

PAPER – 1 : FINANCIAL REPORTING

QUESTIONS

Holding Company Accounts

- War Ltd. purchased on 31st March, 2007, 48,000 shares in Peace Ltd. at 50% premium over face value by issue of 8% debentures at 20% premium. The balance sheets of War and Peace Ltd. as on 31.3.2007, the date of purchase were as under:

Liabilities	War Ltd.	Peace Ltd.	Assets	War Ltd.	Peace Ltd.
	Rs.	Rs.		Rs.	Rs.
Share Capital (Rs. 10)	10,50,000	6,00,000	Fixed assets	6,50,000	2,00,000
General reserve	1,20,000	40,000	Stock in trade	3,00,000	1,80,000
Profit and loss account	80,000	—	Sundry debtors	3,20,000	2,00,000
Sundry Creditors	1,00,000	60,000	Cash in hand	60,000	30,000
			Preliminary expenses	20,000	10,000
			Profit and loss account	—	80,000
	<u>13,50,000</u>	<u>7,00,000</u>		<u>13,50,000</u>	<u>7,00,000</u>

Particulars of War Ltd:

- Profit made:

	Rs.
2007-2008	1,60,000
2008-2009	2,00,000
- The above profit was made after charging depreciation of Rs. 60,000 and Rs. 40,000 respectively.
- Out of profit shown above every year Rs. 20,000 had been transferred to general reserve.
- 10% dividend had been paid in both the years.
- It has been decided to write down investment to face value of shares in 10 years and to provide for share of loss to subsidiary.

Particulars of Peace Ltd.:

The company incurred losses of Rs. 40,000 and Rs. 60,000 in 2007-2008 and 2008-2009 after charging depreciation of 10% p.a. of the book value as on 1.4.2007.

Prepare consolidated balance sheet as at 31.3.2009 of War Ltd., and its subsidiary.

Valuation of Shares

2. The following is the Balance Sheet of N Ltd. as on 31st March, 2009:

Balance Sheet

Liabilities	Rs.	Assets	Rs.
4,00,000 Equity shares of Rs. 10 each fully paid	40,00,000	Goodwill	4,00,000
13.5% Redeemable preference shares of Rs. 100 each fully paid	20,00,000	Building	24,00,000
General Reserve	16,00,000	Machinery	22,00,000
Profit and Loss Account	3,20,000	Furniture	10,00,000
Bank Loan (Secured against fixed assets)	12,00,000	Vehicles	18,00,000
Bills Payable	6,00,000	Investments	16,00,000
Creditors	31,00,000	Stock	11,00,000
		Debtors	18,00,000
		Bank Balance	3,20,000
		Preliminary Expenses	<u>2,00,000</u>
	<u>1,28,20,000</u>		<u>1,28,20,000</u>

Further information:

- (i) Return on capital employed is 20% in similar businesses.
- (ii) Fixed assets are worth 30% more than book value. Stock is overvalued by Rs. 1,00,000, Debtors are to be reduced by Rs. 20,000. Trade investments, which constitute 10% of the total investments are to be valued at 10% below cost.
- (iii) Trade investments were purchased on 1.4.2008. 50% of non-Trade Investments were purchased on 1.4.2007 and the rest on 1.4.2006. Non-Trade Investments yielded 15% return on cost.
- (iv) In 2006-2007 new machinery costing Rs. 2,00,000 was purchased, but wrongly charged to revenue. This amount should be adjusted taking depreciation at 10% on reducing value method.
- (v) In 2007-2008 furniture with a book value of Rs. 1,00,000 was sold for Rs. 60,000.
- (vi) For calculating goodwill two years purchase of super profits based on simple average profits of last four years are to be considered. Profits of last four years are as under:
2005-2006 Rs. 16,00,000, 2006-2007 Rs. 18,00,000, 2007-2008 Rs. 21,00,000, 2008-2009 Rs. 22,00,000.

