4.2006.

A Ltd. is preparing Consolidated Financial Statements in accordance with AS 21 for its various subsidiaries.

Calculate:

- (i) Goodwill if any on acquisition of B Ltd.'s shares.
- (ii) How A Ltd., will reflect the value of investment in B Ltd., in the Consolidated Financial Statements?
- (iii) How the dividend received from B Ltd. will be shown in the Consolidated Financial Statements?

### Solution

In terms of AS 23 B Ltd. will be considered as an associate company of A Ltd. as shares acquired represent to more than 20%.

|                                                                                                                                 |                     |
|---------------------------------------------------------------------------------------------------------------------------------|---------------------|
| <b>(i) Calculation of Goodwill</b>                                                                                              | <b>Rs. in lakhs</b> |
| Cost of investment                                                                                                              | 3.00                |
| Less: Share in the value of Equity of B.Ltd.<br>as at the date of investment<br>[25% of Rs.10 lakhs (Rs.5 lakhs + Rs. 5 lakhs)] | <u>2.50</u>         |
| Goodwill                                                                                                                        | <u>0.50</u>         |

### (ii) A Ltd.

#### Consolidated Profit and Loss Account for the year ended 31st March, 2006

|    |                               |                     |
|----|-------------------------------|---------------------|
|    |                               | <i>Rs. in lakhs</i> |
| By | Share of profits in B Ltd.    | 1.75                |
| By | Dividend received from B Ltd. | 0.50                |
|    | Transfer to investment A/c    | <u>0.50</u> Nil     |

(iii) A Ltd.

**CONSOLIDATED BALANCE SHEET AS ON 31.3.2006**

|                                      | <i>Rs. in lakhs</i> |
|--------------------------------------|---------------------|
| <i>Investment in B Ltd.</i>          |                     |
| Share in B Ltd.'s Equity             | 2.50                |
| Less: Dividend received              | <u>0.50</u>         |
|                                      | 2.00                |
| Share of Profit for year 2005 – 2006 | <u>1.75</u>         |
|                                      | 3.75                |
| Add: Goodwill                        | <u>0.50</u> 4.25    |

**Working Notes:**

1. Dividend received from B Ltd. amounting to Rs. 0.50 lakhs will be reduced from investment value in the books of A Ltd. However goodwill will not change.
2. B Ltd. made a profit of Rs. 7 lakhs for the year ended 31st March, 2006. A Ltd.'s share in the profits of Rs. 7 lakhs is Rs. 1.75 lakhs. Investment in B Ltd. will be increased by Rs. 1.75 lakhs and consolidated profit and loss account of A Ltd. will be credited with Rs. 1.75 lakhs in the consolidated financial statement of A Ltd.
3. Dividend declared on 30th April, 2006 will not be recognised in the consolidated financial statements of A Ltd.

**3.3 APPLICATION OF EQUITY METHOD**

An investment in associate is required to be accounted for applying equity method except in two situations. Equity method is not applicable

- (1) when an investment is acquired for the purpose of disposal in the near future, i.e., as short term investments; and
- (2) there is severe long term restriction on fund transfer by the associate to the investor. In these two cases AS 13 should be applied.

**3.4 TREATMENT OF CHANGE IN EQUITY OF ASSOCIATE NOT ARISING OUT OF PROFIT AND LOSS ACCOUNT**

There may arise change in equity of the associate which are not through profit and loss account. For example, the associate may revalue its fixed assets and create revaluation reserve. In such cases, increase/decrease in the value of investments should be directly added to/subtracted from the carrying amount of investments with corresponding credit/debit to the balance of the consolidated profit and loss account in the balance sheet. This adjustment should not be routed through consolidated profit and loss account.

## UNIT 4

### TREATMENT OF INVESTMENT IN JOINT VENTURES IN CONSOLIDATED FINANCIAL STATEMENTS

Joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

Business entities, in their process to achieve improved performance and to provide value addition to stakeholders, exert themselves in establishing various forms of business relationships to have either access or control over the economic resources of other business entities. Joint ventures are one of such form of business relationship. Such relations are made either to promote trade, or to gain access to new markets.

Joint venture is controlled by two or more venturers. Additionally, there can also be investors who do not have control. By joint venture, its co-venturers expect to achieve some common purpose or benefit. In India, The ICAI has come up with an Accounting Standard 27 on "Financial Reporting of interests in Joint Ventures" both in separate financial statements and also in consolidated financial statements.

#### 4.1 SCOPE UNDER AS 27

AS 27 should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place.

Also the requirements relating to accounting for joint ventures in consolidated financial statements, contained in AS 27 are applicable only where consolidated financial statements are prepared and presented by the venturer.

#### 4.2 FORMS OF JOINT VENTURE

AS 27 identifies three broad types of Joint Ventures- jointly controlled operations, jointly controlled assets and jointly controlled entities.

##### 4.2.1 Jointly Controlled Operations

The operation of some joint ventures involves the use of the assets and other resources of the venturers rather than the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venturer uses its own fixed assets and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finance, which represent its own obligations. The joint venture's activities may be carried out by the venturer's employees alongside the venturer's similar activities. The joint venture agreement usually provides means by which the revenue from the jointly controlled operations and any expenses incurred in common are shared among the

venturers.

An example of a jointly controlled operation is when two or more venturers combine their operations, resources and expertise in order to manufacture, market and distribute, jointly, a particular product, such as an aircraft. Different parts of the manufacturing process are carried out by each of the venturers. Each venturer bears its own costs and takes a share of the revenue from the sale of the aircraft, such share being determined in accordance with the contractual arrangement.

#### **4.2.2 Jointly Controlled Assets**

Some joint ventures involve the joint control, and often the joint ownership, by the venturers of one or more assets contributed to, or acquired for the purpose of, the joint venture and dedicated to the purposes of the joint venture. The assets are used to obtain economic benefits for the venturers. Each venturer may take a share of the output from the assets and each bears an agreed share of the expenses incurred.

An example of a jointly controlled asset is an oil pipeline jointly controlled and operated by a number of oil production companies. Each venturer uses the pipeline to transport its own product in return for which it bears an agreed proportion of the expenses of operating the pipeline. Another example of a jointly controlled asset is when two enterprises jointly control a property, each taking a share of the rents received and bearing a share of the expenses.

#### **4.2.3 Jointly Controlled Entities**

A jointly controlled entity is a joint venture which involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other enterprises, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity.

### **4.3 ACCOUNTING TREATMENT**

#### **4.3.1 Jointly Controlled Operations**

As per para 13 of AS 27, in respect of its interests in jointly controlled operations, a venturer should recognise in its separate financial statements and consequently in its consolidated financial statements:

- (a) the assets that it controls and the liabilities that it incurs; and
- (b) the expenses that it incurs and its share of the income that it earns from the joint venture.

Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

#### **4.3.2 Jointly Controlled Assets**

As per para 19 of AS 27, in respect of its interest in jointly controlled assets, a venturer should recognise, in its separate financial statements, and consequently in its consolidated

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financial statements:

- (a) its share of the jointly controlled assets, classified according to the nature of the assets;
- (b) any liabilities which it has incurred;
- (c) its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;
- (d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and
- (e) any expenses which it has incurred in respect of its interest in the joint venture.

Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

### 4.3.3 Jointly Controlled Entities

A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other enterprises in conformity with the requirements of AS 27 applicable to that jointly controlled entity.

#### *Separate Financial Statements of a Venturer*

In a venturer's separate financial statements, interest in a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 13, Accounting for Investments.

#### *Consolidated Financial Statements of a Venturer*

In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using proportionate consolidation except

- (a) an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future; and
- (b) an interest in a jointly controlled entity which operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

Interest in such a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 13, Accounting for Investments.

## 4.4 PROPORTIONATE CONSOLIDATION METHOD

The application of proportionate consolidation means that the consolidated balance sheet of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible. The consolidated statement of profit and loss of the venturer includes its share of the income and expenses of the jointly controlled entity. Many of the procedures appropriate for the application of proportionate consolidation are similar to the procedures for the consolidation of investments in subsidiaries, which are set



out in Accounting Standard (AS) 21, Consolidated Financial Statements.

For the purpose of applying proportionate consolidation, the venturer uses the consolidated financial statements of the jointly controlled entity.

Under proportionate consolidation, the venturer includes separate line items for its share of the assets, liabilities, income and expenses of the jointly controlled entity in its consolidated financial statements. For example, it shows its share of the inventory of the jointly controlled entity separately as part of the inventory of the consolidated group; it shows its share of the fixed assets of the jointly controlled entity separately as part of the same items of the consolidated group.

#### **4.4.1 STEPS FOR PROPORTIONATE CONSOLIDATION**

All the steps are similar to those of consolidation of Subsidiary except that when Consolidated Balance sheet is prepared; the venturer's (Investor) proportionate share of each asset and liability is added.

**Step 1:** Ascertain the date of Investment of venturer in Jointly Controlled Entities (JCE).

**Step 2:** Ascertain venturer's share of Interest in the Jointly Controlled Entities.

**Step 3:** Analyse profits of the Jointly Controlled Entities as pre-acquisition and post-acquisition with reference to date of acquisition.

**Step 4:** Ascertain the venturer's share of both pre-acquisition and post-acquisition profits of Jointly Controlled Entities analysed above.

**Step 5:** Ascertain Goodwill/Capital Reserve

|    |                                                                                                           |            |            |
|----|-----------------------------------------------------------------------------------------------------------|------------|------------|
| A) | Cost of Investment                                                                                        |            |            |
|    | Amount invested                                                                                           | XXX        |            |
|    | Less: Pre acquisition dividend                                                                            | <u>XXX</u> | XXX        |
| B) | Less: Venturer's share of net assets in JCE as at date of acquisition represented by venturer's share of: |            |            |
|    | (i) Share Capital                                                                                         | XXX        |            |
|    | (ii) Pre acquisition profits                                                                              | <u>XXX</u> | <u>XXX</u> |
| C) | Goodwill/Capital Reserve (Difference between A & B)                                                       |            | <u>XXX</u> |

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**Steps 6:** Elimination of Inter Company transactions.

Elimination of unrealized profit on unsold stock forming part of intra group transactions to be eliminated to the extent of venturer's stake.

**Step 7:** Reserves for Consolidated Balance Sheet

|    |                                                                                                                                |              |
|----|--------------------------------------------------------------------------------------------------------------------------------|--------------|
| a) | Aggregate reserves for Consolidated Balance Sheet of holding company and subsidiaries as per AS 21 and AS 23 where applicable. | XXX          |
| b) | Add: Venturer's share of post acquisition profit (Step 4)                                                                      | XXX          |
| c) | Less: Venturer's share of unrealized profit (Step 6A)                                                                          | <u>(XXX)</u> |
|    |                                                                                                                                | <u>XXX</u>   |

**Step 8:** Prepare Consolidated Balance Sheet

### Liabilities

|                                    | Parents | Subsidiary<br>(Say 80%)` | Associate | JCE<br>(Say 50%) | Adj.                                                            | Consolidated |
|------------------------------------|---------|--------------------------|-----------|------------------|-----------------------------------------------------------------|--------------|
| Share Capital                      | 100%    | --                       | --        | --               | Cancel Cross holding only                                       | XXX          |
| Reserves                           |         |                          |           |                  |                                                                 | Step 7       |
| Minority Interest                  | -       | 20%                      | -         | -                | -                                                               | XXX          |
| Outside Liabilities (Individually) | 100%    | 100%                     | -         | 50%              | Cancel Inter Company Balances<br>Subsidiary – 100%<br>JCE – 50% | XXX          |
|                                    |         |                          |           |                  |                                                                 | <u>XXX</u>   |

**Assets**

|                                                 | <i>Parent</i> | <i>Subsidiary<br/>(Say 80%)</i> | <i>Associate</i>                                                                             | <i>JCE<br/>(Say<br/>50%)</i> | <i>Adj.</i>                                                                           | <i>Consolidated</i> |
|-------------------------------------------------|---------------|---------------------------------|----------------------------------------------------------------------------------------------|------------------------------|---------------------------------------------------------------------------------------|---------------------|
| Fixed Assets                                    | 100%          | 100%                            |                                                                                              | 50%                          | Adjust for<br>-Revaluation<br>-Unamortised<br>profit on Intra<br>group<br>transaction | XXX                 |
| Investment                                      | -             | -                               | - Only Outside Investment and<br>carrying amount of Investment in<br>Associate as per Step 8 |                              |                                                                                       | XXX                 |
| Current<br>Assets Loans<br>and Advances         | 100%          | 100%                            | -                                                                                            | 50%                          | Adjust for<br>-Unrealised<br>profit on Intra<br>group<br>transaction                  | XXX                 |
| Miscellaneous                                   | 100%          | -                               | -                                                                                            | -                            | -                                                                                     | XXX                 |
| Expenditure<br>to the extent<br>not written off |               |                                 |                                                                                              |                              |                                                                                       | <u>XXX</u>          |
|                                                 |               |                                 |                                                                                              |                              |                                                                                       | <u>XXX</u>          |

**4.5 DIFFERENT REPORTING DATES**

The financial statements of the jointly controlled entity used in applying proportionate consolidation is usually drawn up to the same date as the financial statements of the venturer. When the reporting dates are different, the jointly controlled entity often prepares, for applying proportionate consolidation, statements as at the same date as that of the venturer. When it is impracticable to do this, financial statements drawn up to different reporting dates may be used provided the difference in reporting dates is not more than six months. In such a case, adjustments are made for the effects of significant transactions or other events that occur between the date of financial statements of the jointly controlled entity and the date of the venturer's financial statements. The consistency principle requires that the length of the reporting periods, and any difference in the reporting dates, are consistent from period to period.

**4.6 UNIFORM ACCOUNTING POLICIES**

The venturer usually prepares consolidated financial statements using uniform accounting policies for the like transactions and events in similar circumstances. In case a jointly controlled entity uses accounting policies other than those adopted for the consolidated

## **5.100 Financial Reporting**

financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to the financial statements of the jointly controlled entity when they are used by the venturer in applying proportionate consolidation. If it is not practicable to do so, that fact is disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

### **4.7 OFFSETTING OF ASSETS AND LIABILITIES**

While giving effect to proportionate consolidation, it is inappropriate to offset any assets or liabilities by the deduction of other liabilities or assets or any income or expenses by the deduction of other expenses or income, unless a legal right of set-off exists and the offsetting represents the expectation as to the realisation of the asset or the settlement of the liability.

### **4.8 GOODWILL OR CAPITAL RESERVE**

Any excess of the cost to the venturer of its interest in a jointly controlled entity over its share of net assets of the jointly controlled entity, at the date on which interest in the jointly controlled entity is acquired, is recognised as goodwill, and separately disclosed in the consolidated financial statements. When the cost to the venturer of its interest in a jointly controlled entity is less than its share of the net assets of the jointly controlled entity, at the date on which interest in the jointly controlled entity is acquired, the difference is treated as a capital reserve in the consolidated financial statements. Where the carrying amount of the venturer's interest in a jointly controlled entity is different from its cost, the carrying amount is considered for the purpose of above computations.

### **4.9 DISCONTINUANCE OF PROPORTIONATE CONSOLIDATION METHOD**

A venturer should discontinue the use of proportionate consolidation from the date that:

- (a) it ceases to have joint control over a jointly controlled entity but retains, either in whole or in part, its interest in the entity; or
- (b) the use of the proportionate consolidation is no longer appropriate because the jointly controlled entity operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

From the date of discontinuing the use of the proportionate consolidation, interest in a jointly controlled entity should be accounted for:

- (a) in accordance with Accounting Standard (AS) 21, Consolidated Financial Statements, if the venturer acquires unilateral control over the entity and becomes parent within the meaning of that Standard; and
- (b) in all other cases, as an investment in accordance with Accounting Standard (AS) 13, Accounting for Investments, or in accordance with Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements, as appropriate. For this purpose, cost of the investment should be determined as under:
  - (i) the venturer's share in the net assets of the jointly controlled entity as at the date

of discontinuance of proportionate consolidation should be ascertained, and

- (ii) the amount of net assets so ascertained should be adjusted with the carrying amount of the relevant goodwill/capital reserve (see paragraph 37) as at the date of discontinuance of proportionate consolidation.

#### **4.10 JOINT VENTURE CUM SUBSIDIARY**

When an enterprise establishes joint control over an Entity, which is also a subsidiary of that enterprise as per AS 21, such entity is treated as subsidiary company as per AS 21 and should be accounted accordingly. However, the consolidation of such entity does not preclude other venturers from treating such entity as a Joint Venture under AS 27.

##### **Illustration**

Consolidated data of X Ltd., and its 100% subsidiary Y Ltd. and also information of Z Ltd. relating to the year end 31<sup>st</sup> March, 2006 is given below:

##### **BALANCE SHEET**

|                               | <i>(Rs. in thousand)</i>                                    |               |
|-------------------------------|-------------------------------------------------------------|---------------|
|                               | <i>CBS of X Ltd. and<br/>its 100%<br/>Subsidiary Y Ltd.</i> | <i>Z Ltd.</i> |
| Issued ordinary share capital | 2,000                                                       | 1,000         |
| Reserves                      | 3,450                                                       | 2,000         |
| Debentures                    | 2,000                                                       | 1,500         |
| Current liabilities           | <u>4,550</u>                                                | <u>2,500</u>  |
| Total                         | <u>12,000</u>                                               | <u>7,000</u>  |
| Fixed assets (net)            | 6,500                                                       | 4,000         |
| Investment in Z Ltd. at cost  | 2,000                                                       | ---           |
| Current assets                | <u>3,500</u>                                                | <u>3,000</u>  |
| Total                         | <u>12,000</u>                                               | <u>7,000</u>  |

##### **PROFIT AND LOSS ACCOUNT**

|                           | <i>X Ltd and its<br/>100%<br/>Subsidiary Y<br/>Ltd.</i> | <i>Z Ltd.</i> |
|---------------------------|---------------------------------------------------------|---------------|
| Sales                     | 2000                                                    | 1000          |
| Expenses                  | <u>(900)</u>                                            | <u>(500)</u>  |
| Trading profit before tax | 1,100                                                   | 500           |

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|                              |              |              |
|------------------------------|--------------|--------------|
| Dividend from Uncertain Ltd. | 100          | ----         |
| Taxation                     | <u>(600)</u> | <u>(200)</u> |
| Profit after tax             | 600          | 300          |
| Opening Balance              | 3150         | 1100         |
| Dividends paid               | <u>(300)</u> | <u>(200)</u> |
| Retained Profit              | <u>3450</u>  | <u>1200</u>  |

X Ltd. acquired 50% of the ordinary share capital of Z Ltd. on 1<sup>st</sup> April, 2005 for Rs.2000 thousands when its reserves were Rs.1900 thousands and sold this holding on 3<sup>rd</sup> April, 2006 for Rs.2050 thousands.

You are required to prepare the 'Group' Profit and Loss account and Balance Sheet on four bases as follows:

1. When Z Ltd. is treated as a subsidiary
2. When Z Ltd. is treated as an associated company
3. When Z Ltd. is treated as an investment
4. When Z Ltd. is treated as a Joint Venture.

**Consolidated Financial Statements of Group Companies 5.103**

**Solution**

|    | <i>Particulars</i>                                                    | <i>Subsidiary</i>                                                                                                                                                       | <i>Investment</i>          | <i>Associate</i>                                                                                                          | <i>Joint Venture</i>                                                                                                      |
|----|-----------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------|---------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------|
| a. | Accounting Standard Applicable                                        | 21                                                                                                                                                                      | 13                         | 23                                                                                                                        | 27                                                                                                                        |
| b. | Method                                                                | Full Consolidation                                                                                                                                                      | Cost method                | Equity method                                                                                                             | Proportionate Consolidation                                                                                               |
| c. | Date of Acquisition                                                   | 1 <sup>st</sup> April 2005                                                                                                                                              | 1 <sup>st</sup> April 2005 | 1 <sup>st</sup> April 2005                                                                                                | 1 <sup>st</sup> April 2005                                                                                                |
| d. | Shareholding                                                          | X Ltd – 50%<br>Minority Int. – 50%                                                                                                                                      | Not applicable             | Extent of investment 50%.                                                                                                 | Extent of financial interest 50%.                                                                                         |
| e. | Analysis of reserves                                                  | 1) Opening balance 1900 thousands pre-acquisition<br>2) Current year retained profit 100 thousands post-acquisition                                                     | Not applicable             | 1) Opening balance 1900 thousands pre-acquisition<br>2) Current year retained profit 100 thousands post acquisition       | 1) Opening balance 1900 thousands pre-acquisition<br>2) Current year retained profit 100 thousand post acquisition.       |
| f. | Apportionment of Profits<br>1) Pre-acquisition<br>2) Post-acquisition | 1) X Ltd. – 950 thousands<br>2) Minority – 950 thousands<br>1) X Ltd. – 50 thousands<br>2) Minority – 50 thousands                                                      | Not applicable             | 1) X Ltd. – 950 thousands (Investing Co. Interest)<br>2) X Ltd. – 50 thousands                                            | 1) X Ltd. – 950 thousands (Venturer Interest).<br>2) X Ltd. – 50 thousands.                                               |
| g. | Outsider's interest                                                   | Minority Interest<br>1) Share capital - 500 thousands<br>2) Pre-acquisition – 950 thousands<br>3) Post acquisition - <u>50</u> thousands<br>Total <u>1500</u> thousands | Not applicable             |                                                                                                                           |                                                                                                                           |
| h. | Goodwill/Capital Reserve                                              | 1) Cost of Investment – 2000 thousands<br>2) Share of Net Assets on the date of investment<br>- Share Capital 500 thousands                                             | Not applicable             | 1) Cost of investment 2000 thousands<br>2) Share of net assets on the date of investment<br>- share capital 500 thousands | 1) Cost of investment 2000 thousands<br>2) Share of net assets on the date of investment<br>- Share capital 500 thousands |

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|    |                                                                                |                                                                                                             |                |                                                                                                                                                                                                                                                                                    |                                                                                                                |
|----|--------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------|----------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------|
|    |                                                                                | - Capital Profits <u>950</u> thousands<br>- <u>1450</u> thousands<br>3) Goodwill              550 thousands |                | - capital profits <u>950</u> thousands<br>Total <u>1450</u> thousands<br>- Goodwill              550 thousands                                                                                                                                                                     | - Capital profits <u>950</u> thousands<br>Total <u>1450</u> thousands<br>- Goodwill              550 thousands |
| i. | Inter Company Transactions<br>1) Inter company owings<br>2) Unrealised Profits | Eliminate in full<br><br>Eliminate in full                                                                  | Not applicable | Not applicable<br><br>Eliminate to the extent of investing co's interest                                                                                                                                                                                                           | Eliminate to the extent of venturer's interest                                                                 |
| J. | Reserves for CBS                                                               | *                                                                                                           | Not Applicable | *                                                                                                                                                                                                                                                                                  | *                                                                                                              |
| k. | Carrying amount of Investment in CBS                                           | Nil                                                                                                         | 2000 thousands | a) Amount Invested<br>i) Share of<br>Net Assets      1450 thousands<br>ii) Goodwill - <u>550</u> thousands<br><u>2000</u> thousands<br>b) Add. Share of Post Acquisition profits<br>150 thousand<br>c) Less: Dividend received <u>100</u> thousands<br>Total <u>2059</u> thousands | Nil                                                                                                            |

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\* Reserves for CBS



**CONSOLIDATE PROFIT AND LOSS A/C****as at 31.03.2006**

|                                          | <i>Rs. in thousands</i> |                  |                      |
|------------------------------------------|-------------------------|------------------|----------------------|
| <i>Particulars</i>                       | <i>Subsidiary</i>       | <i>Associate</i> | <i>Joint Venture</i> |
| Sales                                    | 3000                    | 2000             | 2500                 |
| Expenses                                 | (1400)                  | (900)            | (1150)               |
| Dividend                                 | <u>-</u>                | <u>-</u>         | <u>-</u>             |
| PBT                                      | 1600                    | 1100             | 1350                 |
| Tax                                      | <u>(800)</u>            | <u>(600)</u>     | <u>(700)</u>         |
| PAT                                      | 800                     | 500              | 650                  |
| Share of profits from Associate          | -                       | 150              | -                    |
| Opening Balance B/d                      | 3150                    | 3150             | 3150                 |
| Dividend Paid                            | (300)                   | (300)            | (300)                |
| Share of Minority Interest               | <u>(150)</u>            | <u>-</u>         | <u>-</u>             |
| Balance carried forward to Balance Sheet | <u>3500</u>             | <u>3500</u>      | <u>3500</u>          |

**CONSOLIDATED BALANCE SHEET****as at 31.03.2006**

|                     | <i>Rs. in thousands</i> |                      |                     |                         |
|---------------------|-------------------------|----------------------|---------------------|-------------------------|
|                     | <i>If Subsidiary</i>    | <i>If Investment</i> | <i>If Associate</i> | <i>If Joint Venture</i> |
| <b>Liabilities</b>  |                         |                      |                     |                         |
| Share Capital       | 2,000                   | 2,000                | 2,000               | 2,000                   |
| Reserves            | 3,500                   | 3,450                | 3,500               | 3,500                   |
| Minority Interest   | 1,500                   | -                    | -                   | -                       |
| Debentures          | 3,500                   | 2,000                | 2,000               | 2,750                   |
| Current Liabilities | <u>7,050</u>            | <u>4,550</u>         | <u>4,550</u>        | <u>5,800</u>            |
| Total               | <u>17,550</u>           | <u>12,000</u>        | <u>12,050</u>       | <u>14,050</u>           |
| <b>Assets</b>       |                         |                      |                     |                         |
| Goodwill            | 550                     | -                    | -                   | 550                     |
| Fixed Assets        | 10,500                  | 6,500                | 6,500               | 8,500                   |

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|                |               |               |                                              |               |
|----------------|---------------|---------------|----------------------------------------------|---------------|
| Investments    | -             | 2,000         | 2,050<br>(Goodwill –<br>Rs.550<br>thousands) | -             |
| Current Assets | <u>6,500</u>  | <u>3,500</u>  | <u>3,500</u>                                 | <u>5,000</u>  |
| Total          | <u>17,550</u> | <u>12,000</u> | <u>12,050</u>                                | <u>14,050</u> |

### Self-examination Questions

- How would you treat the following items in the accounts of a holding company? Give reasons for your answer:
  - A loan by the holding company to one of its subsidiary companies for the purpose of repaying money borrowed by the latter company on the security of debentures.
  - A temporary advance to the holding company by a Subsidiary company.
  - A premium on shares issued in exchange by the holding company for shares in the subsidiary company.
  - A dividend received from a subsidiary company which is paid out on that company's shares held by the holding company and for which allowance was made in the purchase price of the shares.
- The following is given:

#### Summarised Balance Sheet

| <i>Liabilities</i> | <b>H Ltd.</b>   | <b>S Ltd.</b>   | <i>Assets</i>     | <b>H Ltd.</b>   | <b>S Ltd.</b>   |
|--------------------|-----------------|-----------------|-------------------|-----------------|-----------------|
|                    | <i>Rs.</i>      | <i>Rs.</i>      |                   | <i>Rs.</i>      | <i>Rs.</i>      |
| Share Capital      |                 |                 | 16,000 shares     |                 |                 |
| Rs. 10 each        | 3,60,000        | 2,00,000        | in S Ltd.         | 1,10,000        | —               |
| Creditors          | 1,60,000        | 60,000          | Sundry Assets     | 4,80,000        | 2,10,000        |
| Profit & Loss A/c  | <u>70,000</u>   | <u>—</u>        | Profit & Loss A/c | <u>—</u>        | <u>50,000</u>   |
|                    | <u>5,90,000</u> | <u>2,60,000</u> |                   | <u>5,90,000</u> | <u>2,60,000</u> |

Calculate Cost of Control/Capital Reserve, in each of the following cases:

- If Profit & Loss Account of S Ltd. showed a debit balance of Rs. 80,000 on the date of acquisition:
  - Continuing (i) if S Ltd.'s Fixed Assets (land) was undervalued by Rs. 60,000.
  - If the shares in S Ltd. were purchased for Rs. 90,000.