(vii) Additional depreciation provision at the rate of 10% on the additional value of Plant and Machinery alone may be considered for arriving at average profit.

Find out the intrinsic value of the equity share. Income-tax and Dividend tax are not to be considered.

Valuation of Goodwill

3. The following Balance Sheet of X Ltd. is given:

X Ltd.			
Balance Sheet as on 31st March, 2005			
Liabilities	Rs.	Assets	Rs.
5,000 shares of Rs. 100 each fully paid	50,00,000	Goodwill	4,00,000
Bank overdraft	18,60,000	Land and building at cost	32,00,000
Creditors	21,10,000	Plant and machinery at cost	28,00,000
Provision for taxation	5,10,000	Stock	32,00,000
Profit and Loss Appropriation A/c	<u>21,20,000</u>	Debtors considered good	20,00,000
	<u>1,16,00,000</u>		<u>1,16,00,000</u>

In 1986 when the company commenced operation the paid up capital was same. The Loss/Profit for each of the last 5 years was – years 2000-2001 – Loss (Rs. 5,50,000); 2001-2002 Rs. 9,82,000; 2002-2003 Rs. 11,70,000; 2003-2004 Rs. 14,50,000; 2004-2005 Rs. 17,00,000;

Although income-tax has so far been paid @ 40% and the above profits have been arrived at on the basis of such tax rate, it has been decided that with effect from the year 2004-2005 the Income-tax rate of 45% should be taken into consideration. 10% dividend in 2001-2002 and 2002-2003 and 15% dividend in 2003-2004 and 2004-2005 have been paid. Market price of shares of the company on 31st March, 2005 is Rs. 125. With effect from 1st April, 2005 Managing Director's remuneration has been approved by the Government to be Rs. 8,00,000 in place of Rs. 6,00,000. The company has been able to secure a contract for supply of materials at advantageous prices. The advantage has been valued at Rs. 4,00,000 per annum for the next five years.

Ascertain goodwill at 3 year's purchase of super profit (for calculation of future maintainable profit weighted average is to be taken).

Corporate Restructuring

4. The summarized Balance sheets of X Ltd. and its subsidiary Y Ltd. as at 31.3.2009 were as follows:

Liabilities	X Ltd. Rs.	Y Ltd. Rs.	Assets	X Ltd. Rs.	Y Ltd. Rs.
Share capital (Share of Rs.10 each)	50,00,000	10,00,000	Fixed assets	60,00,000	18,00,000
General reserves	50,00,000	20,00,000	Investment in Y Ltd. (60,000 shares)	6,00,000	---
Profit and Loss account	20,00,000	15,00,000	Sundry debtors	35,00,000	5,00,000
Secured loan	20,00,000	2,50,000	Inventories	30,00,000	25,00,000
Current liabilities	<u>30,00,000</u>	<u>2,50,000</u>	Cash and bank	39,00,000	2,00,000
	<u>1,70,00,000</u>	<u>50,00,000</u>		<u>1,70,00,000</u>	<u>50,00,000</u>

X Ltd. holds 60% of the paid-up capital of Y Ltd. and the balance is held by a foreign company.

A memorandum of understanding has been entered into with the foreign company by X Ltd. to the following effect:

- The shares held by the foreign company will be sold to X Ltd. at a price per share to be calculated by capitalizing the yield at 15%. Yield, for this purpose, would mean 50% of the average of pre-tax profits for the last 3 years, which were Rs.12 lakhs, 18 lakhs and 24 lakhs respectively. (Average tax rate was 40%).
- The actual cost of shares to the foreign company was Rs.4,40,000 only. Gains accruing to the foreign company are taxable at 20%. The tax payable will be deducted from the sale proceeds and paid to government by X. 50% of the consideration (after payment of tax) will be remitted to the foreign company by X Ltd. and also any cash for fractional shares allotted.
- For the balance of consideration, X Ltd. would issue its shares at their intrinsic value.

It was also decided that X Ltd. would absorb Y Ltd. Simultaneously by writing down the Fixed assets of Y Ltd. by 10%. The Balance Sheet figures included a sum of Rs.1,00,000 due by Y Ltd. to X Ltd. and stock of X Ltd. included stock of Rs.1,50,000 purchased from Y Ltd., who sold them at cost plus 20%.

The entire arrangement was approved and put through by all concern effective from 1.4.2009.

You are required to indicate how the above arrangements will be recorded in the books of X Ltd. and also prepare a Balance Sheet after absorption of Y Ltd. Workings should form part of your answer.

Value Added

5. From the following Profit & Loss Account of Brightex Co. Ltd., prepare a gross value added statement for the year ended 31.12.2008:

Show also the reconciliation between gross value added and profit before taxation.

Profit and Loss Account for the year ended 31.12.2008

	Notes	(Rs.'000)	(Rs.'000)
Income :			
Sales			6,240
Other Income			<u>55</u>
			6,295
Expenditure:			
Production and operational expenses	1	4,320	
Administration expenses (Factory)	2	180	
Interest & Other charges	3	624	
Depreciation		<u>16</u>	<u>5,140</u>
Profit before tax			1,155
Provision for tax			<u>55</u>
			1,100
Balance as per last Balance Sheet			<u>60</u>
			1,160
Transferred to fixed assets replacement reserve		400	
Dividend paid		<u>160</u>	<u>560</u>
Surplus carried to Balance Sheet			<u>600</u>
Notes:			
1. Production & Operation expenses :			
Consumption of raw materials			3,210
Consumption of stores			40
Local tax			8
Salaries to administrative staff			620
Other manufacturing expenses			<u>442</u>
			<u>4,320</u>

2. Administration expenses include salaries and commission to directors 5
3. Interest on other charges include :
 - (a) Interest on bank overdraft (Overdraft is of temporary nature) 109
 - (b) Fixed loan from I.C.I.C.I. 51
 - (c) Working capital loan from I.F.C.I. 20
 - (d) Excise duties amount to one-tenth of total value added by manufacturing and trading activities.

Economic Value Added

6. (a) What are the advantages of preparation of Value Added (VA) statements?
- (b) The following information is available of a concern; calculate E.V.A.:

Debt capital 12%	Rs. 2,000 crores
Equity capital	Rs. 500 crores
Reserve and surplus	Rs. 7,500 crores
Capital employed	Rs. 10,000 crores
Risk-free rate	9%
Beta factor	1.05
Market rate of return	19%
Equity (market) risk premium	10%
Operating profit after tax	Rs.2,100 crores
Tax rate	30%

Human Resource Accounting

7. A company has a capital base of Rs.1 crore and has earned profits to the tune of Rs.11 lakhs. The Return on Investment (ROI) of the particular industry to which the company belongs is 12.5%. If the services of a particular executive are acquired by the company, it is expected that the profits will increase by Rs.2.5 lakhs over and above the target profit.

Determine the amount of maximum bid price for that particular executive and the maximum salary that could be offered to him.

NBFC

8. (a) Define the following terms in the context of NBFC:
 - (i) Earning value (equity share).

(ii) Subordinated debt.

- (b) ABC Finance Ltd. is a non-banking finance company. The extracts of its balance sheet are given below:

Liabilities	Amount	Assets	Amount
Paid up equity share capital	100	Leased out Assets Investment:	800
Free Reserves	500	In shares of subsidiaries and	
Loans	400	group companies	100
Deposits	400	In debentures of subsidiaries	
		and group companies	100
		Cash and Bank balances	200
		Deferred Expenditure	<u>200</u>
	<u>1,400</u>		<u>1,400</u>

You are required to compute Tier – I Capital of ABC Finance Ltd. according to NBFC Prudential Norms (RBI) Directions 1998.