3. Following is the balance sheet of Minor Ltd. as on 31st December, 2006.

| <i>Liabilities</i>           | <i>Rs.</i>    | <i>Rs.</i>      | <i>Assets</i>            | <i>Rs.</i>      |
|------------------------------|---------------|-----------------|--------------------------|-----------------|
| Share Capital                |               |                 | Fixed Assets             | 1,60,000        |
| 10,000 shares of Rs. 10 each |               | 1,00,000        | Sinking fund Investments | 15,000          |
| Share Premium as             |               |                 | Current Assets           | 1,16,000        |
| on 1.1.2006                  |               | 20,000          |                          |                 |
| Sinking Fund for             |               |                 |                          |                 |
| Redemption of                |               |                 |                          |                 |
| Debentures as on 1.1.2006    | 12,000        |                 |                          |                 |
| Transfer during the year     | <u>3,000</u>  | 15,000          |                          |                 |
| General Reserve              |               |                 |                          |                 |
| as on 1.1.2006               | 50,000        |                 |                          |                 |
| Addition during the year     | <u>10,000</u> | 60,000          |                          |                 |
| Profit & Loss A/c            |               |                 |                          |                 |
| as on 1.1.2006               | 8,000         |                 |                          |                 |
| Profit for the year          | <u>22,000</u> |                 |                          |                 |
|                              | 30,000        |                 |                          |                 |
| Less: Transfer to            |               |                 |                          |                 |
| Sinking Fund and             |               |                 |                          |                 |
| General Reserve              | 13,000        |                 |                          |                 |
| Dividend paid in             |               |                 |                          |                 |
| March '2006 for 2005         | 3,000         |                 |                          |                 |
| Proposed Dividends           | <u>10,000</u> | 4,000           |                          |                 |
| 9% Debentures                |               | 40,000          |                          |                 |
| Current Liabilities          |               | 42,000          |                          |                 |
| Proposed Dividends           |               | <u>10,000</u>   |                          |                 |
|                              |               | <u>2,91,000</u> |                          | <u>2,91,000</u> |

Major Ltd. acquired 7,500 shares in Minor Ltd. @ Rs. 25 per share on 30th June, 2006.

Calculate :

- (a) Cost of Control / Capital Reserve
- (b) Minority Interest

4. B Ltd.'s issued Equity Share Capital was Rs. 3,20,000 in shares of Rs. 10 each; on 1st April, 2004 when B Ltd. had revenue reserve of Rs. 68,000 A Ltd. acquired 8,000 shares.

### 5.108 Financial Reporting

On 1st April, 2006 when B Ltd. had revenue reserve of Rs. 96,000, A Ltd. acquired 20,000 more equity shares. Calculate the pre-acquisition profits arising on consolidating the balance sheets of A Ltd. and B Ltd. assuming B Ltd. paid no dividends.

5. H Ltd. acquired 75% of the equity shares of S Ltd. Balance Sheets on the date of acquisition were:

|                 | H Ltd.          | S Ltd.          |                | H Ltd.          | S Ltd.          |
|-----------------|-----------------|-----------------|----------------|-----------------|-----------------|
|                 | Rs.             | Rs.             |                | Rs.             | Rs.             |
| Share Capital   |                 |                 | Cost of Shares | 2,50,000        | —               |
| Rs. 10 each     | 5,00,000        | 2,00,000        | Sundry Assets  | 5,00,000        | 3,00,000        |
| General Reserve | <u>2,50,000</u> | <u>1,00,000</u> |                |                 |                 |
|                 | <u>7,50,000</u> | <u>3,00,000</u> |                | <u>7,50,000</u> | <u>3,00,000</u> |

In the years following acquisition S Ltd. earned a profit of Rs. 4,00,000 and made a one for one bonus issue, utilising existing general reserve fully.

Calculate the amount of Cost of Control Capital Reserve (a) on the date of acquisition and (b) after the bonus issue.

6. On 1st July, 2006, the Mighty Co. Ltd. bought 4,500 shares of Rs. 10 each fully paid in the Meekly Co. Ltd. At the time it was estimated that the tangible assets and liabilities of Meekly Co. might be taken at the book values except the building, etc. which were under valued by Rs. 25,000.

Each company prepared a Balance Sheet as on 31st December, 2006, as follows:

| Liabilities           | Mighty Co.      | Meekly Co.    | Assets           | Mighty Co.      | Meekly Co.    |
|-----------------------|-----------------|---------------|------------------|-----------------|---------------|
|                       | Rs.             | Rs.           |                  | Rs.             | Rs.           |
| Share Capital         | 2,00,000        | 60,000        | Building, etc.   | 1,50,000        | 65,000        |
| General Reserve       | 50,000          | 6,000         | Sundry Assets    | 50,000          | 11,000        |
| Creditors             | 15,000          | 10,000        | Debtors          | 20,000          | 15,000        |
| Profit & Loss- 1.1.99 | 25,000          | 3,000         | Shares in Meekly |                 |               |
| Profit for the year   | <u>40,000</u>   | <u>12,000</u> | Co. Ltd.         | <u>1,10,000</u> | <u>—</u>      |
|                       | <u>3,30,000</u> | <u>91,000</u> |                  | <u>3,30,000</u> | <u>91,000</u> |

Consolidate the balance sheets.

7. Sure Ltd. purchased on 1st July, 2005, 4,000 equity shares in Steady Ltd. at a cost of Rs. 6,50,000. The share capital of the latter company consisted on 1st Jan., 2005, of 5,000 shares of Rs. 100 each fully paid. The company had a balance of Rs. 2,00,000 in General Reserve and Rs. 1,20,000 in the Profit and Loss Account on that date. It earned profit of Rs. 1,50,000 in 2005 and Rs. 50,000 in 2006 respectively.

At a meeting held in August 2005, Steady Ltd. issued fully paid bonus shares at the rate of one for two held. A dividend of 15% was declared by the company for each of the year

## Consolidated Financial Statements of Group Companies 5.109

2005 and 2006, paid on 31st December.

On 31st January, 2007 Sure Ltd. disposed of 1,000 shares in Steady Ltd. at Rs. 110 per share. You are required to write the journal entries in the books of Sure Ltd. in respect of the foregoing.

8. The following are the Balance Sheets of A Ltd. and Subsidiaries B Ltd. and C Ltd. as on 31st December, 2006.

|                  | A Ltd.           | B Ltd.           | C Ltd.          |                 | A Ltd.           | B Ltd.           | C Ltd.          |
|------------------|------------------|------------------|-----------------|-----------------|------------------|------------------|-----------------|
|                  | Rs.              | Rs.              | Rs.             |                 | Rs.              | Rs.              | Rs.             |
| Share Capital    |                  |                  |                 | Fixed Assets    | 2,80,000         | 5,50,000         | 3,75,000        |
| (in shares of    |                  |                  |                 | Investment      |                  |                  |                 |
| Rs. 100 each)    | 12,50,000        | 10,00,000        | 6,00,000        | at cost         | 10,30,000        | 5,30,000         |                 |
| Reserves         | 1,80,000         | 1,00,000         | 72,000          | Stock-in- trade | 1,20,000         | —                |                 |
| Profit & Loss    |                  |                  |                 |                 |                  |                  |                 |
| Account          | 1,60,000         | 20,000           | 51,000          | Sundry Debtors  | 2,63,000         | 1,60,000         | 3,48,000        |
| Sundry Creditors | <u>1,03,000</u>  | <u>1,20,000</u>  | <u>—</u>        |                 |                  |                  |                 |
| Total            | <u>16,93,000</u> | <u>12,40,000</u> | <u>7,23,000</u> | Total           | <u>16,93,000</u> | <u>12,40,000</u> | <u>7,23,000</u> |

- (a) The break-up of investments, which were all made on 30th June, 2006 is as under:
- (i) A Ltd. held 7,500 shares in B Ltd. at a cost of Rs. 8,50,000 and 1,500 shares in C Ltd. at a cost of Rs. 1,80,000
  - (ii) B Ltd. held 4,000 shares in C Ltd. at cost of Rs. 5,30,000.
- (b) (i) Sundry Creditors of A Ltd. include Rs. 33,000 due to C Ltd. which amount is duly reflected in the books of C Ltd.
- (ii) Sundry Creditors of B Ltd. include Rs. 72,000 due to A Ltd. whereas Sundry Debtors of A Ltd include Rs. 86,000 due from B Ltd. The difference of Rs.14,000 being cash in transit from B Ltd. to A Ltd. as on 31st December, 2006.
- (c) (i) The subsidiaries' position as on the date acquisition of shares (ie, on 30th June. 2006) was as follows :

|                         | B Ltd.   | C Ltd.   |
|-------------------------|----------|----------|
|                         | Rs.      | Rs.      |
| Reserves                | 90,000   | 60,000   |
| Profit and Loss Account | 10,000   | 8,400    |
| Sundry Creditors        | 40,000   |          |
| Fixed Assets            | 5,50,000 | 3,68,400 |

### 5.110 Financial Reporting

|                |          |        |
|----------------|----------|--------|
| Stock-in-trade | 40,000   |        |
| Sundry Debtors | 5,50,000 | 30,000 |

(ii) The whole of the stock-in-trade of B Ltd. as on 30th June, 2006 was subsequently sold to A Ltd. at a profit of 20% on selling price.

(d) The stock-in-trade of A Ltd. as on 31st December, 2006 includes Rs. 25,000 being cost to A Ltd. of the above stock purchased from B Ltd. and remaining unsold as on that date.

Prepare a Consolidated Balance Sheet as on 31st December, 2006.

9. The following are the balances in the books of three companies as on 31st December, 2006

|                                      | Red Ltd.        | White Ltd.      | Blue Ltd.       |
|--------------------------------------|-----------------|-----------------|-----------------|
|                                      | Rs.             | Rs.             | Rs.             |
| Trading Profit                       | 60,000          | 20,000          | 12,000          |
| Equity Share Capital (Rs. 10)        | 3,00,000        | 1,20,000        | 60,000          |
| 9% Preference Share capital (Rs. 10) | —               | —               | 40,000          |
| Profit & Loss Account (B/F)          | 12,000          | 14,200          | 6,200           |
| Share Premium                        | —               | 30,000          | —               |
| General Reserve                      | 40,000          | 18,000          | 30,000          |
| Creditors                            | 28,000          | 17,800          | 15,800          |
|                                      | <u>4,40,000</u> | <u>2,20,000</u> | <u>1,64,000</u> |
| <i>Debit balances:</i>               |                 |                 |                 |
| Directors' fees                      | 4,000           | 3,000           | 2,000           |
| Interim Equity Dividend paid         | 15,000          | —               | 3,000           |
| Preference Dividend for 2006 paid    | —               | —               | 3,600           |
| Investment in White Ltd. (cost)      | 1,00,000        | —               | —               |
| Investment in Blue Ltd. (cost)       | —               | 60,000          | —               |
| Other Assets                         | <u>3,21,000</u> | <u>1,57,000</u> | <u>1,55,400</u> |
|                                      | <u>4,40,000</u> | <u>2,20,000</u> | <u>1,64,000</u> |
| Proposed Final Dividend              | 10%             | 12½%            | 8%              |

White Ltd. was formed in 2003, Red Ltd. and Black Ltd. subscribing at par for two third and one third respectively of the issued Share Capital.

In June, 2006 these two companies took up additional shares in White Ltd. in the same proportion, at a premium of Rs. 10 per share, *ranking pari passu* with the existing shares, to provide White Ltd. with the exact amount of funds to acquire, as on 1st July, 2006 the

## Consolidated Financial Statements of Group Companies 5.111

whole of the issued equity share capital of Blue Ltd., Ex-2006 interim Dividend: no part of the preference capital was acquired:

Blue Ltd.'s, interim equity dividend of Rs. 3,000 was paid out of the pre-acquisition profits.

You are required to prepare the consolidated Balance Sheet of Red Ltd. as on 31st December, 2006 (Show workings).

10. On 1st February, 2006, A Ltd. purchased 2,70,000 equity shares and 9,000 preference shares in B Ltd. Both the companies make up their accounts on 30th June each year. The following figures are extracted from the companies' records for the year ended on 30th June, 2006:

|                                             | A Ltd.      | B Ltd.      |
|---------------------------------------------|-------------|-------------|
|                                             | Rs.         | Rs.         |
| Sales                                       | 1,62,00,000 | 1,53,00,000 |
| Purchases                                   | 89,63,820   | 86,86,440   |
| Selling expenses                            | 8,10,000    | 12,15,000   |
| Overhead expenses                           | 20,70,000   | 9,45,000    |
| Interim dividend paid on 1st January, 2006: |             |             |
| On equity shares                            | 13,50,000   | 7,20,000    |
| On preference shares                        | —           | 81,000      |
| Stock on 30th June, 2005                    | 8,93,700    | 18,05,040   |
| Issued and paid-up Share Capital:           |             |             |
| Equity shares of Rs. 10 each                | 54,00,000   | 36,00,000   |
| 9% preference shares of Rs. 100 each        | —           | 18,00,000   |
| Profit and Loss Account :                   |             |             |
| Balance on 30th June, 2005                  | 4,81,500    | 5,76,000    |

The following additional information is relevant:

(1) Profit of B Ltd. accrued evenly throughout the year.

(2) Stocks on hand on 30th June, 2006 were:

A Ltd.                      Rs. 15,77,520

B Ltd.                      Rs. 16,71,480

(3) Provision for taxation based on profits for the year is to be made as follows:

A Ltd.                      Rs. 27,00,000

B Ltd.                      Rs. 19,44,000

### 5.112 Financial Reporting

- (4) A Ltd. proposed to pay final dividend on equity shares at 25%.
- (5) B Ltd. proposes to pay half year's dividend on preference shares and a final dividend on equity shares at 30%.
- (6) B Ltd. sold to A Ltd. in March, 2006 material worth Rs. 7,50,000 at cost plus 25% of which A Ltd. still had unsold stock of Rs. 5,20,500 as on 30th June, 2006.

You are required to:

- (a) Prepare Consolidated Profit and Loss Account of A Ltd. and its Subsidiary B Ltd. for the year ended on 30th June, 2006.
- (b) Show your calculations for:
  - (i) Minority Interest (in profits);
  - (ii) Capital Reserve and;
  - (iii) Provision for unrealised Profits.

11. The Balance Sheet of three companies showed the following positions as on 30th June, 2006.

|                                                               | Star Ltd.     |                 | Blue Ltd.     |                 | Green Ltd.    |                 |
|---------------------------------------------------------------|---------------|-----------------|---------------|-----------------|---------------|-----------------|
|                                                               | Rs.           | Rs.             | Rs.           | Rs.             | Rs.           | Rs.             |
| Fixed Assets:                                                 |               |                 |               |                 |               |                 |
| Land and Building at cost                                     |               | 1,60,000        |               | 60,000          |               | 80,000          |
| Furniture and Fittings at cost                                | 1,50,000      |                 | 50,000        |                 | 46,000        |                 |
| Less: Depreciation upto June 30, 2006                         | <u>70,000</u> | <u>80,000</u>   | <u>26,000</u> | <u>24,000</u>   | <u>15,000</u> | <u>31,000</u>   |
|                                                               |               | 2,40,000        |               | 84,000          |               | 1,11,000        |
| Shares in Blue Ltd. at cost                                   |               | 1,25,000        |               |                 |               |                 |
| Shares in Green Ltd. at cost                                  |               |                 |               | 1,60,000        |               |                 |
| Current Assets:                                               |               |                 |               |                 |               |                 |
| Stock-in-trade                                                |               | 42,400          |               | 50,300          |               | 61,200          |
| Debtors                                                       |               | 82,390          |               | 46,610          |               | 44,300          |
| Bank Balance                                                  |               | <u>1,30,400</u> |               | <u>22,350</u>   |               | <u>77,750</u>   |
| Share Capital                                                 |               | <u>6,20,190</u> |               | <u>3,63,260</u> |               | <u>2,94,250</u> |
| Authorised and Issued Equity Shares of Rs. 10 each fully paid |               | 2,50,000        |               | 1,00,000        |               | 1,50,000        |
| Reserve and Surpluses:                                        |               |                 |               |                 |               |                 |
| Capital Reserve                                               |               | 40,000          |               | —               |               | 30,000          |



**Consolidated Financial Statements of Group Companies 5.113**

|                                      |                 |                 |                 |
|--------------------------------------|-----------------|-----------------|-----------------|
| Revenue Reserve                      | 77,496          | 61,420          | 32,425          |
| Current Liabilities and Provisions : |                 |                 |                 |
| Creditors                            | 80,194          | 90,940          | 16,340          |
| Income-tax                           | 72,500          | 60,900          | 35,485          |
| Proposed Dividends                   | <u>1,00,000</u> | <u>50,000</u>   | <u>30,000</u>   |
|                                      | <u>6,20,190</u> | <u>3,63,260</u> | <u>2,94,250</u> |

You also obtain the following information:

- (1) Blue Ltd. acquired 12,000 shares in Green Ltd. in 2002-2003 when the balance on Capital Reserve had been Rs. 20,000 and on Revenue Reserve Rs. 22,000.
- (2) Star Ltd. purchased 7,500 shares in Blue Ltd. in 2002-2003 when the balance on the Consolidated Revenue Reserve had been Rs. 25,000. The balance on Capital Reserve in Green Ltd. at that time was Rs. 30,000.
- (3) Star Ltd. purchased a further 1,500 shares in Blue Ltd. in 2004-2005 when the balance on the consolidated Revenue Reserve had been Rs. 40,000.
- (4) Proposed dividends from subsidiary companies have been included in the figure for debtors in the accounts of parent companies.

You are required to prepare the Consolidated Balance Sheet of Star Ltd. and its subsidiaries as on 30th June, 2006 together with your consolidation schedule.

- 12.** A Ltd. holds 80% of the share capital of B Ltd. and 70% of the share capital of C Ltd. at the date of acquisition of the shares. The shareholders' funds of each of the two companies, were as follows :

|                       | <b>B Ltd.</b>                    | <b>C Ltd.</b>                    |
|-----------------------|----------------------------------|----------------------------------|
|                       | <i>(Figures in lakhs of Rs.)</i> | <i>(Figures in lakhs of Rs.)</i> |
| Paid up capital       | 3.00                             | 1.60                             |
| Reserves              | 0.70                             | 0.20                             |
| Profit & Loss Account | 0.50                             | 0.30                             |

Extracts from the Balance Sheets of all the companies as on 30th June 2006, were as under:

|                                            | <i>(Figures in lakhs of Rupees)</i> |               |               |
|--------------------------------------------|-------------------------------------|---------------|---------------|
| <i>Liabilities:</i>                        | <b>A Ltd.</b>                       | <b>B Ltd.</b> | <b>C Ltd.</b> |
| Paid up Capital                            | 4.00                                | 3.00          | 1.60          |
| Reserves                                   | 1.50                                | 0.70          | 0.20          |
| Profit & Loss Account Balance              | 0.90                                | 0.20          | 0.14          |
| Profits for the year ended 30th June, 2006 | 1.20                                | 0.35          | 0.26          |
| Debentures                                 | 2.00                                | —             | 0.50          |
| Creditors                                  | 0.80                                | 0.30          | 0.20          |
| Inter-company Advances                     | <u>0.30</u>                         | <u>—</u>      | <u>0.10</u>   |
|                                            | <u>10.70</u>                        | <u>4.55</u>   | <u>3.00</u>   |

## 5.114 Financial Reporting

|                               |       |      |      |
|-------------------------------|-------|------|------|
| Assets:                       |       |      |      |
| Stock in Trade                | 1.20  | 0.95 | 0.30 |
| Sundry Debtors                | 1.00  | 0.70 | 0.50 |
| Plant & Machinery             | 2.80  | 2.60 | 2.20 |
| Debentures in C Ltd. (at par) | 0.20  | —    | —    |
| Shares in B Ltd.              | 4.00  | —    | —    |
| Shares in C Ltd.              | 1.40  | —    | —    |
| Inter-company advances:       |       |      |      |
| A Ltd.                        | —     | 0.30 | —    |
| C Ltd.                        | 0.10  | —    | —    |
|                               | 10.70 | 4.55 | 3.00 |

### *Additional Information as follows :*

- (i) Included in the Stock in trade on 30th June, 2006 were goods acquired from associated companies on which profits have been made by the respective companies as under:
  - A Ltd. .... Goods from B Ltd. at Rs. 6,000 above cost.
  - B Ltd. .... Goods from C Ltd. at Rs. 4,000 above cost.
  - C Ltd. .... Goods from A Ltd. at Rs. 2,000 above cost.
- (ii) A Ltd. purchased an item of Plant from B Ltd. on 30th September, 2005 for Rs. 24,000 on which the latter company had made a profit of Rs 2,400. Depreciation has been charged in the accounts of the purchase at 10% per annum.
- (iii) Dividends were paid during the year as follows:
  - A Ltd. at the rate of 10% per annum.
  - C Ltd. at the rate of 10% per annum out of pre-acquisition profits.
  - B Ltd. at the rate of 10% per annum out of pre-acquisition profits.
- (iv) A Ltd. has included all dividends received during the year in its Profits and Loss Account.

You are required to prepare a consolidated Balance Sheet of A Ltd. and its subsidiaries as on 30th June, 2006.

### **References :**

- AS 13 : *Accounting for Investments.*
- AS 21 : *Consolidated Financial Statements*
- AS 23 : *Accounting for Investments in Associates*
- AS 27 : *Financial Reporting of Interests in Joint Ventures*

## ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS

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### 1. INTRODUCTION

During the last few years, a number of new financial instruments have assumed significance in the Indian economy. With rapid globalisation, this trend is likely to accelerate in future. Derivatives are a kind of financial instruments whose values change in response to the change in specified interest rates, security prices, commodity prices, index of prices or rates, or similar variables. Typical examples of derivatives are futures and forward contracts, swaps and option contracts. In India no standard has been prescribed for accounting of derivative contracts in the books of accounts. Recently, the Institute of Chartered Accountants of India came out with the exposure draft of proposed 'Accounting Standard on Financial Instruments: Presentation', which is still under discussion at various forums.

### 2. DERIVATIVES

Derivatives are financial instruments that drive their value from changes in benchmark based on stock prices, interest rates, mortgage rates, currency rates, commodity prices or some other agreed upon base. Derivative Financial Instruments (DFIs) can be either on the balance sheet or off the balance sheet and include: options contract, interest rate swap, interest rate floors, interest rate collars, forward contract, futures, etc. The method of accounting for derivatives would depend on the standard issued by the ICAI and pronouncements of other regulatory bodies such as the Securities and Exchange Board of India. However, the main issues relating to its accounting are its recognition, classification, impairment and de-recognition.

According to FASB 133 para 6, "derivative instrument is a financial instrument or other contract with all three of the following characteristics :

- (a) It has (1) one or more underlying and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and in some cases, whether or not a settlement is required.
- (b) It requires no initial net investment or an initial net investment that is smaller than would

## 6.2 Financial Reporting

be expected to have a similar response to changes in market factors.

- (c) Its terms require or permit net settlement, it can readily be settled net by a means outside the contract or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement."

According to International Accounting Standard (IAS) 39 para 10, "a derivative is a financial instrument :

- (a) whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable (sometimes called the underlying);
- (b) that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
- (c) that is settled at a future date."