Inflation Accounting

9. P Ltd. started its business on 01.04.2007, It issued one lac Equity Shares of Rs. 10 each at par and 30,000, 9% Debentures of Rs. 50 each, both were fully subscribed. It purchased Plant and Machinery for worth Rs. 15 Lac and goods for trading worth Rs. 12 lac @ Rs. 100 per unit. Estimated life of plant and machinery was 10 years with no scrap value. Goods were sold at Profit of 40% on selling price. Collection from Debtors outstanding as on 31.3.2008 amounted to Rs. 5 lac. Goods sold were replaced at a cost of Rs. 120 per unit, the number of units being the same. Trade Creditors outstanding as on 31.3.2008 were Rs. 3 lac. The replaced goods were entirely in stock on 31.3.2008, replacement cost of goods was considered to be Rs. 140 per unit. Replacement cost of machine was Rs. 20 lac as on 31.3.2008. Draft Profit and Loss Account and Replacement reserve on replacement cost basis.

Employee Share Based Payments

10. ABC Ltd. grants 1,000 employees stock options on 1.4.2004 at Rs.40, when the market price is Rs.160. The vesting period is 2½ years and the maximum exercise period is one year. 300 unvested options lapse on 1.5.2006. 600 options are exercised on 30.6.2007. 100 vested options lapse at the end of the exercise period.

Pass Journal Entries giving suitable narrations.

Financial Instruments

11. On April 1, 2007, Omega 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 following value of swap and debt are available

	Value of swap Rs.in lakh	Value of debt Rs. in lakh
April 1, 2007	+ 0.2	10.2
March 31, 2008	– 0.1	9.9

Six-month LIBOR on April 1, 2007 was 6% and that on October 1, 2007 was 8%.

Show important accounting entries in respect of the swap arrangement.

Brand Valuation

12. What are the difficulties in accounting of brands? Explain in brief.

Corporate Financial Reporting

13. What is the role of SEBI in Indian financial reporting system? Describe in brief.

Indian AS, IFRS and US GAAPs

14. Explain significant differences and similarities between Indian Accounting Standards, IAS/IFRS and US GAAPs on the issues of
- (a) Changes in accounting policies.
 - (b) Inventories .

Short Notes

15. Write short notes on:
- (i) Asset Management company in the context of mutual fund.
 - (ii) Capital adequacy requirements for merchant bankers.
 - (iii) Embedded derivatives.
 - (iv) Growing scope of human capital reporting.

Theory Question based on Accounting Standards

16. Distinguish between
- (i) Integral foreign operation and Non-integral foreign operation.
 - (ii) Operating lease and Non-operating lease.
17. (a) Explain the method of accounting for investment by a holding company in its subsidiaries.

- (b) Discuss with reference to the Accounting Standards, the nature of classification and disclosure requirements in the statement of profit and loss of an entity in the following cases –
- Losses sustained as a result of enemy action.
 - Disposal of long-term investments of a trading entity.
- (c) How refund of revenue grant received from the Government is disclosed in the Financial Statements?
- (d) Describe the disclosure requirements for 'deferred tax assets' and 'deferred tax liabilities' as per AS 22.
- (e) Explain the concept of related party transactions under AS 18.

Practical Questions based on Accounting Standards and Guidance Notes

18. (a) Arrange and redraft the following Cash Flow Statement in proper order keeping in mind the requirements of AS-3:

	Rs. (in lacs)	Rs.(in lacs)
Net Profit		60,000
Add: Sale of Investments		70,000
Depreciation on Assets		11,000
Issue of Preference Shares		9,000
Loan raised		4,500
Decrease in Stock		12,000
		1,66,500
Less: Purchase of Fixed Assets	65,000	
Decrease in Creditors	6,000	
Increase in Debtors	8,000	
Exchange gain	8,000	
Profit on sale of investments	12,000	
Redemption of Debenture	5,700	
Dividend paid	1,400	
Interest paid	945	1,07,045
		59,455
Add: Opening cash and cash equivalent		12,341
Closing cash and cash equivalent		71,796

- (b) P Ltd. has 60% voting right in Q Ltd. Q Ltd. has 20% voting right in R Ltd. Also, P Ltd. directly enjoys voting right of 14% in R Ltd. R Ltd. is a listed company and regularly supplies goods to P Ltd. The management of R Ltd. has not disclosed its relationship with P Ltd.

How would you assess the situation from the viewpoint of AS 18 on Related Party Disclosures?

19. (a) A plant was depreciated under two different methods as under:

Year	SLM (Rs. in lakhs)	W.D.V. (Rs. in lakhs)
1	7.80	21.38
2	7.80	15.80
3	7.80	11.68
4	<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.

- (b) The Chief Accountant of Sports Ltd. gives the following data regarding its six segments:

	Rs. In lakhs						
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.

- (c) The following details are available in the books of ABC Ltd.,

Particulars	Rs. in lakhs
Provision for tax:	
For 2005-2006	200
For 2006-2007	300
For 2007-2008	250

Advance tax paid:

For 2005-2006	175
For 2006-2007	350
For 2007-2008	270

ABC Ltd. estimates its Deferred Tax Liabilities to be Rs.100 lakhs and its Deferred Tax Assets to be Rs.20 lakhs. How will the above be disclosed?

20. (a) U.K. International Ltd. is developing a new production process. During the financial year ending 31st March, 2007, the total expenditure incurred was Rs.50 lakhs. This process met the criteria for recognition as an intangible asset on 1st December, 2006. Expenditure incurred till this date was Rs.22 lakhs. Further expenditure incurred on the process for the financial year ending 31st March, 2008 was Rs.80 lakhs. As at 31st March, 2008, the recoverable amount of know-how embodied in the process is estimated to be Rs.72 lakhs. This includes estimates of future cash outflows as well as inflows.

You are required to calculate:

- (i) Amount to be charged to Profit and Loss A/c for the year ending 31st March, 2007 and carrying value of intangible as on that date.
- (ii) Amount to be charged to Profit and Loss A/c and carrying value of intangible as on 31st March, 2008.

Ignore depreciation.

- (b) A private limited company manufacturing fancy terry towels had valued its closing stock of inventories of finished goods at the realisable value, inclusive of profit and the export cash incentives. Firm contracts had been received and goods were packed for export, but the ownership in these goods had not been transferred to the foreign buyers.

Comment on the valuation of the stocks by the company.

- (c) A company with a turnover of Rs.250 crores and an annual advertising budget of Rs.2 crore had taken up the marketing of a new product. It was estimated that the company would have a turnover of Rs. 25 crores from the new product. The company had debited to its Profit and Loss account the total expenditure of Rs.2 crore incurred on extensive special initial advertisement campaign for the new product.

Is the procedure adopted by the company correct?

- (d) A company deals in petroleum products. The sale price of petrol is fixed by the government. After the Balance Sheet date, but before the finalisation of the company's accounts, the government unexpectedly increased the price

retrospectively. Can the company account for additional revenue at the close of the year? Discuss.

21. (a) 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?
- (b) 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 3rd 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.
- (c) 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.

22. (a) On 1st December, 2008, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for Rs. 85 lakhs. On 31st March, 2009 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, 2009 as per provisions of Accounting Standard 7 (Revised)?
- (b) Mini Ltd. took a factory premises on lease on 1.4.07 for Rs.2,00,000 per month. The lease is operating lease. During March, 2008, Mini Ltd. relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2010. The lease cannot be cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months upto 31.12.2010 should be provided in the accounts for the year ending 31.3.2008. Mini Ltd. seeks your advice.

- (c) X Co. Ltd. supplied the following information. You are required to compute the basic earning per share:

(Accounting year 1.1.2007 – 31.12.2007)

Net Profit	:	Year 2007 : Rs. 20,00,000
	:	Year 2008 : 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 – 31.3.2008.

Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2008 : Rs. 25

23. (a) 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.

- (i) State with reason whether the lease constitutes finance lease.
- (ii) Calculate unearned finance income.

- (b) 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.