From the above, it follows that the definition of derivative as per FASB 133 and IAS 39 is more or less same. Typical examples of derivatives are futures and forward, swap and option contracts. One of the defining conditions of a derivative is that it requires little initial net investment relative to other contracts that have a similar response to market conditions. An option contract meets that definition because the premium is significantly less than the investment that would be required to obtain the underlying financial instrument to which the option is linked.

If one takes Indian scenario, forward contracts are in operation for last number of years, mainly to control or to manage the foreign exchange rate risk. Since April, 1996, cross currency options are allowed. Since August 1996, interest rate swaps, currency swaps, purchase of interest rate swap and collars and forward rate agreements are also allowed. Rupee-based derivatives are also allowed since August 1997 resulting into 5 year forward contract, which originally was available only for 6 months. In the equity market in India, stock index futures are available since June, 2000.

There are varieties of issues attached with these developments of derivatives :

- (i) effects on (a) capital market, (b) money market, (c) exchange rates and (d) interest rates.
- (ii) The burning issue will be taxation of derivatives and the accounting treatment.

Thus a derivative contract generally has the following features:

Initial cost like deferred discount/premium (forward contracts), option premium (options contract) and margins (futures contract).

Profit/loss and changes in assets/liabilities which arise on completion/termination/ expiration of the contract.

Marking the contract to market at the end of each trading session.

Compensating profit/loss between hedged assets and hedging instruments.

Accounting for foreign exchange derivatives is guided by AS 11(Revised 2003) on 'the effect of changes in foreign exchange rates'. The Institute of Chartered Accountants of India has recently issued a Guidance Note on Accounting for Equity Index Futures and Equity Stock Futures and Options'.

There is also the Employee Stock Option Scheme and Employee Stock Purchase Scheme Guidelines, 1999 issued by SEBI. Globally, stringent accounting practices are being followed for presentation and accounting of financial instruments and derivative contracts. The International Accounting Standards Committee has issued International Accounting Standard (IAS) 39, Financial Instruments: Recognition and Measurement, effective since January 1, 2001. Similarly, the Financial Accounting Standard Board (US) has issued FASB 133, Accounting for Derivative Instruments and Hedging Activities, applicable to companies since January 1, 2001.

IAS 39 and FAS 133 require all derivatives, including hedges, to be recognised on the balance-sheet at their fair value. Internationally, fair value is considered to be the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Fair value can be defined as: "Value at which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction."

Fair value is computed as the actual amounts give a wrong picture, while the total exposure of the system may sound huge, whereas for a single bank, presentation on net basis could be much lower because of offsetting trades.

The accounting for changes in fair value of a derivative contract is depended on the intended use of such contract. Broadly, derivative contract is classified into hedging and speculation.

The accounting treatment of derivatives varies under the two classifications. FAS 133 requires the following treatment of derivative contracts:

*Fair value hedge:* For a derivative contract which is entered into as a hedge against possible change in value of a recognised asset or liability, the gain or loss is recognised in the earning in the period of change together with the offsetting gain or loss on the hedged item attributable to risk hedged. The final effect on the earning is to the extent hedge is not effective.

*Cash flow hedge:* For a derivative contract which is entered into as a hedge against a variable cash flow of a forecasted transaction, the gain or loss is initially reported outside the P&L account and subsequently it is reclassified into earnings when the forecasted transaction affects the earnings. The portion of probable loss which is not covered by the hedge is immediately recognised.

## 6.4 Financial Reporting

A hedging contract entered into to cover the foreign currency exposure of a net operation in foreign operation, the gain or loss is reported outside the P&L account.

For a contract which is not designated as hedging, gain or loss is recognised in the period of change.

The entity that applies the hedge accounting standard is required to establish at the inception of the contract, the method it will use to assess the effectiveness and ineffectiveness of the hedging derivative instrument. The method adopted should be consistent with the entity's approach to managing risk. Whereas in India such transactions are shown as off-balance-sheet items which fail to present a complete picture of the exposure of a banking institution in the derivatives market. The proposed 'Accounting Standard on Financial Instruments: Presentation' deals with only the presentation aspect of the financial instruments in the balance-sheet of such instruments. A separate standard may be issued for disclosure requirements regarding financial instruments.

Until comprehensive standards for accounting of derivative contracts are devised and implemented in India, banks need to devise their own methods of presenting and disclosing information relating to derivative contracts entered into by them. Banks can take clue for the international standards in effect. Also, with the deadline for implementation of the new capital accord (Basel II) closing in, the risk exposure of the banking institutions in the off-balance-sheet items are required to be properly evaluated and considered to be presented in more transparent manner.

Thus, there is a dire need of a standard on accounting practice to be followed for financial instruments considering the financial implication and destructive power of derivative instruments witnessed by the financial world in: collapse of Barings, an investment bank; bail-out of hedge fund Long-Term Capital Management by the US Federal Reserve in 1995, and the Enron debacle.

The swap that is entered for hedging purposes should be accounted on accrual basis, except the swap designated with an asset or liability that is carried at lower of the cost or market value in the financial statements. In that case, the swap should be marked to market with the resulting gain/loss recorded as an adjustment to market value of the designated asset/liability.

Gains or losses on termination of swaps should be recognised when the offsetting gain/loss is recognised on the designated asset/liability. This implies that any gain or loss on terminated swap would be deferred and recognised over the shorter of the remaining contractual life of the swap or remaining life of the asset/liability.

### Accounting for trading purpose

- ◆ Trading swaps should be marked to market with changes recorded in the income statement.
- ◆ Income and expenditure relating to these swaps should be recognised on settlement

dates.

- ◆ Fee should be recognised as immediate income or expenditure.
- ◆ Gains or losses on the termination of swaps should be recorded as immediate income or expenses

**2.1 Forward Contracts:** A forward contract is basically a contractual arrangement in which one party buys and other party sells designated currency at a forward rate mutually agreed upon on the date of contract for delivery at designated future date. As mentioned in the preceding para, forward contracts are allowed in India for long. Not only this but para 13 of Accounting Standard 11 'Accounting for Effects of Changes in Foreign Exchange Rates' deals with accounting treatment of Forward Contract. Accordingly, 'An enterprise may enter into a forward contract or other financial instrument that is in substance a forward exchange contract to establish the amount of reporting currency required or available at settlement date of a transaction. The difference between the forward rate and the exchange rate at the date of transaction should be recognised as income or expense over the life of the contract, except in respect of liabilities incurred for acquiring fixed assets, in which case, such difference should be adjusted in carrying amount of the respective fixed assets.

For example, suppose XYZ Ltd. needs \$3,00,000 on May 1, 2000 for repayment of loan installment and interest. As on December 1, 1999, it appears to the company that the dollar may be dearer as compared to the exchange rate prevailing on that date, say \$1 = Rs. 43.50. Accordingly, XYZ Ltd. may enter into a forward contract with a banker for \$3,00,000. The forward rate may be higher or lower than the spot rate prevailing on the date of the forward contract. Let us assume forward rate as on December 1, 1999 was \$ 1 = Rs. 44 as against the spot rate of Rs. 43.50. As on the future date, i.e., May 1, 2000, the banker will pay XYZ Ltd. \$ 3,00,000 at Rs. 44 irrespective of the spot rate as on that date. Let us assume that the Spot rate as on that date is \$ 1 = Rs. 44.80.

In the given example XYZ Ltd. gained Rs. 2,40,000 by entering into the forward contract.

Payment to be made as per forward contract

|                          |                 |
|--------------------------|-----------------|
| (US \$3,00,000 × Rs. 44) | Rs. 1,32,00,000 |
|--------------------------|-----------------|

Amount payable had the forward  
contract not been in place

|                             |                 |
|-----------------------------|-----------------|
| (US \$3,00,000 × Rs. 44.80) | Rs. 1,34,40,000 |
|-----------------------------|-----------------|

Gain arising out of the forward

|                   |              |
|-------------------|--------------|
| exchange contract | Rs. 2,40,000 |
|-------------------|--------------|

## 6.6 Financial Reporting

**2.2 Interest Rate Swap:** Interest Rate Swap is allowed in India. Swap is basically a financial contract. This involves exchange of one set of payment (which is the obligation of other party 'B'). The interest Rate Swap involves the exchange of one interest rate payment with other interest rate payment where the principal amount is denominated in the same currency.

*"The IRS can be defined as contract between two parties (called counter parties) to exchange on a particular date in the future, one series of cash flows (fixed interest) for other series of cash flows (variable or floating interest) in the same currency on the same principal (an agreed amount – called notional principal) for an agreed period of time."*

Coming to the accounting treatment, the flow of transactions will be like this :

Consider XYZ Ltd., a manufacturing firm, which wants to borrow 5 year fixed rate rupee funding to finance an expansion project. Its credit rating is not very high. It is BBB. It finds that it will have to pay interest @11% if it borrows at fixed interest rate. In the floating rate market, it can issue floating rate note at margin of 0.75% over the prime rate, which is 10%. On the other hand, ABC Inc., a large unit is looking for floating rate note but finds that it will have to pay prime rate, while in the fixed rate market it can raise 5 year funds at 9.5% due to AAA rating and BBB rating is 150bp in fixed rate segment and 75bp in floating rate segment. This differential is known as Quality Spread differential. The requirements and access of the two parties are summarised below :

|                       | XYZ Ltd.<br>(BBB)  | ABC Ltd.<br>(AAA) |
|-----------------------|--------------------|-------------------|
| Requirements          | Fixed rate         | Floating Rate     |
| Cost of Fixed loan    | 11%                | 9.5%              |
| Cost of floating rate | Prime rate + 0.75% | Prime rate (10%)  |

Thus, for XYZ Ltd., even though interested in fixed rate loan, it is advisable to go for floating rate which will be 0.25% lower than fixed rate. Similarly for ABC Ltd., even though it is interested in floating rate loan, it is advisable for it to go for fixed rate as it is 0.5% lower than the floating rate. Under the circumstances, they may raise a loan the way it is cheaper and then they may enter it swap through an intermediary, a swap bank. Let us assume that the swap bank may pay fixed interest to ABC Ltd. @ 9.5% which ABC Ltd. will pass on to a lender and ABC Ltd. will effectively pay a floating rate of prime rate - .25% (9.75) to swap bank. Hence, their effective cost will be 9.75%. Simultaneously, swap bank will pay prime rate – 0.25% to XYZ Ltd., which they will pass on to floating rate lender by adding 1% (as the cost is prime rate +0.75%) and they will charge a fixed rate of 9.75%. Thus, the effective cost to XYZ Ltd. will be 10.75%, which is again 0.25% lower than the fixed rate loan raised from the market and simultaneously, the swap bank will also have net gain of 0.25%. For the purpose of accounting, let us assume that the amount borrowed from the financial institution is Rs.



100,00,000. The transaction-wise accounting entries are easy to understand in the books of ABC Ltd. The accounting entries in the books of ABC Ltd. will be :

At the time of borrowing :

|                                             |            |            |
|---------------------------------------------|------------|------------|
| Cash                                        | 100,00,000 |            |
| To Loan                                     |            | 100,00,000 |
| Interest liability for six months will be : |            |            |
| Interest                                    | 47,50,000  |            |
| To FI                                       |            | 47,50,000  |
| FI                                          | 47,50,000  |            |
| To Cash                                     |            | 47,50,000  |
| Interest                                    | 48,75,000  |            |
| To Swap Bank                                |            | 48,75,000  |
| Swap Bank                                   | 48,75,000  |            |
| To Cash                                     |            | 48,75,000  |
| Swap Bank                                   | 47,50,000  |            |
| To Interest                                 |            | 47,50,000  |
| Cash                                        | 47,50,000  |            |
| To Swap Bank                                |            | 47,50,000  |

FASB 133 deals with fair value hedge. Accordingly, interest rate swap is the fair value hedge. According to para 22, gains and losses on qualifying fair value, hedged value shall be accounted as follows :

- (a) the gain or loss on the hedging instrument shall be recognized currently in earnings.
- (b) the gain or loss (the change in the fair value) on the hedged item, attributable to the hedged risk, shall adjust the carrying amount of the hedged item and be currently recognized in earnings.

Thus, in the above case, it is required to find out what is the fair value of swap at the year end. This is considered to be an asset till the time period is over and the gain will be credited to profit and loss account. Thus, if the fair value of the swap is, say, 'X', then the entry will be :

|                 |   |   |
|-----------------|---|---|
| Swap            | X |   |
| To Gain on swap |   | X |

Moreover, on account of swap, the market value of debt is also likely to change. Out of the total value, part may be attributable to change in the interest rate say X\*. If the market value goes up it is to be considered as an obligation to pay premium. The proposed entry can be :

## 6.8 Financial Reporting

Loss on debt

X\*

To premium on note payable

X\*

IAS 32, which deals with 'Financial instrument : Disclosure and Presentation' also explains, vide its para 43, that transaction in financial instruments may result in an enterprise's assuming or transferring to another party one or more of the financial risks viz., price risk credit risk, liquidity risk and cash flow risk. The price risk also covers within its purview the interest rate risk, which is defined as the 'risk that the value of financial instrument will fluctuate due to changes in market interest rates.' Para 49 of the IAS 32 states that when financial instrument held or issued by an enterprise, either individually or as class, creates a potentially significant exposure to the risks described in para 43 (mentioned above). Terms and conditions that may warrant disclosure include:

The principal stated face value or similar amount, which for some derivative instrument, such as, interest rate swap may be the amount on which future payments are based. Para 51 of IAS 32 also states "similarly, it is important to disclosure relationship between components of 'synthetic instruments', such as, fixed rate debt created by borrowing at a floating rate and entering into a floating to fixed interest rate swap". In each case, the enterprise presents the individual financial assets and financial liabilities in its balance-sheet according to their nature, either separately or in the class of financial asset or financial liability to which they belong. The extent to which risk exposure is altered by relationship among the assets and liabilities may be apparent to financial statement users from information of the type described in para 49, but, in some circumstances further disclosure is necessary.

According to para 57 of IAS 32, "An enterprise provides information concerning its exposure to the effects of future changes in the prevailing level of interest rates." Changes in market interest rates have direct effect on the contractually determined cash flows associated with some financial assets and financial liabilities (cash flow risk) and on the fair value of others (price risk).

According to para 60, "An enterprise indicates which of its financial assets and financial liabilities are :

- (a) exposed to interest rate price risk, such as momentary financial assets and financial liabilities with fixed interest rate;
- (b) exposed to interest rate cash flow risk, such as monetary financial assets and financial liabilities with a floating interest rate that is reset as market rate changes;
- (c) not exposed to interest rate risk such as some investment in equity securities".

Thus, IAS 32 included numerous provisions regarding presentation and disclosure of interest rate swap. Moreover, IAS 39, which deals with 'Financial Instruments : Recognition and measurement' – also deals with fair value hedges. According to para 153 of the same "If fair value hedge meets the conditions in para 142 during the financial reporting period, it should

be accounted as follows:

- (a) the gain or loss from re-measuring the hedging instrument at fair value should be recognised immediately in net profit or loss; and
- (b) the gain or loss on the hedged item attributable to the hedged risk should adjust the carrying amount of the hedged item and be recognised immediately in net profit or loss".

Both these are taken care of in the accounting entries proposed above.

**2.3 Currency Swap:** In a currency swap, the two payment streams being exchanged are denominated in two different currencies. Usually, an exchange of principal amount at the beginning and re-exchange at termination are features of currency swap. The principal amounts are equal at the currency market rate. A typical currency swap situation is explained in the following illustration :

|                     | Corp. AUST | Corp. FREN |
|---------------------|------------|------------|
| Requirements        | FRF        | AUD        |
|                     | funding    | funding    |
| Cost of AUD funding | 15%        | 16%        |
| Cost of FRF Funding | 11%        | 10%        |

In their home currencies each company has a 1% borrowing advantage. Corp. AUST for example can borrow AUD @ 15% or 1% below Corp. FREN. Similarly Corp. FREN can borrow FRF @ 10%, which is 1% below the cost to Corp. AUST. It is this relative advantage that allows currency swap to materialize. The currency swap process is as follows :

1. Corp. FREN borrows FRF @ 10% and Corp. AUST borrows AUD @ 15%.
2. The two companies then exchange the debt with each other so that Corp. AUST has FRF debt @ 10% and Corp. FREN has AUD debt @ 15%.

Each party reduces its borrowing cost by 1%. However, it is difficult for most corporations and government borrowers to locate others that want to do an off-setting transaction at the same time and for the same amount. They also face credit risk with others. Under the circumstances, swap deals will be entered into through a bank. In exchange of services to be rendered, bank will take part of the savings involved in the swap. Consequently, the net savings of the swap for Corp. AUST and Corp. FREN will be less than 1%.

Let us assume that spot FRF/AUD exchange rate is 5 FRF per 1 AUD. A deal based on 100 million AUD is executed. In order for swap to work, it is essential that the amount be of the same value. In the above case, 500 million FRF issue is needed to work the swap. Let us further assume that both corporations are raising funds in their own currencies. Corp. FREN, after raising the FRF loan, enters into a swap with bank with in turn, will allow Corp. AUST to use FRF loan @ 10.20%. Simultaneously, the bank will allow Corp. FREN to use AUD debt @

## 6.10 Financial Reporting

15.20%. Thus, effectively both of them will be saving 0.80%. The transactions can be summarised as follows:

| Time | Transaction        | Corp. FREN    | Bank          | Corp. AUST   |
|------|--------------------|---------------|---------------|--------------|
| 0    | Original Loan      | 500 million   | - -           |              |
|      | FREN to Bank       | (500) million | 500 million   | -            |
|      | Bank to AUST       | -             | (500) million | 500 million  |
| 1    | Interest payments: |               |               |              |
|      | AUST to Bank       | -             | 51 million    | (51) million |
|      | Bank to FREN       | 50 million    | (50) million  | -            |
|      | FREN to investor   | (50) million  | - -           |              |

### In terms of AUD :

| Time | Transaction             | Corp. FREN     | Bank          | Corp. AUST   |
|------|-------------------------|----------------|---------------|--------------|
| 0    | Original Loan           |                |               | 100 million  |
|      | AUST to Bank            |                | 100 million   | (100)million |
|      | Bank to FREN            | 100 million    | (100) million |              |
| 1    | Interest payments:      |                |               |              |
|      | FREN to Bank            | (15.2) million | 15.2 million  |              |
|      | Bank to AUST            |                | (15) million  | 15 million   |
|      | AUST to investor/lender |                |               | (15) million |

### Initial borrowing :

|                                                     |         |         |
|-----------------------------------------------------|---------|---------|
| Cash                                                | 500 ml. |         |
| To FRF Loan                                         |         | 500 ml. |
| FRF Loan                                            | 500 ml. |         |
| To Cash                                             |         | 500 ml. |
| (For FRF Loan passed to intermediary/Swap Bank)     |         |         |
| Cash                                                | 500 ml. |         |
| To AUD Loan                                         |         | 500 ml. |
| (For AUD Loan received from intermediary/Swap Bank) |         |         |
| Interest on AUD Loan                                | 76 ml.  |         |
| To Cash                                             |         | 76 ml.  |
| (Interest payment of 15.2 ml. AUD @ 5 FRF)          |         |         |

|                                                       |        |        |
|-------------------------------------------------------|--------|--------|
| Cash                                                  | 50 ml. |        |
| To interest on FRF Loan (int. receipt from Swap Bank) |        | 50 ml. |
| Interest on FRF Loan                                  | 50 ml. |        |
| To Cash                                               |        | 50 ml. |
| (Int. payment to investor)                            |        |        |

In addition to the above entries entered for the purpose of transaction, the fair value of the loan is also likely to change. Therefore, to the extent that the fair value of the loan will be affected on account of currency swap, entries should also be passed, which will be on similar lines as for the interest rate swap. Moreover, at the end of the term of the debt re-exchange of the debt with the swap bank will also be required and this should also be recorded as per the normal principles of accounting.

**2.4 Currency Options:** Currency options provide the corporate treasurer another tool for hedging foreign exchange risk arising out of the firm's operations. Unlike forward contract options allowing the hedger to gain from favourable exchange rate movements, Currency options are frequently suggested as an appropriate hedging tool because one can remove downside risk without limiting the upside potential. Options can be put option or a call option. A put option is a contract that specifies the currency that the holder has the right to sell. A call option is a contract that specifies the currency that the holder has the right to sell. This can better be explained with the help of an illustration.

In late February, an American Importer anticipates a Yen payment of JPY 100 million to a Japanese supplier sometime in late May. The current USD/JPY spot rate is 0.007739 (which implies that JPY/USD rate of 129.22). A June Yen call option on the Philadelphia Exchange with the strike price of \$0.0078 per yen is available for a premium of 0.0108 cents per yen or \$ 0.000108 per yen. A contract is for JPY 6.25 million. Premium per contract is therefore : \$ 0.000108 × 6250000 = \$ 675. The firm decides to purchase 16 calls for a total premium of \$ 10800. In addition, there is a brokerage fee of \$ 20 per contract. Thus, total expenses in buying the options is \$ 11120. The firm has, in effect, ensured that its buying rate for yen will not exceed - \$ 0.0078 + \$ (11120/100000000) = \$ 0.0079112 per yen. The yen depreciates to \$ 0.0075 per yen in late May when the payment becomes due. The firm will not exercise the option. It can sell 16 calls in the market, provided the resale value exceeds the brokerage commission it will have to pay. Therefore, price per yen is \$ 0.075 + 0.0001125 \$. If Yen appreciates, then the firm will exercise option. Under the above mentioned circumstances, following entries are suggested.

For **purchases** irrespective of contract :

Purchases

    To creditor

Or

## 6.12 Financial Reporting

Fixed asset

To Supplier

**When Option contract is entered into :**

Option premium

To Cash

**Year end**, the amount of the premium is to be debited to profit and loss account or to fixed asset, as the case may be:

P & L

Fixed assets

To Option premium

To Option premium

However, according to FASB 133, the financial option is to be shown as an asset or liability. According to para 28 (c) "If written option is designated as hedging the variability in cash flows for a recognised asset or liability, the combination of the hedged item and the written option provides at least as much potential for favourable cash flows as exposure to unfavourable cash flows. That test is met if all possible percentage favourable changes in the underlying (from zero per cent to 100 per cent) would provide at least as much favourable cash flows as the unfavourable cash flow that would be incurred from an unfavourable change in the underlying of the same percentage. Therefore, depending on the value, it will be accounted as asset or liability. Even IAS 39 clearly states in para 29(d) that 'Financial Options are recognised as assets or liabilities when holder or writer becomes a party to contract.'" Thus, options are to be recognised as asset or liability.

The proposed accounting entry is :

Options

To Unrealised gain

To Gain

**2.5 Stock Index Future:** Stock index futures are instruments where the underlying variable is a stock index future. Both the Bombay Stock Exchange and the National Stock Exchange have introduced index futures in June, 2000 and permit trading on the Sensex Futures and the Nifty Futures respectively.

Recently, the Institute of Chartered Accountants of India has issued the Guidance Note on Accounting for Equity Index Futures and Equity Stock Futures and Options which deals with accounting treatment of equity index futures from the viewpoint of the parties who enter into such futures contracts as buyers or sellers.

### **Shares, Debentures and other securities**

AS 13 on Accounting for Investments deals with accounting of shares, debenture and other securities. (For full text of AS 13 refer unit 3 - chapter 2 PE II Course Study Material)

#### **Cost of Investments**

The cost of an investment should include acquisition charges such as brokerage, fees and duties.

If an investment is acquired, or partly acquired, by the issue of shares or other securities the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

#### **Carrying Amount of Investment**

Investments classified as current investments should be carried in the financial statements at the lower of cost or fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.

Investments classified as long-term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the profit and loss statement.

On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to the profit and loss statement.

#### **Disclosure**

The following information should be disclosed in the financial statements :

- (a) the accounting policies for determination of carrying amount of investments; and
- (b) classification of investments as specified above;
- (c) the amounts included in profit and loss statement for:
  - (i) interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long-term and deducted at source being included under Advance Taxes Paid;

## **6.14 Financial Reporting**

- (ii) profits and losses on disposal of current investments and changes in the carrying amount of such investments; and
- (iii) profits and losses on disposal of long term investments and changes in the carrying amount of such investments;
- (d) significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal;
- (e) the aggregate amount of quoted and unquoted investments; giving the aggregate market value of quoted investments;
- (f) other disclosures as specifically required by the relevant statute governing the enterprise.

### **3. INVESTMENTS IN FINANCIAL STATEMENTS OF MUTUAL FUNDS**

Recently, the Institute of Chartered Accountants of India has issued a Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds. The students are advised to refer the full text of the Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds.

### **4. POSITION OF INDIAN ACCOUNTING STANDARDS**

The Council of the Institute of Chartered Accountants of India has issued the Exposure Draft of Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement. The standard will be mandatory in nature and from the date of this Standard becoming mandatory the following will stand withdrawn in respect of the concerned entities.

- (i) Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, to the extent it deals with contingencies.
- (ii) Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates, to the extent it deals with the 'forward exchange contracts'.
- (iii) Accounting Standard (AS) 13, *Accounting for Investments*, except to the extent it relates to accounting for investment properties.

The Standard establishes principles for recognition and measurement of financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in Accounting Standard (AS) 31, Financial Instruments: Presentation. Requirements for disclosing information about financial instruments are in AS 32, Financial Instruments: Disclosures.

The Accounting Standard 31, Financial Instruments: Presentation, defines a financial instrument as a contract that gives rise to a financial asset of one enterprise and a financial liability or equity instrument of another enterprise. For example, bonds issued by a company gives rise to financial liability for the issuer and financial asset for the acquirer. Likewise purchase of goods on credit gives rise to financial liability for the purchaser and financial asset



for the seller. Financial instruments include primary instruments, e.g. trade receivables, trade payables, bonds issued, bonds acquired, shares acquired, deposits etc. and derivative financial instruments, e.g. financial forwards, futures, options, interest rate swaps and currency swaps.

A financial asset is any asset that is:

- (a) Cash
- (b) Equity instrument of another enterprise, e.g. investments in ordinary shares
- (c) Contractual right (i) to receive cash, e.g. receivables or another financial asset from another enterprise, e.g. investments in convertible debentures or (ii) to exchange financial assets or liabilities with another enterprise under conditions that are potentially favourable to the enterprise, e.g. forward exchange contracts and derivative instruments

Assets, e.g. prepaid expenses, for which the future economic benefit is receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets.

A financial liability is any liability that is:

- (a) A contractual obligation (i) to deliver cash, e.g. payables or another financial asset to another enterprise, e.g. a promissory note payable in government bond, or (ii) to exchange financial assets or financial liabilities with another enterprise under conditions that are potentially unfavourable to the enterprise, forward exchange contracts and derivative instruments; or
- (b) A contract that will or may be settled in the enterprise's own equity instruments and is a non-derivative for which the enterprise is or may be obliged to deliver a variable number of enterprise's own equity instruments, e.g. convertible debentures issued.

Items, e.g. deferred income and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than cash or financial asset.

A contingent obligation, e.g. a financial guarantee issued, is financial liability. Likewise, a contingent right, e.g. financial guarantee received, is financial asset. Such financial assets/liabilities are not always recognised in financial statements.

The Exposure Draft proposes that Financial Instruments should be classified into four categories, viz., 'Financial assets and financial liabilities at fair value through profit or loss', 'Held-to maturity investments', 'Loans and receivables' and 'Available-for-sale financial assets'. It is proposed that that fair value approach should be followed in respect of 'Financial assets and financial liabilities at fair value through profit or loss' and 'Available-for-sale financial assets'. Fair value is the amount for which an asset can be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

## 6.16 Financial Reporting

A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.

- (a) It is held for trading.
- (b) It is designated as 'financial asset/ financial liability at fair value through profit or loss'. This an entity can do to eliminate/reduce recognition and measurement inconsistency, e.g. instead of using one classification for a financial asset and another classification for related financial liability, an entity can classify both as financial asset/liability at fair value through profit or loss. Similarly a portfolio of financial assets and liabilities can be put under this head, when the performance of the portfolio is measured on fair value basis.

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity.

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments, or (c) financial assets at fair value through profit or loss.

**4.1 Initial Recognition:** An entity should recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument.

Upon initial recognition:

- (a) A financial asset or financial liability at fair value through profit or loss should be measured at fair value on the date of acquisition or issue.
- (b) Short-term receivables and short-term payables with no stated interest rate, e.g. trade debtors and trade creditors, should be measured at original invoice amount, unless the effect of discounting is material.
- (c) Other financial assets or financial liabilities should be measured at fair value plus/ minus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

A regular way purchase or sale of financial assets should be recognised and derecognised either on trade date or on settlement date. The trade date is the date that an entity commits itself to purchase or sell an asset. The settlement date is the date on which an asset is delivered. Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.

A regular way purchase or sale is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by

regulation or convention in the marketplace concerned.

A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.

The fair value of a financial asset may change during the period between the trade date and settlement date. In settlement date accounting, such changes in the fair values of financial assets classified as 'available for sale', are recognised in appropriate equity account, e.g. Investment Revaluation Reserve. In case of 'financial assets at fair value through profit or loss', these changes in fair values are recognised in the statement of profit and loss. The changes in fair values of financial assets carried at cost or amortised cost, e.g. assets held-to-maturity, are not recognised.

### Illustration 1

On March 30, 2006, fair value per ordinary share of A Ltd. was Rs. 45. On this date, B Ltd. committed to buy 10,000 of these shares at fair value. B Ltd. paid the price and accepted delivery of these shares on April 3, 2006. B Ltd. closed its annual accounts on March 31, 2006. Fair value of A Ltd. shares was Rs. 45.40 on March 31, 2006 and Rs. 45.30 on April 3, 2006.

Show journal entries in the books of B Ltd. in respect of above in the following three cases:

- B Ltd. classifies its investments in A Ltd. as 'financial asset held-to-maturity'
- B Ltd. classifies its investments in A Ltd. as 'financial asset available for sale'
- B Ltd. classifies its investments in A Ltd. as 'financial asset at fair value through profit or loss'

### Solution

#### Books of B Ltd.

Investments in A Ltd. is classified as 'financial asset held to maturity'

#### Trade Date Accounting

| Date           |             | Rs.      | Rs.      |
|----------------|-------------|----------|----------|
| March 30, 2006 | Investments | 4,50,000 |          |
|                | To Bank     |          | 4,50,000 |

#### Settlement Date Accounting

| Date          |             | Rs.      | Rs.      |
|---------------|-------------|----------|----------|
| April 3, 2006 | Investments | 4,50,000 |          |
|               | To Bank     |          | 4,50,000 |

## 6.18 Financial Reporting

Investments in A Ltd. is classified as 'financial asset available for sale'

### Trade Date Accounting

| <i>Date</i>    |                                   | <i>Rs.</i> | <i>Rs.</i> |
|----------------|-----------------------------------|------------|------------|
| March 30, 2006 | Investments                       | 4,50,000   |            |
|                | To Payables                       |            | 4,50,000   |
| March 31, 2006 | Investments                       | 4,000      |            |
|                | To Fair Value Adjustments         |            | 4,000      |
| March 31, 2006 | Fair Value Adjustments            | 4,000      |            |
|                | To Investment Revaluation Reserve |            | 4,000      |
| April 3, 2006  | Payables                          | 4,50,000   |            |
|                | To Bank                           |            | 4,50,000   |
| April 3, 2006  | Fair Value Adjustments            | 1,000      |            |
|                | To Investments                    |            | 1,000      |
| March 31, 2007 | Fair Value Adjustments            | 1,000      |            |
|                | To Investment Revaluation Reserve |            | 1,000      |

### Settlement Date Accounting

| <i>Date</i>    |                                   | <i>Rs.</i> | <i>Rs.</i> |
|----------------|-----------------------------------|------------|------------|
| March 31, 2006 | Fair Value Adjustments            | 4,000      |            |
|                | To Investment Revaluation Reserve |            | 4,000      |
| April 3, 2006  | Investments                       | 4,53,000   |            |
|                | To Bank                           |            | 4,50,000   |
|                | To Fair Value Adjustments         |            | 3,000      |
| March 31, 2007 | Fair Value Adjustments            | 1,000      |            |
|                | To Investment Revaluation Reserve |            | 1,000      |

Investments in A Ltd. is classified as 'financial asset at fair value through profit or loss'

### Trade Date Accounting

| <i>Date</i>    |                           | <i>Rs.</i> | <i>Rs.</i> |
|----------------|---------------------------|------------|------------|
| March 30, 2006 | Investments               | 4,50,000   |            |
|                | To Payables               |            | 4,50,000   |
| March 31, 2006 | Investments               | 4,000      |            |
|                | To Fair Value Adjustments |            | 4,000      |

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|                |                        |          |          |
|----------------|------------------------|----------|----------|
| March 31, 2006 | Fair Value Adjustments | 4,000    |          |
|                | To Profit & Loss A/c   |          | 4,000    |
| April 3, 2006  | Payables               | 4,50,000 |          |
|                | To Bank                |          | 4,50,000 |
| April 3, 2006  | Fair Value Adjustments | 1,000    |          |
|                | To Investments         |          | 1,000    |
| March 31, 2007 | Fair Value Adjustments | 1,000    |          |
|                | To Profit & Loss A/c   |          | 1,000    |

### Settlement Date Accounting

| <i>Date</i>    |                           | <i>Rs.</i> | <i>Rs.</i> |
|----------------|---------------------------|------------|------------|
| March 31, 2006 | Fair Value Adjustments    | 4,000      |            |
|                | To Profit & Loss A/c      |            | 4,000      |
| April 3, 2006  | Investments               | 4,53,000   |            |
|                | To Bank                   |            | 4,50,000   |
|                | To Fair Value Adjustments |            | 3,000      |
| March 31, 2007 | Fair Value Adjustments    | 1,000      |            |
|                | To Profit & Loss A/c      |            | 1,000      |

**4.2 Subsequent Measurement of Financial Assets:** After initial recognition, except for the following, an entity should measure its financial assets at their fair values.

- (a) Loans and receivables and held-to-maturity investments should be measured at amortised cost using the effective interest method.
- (b) Short-term receivables with no stated interest rate, e.g. trade debtors can be measured at amortised cost only if the effect of discounting is material. In other cases these are measured at the original invoice amount.
- (c) Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, should be measured at cost

**4.3 Subsequent Measurement of Financial Liabilities :** After initial recognition, an entity should measure all financial liabilities at amortised cost using the effective interest method, except for:

- (a) Financial liabilities at fair value through profit or loss. Such liabilities, should be

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measured at fair value. However, a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, should be measured at cost.

- (b) Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. The standard prescribes different measurement principles for these cases.
- (c) Short-term payables with no stated interest rate, e.g. trade creditors can be measured at amortised cost only if the effect of discounting is material. In other cases these are measured at the original invoice amount.
- (d) Financial guarantee contracts and commitments to provide a loan at a below-market interest rate. These items, after initial recognition, should be measured at the higher of:
  - (i) The amount determined in accordance with AS 29; and
  - (ii) The amount initially recognised less, when appropriate, cumulative amortisation recognised, if any.

Financial assets/liabilities that are designated as hedged items are subject to measurement under the hedge accounting requirements of the AS 30. All financial assets except those measured at fair value through profit or loss, should be reviewed for impairment in accordance with the requirements of AS 30.

**4.4 Effective Interest Method :** The Effective Interest Method is a method of calculating the amortised cost of a financial assets or a financial liability and of allocating the interest income or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

### Amortised Cost

The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition, adjusted for principal repayments, amortisation of difference between initial amount (I) and maturity amount (M) and impairments as indicated below:

|                                                                     | <i>Rs.</i> |
|---------------------------------------------------------------------|------------|
| Value at which initially recognised (Initial Amount)                | I          |
| (–) Principal repayments                                            | P          |
|                                                                     | I – P      |
| (±) Cumulative amortisation of (I – M) by effective interest method | A          |
|                                                                     | I – P ± A  |

|                                                          |                      |
|----------------------------------------------------------|----------------------|
| (–) Reduction for impairment or uncollectability         | R                    |
| Amortised cost of financial asset or financial liability | <u>I – P ± A – R</u> |

**Illustration 2**

A Ltd. borrows Rs. 10 lakh from B Ltd. under the following terms:

- (a) The loan will carry 5% annual rate of interest, payable at the end of each year.
- (b) A Ltd. will make immediate payment of an origination fee of Rs. 70,000 to B Ltd.
- (c) The principal will be repaid in two instalments, Rs. 4 lakh at the end of year 3 and Rs. 6 lakh at the end of year 5.

Show the Loan A/c in books of B Ltd.

**Solution**

Fair value of the loan = Rs. 10 lakh

Transaction cost = Origination fee = Rs. 70,000

Fair value, net of transaction cost = Rs. 9.30 lakh

The loan taken is recognised initially at Rs. 9.30 lakh

Effective interest rate is discounting rate at which present value of interest and principal payments over 5 years is equal to Rs. 9.30 lakh. This rate is determined by trial and error as shown below:

Present value at guessed rate 6%

| Year | Cash Flow<br>Rs. 000 | DF<br>6% | PV<br>Rs. 000 |
|------|----------------------|----------|---------------|
| 1    | 50                   | 0.943    | 47            |
| 2    | 50                   | 0.890    | 44            |
| 3    | 450                  | 0.839    | 378           |
| 4    | 30                   | 0.792    | 24            |
| 5    | 630                  | 0.747    | <u>471</u>    |
|      |                      |          | <u>964</u>    |

Present value at guessed rate 8%

| Year | Cash Flow<br>Rs. 000 | DF<br>8% | PV<br>Rs. 000 |
|------|----------------------|----------|---------------|
| 1    | 50                   | 0.926    | 46            |
| 2    | 50                   | 0.857    | 43            |

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|   |     |       |     |
|---|-----|-------|-----|
| 3 | 450 | 0.794 | 357 |
| 4 | 30  | 0.735 | 22  |
| 5 | 630 | 0.680 | 429 |
|   |     |       | 897 |

$$\text{Effective interest rate (by interpolation)} = 6\% + \frac{8-6}{964-897} \times (964-930) = 7\%$$

Computation of interest cost

| Year | <i>Amortised cost<br/>(Opening)</i><br>Rs. 000 | <i>Interest cost at<br/>7%</i><br>Rs. 000 | <i>Cash paid</i><br>Rs. 000 | <i>Amortised cost<br/>(Closing)</i><br>Rs. 000 |
|------|------------------------------------------------|-------------------------------------------|-----------------------------|------------------------------------------------|
| 1    | 930                                            | 65                                        | 50                          | 945                                            |
| 2    | 945                                            | 66                                        | 50                          | 961                                            |
| 3    | 961                                            | 67                                        | 450                         | 578                                            |
| 4    | 578                                            | 41                                        | 30                          | 589                                            |
| 5    | 589                                            | 41                                        | 630                         | Nil                                            |

In the books of A Ltd.

| Loan A/c |                |              |        |                |              |
|----------|----------------|--------------|--------|----------------|--------------|
|          |                | Rs. 000      |        |                | Rs. 000      |
| Year 1   | To Bank        | 70           | Year 1 | By Bank        | 1,000        |
|          | To Bank        | 50           |        | By Interest    | 65           |
|          | To Balance c/d | <u>945</u>   |        |                |              |
|          |                | <u>1,065</u> |        |                | <u>1,065</u> |
| Year 2   | To Bank        | 50           | Year 2 | By Balance b/d | 945          |
|          | To Balance c/d | <u>961</u>   |        | By Interest    | <u>66</u>    |
|          |                | <u>1,011</u> |        |                | <u>1,011</u> |
| Year 3   | To Bank        | 450          | Year 3 | By Balance b/d | 961          |
|          | To Balance c/d | <u>578</u>   |        | By Interest    | <u>67</u>    |
|          |                | <u>1,028</u> |        |                | <u>1,028</u> |
| Year 4   | To Bank        | 30           | Year 4 | By Balance b/d | 578          |
|          | To Balance c/d | <u>589</u>   |        | By Interest    | <u>41</u>    |



|        |         |               |        |                |            |
|--------|---------|---------------|--------|----------------|------------|
|        |         | <u>619</u>    |        |                | <u>619</u> |
| Year 5 | To Bank | 630           | Year 5 | By Balance b/d | 589        |
|        |         | <u>      </u> |        | By Interest    | <u>41</u>  |
|        |         | 630           |        |                | <u>630</u> |

**4.5 Derecognition of a Financial Asset:** An entity should derecognise a financial asset when, and only when:

- (a) The contractual rights to the cash flows from the financial asset expire; or
- (b) It transfers the financial asset in manner prescribed by the standard and the transfer qualifies for derecognition in accordance with the standard.

On derecognition of a financial asset, the difference between the carrying amount and consideration received is recognised in the statement of profit and loss.

At the time of derecognition of a financial asset available for sale, the cumulative gain or loss previously recognised in Investment Revaluation Reserve should be recognised in the statement of profit and loss.

**4.6 Transfer of Financial Assets:** An entity transfers a financial asset if, and only if, it either:

- (a) Transfers the contractual rights to receive the cash flows of the financial asset; or
- (b) Retains the contractual rights to receive the cash flows of the financial asset, (the original asset) but assumes a contractual obligation to pay the cash flows to one or more recipients (the eventual recipients) in an arrangement that meets all of the following three conditions.
  - (i) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset.
  - (ii) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
  - (iii) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in AS 3, Cash Flow Statements) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

Debt securitisation is an example of the situation described in (b) above. The entity can be the originator of the financial asset that passes on cash flows to unrelated third party investors

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through a special purpose entity.

**4.7 Risks and rewards of ownership:** When despite transfer, an entity retains substantial risks and rewards of ownership of a financial asset, or retains control over it, derecognition of the financial asset is not permitted.

If the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity should derecognise the financial asset.

If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, it should derecognise the financial asset, provided it does not retain control over the financial asset.

**4.8 Continuing involvement in transferred assets:** If the entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, but retains control of the transferred asset, the entity continues to recognise the transferred asset to the extent of its continuing involvement.

The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example, when the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of the carrying amount of the asset and the guarantee amount.

When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises an associated liability. Despite the other measurement requirements, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained.

If the transferred asset is measured at amortised cost, the associated liability cannot be designated as a financial liability as at fair value through profit or loss. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:

- (a) The amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost; or
- (b) Equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.

The entity should continue to recognise any income arising on the transferred asset to the extent of its continuing involvement and should recognise any expense incurred on the associated liability.

For the purpose of subsequent measurement, recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other and should not be offset.

**4.9 Post-derecognition rights and obligations:** When a financial asset is derecognised on transfer, rights and obligations created or retained in the transfer should be recognised separately as assets or liabilities.

If, as a result of a transfer, a financial asset is derecognised in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity should recognise the new financial asset, financial liability or servicing liability at fair value.

**4.10 Servicing Asset/ Liability:** When a financial asset is derecognised in its entirety, but the entity retains the right to service the financial asset for a fee, it should recognise either a servicing asset or a servicing liability for that servicing contract.

If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation should be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset should be recognised for the servicing right. The value of servicing asset is a part of carrying amount of the financial asset allocated on the basis of fair value of different components of financial asset, e.g. interest strip (present value of interest cash flows), principal strip (present value of interest cash flows) and servicing asset (present values of net servicing cash flows).

**4.11 Partial transfers :** Derecognition criteria should be applied to whole of a financial asset in all cases except when a part of financial asset satisfies any one of the following conditions.

- (a) The part comprises only specifically identified cash flows from a financial asset. Consider the case of a bond. A bond gives rise to two identifiable cash flows, viz. cash flows for principal repayments and cash flows for interests. Value of a bond comprise of principal strip and interest strip. If interest strip of a bond is transferred, the transferee gets the right to receive the interests but not the principals. When an entity transfers interest strip, the derecognition criteria are applied to the interest strip.
- (b) The part comprises only a proportionate share of all cash flows from a financial asset. For example, when an entity transfers a bond in such way that the transferee obtains the rights to receive 90% share of all cash flows from the bond, the derecognition criteria are applied to 90% of those cash flows.
- (c) The part comprises only a proportionate share of specifically identified cash flows from a financial asset. For example, when an entity transfers interest strip of a bond in such way that the transferee gets the right to receive 90% of interest cash flows the derecognition criteria are applied to 90% of interest cash flows.

**4.12 Gains/Losses on partial derecognition:** If the transferred asset is part of a larger financial asset (e.g., interest strip), and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset should be allocated

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between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset should be treated as a part that continues to be recognised.

In case of financial assets available-for-sale, the cumulative gain or loss that had been recognised in Investment Revaluation Reserve is allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts.

The difference between the carrying amounts allocated to the part derecognised and consideration received (plus allocated cumulative gain/loss recognised in Investment Revaluation Reserve) for that part should be recognised in the statement of profit and loss.

When an entity continues to recognise a part of financial asset due to its continuous involvement, the carrying amount of the financial asset is allocated between part recognised and part derecognised on the basis of relative fair values. Gains/losses on derecognition is computed in the way as indicated above and should be recognised in the statement of profit and loss.

**4.13 Transfers not qualifying for derecognition:** If a transfer does not qualify for derecognition, the entity should continue to recognise the transferred asset and should recognise a financial liability for the consideration received. In subsequent periods, the entity should recognise any income on the transferred asset and any expense incurred on the financial liability.

If a transferred asset continues to be recognised, the asset and the associated liability should not be offset. Similarly, the entity should not offset any income arising from the transferred asset with any expense incurred on the associated liability

**4.14 Collateral:** If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or re-pledge the collateral and on whether the transferor has defaulted. The transferor and transferee should account for the collateral as follows:

- (a) If the transferee has the right by contract or custom to sell or re-pledge the collateral, then the transferor should reclassify that asset in its balance sheet (e.g., as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.
- (b) If the transferee sells collateral pledged to it, it should recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.
- (c) If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it should derecognise the collateral, and the transferee should recognise the collateral as its asset initially measured at fair value or, if it has already

sold the collateral, derecognise its obligation to return the collateral.

- (d) Except as provided in (c) above, the transferor should continue to carry the collateral as its asset, and the transferee should not recognise the collateral as an asset.

### Illustration 3

A Ltd. has lent Rs. 50,000 yielding 18% interest p.a. for 10 years. The company transferred the right to receive principal Rs. 50,000 on maturity and the right to receive 14% interest per year. Of the balance 4% interest, 2% is due to the transferor, i.e. A Ltd. as service fee for collection of principal and interest. The expected cost for collection etc. is Rs. 400. A Ltd. has retained the right to receive the remaining 2% interest per year.

Show important accounting entries in books of A Ltd. Assume expected yield rate 13% p.a.

### Solution

|                               | <i>Interest<br/>Transferred</i> | <i>Principal<br/>Transferred</i> | <i>Interest<br/>Retained</i> | <i>Service<br/>Fee</i> |
|-------------------------------|---------------------------------|----------------------------------|------------------------------|------------------------|
|                               | <i>Rs.</i>                      | <i>Rs.</i>                       | <i>Rs.</i>                   | <i>Rs.</i>             |
| Cash inflow                   | 7,000                           | 50,000                           | 1,000                        | 1,000                  |
| Less: Cost of servicing loan  | ---                             | ---                              | ---                          | 400                    |
| Net cash flow                 | 7,000                           | 50,000                           | 1,000                        | 600                    |
| Year                          | 1 - 10                          | 10                               | 1 - 10                       | 1 - 10                 |
| DF (13%)                      | 5.43                            | 0.29                             | 5.43                         | 5.43                   |
| Fair value of components      | 38,010                          | 14,500                           | 5,430                        | 3,258                  |
| Allocation of carrying amount |                                 |                                  |                              |                        |
|                               | <i>Fair value</i>               |                                  | <i>Carrying amount</i>       |                        |
|                               | <i>Rs.</i>                      | <i>Rs.</i>                       | <i>Rs.</i>                   |                        |
| Principal transferred         | 38,010                          |                                  |                              |                        |
| Interest transferred          | <u>14,500</u>                   | 52,510                           | 42,902                       |                        |
| Servicing asset               |                                 | 3,258                            | 2,662                        |                        |
| Interest strip                |                                 | <u>5,430</u>                     | <u>4,436</u>                 |                        |
| Total                         |                                 | <u>61,198</u>                    | <u>50,000</u>                |                        |

## 6.28 Financial Reporting

Books of A Ltd.

|                      |     | Rs.    | Rs.    |
|----------------------|-----|--------|--------|
| Cash                 | Dr. | 52,510 |        |
| To Loan              |     |        | 42,902 |
| To Profit & Loss A/c |     |        | 9,608  |
| Servicing Asset      | Dr. | 2,662  |        |
| Interest Strip       | Dr. | 4,436  |        |
| To Loans             |     |        | 7,098  |

### Illustration 4

A Ltd. lent Rs. 20,000 for 8 years at 8% interest payable annually. At the time, the fair value of the loan at effective annual interest rate of 10.2% was Rs. 17,670. The borrower had the option to pre-pay the loan. After 3 years, when amortised cost of the loan was Rs. 18,100, the company transferred its right to receive principal to the extent of Rs. 90% and interest to the extent of 9.5% in favour of B Ltd. The consideration for the transaction was Rs. 16,700. The other particulars of the transaction were as below:

- Fair value of the loan at the time of transaction at effective interest rate of 10% was Rs. 18,484. A Ltd. retained the excess spread of 0.5% principal transferred.
- A Ltd. retained the right to receive collections of principal to the extent of Rs. 2,000 plus interest thereon. Defaults if any, are deductible from the company's claim on the principal, subject to maximum Rs. 2,000.
- The estimated fair value of the excess spread of 0.5% is Rs. 38.
- Collections from pre-payments are to be allocated between A Ltd. and the transferee proportionately in the ratio of 1:9.

Show journal entry to record the transfer.

### Solution

The company has transferred the significant prepayment risk but has retained control over the loan. It has also retained significant default risk, giving credit enhancement for the transferee. The continuing involvement approach in this case is appropriate.

### Allocation of carrying amount of loan

| Component of loan | Fair Value<br>Rs. | Proportion<br>Rs. | Carrying amount allocated<br>Rs. |
|-------------------|-------------------|-------------------|----------------------------------|
| Part transferred  | 16,636            | 90%               | 16,290                           |

## Accounting and Reporting of Financial Instruments 6.29

|               |               |     |               |
|---------------|---------------|-----|---------------|
| Part retained | <u>1,848</u>  | 10% | <u>1,810</u>  |
|               | <u>18,484</u> |     | <u>18,100</u> |

Gain from part transferred = Rs. 16,636 – Rs. 16,290 = Rs. 346

Carrying amount of part retained = Rs. 1,810

Fair value of part transferred = Rs. 16,636

Consideration received from transferee = Rs. 16,700

Value of credit enhancement = Rs. 16,700 – Rs. 16,636 = Rs. 64

Value of interest strip = Rs. 38

Value of income recognised in subsequent time periods on time proportion basis

= Rs. 64 + Rs. 38 = Rs. 102

In respect of principal not transferred, the company should recognise Rs. 2,000 as asset as well as liability (for the possibility of default) for continued involvement.