- (c) X Ltd. began construction of a new building on 1st January, 2007. It obtained Rs.1 lakh special loan to finance the construction of the building on 1st January, 2007 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

Amount	Rate of Interest
Rs.5,00,000	11%
Rs.9,00,000	13%

The expenditure that were made on the building project were as follows:

	Rs.
January 2007	2,00,000
April 2007	2,50,000
July 2007	4,50,000
December 2007	1,20,000

Building was completed by 31st December, 2007. Following the principles prescribed in AS-16 'Borrowing Cost,' calculate the amount of interest to be capitalized and pass one Journal Entry for capitalizing the cost and borrowing cost in respect of the building.

- (d) 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 respective from Y Co. Ltd. during the year 2007-08.

You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.

24. 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?
25. (a) 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.
- (b) 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 2007-2008 were Rs. 1.95 crores. How should this information be shown in the Financial Statements of the Company.

SUGGESTED ANSWERS/HINTS

1. Consolidated Balance Sheet of War Ltd. and its subsidiary Peace Ltd.

as at 31st March, 2009

Liabilities	Rs.	Assets	Rs.
Share Capital:		Goodwill	2,32,000
Issued and Subscribed:		Fixed Assets:	
1,05,000 shares of Rs. 10 each		War Ltd.	5,50,000
Fully paid up	10,50,000	Peace Ltd.	<u>1,60,000</u>
Minority Interest	90,000	Net Current Assets:	7,10,000
Capital Reserve	1,20,000	War Ltd.	8,30,000
General Reserve	1,60,000	Peace Ltd.	<u>2,90,000</u>
Profit and Loss Account	62,000	Preliminary Expenses	20,000
8% Debentures	<u>6,00,000</u>		
	<u>20,82,000</u>		<u>20,82,000</u>

Working Notes:

(1) Investment in Peace Ltd. (48,000 shares)

	Rs.
Face value of shares	4,80,000
Premium (50%) over face value	<u>2,40,000</u>
Cost of investment	<u>7,20,000</u>

Acquired by issue of debentures at 20% premium:

	Rs.
8% Debentures	6,00,000
(Nominal value = $7,20,000 / 120 \times 100$)	
Debenture premium	<u>1,20,000</u>
	7,20,000
Writing down of investment	
2007-2008 : $1/10 \times 2,40,000$	(24,000)
2008-2009 : $1/10 \times 2,40,000$	<u>(24,000)</u>
Investment as on 31.3.2009	<u>6,72,000</u>

(2) Balance of Profit and Loss Account on 31st March, 2009

	War Ltd. Rs.	Peace Ltd. Rs.
Balance as on 31.3.2007	80,000	(80,000)
Profit/(Loss)		
For 2007-2008	1,60,000	(40,000)
For 2008-2009	2,00,000	(60,000)
Investment written off		
2007-2008	(24,000)	
2008-2009	(24,000)	
Provision for share of loss in subsidiary		
2007-2008: $\frac{4}{5} \times 40,000$	(32,000)	
2008-2009: $\frac{4}{5} \times 60,000$	(48,000)	
Transfer to General Reserve		
2007-2008	(20,000)	
2008-2009	(20,000)	
Dividend		
2007-2008	(1,05,000)	
2008-2009	<u>(1,05,000)</u>	
	<u>62,000</u>	<u>(1,80,000)</u>

(In the absence of information, taxation has not been considered).

(3) Balance Sheets as at 31st March, 2009

Liabilities	War Ltd. Rs.	Peace Ltd. Rs.	Assets	War Ltd. Rs.	Peace Ltd. Rs.
Share Capital	10,50,000	6,00,000	Fixed assets*	5,50,000	1,60,000
Capital reserve	1,20,000	—	Investment	6,72,000	
(Debenture premium)			Less:		
General reserve	1,60,000	40,000	Provision for		
			loss in subsidiary	<u>80,000</u>	—
Profit and loss account	62,000	—	Net current assets	8,30,000	2,90,000
8% Debentures	6,00,000	—	(Balancing figure)		
			Preliminary expenses	20,000	10,000
			Profit and loss account	<u>—</u>	<u>1,80,000</u>
	<u>19,92,000</u>	<u>6,40,000</u>		<u>19,92,000</u>	<u>6,40,000</u>

*Fixed Assets on 31st March, 2009

	War Ltd. Rs.	Peace Ltd. Rs.
Fixed assets on 31.3.2007	6,50,000	2,00,000
Less: Depreciation		
2007-2008	(60,000)	(20,000)
2008-2009	<u>(40,000)</u>	<u>(20,000)</u>
	<u>5,50,000</u>	<u>1,60,000</u>

Note: In the absence of information about the movement in individual current assets and current liabilities, balance sheets on 31.3.2009 have been prepared on the basis of net current assets.

(4) Computations for Consolidation

(a) Analysis of Profits/(Losses) of Peace Ltd.

	Capital Profit Rs.	Revenue Profit Rs.
General Reserve on 31.3.2007	40,000	—
Profit and Loss Account on 31.3.2007	(80,000)	
Profit/(Loss) for the years 2007-2008 and 2008-2009	<u>(40,000)</u>	<u>(1,00,000)</u>
Minority Interest (1/5)	(8,000)	(20,000)
Share of War Ltd. (4/5)	(32,000)	(80,000)

(b) Minority Interest

	Rs.
Share Capital	1,20,000
Capital profits/(losses)	(8,000)
Revenue profits/(losses)	(20,000)
Preliminary expenses ($1/5 \times 10,000$)	<u>(2,000)</u>
	<u>90,000</u>

(c) Cost of Control

		Rs.
Investment in Peace Ltd.		6,72,000
Less: Paid up value of investment	4,80,000	
Capital profit/(losses)	(32,000)	
Preliminary expenses ($4/5 \times 10,000$)	<u>(8,000)</u>	<u>4,40,000</u>
Goodwill		<u>2,32,000</u>

(d) Profit and Loss Account – War Ltd.

	Rs.
Balance	62,000
Less: Share of loss in Peace Ltd.	<u>80,000</u>
	(18,000)
Add: Provision for loss in subsidiary	<u>80,000</u>
	<u>62,000</u>

2. Calculation of intrinsic value of equity shares of N Ltd.

(a) Calculation of Goodwill

(i) Capital employed

Fixed Assets	Rs.	Rs.
Building	24,00,000	
Machinery (Rs. 22,00,000 + Rs. 1,45,800)	23,45,800	
Furniture	10,00,000	
Vehicles	<u>18,00,000</u>	
	75,45,800	
Add: 30% increase	<u>22,63,740</u>	
	98,09,540	
Trade investments (Rs.16,00,000 × 10% × 90%)	1,44,000	
Debtors (Rs. 18,00,000 – Rs. 20,000)	17,80,000	
Stock (Rs. 11,00,000 – Rs. 1,00,000)	10,00,000	
Bank balance	<u>3,20,000</u>	1,30,53,540
Less: Outside liabilities		
Bank Loan	12,00,000	
Bills payable	6,00,000	
Creditors	<u>31,00,000</u>	<u>49,00,000</u>
Capital employed		<u>81,53,540</u>

(ii) Future maintainable profit

Calculation of average profit

	2005-2006	2006-2007	2007-2008	2008-2009
	Rs.	Rs.	Rs.	Rs.
Profit given	16,00,000	18,00,000	21,00,000	22,00,000
Add: Capital expenditure of machinery charged to revenue		2,00,000		
Loss on sale of furniture			<u>40,000</u>	
	<u>16,00,000</u>	<u>20,00,000</u>	<u>21,40,000</u>	<u>22,00,000</u>
Less: Depreciation on machinery		20,000	18,000	16,200