Value of liability for continued involvement

= Principal retained + Deferred Income = Rs. 2,000 + Rs. 102 = Rs. 2,102

### Books of A Ltd.

|                                                  |     | Rs.    | Rs.    |
|--------------------------------------------------|-----|--------|--------|
| Bank                                             | Dr. | 16,700 |        |
| Financial Asset for continued involvement        | Dr. | 2,000  |        |
| Interest strip                                   | Dr. | 38     |        |
| To Loan                                          |     |        | 16,290 |
| To Profit & Loss A/c                             |     |        | 346    |
| To Financial Liability for continued involvement |     |        | 2,102  |

The company will recognise interest on balance of loan in subsequent periods by effective interest method.

**4.15 Buy-back of shares:** If an enterprise buys-back its own shares, nominal value of those shares should be deducted from share capital. No gain or loss should be recognised in the statement of profit and loss on the purchase or cancellation of an enterprise's own shares. Difference between the consideration paid and nominal value of shares bought back, should be directly recognised in reserves and surplus.

### 6.30 Financial Reporting

#### Illustration 5

Following is the balance sheet of A Ltd. as at 31/03/06

| Liabilities            | Rs. 000 | Assets                | Rs. 000 |
|------------------------|---------|-----------------------|---------|
| Share Capital (Rs. 10) | 2,000   | Fixed Assets          | 6,750   |
| Securities Premium     | 250     | Non-trade Investments | 750     |
| General Reserves       | 1,950   | Stock                 | 1,500   |
| Profit & Loss A/c      | 300     | Debtors               | 900     |
| 10% Debentures         | 5,000   | Bank                  | 400     |
| Creditors              | 800     |                       |         |
|                        | 10,300  |                       | 10,300  |

The company bought back 40,000 shares at Rs. 20 per share. The buy-back was financed by sale of non-trade investments for Rs. 8 lakh.

Show important accounting entries in books of the company to record the buy-back.

#### Solution

|                               |     | Rs. 000 | Rs. 000         |
|-------------------------------|-----|---------|-----------------|
| Bank                          | Dr. | 800     |                 |
| To Investments                |     |         | 750             |
| To Profit & Loss A/c          |     |         | 50              |
| Share Capital                 | Dr. | 400     | 40 × Rs. 10     |
| Buy-back Premium              | Dr. | 400     | 40 × Rs. 10     |
| To Bank                       |     |         | 800 40 × Rs. 20 |
| Securities Premium            | Dr. | 250     |                 |
| General Reserve               | Dr. | 150     |                 |
| To Buy-back premium           |     |         | 400             |
| General Reserve               | Dr. | 400     |                 |
| To Capital Redemption Reserve |     |         | 400             |



**Note:**

Where a buy back of shares is sourced out of free reserves, Section 77 AA of the Companies Act, 1956 requires creation of a Capital Redemption Reserve by transfer from free reserves, of an amount equal to nominal value of shares bought.

**4.16 Derecognition of a Financial Liability:** An entity should remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished, i.e., when the obligation specified in the contract is discharged or cancelled or expires.

An exchange between an existing borrower and lender of debt instruments with substantially different terms should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, should be recognised in the statement of profit and loss.

If an entity repurchases a part of a financial liability, the entity allocates the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised is recognised in the statement of profit and loss.

**4.17 Impairment and Uncollectability of Financial Assets :** An entity should assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the impairment loss should be measured and dealt in the following manner.

**4.18 Impairment of financial assets carried at amortised cost :** If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition). The carrying amount of the asset should be reduced either directly or through use of an allowance account. The amount of the loss should be recognised in the statement of profit and loss.

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If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss should be reversed either directly or by adjusting an allowance account. The reversal should not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal should be recognised in the statement of profit and loss.

**4.19 Impairment of short-term receivables carried at original invoice amount:** If there is objective evidence that an impairment loss on short-term receivables carried at original invoice amount has been incurred (i.e., some of the short-term receivables may not be recoverable), the amount of the loss is measured as the difference between the receivables' carrying amount and the undiscounted amount of estimated future cash flows (excluding future credit losses that have not been incurred). The carrying amount of the receivables should be reduced either directly or through use of an allowance account. The amount of the loss should be recognised in the statement of profit and loss.

If in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss should be reversed either directly or by adjusting the allowance account. The reversal should not result in a carrying amount of the short-term receivable that exceeds what the amount would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal should be recognised in the statement of profit and loss

**Note:** In line with the terminology prevalent internationally, the words 'allowance account' have been used here in the context of impairment of assets and doubtful debts. The term commonly used is 'provisions', e.g., provision for bad and doubtful debts.

**4.20 Impairment of financial assets carried at cost :** If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. The amount of the loss should be recognised in the statement of profit and loss. Such impairment losses should not be reversed.

**4.21 Impairment of available-for-sale financial assets :** When a decline in the fair value of an available-for-sale financial asset has been recognised directly in the appropriate equity account, e.g. Investment Revaluation Reserve, and there is objective evidence that the asset is impaired, the cumulative loss that had been recognised directly in the equity account should be removed from the equity account and recognised in the statement of profit and loss even though the financial asset has not been derecognised.

The amount of the cumulative loss that is removed from the equity account and recognised in the statement of profit and loss should be the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that financial asset previously recognised in the statement of profit and loss.

Impairment losses recognised in the statement of profit and loss for an investment in an equity instrument classified as available for sale should not be reversed through the statement of profit and loss. This is because in case of equity instruments classified as available for sale, reversals of impairment losses cannot be distinguished from other increases in fair value.

If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in the statement of profit and loss, the impairment loss should be reversed, with the amount of the reversal recognised in the statement of profit and loss.

**4.22 Derivatives:** The expression 'financial instruments' include derivatives. The proposed AS 30 defines derivative as a financial instrument or other contract within the scope of the standard with all three of the following characteristics:

- (a) Its value changes in response to the change in specified financial or non-financial variable. The examples of financial variables include interest rates, financial instrument prices, commodity prices, foreign exchange rates, index of prices or rates, credit ratings or credit indices. The examples of non-financial variables include index of earthquake losses in a particular region or index of temperatures in a particular city. If the non-financial variable is specific to a party to the contract, e.g. occurrence or non-occurrence of fire that damages or destroys an asset of a party to the contract, the contract is not derivative for the purpose of the standard.
- (b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors;
- (c) It is settled at a future date.

Examples of derivatives include, forwards, commodity futures, currency futures, index futures, call and put options on commodity, currency and indices, interest rate swaps and currency swap.

### **Embedded Derivatives**

An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract, with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

An embedded derivative should be separated from the host contract and accounted for as a derivative if (i) the economic characteristics and risks of the embedded derivative are not

### 6.34 Financial Reporting

closely related to the economic characteristics and risks of the host contract and (ii) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative. However, a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss need not be separated.

An example of a hybrid instrument is a puttable bond. These are bonds that give the holder a right to put (sale) the bonds to the issuer at a price that varies on the basis of the change in an equity or commodity index. In effect, the bond issuer writes a put option, which the bondholder holds. The strike price is the principal and maturity price is the indexed principal payment. The issuer is entitled to option premium (value of put), which the bondholder pays. The consideration for the bond therefore, consists of value of bond (host contract) and value of put (value of embedded derivative). The Black and Scholes Model can be used to value the put. Alternatively, value of put can be determined as excess of fair value of puttable bond over fair value of bond without the put option.

Unless the puttable bond is designated as a financial liability at fair value through profit or loss, the entity is required to separate an embedded derivative (value of put) because the host contract is a debt instrument and the indexed principal payment is not closely related to a host debt instrument.

Notwithstanding the requirements of separation of embedded derivatives from host contract, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:

- (a) The embedded derivatives do not significantly modify the cash flows that otherwise would be required by the contract; or
- (b) It is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivatives is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

Where fair value of an embedded derivative cannot be measured reliably on the basis of terms and conditions of the contract, e.g. when the embedded derivative is based on an unquoted equity instrument, the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract.

If the fair value of the embedded derivative cannot be reliably measured using the method described above, the hybrid (combined) instrument is designated as at fair value through profit or loss.

A common form of compound financial instrument is a debt instrument with conversion option, such as a debenture convertible into equity shares of the issuer, without any other embedded derivative features. The issuer of such financial instruments should present the liability component, (value of debt without conversion option) and equity component (value of conversion option) separately on the balance sheet.

In case compound financial instruments with multiple derivative features, e.g. a callable convertible bond, the value of derivative feature, e.g. a call option embedded, is included in the liability component.

### Illustration 6

At the beginning of year 1, an enterprise issued 20,000 convertible debentures with face value Rs. 100 per debenture, at par. The debentures have six-year term. The interest at annual rate of 9% is paid half-yearly. The bondholders have an option to convert half of the face value of debentures into 2 ordinary shares at the end of year 3. The bondholders not exercising the conversion option will be repaid at par to the extent of Rs. 50 per debenture at the end of year 3. The non-convertible portion will be repaid at 10% premium at the end of year 6. At the time of issue, the prevailing market interest rate for similar debt without conversion option was 10%.

Compute value of embedded derivative.

### Solution

| <i>Half-year</i>                                | <i>Cash Flow</i><br><i>Rs. 000</i> | <i>DF</i><br><i>(5%)</i> | <i>PV</i><br><i>Rs. 000</i> |
|-------------------------------------------------|------------------------------------|--------------------------|-----------------------------|
| 1 – 6                                           | 90                                 | 5.076                    | 456.84                      |
| 7 – 12                                          | 45                                 | 3.787                    | 170.41                      |
| 12                                              | 1,100                              | 0.557                    | <u>612.70</u>               |
| Value of host (Liability component)             |                                    |                          | 1,239.95                    |
| Value of embedded derivative (Equity component) |                                    |                          | <u>760.05</u>               |
| Issue proceeds                                  |                                    |                          | <u>2,000.00</u>             |

### Illustration 7

Certain callable convertible debentures are issued at Rs. 60. The value of similar debentures without call or equity conversion option is Rs. 57. The value of call as determined using Black and Scholes model for option pricing is Rs. 2.

Determine values of liability and equity component.

### Solution

A callable bond is one that gives the issuer a right to buy the bond from the bondholders at a specified price. This feature in effect is a call option written by the bondholder. The option premium (value of call) is payable by the issuer.

Liability component (disregarding the call) = Rs. 57

Value of call payable by issuer = Rs. 2

### 6.36 Financial Reporting

Liability component = Rs. 57 – Rs. 2 = Rs. 55

Equity component = Rs. 60 – Rs. 55 = Rs. 5

## 5. HEDGE ACCOUNTING

Hedging refers to current actions designed to reduce future uncertainty of cash flow or value of assets, liabilities, firm commitments etc. A forward exchange contract to buy foreign currency for future payments in foreign currency is an example of hedge. To create a hedge, one can take current position on some financial instruments in such way that future changes in fair value of hedged item and the financial instrument used for hedging are opposite. The opposite changes offset, and the net position of the hedger do not change. The hedge accounting refers to symmetric recognition of offsetting changes in values of hedged item and financial instrument used for hedging.

A hedging instrument is mostly a derivative, designated for hedging a specific item of asset, liability etc. Derivatives not regarded as hedge instruments are treated as held for trading instruments.

The risk of changes in foreign currency exchange rates can be hedged using non-derivative financial assets or liabilities whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item, e.g. a foreign currency receivable.

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a non-integral foreign operation that exposes an entity to risk of changes in fair value or future cash flows and is designated as being hedged.

Suppose has committed to buy 1,000 shares of a company after 3 month at current price Rs. 80 per share. The entity purchased a call option on 1,000 shares at strike price Rs. 100 per share.

The hedged item in the above example is the firm commitment to buy 1,000 shares at Rs. 80 per share. The designated hedging instrument is the call option purchased. The hedger expects to receive Re. 1 per share as price differential against the call option purchased for every Re. 1 increase in share price. The price differential received against the purchased call is expected to offset extra payment over current price the hedger may have to make to buy the shares due to price rise.

The price movement in option market and the stock market may not always be same. The mismatch in price movements in two markets may cause a hedge to fail. Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

### Hedging Relationships

The method of hedge accounting depends on type of hedge relationship. Hedging

relationships are of three types:

**Fair value hedge**

This is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk, that could affect profit or loss.

A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

**Cash flow hedge:**

This is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability, e.g. future interest payments on variable rate debt, or a highly probable forecast transaction, that could affect profit or loss.

**Hedge of a net investment in a non-integral foreign operation**

Non-integral foreign operation is a foreign subsidiary, foreign associates and foreign joint venture. These are hedges, designed to protect against translation losses that may arise on translation of foreign currency financial statement into reporting currency.

**Conditions for applying hedge accounting**

A hedging relationship qualifies for hedge accounting if, and only if, all of the following conditions are met.

- (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation should include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
- (b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
- (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.
- (d) The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.
- (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

## **6.38 Financial Reporting**

### **Accounting for Fair Value Hedges**

If a fair value hedge meets the conditions of applicability of hedge accounting stated above:

- (a) The gain or loss from re-measuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with AS 11 (for a non-derivative hedging instrument) should be recognised in the statement of profit and loss; and
- (b) The gain or loss on the hedged item attributable to the hedged risk should adjust the carrying amount of the hedged item and be recognised in the statement of profit and loss. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in the statement of profit and loss applies if the hedged item is an available-for-sale financial asset.

### **Accounting for cash flow hedges**

If a cash flow hedge meets the conditions for application of hedge accounting:

- (a) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge should be recognised directly in an appropriate equity account, say, Hedging Reserve Account; and
- (b) The portion of the gain or loss on the hedging instrument that is determined to be an ineffective hedge should be recognised in the statement of profit and loss.

### **Accounting for hedges of a net investment**

Hedges of a net investment in a non-integral foreign operation including a hedge of a monetary item that is accounted for as part of the net investment as per AS 11, should be accounted for similarly to cash flow hedges:

- (a) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge should be recognised directly in the appropriate equity account; and
- (b) The portion of the gain or loss on the hedging instrument that is determined to be an ineffective hedge should be recognised in the statement of profit and loss. The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised directly in the equity account should be recognised in the statement of profit and loss on disposal of the non-integral foreign operation.

### **Illustration 8**

On April 1, 2006, A Ltd. borrowed Rs. 10 lakh at annual fixed interest rate of 7% payable half-yearly. The life of the loan is 4 years with no pre-payment permitted. The company expected the interest rate to fall and on the same day, it entered into an interest rate swap arrangement, whereby the company would pay 6-month LIBOR and would receive annual fixed interest of 7% every half-year. The swap effectively converted the company's fixed rate obligation to



floating rate obligation.

The follow value of swap and debt are available

|                | <i>Value of swap</i> | <i>Value of debt</i> |
|----------------|----------------------|----------------------|
|                | <i>Rs. lakh</i>      | <i>Rs. lakh</i>      |
| April 1, 2006  | + 0.2                | 10.2                 |
| March 31, 2007 | – 0.1                | 9.9                  |

Six-month LIBOR on April 1, 2006 was 6% and that on October 1, 2006 was 8%.

Show important accounting entries in respect of the swap arrangement.

### Solution

The interest rate swap is used to hedge fair value of fixed-rate debt. This is a case of fair value hedge.

### Books of A Ltd.

|                                                          | <i>Rs.<br/>lakh</i> | <i>Rs.<br/>lakh</i>          |
|----------------------------------------------------------|---------------------|------------------------------|
| Interest                                                 | 0.35                | $10 \times 7\% \times 6/12$  |
| To Cash                                                  |                     | 0.35                         |
| (Interest on fund borrowed for first half-year 2006-07)  |                     |                              |
| Loss on valuation of debt                                | 0.20                | $10.2 - 10$                  |
| To Loan                                                  |                     | 0.20                         |
| (Increase in value of debt recognised)                   |                     |                              |
| Swap Hedge                                               | 0.20                |                              |
| To Gain on Swap Hedge                                    |                     | 0.20                         |
| (Increase in value of swap recognised)                   |                     |                              |
| Cash                                                     | 0.05                | $10 (7\% - 6\%) \times 6/12$ |
| To Interest                                              |                     | 0.05                         |
| (Swap settlement received for first half-year 2006-07)   |                     |                              |
| Interest                                                 | 0.35                | $10 \times 7\% \times 6/12$  |
| To Cash                                                  |                     | 0.35                         |
| (Interest on fund borrowed for second half-year 2006-07) |                     |                              |
| Loan                                                     | 0.30                | $10.2 - 9.9$                 |
| To Gain on valuation of debt                             |                     | 0.30                         |

## 6.40 Financial Reporting

(Decrease in value of debt recognised)

|                    |      |               |
|--------------------|------|---------------|
| Loss on Swap Hedge | 0.30 | 0.2 – (– 0.1) |
| To Swap Hedge      |      | 0.30          |

(Cumulative loss on swap recognised)

|          |      |                     |
|----------|------|---------------------|
| Interest | 0.05 | 10 (8% – 7%) × 6/12 |
| To Cash  |      | 0.05                |

(Swap settlement paid for second half-year 2006-07)

## 6. COMPOUND FINANCIAL INSTRUMENTS

In the case of compound financial instruments, which are instruments with both debt and equity features (i.e., bonds convertible into cash or equity instruments), IAS 32 requires separating the component parts into its debt and equity portions. Interest, dividends, and transaction gains and losses associated with the instrument should be accounted for and reported consistent with the classification of the component from which those amounts were derived. For example, payments related to a component classified as an equity instrument would be reported similarly to a dividend, but payments on a component classified as a debt instrument would be accounted for and reported as interest expense.

### Self-examination Questions

1. Define financial instruments in brief.
2. What guidelines have been prescribed in India for accounting and presentation of financial instruments by ICAI, so far?
3. What is interest rate swap? Is it allowed in India?
4. How is the difference between forward rate and exchange rate recognized on the date of transaction in a forward contract?

## SHARE-BASED PAYMENTS

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*Reference:* The students are advised to refer the full text of the Guidance Note on Accounting for Employee Share-based Payments

### 1. INTRODUCTION

Share based payments\* cover all forms of share-based payment for goods and services supplied to the reporting entity, including:

- ◆ employee share or share option schemes – employees are defined widely and include others providing similar services
- ◆ share-based payments to parties other than employees that have supplied goods or services to the entity
- ◆ payments to be settled in cash or other assets at amounts that depend on share values, eg share appreciation rights.

Share-based payments divide into three main types:

- ◆ 'equity-settled', where the entity receives goods or services in return for equity instruments, such as shares or options
- ◆ 'cash-settled', where the entity receives goods or services in return for incurring liabilities to the supplier for amounts based
- ◆ on the price of the entity's shares or other equity instruments. (Note that 'cash' in this context includes other assets.)
- ◆ transactions that may be settled either in equity instruments or cash at either the entity's or supplier's discretion.

IFRS 2 also covers other transactions, including those to which the reporting entity does not, at first sight, appear to be a party.

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\* The given definition of share based payments is based on International Financial Reporting Standard (IFRS) 2, on share-based payment.

## **7.2 Financial Reporting**

These include transfers of an entity's equity instruments by its shareholders, or transfers of equity instruments of the parent or another entity in the same group, to the entity's employees or to other parties that have supplied goods or services to the entity.

### **2. EMPLOYEE SHARE-BASED PAYMENTS**

Employee share-based payments are incentive payments to employees in form of shares. The expression employee share-based payments also include cash incentives to employees, the size of which is linked with value of shares. The payment in form of shares generally involve grant of options to employees to subscribe shares of employer enterprise at a concessional price, called the exercise price. The employees gain the excess of market price of share at the time of exercise over the specified exercise price. In case of employee share-based payments in form of cash incentive, the excess of market price on specified future date and a stated price is paid in cash. In either case, the value of incentive depends on increase in share value, which is the generally accepted indicator financial success of a business. By linking incentives with value of shares, the employee share-based payment plans effectively integrate personal goals of employees with that of the enterprise.

The day a share-based payment plan is announced and accepted by employees is called the grant date and the day, when the employees become entitled to such payments, is called the vesting date. The period between these two dates is called the vesting period. To qualify for the incentives, the employees put in their efforts during the vesting period to fulfil specified vesting conditions, e.g. reaching a specified sales/profit target. Exercise date is the date when an option is exercised by paying the exercise price.

The value of share-based payment depends on the market value of shares on vesting date/exercise date and hence cannot be known with certainty before these dates. Nevertheless, since the share-based payments are payments for services rendered by employees during the vesting period, the value of share-based payments should be recognised as expense during the vesting period, i.e. before value of such payments are known with certainty.

Two principal issues involved in accounting for employee share-based payments are (i) problem of valuation of share-based payments before vesting date and (ii) problem of allocation of the estimated value of share-based payment to a particular accounting period during the vesting period for recognition as expense.

The International Accounting Standards Board (IASB) has issued the International Financial Reporting Standard (IFRS) 2, on share-based payments. This chapter is however based on the Guidance Note on Accounting for Employee Share-based Payments, issued by the Institute of Chartered Accountants of India..

### 3. SHARE BASED PAYMENT PLANS

Share-based payment plans generally take the form of Employee Stock Option Plans (ESOP), Employee Stock Purchase Plans (ESPP) and Stock Appreciation Rights (SAR). The Employee Stock Option Plan (ESOP) is a contract that gives the employees of an enterprise the right, but not obligation, for a specified period to purchase or subscribe to the specified number shares of the enterprise at a fixed or determinable price, called the exercise price. The Employee Stock Purchase Plan (ESPP), is a plan under which the enterprise offers shares to its employees at a discounted price as part of public issue or otherwise. The Stock Appreciation Rights (SAR) are rights that entitle the employees to receive cash or shares for an amount equivalent to the excess of market price on exercise date over a stated price. The date when a share-based payment plan is announced and agreed, is called the grant date.

For accounting purposes, employee share-based payment plans are classified into the following categories:

- (a) Equity-settled: Under these plans, the employees receive shares, e.g. ESOP
- (b) Cash-settled: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares, e.g. Stock Appreciation Rights (SAR).
- (c) Employee share-based payment plans with cash alternatives: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

The entitlements to share-based payments are based on satisfaction of specified conditions. The specified conditions are vesting conditions and the period taken to satisfy the vesting conditions is the vesting period. The share-based payments are incentives for services rendered by employees over the vesting period and hence are recognised as Employees' Compensation Expense over the vesting period.

The examples of vesting condition include, a sales target, a profit target, a target market price of shares or service conditions such as continuous employment during the vesting period. Market condition is a vesting condition related to market price of shares of the enterprise, e.g. a condition that the payments will be made provided the market price of shares increases by at least 40% over that on grant date, within a period of three years.

### 4. EQUITY SETTLED EMPLOYEE SHARE-BASED PAYMENT PLANS

Payments under these plans are made in form of shares. Under these plans, the enterprise offers new shares issued by it to its employees. The issue price for the shares issued under these plans is the exercise price. At their option, the employees may pay the exercise price and become shareholders of the enterprise. The options are granted subject to fulfilment of specified vesting conditions. This form of plan is commonly called Employees Stock Option Plans (ESOP).

## 7.4 Financial Reporting

Under an ESOP, the employees gain the excess of market price of underlying share on exercise date over the exercise price. The option is not exercised if market price of underlying share on exercise date falls below the exercise price. For example, consider an option at exercise Rs. 45. If market price per share on exercise date is Rs. 50, an employee gains Rs. 5, by purchasing the share at exercise price is Rs. 45. The option is not exercised if market price falls below Rs. 45. Clearly, the ESOP is a call option held by the employees, which is settled by actual delivery of underlying shares. The employer is the writer of the option, but does not charge any option premium. The employer recognises the premium sacrificed, i.e. the value of call, as expense over the vesting period. The value of call for the purpose of accounting for share-based payments can be either the intrinsic value or fair value.

The fair value of an option is defined as the amount for which stock option granted can be exchanged between knowledgeable, willing parties in an arm's length transaction. This should be present value of expected gain of employees on exercise of the option. The expected gain is excess of expected market price at the time of exercise of option over the exercise price. The fair values of options depend on factors like, exercise price, current market price of underlying shares, expected volatility of return from the shares, risk-free rate of return, expected dividends, time allowed to exercise the option after vesting (i.e. life of option) and so on. Standard option pricing models, like Back-Scholes-Merton formula are modified suitably to ascertain fair value the options granted to employees.

Intrinsic value of an option is the excess of market price of the underlying share on the grant date over the exercise price. For example, if market price per share on grant date is Rs. 50 and the exercise of the option is 48, the intrinsic value of option on grant date is Rs. 2.

The value of an Employees Stock Option plan is initially based on fair value/intrinsic value per share on grant date. This is the minimum value of ESOP an enterprise must recognise as expense over vesting period. Where, after the grant date, the terms of an option are modified in a manner to increase its value, e.g. reduction of exercise price, the enterprise must also recognise the increased value of option as expense over vesting period remaining at the time of modification.

The aggregate value of option granted depends on the number of employees satisfying the vesting conditions and the number of options granted to each employee.

Suppose fair value of an option is Rs. 15 per share. If one option is granted per employee and if each option consists of 100 shares, the value of option granted to each employee is Rs. 1,500 (Rs. 15 × 100). If the enterprise expects 200 employees to satisfy the vesting conditions at the end of vesting period, the fair value of option to be recognised as expense is Rs. 3 lakh. (Rs. 1, 500 × 200). If vesting period is 5 years, the enterprise should recognise Rs. 60,000 (Rs. 3 lakh / 5) as expense per year for 5 years.

An enterprise should review all estimates taken in consideration for valuation of option. The value of option recognised as expense in an accounting period is the excess of cumulative

expense as per latest estimates upto the current accounting period over total expense recognised upto the previous accounting period.

Consider the following data in respect of an option granted on April 1, 2006.

|                                                                           | Estimates at the end of |          |
|---------------------------------------------------------------------------|-------------------------|----------|
|                                                                           | 2006-07                 | 2007-08  |
| Expected vesting date                                                     | 31/03/11                | 31/03/10 |
| A. Number employees                                                       | 100                     | 95       |
| B. Number of options per employee                                         | 50                      | 60       |
| C. Fair value per option (Rs.)                                            | 10                      | 12       |
| D. Value of option (Rs.) = A × B × C                                      | 50,000                  | 68,400   |
| E. Vesting Period                                                         | 5                       | 4        |
| F. Expense recognised in 2006-07 = 50,000/5                               | 10,000                  |          |
| G. Total expense recognised upto 2007-08 = (68,400/4) × 2                 |                         | 34,200   |
| Expense recognised in year 2007-08 = Rs. 34,200 – Rs. 10,000 = Rs. 24,200 |                         |          |

## 5. ACCOUNTING PROCEDURE FOR ESOP

The amount recognised as expense in a period is debited to 'Employees' Compensation A/c' with a corresponding credit to an equity account called Stock Options Outstanding A/c'. The amount recognised as expense can be either the intrinsic value or fair value. The Stock Options Outstanding A/c' is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve at the time of settlement. Till such transfer, the credit balance of Stock Options Outstanding A/c is shown in balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

The balance of Employees' Compensation A/c is transferred to the Profit & Loss A/c of the period. In case capitalisation is justified, the balance of Employees' Compensation A/c is transferred to the concerned Asset A/c instead of the Profit & Loss A/c.

On exercise of the option, the enterprise issues shares on receipt of the exercise price. The consideration for such shares comprises of the exercise price and the aggregate value of option recognised as expense, standing to the credit of Stock Options Outstanding A/c. In a situation where the right to obtain shares or stock options expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to General Reserve.

### Illustration 1

The following particulars in respect of stock options granted by a company are available:

## 7.6 Financial Reporting

|                                                      |                |
|------------------------------------------------------|----------------|
| Grant date                                           | April 1, 2006  |
| Number of employees covered                          | 525            |
| Number options granted per employee                  | 100            |
| Vesting condition: Continuous employment for 3 years |                |
| Nominal value per share (Rs.)                        | 100            |
| Exercise price per share (Rs.)                       | 125            |
| Market price per share on grant date (Rs.)           | 149            |
| Vesting date                                         | March 31, 2009 |
| Exercise Date                                        | March 31, 2010 |
| Fair value of option per share on grant date (Rs.)   | 30             |

Position on 31/03/07

(a) Estimated annual rate of departure 2%

(b) Number of employees left = 15

*Position on 31/03/08*

(a) Estimated annual rate of departure 3%

(b) Number of employees left = 10

*Position on 31/03/09*

(a) Number of employees left = 8

(b) Number of employees entitled to exercise option = 492

*Position on 31/03/10*

(a) Number of employees exercising the option = 480

(b) Number of employees not exercising the option = 12

Compute expenses to recognise in each year by (i) fair value method (ii) intrinsic value method and show important accounts in books of the company by both of the methods.

### Solution

*Fair Value Method*

#### Year 2006-07

Fair value of option per share = Rs. 30

Number of shares expected to vest under the scheme

$$= (525 \times 0.98 \times 0.98 \times 0.98) \times 100 = 49,400$$



Fair value =  $49,400 \times \text{Rs. } 30 = \text{Rs. } 14,82,000$

Vesting period = 3 years

Value of option recognised as expense in 2006-07 =  $\text{Rs. } 14,82,000 / 3 = \text{Rs. } 4,94,000$

#### **Year 2007-08**

Fair value of option per share = Rs. 30

Number of shares expected to vest under the scheme

=  $(525 - 15) \times 0.97 \times 0.97 \times 100 = 47,986$

Fair value =  $47,986 \times \text{Rs. } 30 = \text{Rs. } 14,39,580$

Vesting period = 3 years

Number of years expired = 2 years

Cumulative value of option to recognise as expense in 2006-07 and 2007-08

=  $(\text{Rs. } 14,39,580 / 3) \times 2 = \text{Rs. } 9,59,720$

Value of option recognised as expense in 2007-08

=  $\text{Rs. } 9,59,720 - \text{Rs. } 4,94,000 = \text{Rs. } 4,65,720$

#### **Year 2008-09**

Fair value of option per share = Rs. 30

Number of shares actually vested under the scheme =  $492 \times 100 = 49,200$

Fair value =  $49,200 \times \text{Rs. } 30 = \text{Rs. } 14,76,000$

Cumulative value of option to recognise as expense in 3 years = Rs. 14,76,000

Value of option recognised as expense in 2008-09

=  $\text{Rs. } 14,76,000 - \text{Rs. } 9,59,720 = \text{Rs. } 5,16,280$

#### **Year 2009-10**

Fair value of option per share = Rs. 30

Number of shares not subscribed =  $(492 - 480) \times 100 = 1,200$

Value of option forfeited =  $1,200 \times 30 = \text{Rs. } 36,000$

#### **Employees' Compensation A/c**

| Year    |                         | Rs.             | Year    |                      | Rs.             |
|---------|-------------------------|-----------------|---------|----------------------|-----------------|
| 2006-07 | To ESOP Outstanding A/c | <u>4,94,000</u> | 2006-07 | By Profit & Loss A/c | <u>4,94,000</u> |
|         |                         | <u>4,94,000</u> |         |                      | <u>4,94,000</u> |

## 7.8 Financial Reporting

|         |                         |                 |         |                      |                 |
|---------|-------------------------|-----------------|---------|----------------------|-----------------|
| 2007-08 | To ESOP Outstanding A/c | <u>4,65,720</u> | 2007-08 | By Profit & Loss A/c | <u>4,65,720</u> |
|         |                         | <u>4,65,720</u> |         |                      | <u>4,65,720</u> |
| 2008-09 | To ESOP Outstanding A/c | <u>5,16,280</u> | 2008-09 | By Profit & Loss A/c | <u>5,16,280</u> |
|         |                         | <u>5,16,280</u> |         |                      | <u>5,16,280</u> |

### ESOP Outstanding A/c

| Year    |                                     | Rs.              | Year    |                                | Rs.              |
|---------|-------------------------------------|------------------|---------|--------------------------------|------------------|
| 2006-07 | To Balance c/d                      | 4,94,000         | 2006-07 | By Employees' Compensation A/c | <u>4,94,000</u>  |
|         |                                     | <u>4,94,000</u>  |         |                                | <u>4,94,000</u>  |
| 2007-08 | To Balance c/d                      | 9,59,720         | 2007-08 | By Balance b/d                 | 4,94,000         |
|         |                                     | <u>9,59,720</u>  |         | By Employees' Compensation A/c | 4,65,720         |
|         |                                     | <u>9,59,720</u>  |         |                                | <u>9,59,720</u>  |
| 2008-09 | To Balance c/d                      | 14,76,000        | 2008-09 | By Balance b/d                 | 9,59,720         |
|         |                                     | <u>14,76,000</u> |         | By Employees' Compensation A/c | 5,16,280         |
|         |                                     | <u>14,76,000</u> |         |                                | <u>14,76,000</u> |
| 2009-10 | To General Reserve (1,200 × 30)     | 36,000           | 2009-10 | By Balance b/d (49,200 × 30)   | 14,76,000        |
|         | To Share Capital (48,000 × 100)     | 48,00,000        |         | By Bank (48,000 × 125)         | 60,00,000        |
|         | To Securities Premium (48,000 × 55) | <u>26,40,000</u> |         |                                |                  |
|         |                                     | <u>74,76,000</u> |         |                                | <u>74,76,000</u> |

**Note:** Securities Premium

|                                     | Rs.        |
|-------------------------------------|------------|
| Exercise price received per share   | 125        |
| Value of service received per share | <u>30</u>  |
| Consideration received per share    | 155        |
| Less: Nominal value per share       | <u>100</u> |
| Securities premium per share        | <u>55</u>  |

*Intrinsic Value Method***Year 2006-07**

Intrinsic value of option per share = Rs. 149 – Rs. 125 = Rs. 24

Number of shares expected to vest under the scheme

$$= (525 \times 0.98 \times 0.98 \times 0.98) \times 100 = 49,400$$

Intrinsic value = 49,400 × Rs. 24 = Rs. 11,85,600

Vesting period = 3 years

Value of option recognised as expense in 2006-07 = Rs. 11,85,600 / 3 = Rs. 3,95,200

**Year 2007-08**

Intrinsic value of option per share = Rs. 149 – Rs. 125 = Rs. 24

Number of shares expected to vest under the scheme

$$= (525 - 15) \times 0.97 \times 0.97 \times 100 = 47,986$$

Intrinsic value = 47,986 × Rs. 24 = Rs. 11,51,664

Vesting period = 3 years

Number of years expired = 2 years

Cumulative value of option to recognise as expense in 2006-07 and 2007-08

$$= (\text{Rs. } 11,51,664 / 3) \times 2 = \text{Rs. } 7,67,776$$

Value of option recognised as expense in 2007-08

$$= \text{Rs. } 7,67,776 - \text{Rs. } 3,95,200 = \text{Rs. } 3,72,576$$

**Year 2008-09**

Intrinsic value of option per share = Rs. 149 – Rs. 125 = Rs. 24

Number of shares actually vested under the scheme = 492 × 100 = 49,200

Intrinsic value = 49,200 × Rs. 24 = Rs. 11,80,800

Cumulative value of option to recognise as expense in 3 years = Rs. 11,80,800

Value of option recognised as expense in 2008-09

$$= \text{Rs. } 11,80,800 - \text{Rs. } 7,67,776 = \text{Rs. } 4,13,024$$

**Year 2009-10**

Intrinsic value of option per share = Rs. 149 – Rs. 125 = Rs. 24

Number of shares not subscribed = (492 – 480) × 100 = 1,200

Value of option forfeited = 1,200 × 24 = Rs. 28,800

## 7.10 Financial Reporting

### Employees' Compensation A/c

| Year    |                         | Rs.             | Year    |                      | Rs.             |
|---------|-------------------------|-----------------|---------|----------------------|-----------------|
| 2006-07 | To ESOP Outstanding A/c | <u>3,95,200</u> | 2006-07 | By Profit & Loss A/c | <u>3,95,200</u> |
|         |                         | <u>3,95,200</u> |         |                      | <u>3,95,200</u> |
| 2007-08 | To ESOP Outstanding A/c | <u>3,72,576</u> | 2007-08 | By Profit & Loss A/c | <u>3,72,576</u> |
|         |                         | <u>3,72,576</u> |         |                      | <u>3,72,576</u> |
| 2008-09 | To ESOP Outstanding A/c | <u>4,13,024</u> | 2008-09 | By Profit & Loss A/c | <u>4,13,024</u> |
|         |                         | <u>4,13,024</u> |         |                      | <u>4,13,024</u> |

### ESOP Outstanding A/c

| Year    |                                     | Rs.              | Year    |                                | Rs.              |
|---------|-------------------------------------|------------------|---------|--------------------------------|------------------|
| 2006-07 | To Balance c/d                      | <u>3,95,200</u>  | 2006-07 | By Employees' Compensation A/c | <u>3,95,200</u>  |
|         |                                     | <u>3,95,200</u>  |         |                                | <u>3,95,200</u>  |
| 2007-08 | To Balance c/d                      | <u>7,67,776</u>  | 2007-08 | By Balance b/d                 | 3,95,200         |
|         |                                     | <u>7,67,776</u>  |         | By Employees' Compensation A/c | <u>3,72,576</u>  |
|         |                                     | <u>7,67,776</u>  |         |                                | <u>7,67,776</u>  |
| 2008-09 | To Balance c/d                      | <u>11,80,800</u> | 2008-09 | By Balance b/d                 | 7,67,776         |
|         |                                     | <u>11,80,800</u> |         | By Employees' Compensation A/c | <u>4,13,024</u>  |
|         |                                     | <u>11,80,800</u> |         |                                | <u>11,80,800</u> |
| 2009-10 | To General Reserve(1,200 × 24)      | 28,800           | 2009-10 | By Balance b/d (49,200 × 24)   | 11,80,800        |
|         | To Share Capital (48,000 × 100)     | 48,00,000        |         | By Bank (48,000 × 125)         | 60,00,000        |
|         | To Securities Premium (48,000 × 49) | <u>23,52,000</u> |         |                                |                  |
|         |                                     | <u>71,80,800</u> |         |                                | <u>71,80,800</u> |

**Note:** Securities Premium

|                                     | Rs. |
|-------------------------------------|-----|
| Exercise price received per share   | 125 |
| Value of service received per share | 24  |
| Consideration received per share    | 149 |
| Less: Nominal value per share       | 100 |
| Securities premium per share        | 49  |

## 6. VARIATION IN VESTING PERIOD

The vesting period, i.e. the time taken to satisfy the vesting conditions can be uncertain. For example, if employees are granted ESOP subject condition that the enterprise achieves a 50% market share, the vesting period can be known only when the market share of the company actually reaches the specified 50% level. In these cases, allocation of option value for recognition as expense in a particular accounting period should be based on estimated vesting period. The initial estimate of vesting period on grant date should be reviewed and revised if necessary, at the end of each accounting period. In case of revision of vesting period, the basis of allocation of option value to a particular accounting period should be based on revised estimate of vesting period.

Where the vesting condition is a market condition, e.g. when an option is granted subject to condition that the market price of the share reaches a specified level, the fair value of option is reduced due to the possibility that the vesting condition may not be satisfied. Such fair values are recognised as expense whether or not the market condition is satisfied, over the vesting period estimated on grant date. The estimates of vesting periods are not revised subsequently in these cases.

### Illustration 2

The following particulars in respect of stock options granted by a company are available:

|                                                    |               |
|----------------------------------------------------|---------------|
| Grant date                                         | April 1, 2006 |
| Number of employees covered                        | 500           |
| Number options granted per employee                | 100           |
| Fair value of option per share on grant date (Rs.) | 25            |

The vesting period shall be determined as below:

- If the company earns Rs. 120 crore or above after taxes in 2006-07, the options will vest on 31/03/07.
- If condition (a) is not satisfied but the company earns Rs. 250 crores or above after taxes in aggregate in 2006-07 and 2007-08, the options will vest on 31/03/08.
- If conditions (a) and (b) are not satisfied but the company earns Rs. 400 crores or above

## 7.12 Financial Reporting

after taxes in aggregate in 2006-07, 2007-08 and 2008-09, the options will vest on 31/03/09.

### **Position on 31/03/07**

- (a) The company earned Rs. 115 crore after taxes in 2006-07
- (b) The company expects to earn Rs. 140 crores in 2007-08 after taxes
- (c) Expected vesting date: March 31, 2008
- (d) Number of employees expected to be entitled to option = 474

### **Position on 31/03/08**

- (a) The company earned Rs. 130 crore after taxes in 2007-08
- (b) The company expects to earn Rs. 160 crores in 2008-09 after taxes
- (c) Expected vesting date: March 31, 2009
- (d) Number of employees expected to be entitled to option = 465

### **Position on 31/03/09**

- (a) The company earned Rs. 165 crore after taxes in 2008-09
- (b) Number of employees on whom the option actually vested = 450

Compute expenses to recognise in each year.

### **Solution**

#### **Year 2006-07**

Fair value of option per share = Rs. 25

Number of shares expected to vest under the scheme =  $474 \times 100 = 47,400$

Fair value =  $47,400 \times \text{Rs. } 25 = \text{Rs. } 11,85,000$

Expected vesting period = 2 years

Value of option recognised as expense in 2006-07 =  $\text{Rs. } 11,85,000 / 2 = \text{Rs. } 5,92,500$

#### **Year 2007-08**

Fair value of option per share = Rs. 25

Number of shares expected to vest under the scheme =  $465 \times 100 = 46,500$

Fair value =  $46,500 \times \text{Rs. } 25 = \text{Rs. } 11,62,500$

Expected vesting period = 3 years

Cumulative value of option to recognise as expense in 2006-07 and 2007-08

$$= (\text{Rs. } 11,62,500 / 3) \times 2 = \text{Rs. } 7,75,000$$

Value of option recognised as expense in 2006-07 = Rs. 5,92,500

Value of option recognised as expense in 2007-08

$$= \text{Rs. } 7,75,000 - \text{Rs. } 5,92,500 = \text{Rs. } 1,82,500$$

#### **Year 2008-09**

Fair value of option per share = Rs. 25

Number of shares actually vested under the scheme =  $450 \times 100 = 45,000$

Fair value =  $45,000 \times \text{Rs. } 25 = \text{Rs. } 11,25,000$

Vesting period = 3 years

Cumulative value of option to recognise as expense in 2006-07, 2007-08 and 2008-09

$$= \text{Rs. } 11,25,000$$

Value of option recognised as expense in 2006-07 and 2007-08 = Rs. 7,75,000

Value of option recognised as expense in 2008-09

$$= \text{Rs. } 11,25,000 - \text{Rs. } 7,75,000 = \text{Rs. } 3,50,000$$

#### **Illustration 3**

The following particulars in respect of stock options granted by a company are available:

|            |               |
|------------|---------------|
| Grant date | April 1, 2006 |
|------------|---------------|

|                             |    |
|-----------------------------|----|
| Number of employees covered | 50 |
|-----------------------------|----|

|                                     |       |
|-------------------------------------|-------|
| Number options granted per employee | 1,000 |
|-------------------------------------|-------|

|                                                    |   |
|----------------------------------------------------|---|
| Fair value of option per share on grant date (Rs.) | 9 |
|----------------------------------------------------|---|

The options will vest to employees serving continuously for 3 years from vesting date, provided the share price is Rs. 70 or above at the end of 2008-09.

The estimates of number employees satisfying the condition of continuous employment were 48 on 31/03/07, 47 on 31/03/08. The number of employees actually satisfying the condition of continuous employment was 45.

The share price at the end of 2008-09 was Rs. 68

Compute expenses to recognise in each year and show important accounts in books of the company.

#### **Solution**

The vesting of options is subject to satisfaction of two conditions viz. service condition of continuous employment for 3 years and market condition that the share price at the end of

## 7.14 Financial Reporting

2008-09 is not less than Rs. 70.

Since the share price on 31/03/09 was Rs. 68, the actual vesting as nil. Despite this, the company should recognise value of option over 3-year vesting period from 2006-07 to 2008-09.

### **Year 2006-07**

Fair value of option per share = Rs. 9

Number of shares expected to vest under the scheme =  $48 \times 1,000 = 48,000$

Fair value =  $48,000 \times \text{Rs. } 9 = \text{Rs. } 4,32,000$

Expected vesting period = 3 years

Value of option recognised as expense in 2006-07 =  $\text{Rs. } 4,32,000 / 3 = \text{Rs. } 1,44,000$

### **Year 2007-08**

Fair value of option per share = Rs. 9

Number of shares expected to vest under the scheme =  $47 \times 1,000 = 47,000$

Fair value =  $47,000 \times \text{Rs. } 9 = \text{Rs. } 4,23,000$

Expected vesting period = 3 years

Cumulative value of option to recognise as expense in 2006-07 and 2007-08  
=  $(\text{Rs. } 4,23,000 / 3) \times 2 = \text{Rs. } 2,82,000$

Value of option recognised as expense in 2006-07 = Rs. 1,44,000

Value of option recognised as expense in 2007-08

=  $\text{Rs. } 2,82,000 - \text{Rs. } 1,44,000 = \text{Rs. } 1,38,000$

### **Year 2008-09**

Fair value of option per share = Rs. 9

Number of shares actually vested under the scheme =  $45 \times 1,000 = 45,000$

Fair value =  $45,000 \times \text{Rs. } 9 = \text{Rs. } 4,05,000$

Vesting period = 3 years

Cumulative value of option to recognise as expense in 2006-07, 2007-08 and 2008-09  
= Rs. 4,05,000

Value of option recognised as expense in 2006-07 and 2007-08 = Rs. 2,82,000

Value of option recognised as expense in 2008-09

=  $\text{Rs. } 4,05,000 - \text{Rs. } 2,82,000 = \text{Rs. } 1,23,000$



**Employees' Compensation A/c**

| Year    |                         | Rs.             | Year    |                      | Rs.             |
|---------|-------------------------|-----------------|---------|----------------------|-----------------|
| 2006-07 | To ESOP Outstanding A/c | <u>1,44,000</u> | 2006-07 | By Profit & Loss A/c | <u>1,44,000</u> |
|         |                         | <u>1,44,000</u> |         |                      | <u>1,44,000</u> |
| 2007-08 | To ESOP Outstanding A/c | <u>1,38,000</u> | 2007-08 | By Profit & Loss A/c | <u>1,38,000</u> |
|         |                         | <u>1,38,000</u> |         |                      | <u>1,38,000</u> |
| 2008-09 | To ESOP Outstanding A/c | <u>1,23,000</u> | 2008-09 | By Profit & Loss A/c | <u>1,23,000</u> |
|         |                         | <u>1,23,000</u> |         |                      | <u>1,23,000</u> |

**ESOP Outstanding A/c**

| Year    |                    | Rs.             | Year    |                                | Rs.             |
|---------|--------------------|-----------------|---------|--------------------------------|-----------------|
| 2006-07 | To Balance c/d     | <u>1,44,000</u> | 2006-07 | By Employees' Compensation A/c | <u>1,44,000</u> |
|         |                    | <u>1,44,000</u> |         |                                | <u>1,44,000</u> |
| 2007-08 | To Balance c/d     | 2,82,000        | 2007-08 | By Balance b/d                 | 1,44,000        |
|         |                    | _____           |         | By Employees' Compensation A/c | <u>1,38,000</u> |
|         |                    | <u>2,82,000</u> |         |                                | <u>2,82,000</u> |
| 2008-09 | To General Reserve | 4,05,000        | 2008-09 | By Balance b/d                 | 2,82,000        |
|         |                    | _____           |         | By Employees' Compensation A/c | <u>1,23,000</u> |
|         |                    | <u>4,05,000</u> |         |                                | <u>4,05,000</u> |

**7. GRADED VESTING**

Graded vesting refers to a situation where options under a plan vest on different dates. For example, a plan may provide that shares offered to an employee shall vest in proportion of 2:3:5 in three years commencing from fourth year. Thus if an employee is offered 100 shares under the plan, 20 shares shall vest in year 4, 30 shares shall vest in year 5 and 50 shares shall vest in year 6. In these cases, based on vesting dates, the plan is segregated into different groups. Each of these groups is then treated as a separate plan with specific vesting period and expected life.

Since one of the factors affecting fair value of an option is expected life, the fair value for each group should be computed separately. Fair value of a group is then allocated to accounting periods and recognised as expense for the period with reference to vesting period for the group.

Intrinsic value of an option does not depend on its expected life. Intrinsic value of option per share shall therefore be same for each group. In the same way as fair value, intrinsic value of a group is allocated to accounting periods and recognised as expense for the period with reference to vesting period for the group.

## 7.16 Financial Reporting

### Illustration 4

The following particulars in respect of stock options granted by a company are available:

|                                     |               |
|-------------------------------------|---------------|
| Grant date                          | April 1, 2006 |
| Number of employees covered         | 400           |
| Number options granted per employee | 60            |
| Nominal value per share (Rs.)       | 100           |
| Exercise price per share (Rs.)      | 125           |

Shares offered were put in three groups. Group 1 was for 20% of shares offered with vesting period one-year. Group II was for 40% of shares offered with vesting period two-years. Group III was for 40% of shares offered with vesting period three-years. Fair value of option per share on grant date was Rs. 10 for Group I, Rs. 12.50 for Group II and Rs. 14 for Group III.

#### ***.Position on 31/03/07***

- (a) Number of employees left = 40
- (b) Estimate of number of employees to leave in 2007-08 = 36
- (c) Estimate of number of employees to leave in 2008-09 = 34
- (d) Number of employees exercising options in Group I = 350

#### ***Position on 31/03/08***

- (a) Number of employees left = 35
- (b) Estimate of number of employees to leave in 2008-09 = 30
- (c) Number of employees exercising options in Group II = 319

#### ***Position on 31/03/09***

- (a) Number of employees left = 28
- (b) Number of employees at the end of last vesting period = 297
- (c) Number of employees exercising options in Group III = 295

Options not exercised immediately on vesting, were forfeited.

Compute expenses to recognise in each year and show important accounts in books of the company by both of the methods.

## Share Based Payments 7.17

### Solution

#### Expected vesting

| Year    | Group | Number of employees expected to qualify | Number of shares vested to each employee | Total number of shares expected to vest | Fair value of option per share | Fair value of option |
|---------|-------|-----------------------------------------|------------------------------------------|-----------------------------------------|--------------------------------|----------------------|
| 2006-07 | I     | 360                                     | 12                                       | 4,320                                   | 10.00                          | 43,200               |
|         | II    | 324                                     | 24                                       | 7,776                                   | 12.50                          | 97,200               |
|         | III   | 290                                     | 24                                       | 6,960                                   | 14.00                          | 97,440               |
| 2007-08 | II    | 325                                     | 24                                       | 7,800                                   | 12.50                          | 97,500               |
|         | III   | 295                                     | 24                                       | 7,080                                   | 14.00                          | 99,120               |
| 2008-09 | III   | 297                                     | 24                                       | 7,128                                   | 14.00                          | 99,792               |

#### Expense recognised in year 2006-07

|           |                 |          |
|-----------|-----------------|----------|
|           | Rs.             |          |
| Group I   | 43,200          |          |
| Group II  | 48,600          | 97,200/2 |
| Group III | <u>32,480</u>   | 97,440/3 |
|           | <u>1,24,280</u> |          |

#### Expense recognised in year 2007-08

|                                            |                 |                |
|--------------------------------------------|-----------------|----------------|
|                                            | Rs.             |                |
| Group I                                    | 43,200          |                |
| Group II                                   | 97,500          |                |
| Group III                                  | <u>66,080</u>   | (99,120/3) × 2 |
| Cumulative expense for 2006-07 and 2007-08 | 2,06,780        |                |
| Less: Expense recognised in 2006-07        | <u>1,24,280</u> |                |
| Expense recognised in 2007-08              | <u>82,500</u>   |                |

## 7.18 Financial Reporting

### Expense recognised in year 2008-09

|                                                 | Rs.             |
|-------------------------------------------------|-----------------|
| Group I                                         | 43,200          |
| Group II                                        | 97,500          |
| Group III                                       | <u>99,792</u>   |
| Cumulative expense for 2006-07 to 2008-09       | 2,40,492        |
| Less: Expense recognised in 2006-07 and 2007-08 | <u>2,06,780</u> |
| Expense recognised in 2007-08                   | <u>33,712</u>   |

### Options Forfeited

|                                      | Group I<br>2006-07 | Group II<br>2007-08 | Group III<br>2008-09 |
|--------------------------------------|--------------------|---------------------|----------------------|
| Number of employees qualifying       | 360                | 325                 | 297                  |
| Less: Number of employees exercising | 350                | 319                 | 295                  |
| Number of employees not exercising   | 10                 | 6                   | 2                    |
| Number of options per employee       | 12                 | 24                  | 24                   |
| Number of options forfeited          | 120                | 144                 | 48                   |

### **Employees' Compensation A/c**

| Year    | Rs.                     | Year    | Rs.                  |
|---------|-------------------------|---------|----------------------|
| 2006-07 | To ESOP Outstanding A/c | 2006-07 | By Profit & Loss A/c |
|         | <u>1,24,280</u>         |         | <u>1,24,280</u>      |
|         | <u>1,24,280</u>         |         | <u>1,24,280</u>      |
| 2007-08 | To ESOP Outstanding A/c | 2007-08 | By Profit & Loss A/c |
|         | <u>82,500</u>           |         | <u>82,500</u>        |
|         | <u>82,500</u>           |         | <u>82,500</u>        |
| 2008-09 | To ESOP Outstanding A/c | 2008-09 | By Profit & Loss A/c |
|         | <u>33,712</u>           |         | <u>33,712</u>        |
|         | <u>33,712</u>           |         | <u>33,712</u>        |

### **ESOP Outstanding A/c**

| Year    | Rs.                                   | Year    | Rs.                            |
|---------|---------------------------------------|---------|--------------------------------|
| 2006-07 | To General Reserve<br>(120 × 10)      | 2006-07 | By Employees' Compensation A/c |
|         | 1,200                                 |         | 1,24,280                       |
|         | To Share Capital<br>(4,200 × 100)     |         | By Bank (4,200 × 125)          |
|         | 4,20,000                              |         | 5,25,000                       |
|         | To Securities Premium<br>(4,200 × 35) |         |                                |
|         | 1,47,000                              |         |                                |

## Share Based Payments 7.19

|         |                                          |                  |         |                                   |  |                  |
|---------|------------------------------------------|------------------|---------|-----------------------------------|--|------------------|
|         | To Balance c/d                           | <u>81,080</u>    |         |                                   |  |                  |
|         |                                          | <u>6,49,280</u>  |         |                                   |  | <u>6,49,280</u>  |
| 2007-08 | To General Reserve<br>(144 × 12.50)      | 1,800            | 2007-08 | By Balance b/d                    |  | 81,080           |
|         | To Share Capital<br>(7,656 × 100)        | 7,65,600         |         | By Employees'<br>Compensation A/c |  | 82,500           |
|         | To Securities Premium<br>(7,656 × 37.50) | 2,87,100         |         | By Bank (7,656 ×<br>125)          |  | 9,57,000         |
|         | To Balance c/d                           | <u>66,080</u>    |         |                                   |  |                  |
|         |                                          | <u>11,20,580</u> |         |                                   |  | <u>11,20,580</u> |
| 2008-09 | To General Reserve<br>(48 × 14)          | 672              | 2008-09 | By Balance b/d                    |  | 66,080           |
|         | To Share Capital<br>(7,080 × 100)        | 7,08,000         |         | By Employees'<br>Compensation A/c |  | 33,712           |
|         | To Securities Premium<br>(7,080 × 39)    | <u>2,76,120</u>  |         | By Bank (7,080 ×<br>125)          |  | <u>8,85,000</u>  |
|         |                                          | <u>9,84,792</u>  |         |                                   |  | <u>9,84,792</u>  |

### Securities Premium

|                                     | Group I       | Group II      | Group III     |
|-------------------------------------|---------------|---------------|---------------|
|                                     | 2006-07       | 2007-08       | 2008-09       |
| Exercise price received per share   | 125.00        | 125.00        | 125.00        |
| Value of service received per share | <u>10.00</u>  | <u>12.50</u>  | <u>14.00</u>  |
| Consideration received per share    | 135.00        | 137.50        | 139.00        |
| Less: Nominal value per share       | <u>100.00</u> | <u>100.00</u> | <u>100.00</u> |
| Securities premium per share        | <u>35.00</u>  | <u>37.50</u>  | <u>39.00</u>  |

## 8. EMPLOYEES' STOCK PURCHASE PLANS (ESPP)

Under these plans, employees are given an option to subscribe to shares of employer in a public issue or otherwise. The exercise price is set at a specified rate of discount on the issue price/ market price on the date of exercise. For example, a company may offer specified number of shares to its employees at 20% discount on market price on grant date. ESPP with option features is treated as ESOP. For example, consider a case where shares are offered to employees at 80% of market price. If employees have the option to pay either 80% of market price of shares on grant date or to pay 80% of market price on date of purchase, the plan is treated as ESOP rather than ESPP. The fair value of ESPP can be less than the discount due

## 7.20 Financial Reporting

to post-vesting restrictions on transfers and similar other factors. The fair value of ESPP is recognised over the vesting period in the same way as ESOP.

### Illustration 5

On April 1, 2006, a company offered 100 shares to each of its 500 employees at Rs. 40 per share. The employees are given a month to decide whether or not to accept the offer. The shares issued under the plan shall be subject to lock-in on transfers for three years from grant date. The market price of shares of the company on the grant date is Rs. 50 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at Rs. 48 per share.

On April 30, 2006, 400 employees accepted the offer and paid Rs. 40 per share purchased. Nominal value of each share is Rs. 10.

Record the issue of shares in book of the company under the aforesaid plan.

### Solution

Fair value of ESPP per share = Rs. 48 – Rs. 40 = Rs. 8

Number of share issued =  $400 \times 100 = 40,000$

Fair value of ESPP =  $40,000 \times \text{Rs. } 8 = \text{Rs. } 3,20,000$

Vesting period = One month

Expense recognised in 2006-07 = Rs. 3,20,000

| Date           |                             | Rs.       | Rs.                                      |
|----------------|-----------------------------|-----------|------------------------------------------|
| April 30, 2006 | Bank                        | 16,00,000 | $40,000 \times \text{Rs. } 40$           |
|                | Employees' Compensation A/c | 3,20,000  | $40,000 \times \text{Rs. } 8$            |
|                | To Share Capital            |           | 4,00,000 $40,000 \times \text{Rs. } 10$  |
|                | To Securities Premium       |           | 15,20,000 $40,000 \times \text{Rs. } 38$ |

## 9. MODIFICATIONS

If the modification reduces the fair value of the options granted, the modification should be ignored. If the modification increases the fair value of the options granted (e.g., when exercise price is reduced), the incremental fair value is recognised as expense over the remaining vesting period. The incremental fair value is the difference between (i) fair value of the modified option estimated on the date of the modification and (ii) fair value of the original option estimated on the date of modification. If the modification occurs after the vesting date, the incremental fair value is recognised immediately, or over the additional vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to the options.

**Illustration 6**

The following particulars in respect of stock options granted by a company are available:

|                                                      |                |
|------------------------------------------------------|----------------|
| Grant date                                           | April 1, 2006  |
| Number of employees covered                          | 600            |
| Number options granted per employee                  | 60             |
| Vesting condition: Continuous employment for 3 years |                |
| Nominal value per share (Rs.)                        | 100            |
| Exercise price per share (Rs.)                       | 125            |
| Vesting date                                         | March 31, 2009 |
| Exercise Date                                        | March 31, 2010 |
| Fair value of option per share on grant date (Rs.)   | 14             |

**Position on 31/03/07**

- (a) Number of employees left = 30
- (b) Estimate of number of employees to leave in 2007-08 and 2008-09 = 70
- (c) Exercise price was reduced to Rs. 120
- (d) Fair value of original option on 31/03/07 = Rs. 13
- (e) Fair value of option at reduced exercise price on 31/03/07 = Rs. 15
- (f) Vesting date for modified option was March 31, 2009

**Position on 31/03/08**

- (a) Number of employees left = 35
- (b) Estimate of number of employees to leave in 2008-09 = 30

**Position on 31/03/09**

- (a) Number of employees left = 28
- (b) Number of employees entitled to exercise option = 507

**Position on 31/03/10**

- (a) Number of employees exercising the option = 500
- (b) Number of employees not exercising the option = 7

Compute the amount of expense the company should recognise in each of the years 2006-07, 2007-08 and 2008-09 and show important accounts in books of the company.

## 7.22 Financial Reporting

### Solution

#### Year 2006-07

Fair value of option per share = Rs. 15

Number of shares expected to vest under the scheme =  $(600 - 100) \times 60 = 30,000$

Fair value =  $30,000 \times \text{Rs. } 14 = \text{Rs. } 4,20,000$

Vesting period = 3 years

Value of option recognised as expense in 2006-07 =  $\text{Rs. } 4,20,000 / 3 = \text{Rs. } 1,40,000$

#### Year 2007-08

Fair value of option per share = Rs. 14

Incremental fair value of option per share =  $\text{Rs. } 15 - \text{Rs. } 13 = \text{Rs. } 2$

Number of shares expected to vest under the scheme =  $(600 - 95) \times 60 = 30,300$

Fair value of option =  $30,300 \times \text{Rs. } 14 = \text{Rs. } 4,24,200$

Incremental fair value =  $30,300 \times \text{Rs. } 2 = \text{Rs. } 60,600$

Vesting period = 3 years;

Remaining vesting period = 2 years (including current year)

Cumulative value of option to recognise as expense in 2006-07 and 2007-08

=  $(\text{Rs. } 4,24,200 / 3) \times 2 + \text{Rs. } 60,600 / 2 = \text{Rs. } 3,13,100$

Value of option recognised as expense in 2006-07 = Rs. 1,40,000

Value of option recognised as expense in 2007-08

=  $\text{Rs. } 3,13,100 - \text{Rs. } 1,40,000 = \text{Rs. } 1,73,100$

#### Year 2008-09

Fair value of option per share = Rs. 14

Number of shares actually vested under the scheme =  $507 \times 60 = 30,420$

Fair value of option =  $30,420 \times \text{Rs. } 14 = \text{Rs. } 4,25,880$

Incremental fair value =  $30,420 \times \text{Rs. } 2 = \text{Rs. } 60,840$

Cumulative value of option to recognise as expense in 3 years

=  $\text{Rs. } 4,25,880 + \text{Rs. } 60,840 = \text{Rs. } 4,86,720$

Value of option recognised as expense in 2006-07 and 2007-08 = Rs. 3,13,100

Value of option recognised as expense in 2008-09

=  $\text{Rs. } 4,86,720 - \text{Rs. } 3,13,100 = \text{Rs. } 1,73,620$



**Employees' Compensation A/c**

| Year    |                         | Rs.             | Year    |                      | Rs.             |
|---------|-------------------------|-----------------|---------|----------------------|-----------------|
| 2006-07 | To ESOP Outstanding A/c | <u>1,40,000</u> | 2006-07 | By Profit & Loss A/c | <u>1,40,000</u> |
|         |                         | <u>1,40,000</u> |         |                      | <u>1,40,000</u> |
| 2007-08 | To ESOP Outstanding A/c | <u>1,73,100</u> | 2007-08 | By Profit & Loss A/c | <u>1,73,100</u> |
|         |                         | <u>1,73,100</u> |         |                      | <u>1,73,100</u> |
| 2008-09 | To ESOP Outstanding A/c | <u>1,73,620</u> | 2008-09 | By Profit & Loss A/c | <u>1,73,620</u> |
|         |                         | <u>1,73,620</u> |         |                      | <u>1,73,620</u> |

**ESOP Outstanding A/c**

| Year    |                                     | Rs.              | Year    |                                | Rs.              |
|---------|-------------------------------------|------------------|---------|--------------------------------|------------------|
| 2006-07 | To Balance c/d                      | <u>1,40,000</u>  | 2006-07 | By Employees' Compensation A/c | <u>1,40,000</u>  |
|         |                                     | <u>1,40,000</u>  |         |                                | <u>1,40,000</u>  |
| 2007-08 | To Balance c/d                      | <u>3,13,100</u>  | 2007-08 | By Balance b/d                 | <u>1,40,000</u>  |
|         |                                     | <u>3,13,100</u>  |         | By Employees' Compensation A/c | <u>1,73,100</u>  |
|         |                                     | <u>3,13,100</u>  |         |                                | <u>3,13,100</u>  |
| 2008-09 | To Balance c/d                      | <u>4,86,720</u>  | 2008-09 | By Balance b/d                 | 3,13,100         |
|         |                                     | <u>4,86,720</u>  |         | By Employees' Compensation A/c | <u>1,73,620</u>  |
|         |                                     | <u>4,86,720</u>  |         |                                | <u>4,86,720</u>  |
| 2009-10 | To General Reserve (420 × 16)       | 6,720            | 2009-10 | By Balance b/d (30,420 × 16)   | 4,86,720         |
|         | To Share Capital (30,000 × 100)     | 30,00,000        |         | By Bank (30,000 × 120)         | 36,00,000        |
|         | To Securities Premium (30,000 × 36) | <u>10,80,000</u> |         |                                |                  |
|         |                                     | <u>40,86,720</u> |         |                                | <u>40,86,720</u> |

## 7.24 Financial Reporting

### **Note:** Securities Premium

|                                     | Rs.        |
|-------------------------------------|------------|
| Exercise price received per share   | 120        |
| Value of service received per share | <u>16</u>  |
| Consideration received per share    | 136        |
| Less: Nominal value per share       | <u>100</u> |
| Securities premium per share        | <u>36</u>  |

## 10. CANCELLATION AND SETTLEMENTS DURING VESTING PERIOD

If an enterprise cancels or settles a grant of shares or stock options during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

- The entire amount of unamortised value of option should be recognised immediately.
- Payments made to the employees on cancellation or settlement should be debited to ESOP Outstanding A/c to the maximum extent of fair value of options granted, measured at the cancellation / settlement date. Any payment in excess of the fair value is recognised as an expense.
- If new options are granted to the employees in replacement for the cancelled options, the replacement is regarded as modification. The incremental fair value for the purpose is the difference between the fair value of replaced option and net fair value of cancelled option, as on the date of replacement. The net fair value of the cancelled option is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation, that is debited to ESOP Outstanding A/c, in accordance with (b) above.

### **Illustration 7**

The following particulars in respect of stock options granted by a company are available:

|                                                      |                |
|------------------------------------------------------|----------------|
| Grant date                                           | April 1, 2006  |
| Number of employees covered                          | 300            |
| Number options granted per employee                  | 50             |
| Vesting condition: Continuous employment for 4 years |                |
| Nominal value per share (Rs.)                        | 100            |
| Exercise price per share (Rs.)                       | 125            |
| Vesting date                                         | March 31, 2010 |
| Exercise Date                                        | March 31, 2011 |
| Fair value of option per share on grant date (Rs.)   | 12             |

The above stock option was cancelled on 31/03/09 on payment of Re. 1.80 per option and was replaced by a new stock option granted on 01/04/09. The fair value of cancelled option on 01/04/09 was Rs. 14.55 per share.

The particulars of new stock option are given below:

|                                                      |                |
|------------------------------------------------------|----------------|
| Grant date                                           | April 1, 2009  |
| Number of employees covered                          | 300            |
| Number options granted per employee                  | 60             |
| Vesting condition: Continuous employment for 3 years |                |
| Nominal value per share (Rs.)                        | 100            |
| Exercise price per share (Rs.)                       | 120            |
| Vesting date                                         | March 31, 2012 |
| Exercise Date                                        | March 31, 2013 |
| Fair value of option per share on grant date (Rs.)   | 15.75          |

There were no departures of employees during the period from 2006-07 to 2012-13.

Compute the amount of expense the company should recognise in each of the years from 2006-07 to 2010-12 and show important accounts in books of the company.

### **Solution**

#### **Year 2006-07 to 2008-09**

Fair value of option per share = Rs. 12

Number of shares expected to vest under the scheme =  $300 \times 50 = 15,000$

Fair value =  $15,000 \times \text{Rs. } 12 = \text{Rs. } 1,80,000$

Vesting period = 4 years

Value of option recognised in each of the years 2006-07 to 2008-09

=  $\text{Rs. } 1,80,000 / 4 = \text{Rs. } 45,000$

Payment on cancellation on 31/03/09 =  $15,000 \times \text{Rs. } 1.80 = \text{Rs. } 27,000$

#### **Year 2009-10 to 2011-12**

Fair value of new option per share on 01/04/09 = Rs. 15

Fair value of cancelled option per share on 01/04/09 = Rs. 14.55

Net fair value of cancelled option per share on 01/04/09

=  $\text{Rs. } 14.55 - \text{Re. } 1.80 = \text{Rs. } 12.75$

## 7.26 Financial Reporting

Incremental fair value of option per share = Rs. 15 – Rs. 12.75 = Rs. 2.25

Number of shares expected to vest under the scheme = 300 × 60 = 18,000

Fair value of new option = 18,000 × Rs. 15.75 = Rs. 2,83,500

Incremental fair value = 18,000 × Rs. 2.25 = Rs. 40,500

Vesting period = 3 years;

Value of option recognised in each of the years 2009-10 to 2011-12

= (Rs. 2,83,500 + Rs. 40,500)/3 = Rs. 1,08,000

### Employees' Compensation A/c

| Year    |                         | Rs.             | Year    |                      | Rs.             |
|---------|-------------------------|-----------------|---------|----------------------|-----------------|
| 2006-07 | To ESOP Outstanding A/c | <u>45,000</u>   | 2006-07 | By Profit & Loss A/c | <u>45,000</u>   |
|         |                         | <u>45,000</u>   |         |                      | <u>45,000</u>   |
| 2007-08 | To ESOP Outstanding A/c | <u>45,000</u>   | 2007-08 | By Profit & Loss A/c | <u>45,000</u>   |
|         |                         | <u>45,000</u>   |         |                      | <u>45,000</u>   |
| 2008-09 | To ESOP Outstanding A/c | <u>45,000</u>   | 2008-09 | By Profit & Loss A/c | <u>45,000</u>   |
|         |                         | <u>45,000</u>   |         |                      | <u>45,000</u>   |
| 2009-10 | To ESOP Outstanding A/c | <u>1,08,000</u> | 2009-10 | By Profit & Loss A/c | <u>1,08,000</u> |
|         |                         | <u>1,08,000</u> |         |                      | <u>1,08,000</u> |
| 2010-11 | To ESOP Outstanding A/c | <u>1,08,000</u> | 2010-11 | By Profit & Loss A/c | <u>1,08,000</u> |
|         |                         | <u>1,08,000</u> |         |                      | <u>1,08,000</u> |
| 2011-12 | To ESOP Outstanding A/c | <u>1,08,000</u> | 2011-12 | By Profit & Loss A/c | <u>1,08,000</u> |
|         |                         | <u>1,08,000</u> |         |                      | <u>1,08,000</u> |

### ESOP Outstanding A/c

| Year    |                | Rs.           | Year    |                                | Rs.           |
|---------|----------------|---------------|---------|--------------------------------|---------------|
| 2006-07 | To Balance c/d | <u>45,000</u> | 2006-07 | By Employees' Compensation A/c | <u>45,000</u> |
|         |                | <u>45,000</u> |         |                                | <u>45,000</u> |
| 2007-08 |                |               | 2007-08 | By Balance b/d                 | 45,000        |
|         | To Balance c/d | <u>90,000</u> |         | By Employees' Compensation A/c | <u>45,000</u> |
|         |                | <u>90,000</u> |         |                                | <u>90,000</u> |
| 2008-09 | To Bank        | 27,000        | 2008-09 | By Balance b/d                 | 90,000        |

## Share Based Payments 7.27

|         |                                     |                  |         |                                |                  |
|---------|-------------------------------------|------------------|---------|--------------------------------|------------------|
|         | To Balance c/d                      | 1,08,000         |         | By Employees' Compensation A/c | <u>45,000</u>    |
|         |                                     | <u>1,35,000</u>  |         |                                | <u>1,35,000</u>  |
| 2009-10 |                                     |                  | 2009-10 | By Balance b/d                 | 1,08,000         |
|         | To Balance c/d                      | 2,16,000         |         | By Employees' Compensation A/c | <u>1,08,000</u>  |
|         |                                     | <u>2,16,000</u>  |         |                                | <u>2,16,000</u>  |
| 2010-11 |                                     |                  | 2010-11 | By Balance b/d                 | 2,16,000         |
|         | To Balance c/d                      | 3,24,000         |         | By Employees' Compensation A/c | <u>1,08,000</u>  |
|         |                                     | <u>3,24,000</u>  |         |                                | <u>3,24,000</u>  |
| 2011-12 |                                     |                  | 2011-12 | By Balance b/d                 | 3,24,000         |
|         | To Balance c/d                      | 4,32,000         |         | By Employees' Compensation A/c | <u>1,08,000</u>  |
|         |                                     | <u>4,32,000</u>  |         |                                | <u>4,32,000</u>  |
| 2009-10 | To Share Capital (18,000 × 100)     | 18,00,000        | 2009-10 | By Balance b/d (18,000 × 24)   | 4,32,000         |
|         | To Securities Premium (18,000 × 44) | <u>7,92,000</u>  |         | By Bank (18,000 × 120)         | 21,60,000        |
|         |                                     | <u>25,92,000</u> |         |                                | <u>25,92,000</u> |

**Note:** Securities Premium

|                                     |            |
|-------------------------------------|------------|
|                                     | Rs.        |
| Exercise price received per share   | 120        |
| Value of service received per share | <u>24</u>  |
| Consideration received per share    | 144        |
| Less: Nominal value per share       | <u>100</u> |
| Securities premium per share        | <u>44</u>  |

### 11. DILUTION OF EARNING PER SHARE (EPS) DUE TO ESOP GRANTED

Dilution of EPS is anticipated fall in EPS. Dilution occurs when expected proportionate increase in number of shares is more than expected proportionate increase in profit available to equity shareholders. For example, if number of shares increases from 10,000 to 11,000 (10% increase) and profit available to equity shareholders increases from Rs. 50,000 to Rs.

## 7.28 Financial Reporting

52,500 (5% increase) the EPS falls from Rs. 5 to Rs. 4.77. The Accounting Standard (AS) 20, Earning per Share, requires disclosure of basic and diluted EPS.

One factor contributing to dilution of EPS is issue of shares at less than fair value. This happens because issue of shares at less than fair value implies issue of certain number of shares for no consideration. For example, consider the case of a share warrant for 4,000 shares at exercise price Rs. 40. On exercise of the warrant, the issuer collects Rs. 1,60,000. If fair of the shares is Rs. 50, the issue proceed is equivalent of price of 3,200. The issuer, by setting the exercise price at Rs. 40, instead of Rs. 50, allows the warrant holder to have 800 shares for no consideration. The shares issued for no consideration increases number of shares but does not increase resources available to the issuer and consequently, no increase in profit can be anticipated. These shares are taken in computation of diluted EPS as potential equity.

$$\text{Number of shares issued for consideration} = \frac{\text{Expected issue proceeds}}{\text{Fair value per share}}$$

Number of shares issued for no consideration

$$= \text{Number of shares issued} - \text{Number of shares issued for consideration}$$

Issue of shares under a scheme of share-based payment, increases the number of shares outstanding. Since the shares are issued at exercise price, which is lower than the fair value of shares issued, in the same way as share warrants, an ESOP gives rise to situation of dilution of EPS. In calculating the number of shares issued for no consideration, the expected proceeds from the exercise of option is taken as sum of (i) Exercise Price (ii) Value of services to be rendered by employees in future upto the vesting date. This value of services is measured as unamortised value of option.

### Illustration 8

The following particulars in respect of stock options granted by a company are available:

|                                                      |                |
|------------------------------------------------------|----------------|
| Grant date                                           | April 1, 2006  |
| Number of employees covered                          | 600            |
| Number options granted per employee                  | 100            |
| Vesting condition: Continuous employment for 3 years |                |
| Nominal value per share (Rs.)                        | 10             |
| Exercise price per share (Rs.)                       | 45             |
| Vesting date                                         | March 31, 2009 |
| Exercise Date                                        | May 31, 2010   |
| Fair value of option per share on grant date (Rs.)   | 15             |

**Position on 31/03/07**

- (a) Number of employees expected to satisfy service condition = 540
- (b) Number of employees left = 15
- (c) Profit before amortisation of ESOP cost = Rs. 11.90 lakh
- (d) Fair value per share = Rs. 60

**Position on 31/03/08**

- (a) Number of employees expected to satisfy service condition = 552
- (b) Number of employees left = 20
- (c) Profit before amortisation of ESOP cost = Rs. 12.62 lakh
- (d) Fair value per share = Rs. 66

**Position on 31/03/09**

- (i) Number of employees left = 11
- (ii) Number of employees entitled to exercise option = 554
- (iii) Profit before amortisation of ESOP cost = Rs. 13.79 lakh
- (iv) Fair value per share = Rs. 72

**Position on 31/05/10**

- (a) Number of employees exercising the option = 550
- (b) Number of employees not exercising the option = 4
- (c) Show Employees Compensation A/c, ESOP Outstanding A/c from 2006-07 to 2009-10.
- (d) Compute basic and diluted EPS for the years 2006-07 to 2008-09.

**Solution**

**Year 2006-07**

Fair value of option per share = Rs. 15

Number of shares expected to vest under the scheme =  $540 \times 100 = 54,000$

Fair value =  $54,000 \times \text{Rs. } 15 = \text{Rs. } 8,10,000$

Vesting period = 3 years

Value of option recognised as expense in 2006-07 =  $\text{Rs. } 8,10,000 / 3 = \text{Rs. } 2,70,000$

### 7.30 Financial Reporting

#### Year 2007-08

Fair value of option per share = Rs. 15

Number of shares expected to vest under the scheme =  $552 \times 100 = 55,200$

Fair value =  $55,200 \times \text{Rs. } 15 = \text{Rs. } 8,28,000$

Vesting period = 3 years

Number of years expired = 2 years

Cumulative value of option to recognise as expense in 2006-07 and 2007-08

=  $(\text{Rs. } 8,28,000 / 3) \times 2 = \text{Rs. } 5,52,000$

Value of option recognised as expense in 2007-08

=  $\text{Rs. } 5,52,000 - \text{Rs. } 2,70,000 = \text{Rs. } 2,82,000$

#### Year 2008-09

Fair value of option per share = Rs. 15

Number of shares actually vested under the scheme =  $554 \times 100 = 55,400$

Fair value =  $55,400 \times \text{Rs. } 15 = \text{Rs. } 8,31,000$

Cumulative value of option to recognise as expense in 3 years = Rs. 8,31,000

Value of option recognised as expense in 2008-09

=  $\text{Rs. } 8,31,000 - \text{Rs. } 5,52,000 = \text{Rs. } 2,79,000$

#### Year 2009-10

Fair value of option per share = Rs. 15

Number of shares not subscribed =  $(554 - 550) \times 100 = 400$

Value of option forfeited =  $400 \times \text{Rs. } 15 = \text{Rs. } 6,000$

#### **Employees' Compensation A/c**

| Year    |                         | Rs.             | Year    |                      | Rs.             |
|---------|-------------------------|-----------------|---------|----------------------|-----------------|
| 2006-07 | To ESOP Outstanding A/c | <u>2,70,000</u> | 2006-07 | By Profit & Loss A/c | <u>2,70,000</u> |
|         |                         | <u>2,70,000</u> |         |                      | <u>2,70,000</u> |
| 2007-08 | To ESOP Outstanding A/c | <u>2,82,000</u> | 2007-08 | By Profit & Loss A/c | <u>2,82,000</u> |
|         |                         | <u>2,82,000</u> |         |                      | <u>2,82,000</u> |
| 2008-09 | To ESOP Outstanding A/c | <u>2,79,000</u> | 2008-09 | By Profit & Loss A/c | <u>2,79,000</u> |
|         |                         | <u>2,79,000</u> |         |                      | <u>2,79,000</u> |



**Share Based Payments    7.31**

**ESOP Outstanding A/c**

| Year    |                                     | Rs.              | Year    |                                | Rs.              |
|---------|-------------------------------------|------------------|---------|--------------------------------|------------------|
| 2006-07 | To Balance c/d                      | 2,70,000         | 2006-07 | By Employees' Compensation A/c | 2,70,000         |
|         |                                     | <u>2,70,000</u>  |         |                                | <u>2,70,000</u>  |
| 2007-08 |                                     |                  | 2007-08 | By Balance b/d                 | 2,70,000         |
|         | To Balance c/d                      | 5,52,000         |         | By Employees' Compensation A/c | 2,82,000         |
|         |                                     | <u>5,52,000</u>  |         |                                | <u>5,52,000</u>  |
| 2008-09 |                                     |                  | 2008-09 | By Balance b/d                 | 5,52,000         |
|         | To Balance c/d                      | 8,31,000         |         | By Employees' Compensation A/c | 2,79,000         |
|         |                                     | <u>8,31,000</u>  |         |                                | <u>8,31,000</u>  |
| 2009-10 | To General Reserve (400 × 15)       | 6,000            | 2009-10 | By Balance b/d (55,400 × 15)   | 8,31,000         |
|         | To Share Capital (55,000 × 10)      | 5,50,000         |         | By Bank (55,000 × 45)          | 24,75,000        |
|         | To Securities Premium (55,000 × 50) | <u>27,50,000</u> |         |                                |                  |
|         |                                     | <u>33,06,000</u> |         |                                | <u>33,06,000</u> |

**Note:** Securities Premium

|                                     |           |
|-------------------------------------|-----------|
|                                     | Rs.       |
| Exercise price received per share   | 45        |
| Value of service received per share | <u>15</u> |
| Consideration received per share    | 60        |
| Less: Nominal value per share       | <u>10</u> |
| Securities premium per share        | <u>50</u> |

## 7.32 Financial Reporting

### Computation of Basic EPS

|                                          | 2006-07    | 2007-08    | 2008-09      |
|------------------------------------------|------------|------------|--------------|
|                                          | Rs. 000    | Rs. 000    | Rs. 000      |
| Profit before amortisation of ESOP costs | 1,190      | 1,262      | 1,379        |
| Less: ESOP cost amortised                | <u>270</u> | <u>282</u> | <u>279</u>   |
| Net profit for shareholders              | <u>920</u> | <u>980</u> | <u>1,100</u> |
| Number of shares outstanding ('000)      | 400        | 400        | 400          |
| Basic EPS                                | 2.30       | 2.45       | 2.75         |

### Potential Equity

|                                                            | 2006-07        | 2007-08        | 2008-09        |
|------------------------------------------------------------|----------------|----------------|----------------|
| A. Actual number of employees                              | 585            | 565            | 554            |
| B. Option granted per employee                             | 100            | 100            | 100            |
| C. Number of options outstanding                           | 58,500         | 56,500         | 55,400         |
| D. Unamortised ESOP cost per option (Rs.)                  | 10             | 5              | Nil            |
| E. Exercise Price (Rs. 45)                                 | 45             | 45             | 45             |
| F. Expected exercise price to be received (C x E): Rs. 000 | 2,632.5        | 2,542.5        | 2,493.0        |
| G. Unamortised ESOP cost ((C x D) : Rs. 000                | <u>585.0</u>   | <u>282.5</u>   | <u>Nil</u>     |
| H. Total proceeds: Rs. 000                                 | <u>3,217.5</u> | <u>2,825.0</u> | <u>2,493.0</u> |
| I. Fair value per share (Rs.)                              | 60             | 66             | 72             |
| J. Number of shares issued for consideration (H/I)         | 53,625         | 42,803         | 34,625         |
| K. Potential Equity (C – J)                                | 4,875          | 13,697         | 20,775         |

### Computation of Diluted EPS

|                              | 2006-07  | 2007-08  | 2008-09   |
|------------------------------|----------|----------|-----------|
|                              | Rs.      | Rs.      | Rs.       |
| Net profit for shareholders  | 9,20,000 | 9,80,000 | 11,00,000 |
| Number of shares outstanding | 4,00,000 | 4,00,000 | 4,00,000  |
| Potential Equity             | 4,875    | 13,697   | 20,775    |
| Total number of share        | 4,04,875 | 4,13,697 | 4,20,775  |
| Diluted EPS                  | 2.27     | 2.37     | 2.61      |

## 12. STOCK APPRECIATION RIGHTS (SAR)

Stock Appreciation Rights (SAR) entitle the employees to claim cash payment to the extent of excess of market price of underlying shares on exercise date over the exercise price. Stock Appreciation Rights are not exercised if market price of underlying shares on exercise date is less than the exercise price. SAR is therefore a call option held by employees. The employer recognises the value of call as expense over the vesting period.

The accounting procedures for ESOP and SAR are similar except that: (i) The liability for SAR is recognised as Provision instead of ESOP Outstanding and (ii) value per option is reassessed at each reporting date.

### Illustration 9

A company announced a Stock Appreciation Right on 01/04/06 for each of its 525 employees. The scheme gives the employees the right to claim cash payment equivalent to excess on market price of company's shares on exercise date over the exercise price Rs. 125 per share in respect of 100 shares, subject to condition of continuous employment for 3 years. The SAR is exercisable after 31/03/09 but before 30/06/09. The fair value of SAR was Rs. 21 in 2006-07, Rs. 23 in 2007-08 and Rs. 24 in 2008-09. In 2006-07 the company estimates that 2% of the employees shall leave the company annually. This was revised to 3% in 2007-08. Actually, 15 employees left the company in 2006-07, 10 left in 2007-08 and 8 left in 2008-09. The SAR therefore actually vested to 492 employees. On 30/06/09, when the SAR was exercised, the intrinsic value was Rs. 25 per share.

Show Provision for SAR A/c by fair value method.

### Solution

#### Year 2006-07

Fair value of SAR per share = Rs. 21

Number of SAR expected to vest =  $(525 \times 0.98 \times 0.98 \times 0.98) \times 100 = 49,400$

Fair value =  $49,400 \times \text{Rs. } 21 = \text{Rs. } 10,37,400$

Vesting period = 3 years

Value of SAR recognised as expense in 2006-07 =  $\text{Rs. } 10,37,400 / 3 = \text{Rs. } 3,45,800$

#### Year 2007-08

Fair value of SAR per share = Rs. 23

Number of SAR expected to vest =  $(525 - 15) \times 0.97 \times 0.97 \times 100 = 47,986$

Fair value =  $47,986 \times \text{Rs. } 23 = \text{Rs. } 11,03,678$

Vesting period = 3 years

### 7.34 Financial Reporting

Number of years expired = 2 years

Cumulative value of SAR to recognise as expense in 2006-07 and 2007-08

= (Rs. 11, 03,678/ 3) × 2 = Rs. 7, 35,585

Value of SAR recognised as expense in 2007-08

= Rs. 735,785 – Rs. 3, 45,800 = Rs. 3, 89,985

#### Year 2008-09

Fair value of SAR per share = Rs. 24 = Rs. 24

Number of SAR actually vested = 492 x 100 = 49,200

Fair value = 49,200 x Rs. 24 = Rs. 11,80,800

Cumulative value of SAR to recognise as expense in 3 years = Rs. 11,80,800

Value of SAR recognised as expense in 2008-09

= Rs. 11,80,800 – Rs. 7,35,785 = Rs.4,45,015

#### Year 2009-10

Intrinsic value of SAR per share = Rs. 25

Cash payment = 49,200 × Rs. 25 = 12,30,000

Value of SAR recognised as expense in 2009-10

= Rs. 12,30,000 – Rs. 11,80,800 = Rs. 49,200

#### **Provision for SAR A/c**

| Year    |                | Rs.              | Year    |                                | Rs.              |
|---------|----------------|------------------|---------|--------------------------------|------------------|
| 2006-07 | To Balance c/d | 3,45,800         | 2006-07 | By Employees' Compensation A/c | 3,45,800         |
|         |                | <u>3,45,800</u>  |         |                                | <u>3,45,800</u>  |
| 2007-08 | To Balance c/d | 7,35,785         | 2007-08 | By Balance b/d                 | 3,45,800         |
|         |                |                  |         | By Employees' Compensation A/c | 3,89,985         |
|         |                | <u>7,35,785</u>  |         |                                | <u>7,35,785</u>  |
| 2008-09 | To Balance c/d | 11,80,800        | 2008-09 | By Balance b/d                 | 7,35,785         |
|         |                |                  |         | By Employees' Compensation A/c | 4,45,015         |
|         |                | <u>11,80,800</u> |         |                                | <u>11,80,800</u> |

|         |               |                  |         |              |                           |
|---------|---------------|------------------|---------|--------------|---------------------------|
| 2009-10 | To            | Bank             | 2009-10 | By           | Balance b/d (49,200 × 24) |
|         | (49,200 × 25) | 12,30,000        |         |              | 11,80,800                 |
|         |               |                  |         | By           | Employees'                |
|         |               |                  |         | Compensation | <u>49,200</u>             |
|         |               | <u>12,30,000</u> |         |              | <u>12,30,000</u>          |

### 13. EMPLOYEE SHARE-BASED PAYMENT PLANS WITH CASH ALTERNATIVES

These plans consist of two components viz., (i) liability, i.e., the employer's obligation to pay price differential in cash and (ii) equity, i.e., the employer's obligation to issue shares at exercise price. The company should first measure, on the grant date, fair value of the plan on the assumption that all employees will exercise their options in favour of (i) cash settlement (ii) equity settlement. The fair value of plan for cash settlement is the fair value of the liability component. The excess, if any, of fair value of plan for equity settlement over the liability component is the fair value of equity component. The accounting procedure for equity component is same as that for ESOP. The accounting procedure for liability component is same as that for SAR.

On the date of settlement, the company should remeasure the liability to its fair value. If the employees opt for shares, the amount of liability should be treated as the consideration for the shares issued. If the employees opt for cash settlement, the balance in ESOP Outstanding A/c should be transferred to general reserve.

#### Illustration 10

A company announced a share-based payment plan for its employees on 01/04/06, subject to a vesting period of 3 years. By the plan, the employees can (i) either claim difference between exercise price Rs. 150 per share and market price of those shares on vesting date in respect of 10,000 shares or (ii) can subscribe to 12,000 shares at exercise price Rs. 150 per share, subject to lock in period of 5 years. On 01/04/06, fair value of the option, without considering restrictions on transfers was Rs. 30 and that after considering restrictions on transfer was Rs. 27. The fair value estimates, without considering transfer restrictions were Rs. 31.50, Rs. 32.70 and Rs. 34 respectively, at the end of 2006-07, 2007-08 and 2008-09.

Show important accounts in books of the company if employees opt for (i) cash settlement (ii) equity settlement.

#### Solution

|                                                          |                 |                     |
|----------------------------------------------------------|-----------------|---------------------|
|                                                          | Rs.             |                     |
| Fair value under equity settlement = 12,000 × Rs. 27     | 3,24,000        |                     |
| Less: Fair value under cash settlement = 10,000 × Rs. 30 | <u>3,00,000</u> | Liability component |
|                                                          | <u>24,000</u>   | Equity component    |

### 7.36 Financial Reporting

Vesting period = 3 years

Expense to be recognised each year for equity component = Rs. 24,000 / 3 = Rs. 8,000

#### **Expense recognised for liability component:**

##### **2006-07**

Number of shares = 10,000

Fair value = Rs. 31.50 per share

Fair value of liability component = 10,000 × Rs. 31.50 = Rs. 3,15,000

Vesting period = 3 years

Expense recognised = Rs. 3,15,000/3 = Rs. 1,05,000

##### **2007-08**

Number of shares = 10,000

Fair value = Rs. 32.70 per share

Fair value of liability component = 10,000 × Rs. 32.70 = Rs. 3,27,000

Vesting period = 3 years

Number of years expired = 2 years

Cumulative expense to be recognised upto 2007-08

= (Rs. 3,27,000/3) × 2 = Rs. 2,18,000

Expense recognised in 2006-07 = Rs. 1,05,000

Expense recognised in 2007-08 = Rs. 2,18,000 – Rs. 1,05,000 = Rs. 1,13,000

##### **2008-09**

Number of shares = 10,000

Fair value = Rs. 34 per share

Fair value of liability component = 10,000 × Rs. 34 = Rs. 3,40,000

Vesting period = 3 years

Number of years expired = 3 years

Cumulative expense to be recognised upto 2008-09 = Rs. 3,40,000

Cumulative expense to be recognised upto 2007-08 = Rs. 2,18,000

Expense recognised in 2008-09 = Rs. 3,40,000 – Rs. 2,18,000 = Rs. 1,22,000

**Share Based Payments 7.37**

**Employees' Compensation A/c**

| Year    |                            | Rs.             | Year    |                      | Rs.             |
|---------|----------------------------|-----------------|---------|----------------------|-----------------|
| 2006-07 | To Provision For Liability | 1,05,000        | 2006-07 | By Profit & Loss A/c | 1,13,000        |
|         | To ESOP Outstanding        | <u>8,000</u>    |         |                      |                 |
|         |                            | <u>1,13,000</u> |         |                      | <u>1,13,000</u> |
| 2007-08 | To Provision For Liability | 1,13,000        | 2007-08 | By Profit & Loss A/c | 1,21,000        |
|         | To ESOP Outstanding        | <u>8,000</u>    |         |                      |                 |
|         |                            | <u>1,21,000</u> |         |                      | <u>1,21,000</u> |
| 2008-09 | To Provision For Liability | 1,22,000        | 2008-09 | By Profit & Loss A/c | 1,30,000        |
|         | To ESOP Outstanding        | <u>8,000</u>    |         |                      |                 |
|         |                            | <u>1,30,000</u> |         |                      | <u>1,30,000</u> |

**Provision for Liability Component A/c**

| Year    |                | Rs.               | Year    |                                | Rs.             |
|---------|----------------|-------------------|---------|--------------------------------|-----------------|
| 2006-07 | To Balance c/d | <u>1,05,000</u>   | 2006-07 | By Employees' Compensation A/c | <u>1,05,000</u> |
|         |                | <u>1,05,000</u>   |         |                                | <u>1,05,000</u> |
| 2007-08 | To Balance c/d | 2,18,000          | 2007-08 | By Balance b/d                 | 1,05,000        |
|         |                | <u>          </u> |         | By Employees' Compensation A/c | <u>1,13,000</u> |
|         |                | <u>2,18,000</u>   |         |                                | <u>2,18,000</u> |
| 2008-09 | To Balance c/d | 3,40,000          | 2008-09 | By Balance b/d                 | 2,18,000        |
|         |                | <u>          </u> |         | By Employees' Compensation A/c | <u>1,22,000</u> |
|         |                | <u>3,40,000</u>   |         |                                | <u>3,40,000</u> |

**ESOP Outstanding A/c**

| Year    |                | Rs.               | Year    |                                | Rs.           |
|---------|----------------|-------------------|---------|--------------------------------|---------------|
| 2006-07 | To Balance c/d | <u>8,000</u>      | 2006-07 | By Employees' Compensation A/c | <u>8,000</u>  |
|         |                | <u>8,000</u>      |         |                                | <u>8,000</u>  |
| 2007-08 | To Balance c/d | 16,000            | 2007-08 | By Balance b/d                 | 8,000         |
|         |                | <u>          </u> |         | By Employees' Compensation A/c | <u>8,000</u>  |
|         |                | <u>16,000</u>     |         |                                | <u>16,000</u> |
| 2008-09 | To Balance c/d | 24,000            | 2008-09 | By Balance b/d                 | 16,000        |
|         |                | <u>          </u> |         | By Employees' Compensation A/c | <u>8,000</u>  |
|         |                | <u>24,000</u>     |         |                                | <u>24,000</u> |

## 7.38 Financial Reporting

### Cash Settlement

Provision for Liability Component A/c

|         |         | Rs.             |         |                | Rs.             |
|---------|---------|-----------------|---------|----------------|-----------------|
| 2009-10 | To Bank | <u>3,40,000</u> | 2009-10 | By Balance b/d | <u>3,40,000</u> |
|         |         | <u>3,40,000</u> |         |                | <u>3,40,000</u> |

### **ESOP Outstanding A/c**

| Year    |                    | Rs.           | Year    |                | Rs.           |
|---------|--------------------|---------------|---------|----------------|---------------|
| 2009-10 | To General Reserve | <u>24,000</u> | 2009-10 | By Balance b/d | <u>24,000</u> |
|         |                    | <u>24,000</u> |         |                | <u>24,000</u> |

### Equity Settlement

### **Provision for Liability Component A/c**

|         |                         | Rs.             |         |                | Rs.             |
|---------|-------------------------|-----------------|---------|----------------|-----------------|
| 2009-10 | To ESOP Outstanding A/c | <u>3,40,000</u> | 2009-10 | By Balance b/d | <u>3,40,000</u> |
|         |                         | <u>3,40,000</u> |         |                | <u>3,40,000</u> |

### **ESOP Outstanding A/c**

| Year    |                       | Rs.              | Year    |                                      | Rs.              |
|---------|-----------------------|------------------|---------|--------------------------------------|------------------|
| 2009-10 | To Share Capital      | 12,00,000        | 2009-10 | By Balance b/d                       | 24,000           |
|         | To Securities Premium | 9,64,000         |         | By Provision for Liability Component | 3,40,000         |
|         |                       | <u>21,64,000</u> |         | By Bank                              | <u>18,00,000</u> |
|         |                       |                  |         |                                      | <u>21,64,000</u> |

## 14. DISCLOSURES

The Guidance Note on Accounting for Employee Share-based Payments issued by The Institute of Chartered Accountants of India requires enterprises to disclose the following in respect of such payments:

1. Method used to account for the employee share-based payment plans. Where an enterprise uses the intrinsic value method, it should also disclose the impact on the net results and EPS- both basic and diluted –for the accounting period, had the fair value method been used.
2. Information that enables users of the financial statements to understand the nature and extent of employee share-based payment plans that existed during the period. In particular, it should disclose:



- (a) A description of each type of employee share-based payment plan that existed at any time during the period, including the general terms and conditions of each plan, such as vesting requirement, the maximum term of options granted, and the method of settlement (e.g., whether in cash or equity).
  - (b) The number and weighted average exercise prices of stock options for each of the following groups of options:
    - (i) Outstanding at the beginning of the period;
    - (ii) Granted during the period;
    - (iii) Forfeited during the period;
    - (iv) Exercised during the period;
    - (v) Expired during the period;
    - (vi) Outstanding at the end of the period; and
    - (vii) Exercisable at the end of the period
  - (c) For stock options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the enterprise may instead disclose the weighted average share price during the period.
  - (d) For stock options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life (comprising the vesting period and the exercise period). If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.
1. An enterprise should disclose the following information to enable users of the financial statements to understand how the fair value of shares or stock options granted, during the period, was determined:
    - (a) For stock options granted during the period, the weighted average fair value of those options at the grant date and information on how that fair value was measured, including:
      - (i) The option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life ( comprising the vesting period and the exercise period ), expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;
      - (ii) How expected volatility was determined, including an explanation of the extent to which expected volatility; and

## 7.40 Financial Reporting

- (iii) Whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition.
  - (b) For other instrument granted during the period (i.e., other than stock options), the number and weighted average fair value of those instruments at the granted date, and information on how that fair value was measured, including:
    - (i) If fair value was not measured on the basis of an observable market price, how it was determined;
    - (ii) Whether and how expected dividends were incorporated into the measured of fair value; and
    - (iii) Whether and how any other features of the instruments granted were incorporated into the measurement of fair value.
  - (c) For the employee share-based payment plans that were modified during the period:
    - (i) An explanation of those modifications;
    - (ii) The incremental fair value granted (as a result of those modifications); and
    - (iii) Information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) and (b) above, where applicable.
2. An enterprise should disclose the following information to enable users of the financial statement to understand the effect of employee share-based payment plans on the profit or loss of the enterprise for the period and on its financial position:
- (a) The total expense recognized for the period arising from employee share-based payment plans in which the services received did not qualify for recognition as a part of the cost of an asset and hence were recognized immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled employee share-based payment plans;
  - (b) For liability arising from employee share-based payment plans;
    - (i) The total carrying amount at the end of the period; and
    - (ii) The total intrinsic value at the end of the period of liabilities for which the right of the employee to cash or other assets had vested by the end of the period (e.g., vested stock appreciation rights).

**Illustration 10**

The following particulars in respect of stock options granted by a company are available:

|                                                        |               |
|--------------------------------------------------------|---------------|
| Grant date                                             | April 1, 2006 |
| Number of employees covered                            | 300           |
| Vesting condition: Continuous employment upto 31/03/09 | 100           |
| Nominal value per share (Rs.)                          | 10            |
| Exercise price per share (Rs.)                         | 40            |
| Fair value of option per share on grant date (Rs.)     | 20            |
| Exercise date                                          | July 31, 2009 |

The number options to vest per employee shall depend on company's average annual earning after tax during vesting period as per the table below:

| Average annual earning after tax           | Number of options per employee |
|--------------------------------------------|--------------------------------|
| Less than Rs. 100 crores                   | Nil                            |
| Rs. 100 crores to less than Rs. 120 crores | 30                             |
| Rs. 120 crores to less than Rs. 150 crores | 45                             |
| Above Rs. 150 crores                       | 60                             |

**Position on 31/03/07**

- (a) The company expects to earn Rs. 115 crores after tax on average per year during vesting period.
- (b) Number of employees expected to be entitled to option = 280

**Position on 31/03/08**

- (a) The company expects to earn Rs. 130 crores after tax on average per year during vesting period.
- (b) Number of employees expected to be entitled to option = 270

**Position on 31/03/09**

- (a) The company earned Rs. 128 crores after tax on average per year during vesting period.
- (b) Number of employees entitled to option = 275

## 7.42 Financial Reporting

### **Position on July 31, 2009**

Number of employees exercising option = 265

Compute expenses to recognise in each year and show important accounts in books of the company.

### **Solution**

Expense recognised in year 2006-07 = Rs. 56,000

Expense recognised in year 2007-08 = Rs. 1,06,000

Expense recognised in year 2008-09 = Rs. 85,500

Value of options forfeited = Rs. 9,000

### **Self-examination Questions**

1. Define the following terms in the context of Guidance Note on Accounting for Employee Share-based Payments:
  - (a) Exercise period.
  - (b) Grant date.
  - (c) Reload feature.
  - (d) Vesting period.
2. Explain the classification of employee share based payment plans for Accounting purpose.
3. Describe the measurement of cash settled employee share based payment plans.
4. What are the implications of shares granted under an employee share based payment plans on earning per share?
5. Explain the procedure of for determination of vesting period.