Income from non-trade investments	1,08,000	2,16,000	2,16,000
Reduction in value of stock			1,00,000
Bad debts			<u>20,000</u>
Adjusted profit	<u>16,00,000</u>	<u>18,72,000</u>	<u>19,06,000</u>
			Rs.
Total adjusted profit for four years (2005-2006 to 2008-2009)			72,25,800
Average profit (Rs. 72,25,800/4)			18,06,450
Less: Depreciation at 10% on additional value of machinery (22,00,000 + 1,45,800) × 30/100 i.e. Rs. 7,03,740			<u>70,374</u>
Adjusted average profit			<u>17,36,076</u>
(iii) Normal Profit			
20% on capital employed i.e. 20% on Rs. 81,53,540			Rs.16,30,708
(iv) Super profit			
Expected profit – normal profit			
Rs. 17,36,076 – Rs. 16,30,708 = Rs. 1,05,368			
(v) Goodwill			
2 years' purchase of super profit			
Rs. 1,05,368 × 2 = Rs. 2,10,736			
(b) Net assets available to equity shareholders			
	Rs.	Rs.	
Goodwill as calculated in 1(v) above		2,10,736	
Sundry fixed assets		98,09,540	
Trade and Non-trade investments		15,84,000	
Debtors		17,80,000	
Stock		10,00,000	
Bank balance		<u>3,20,000</u>	
		1,47,04,276	
Less: Outside liabilities			
Bank loan	12,00,000		
Bills payable	6,00,000		
Creditors	<u>31,00,000</u>	49,00,000	
Preference share capital		<u>20,00,000</u>	
Net assets for equity shareholders		<u>78,04,276</u>	

(c) Valuation of equity shares

$$\begin{aligned}\text{Value of equity share} &= \frac{\text{Net assets available to equity shareholders}}{\text{Number of equity shares}} \\ &= \frac{\text{Rs. 78,04,276}}{4,00,000} \\ &= \text{Rs. 19.51}\end{aligned}$$

Note:

1. Depreciation on the overall increased value of assets (worth 30% more than book value) has not been considered. Depreciation on the additional value of only plant and machinery has been considered taking depreciation at 10% on reducing value method while calculating average adjusted profit.
 2. Loss on sale of furniture has been taken as non-recurring or extraordinary item.
 3. It has been assumed that preference dividend has been paid till date.
3. (i) Future Maintainable Profit

Year	Profit (P) Rs.	Weight (W)	Product (PW) Rs.
2001-2002	9,82,000	1	9,82,000
2002-2003	11,70,000	2	23,40,000
2003-2004	14,50,000	3	43,50,000
2004-2005	17,00,000	<u>4</u>	<u>68,00,000</u>
		<u>10</u>	<u>1,44,72,000</u>

Weighted average annual profit (after tax) =

$$\frac{\sum PW}{\sum W} = \text{Rs. } \frac{1,44,72,000}{10} \quad \underline{\underline{14,47,200}}$$

Weighted average annual profit before tax $\left(\text{Rs. } 14,47,200 \times \frac{100}{60} \right)$ 24,12,000

Less: Increase in Managing Director's remuneration 2,00,000

22,12,000

Add: Saving in cost of materials 4,00,000

26,12,000

Less: Taxation @ 45% 11,75,400

Future maintainable profit 14,36,600

(ii) Average Capital Employed

	Rs.	Rs.
Assets:		
Land and Buildings		32,00,000
Plant and Machinery		28,00,000
Stock		32,00,000
Sundry Debtors		<u>20,00,000</u>
		1,12,00,000
Less: Outside liabilities:		
Bank overdraft	18,60,000	
Creditors	21,10,000	
Provision for taxation	<u>5,10,000</u>	<u>44,80,000</u>
Capital employed at the end of the year		67,20,000
Add: Dividend @ 15% paid during the year		<u>7,50,000</u>
		74,70,000
Less: Half of the profit (after tax) for the year i.e.		
Rs. 17,00,000 × ½		<u>8,50,000</u>
Average capital employed		<u>66,20,000</u>

(iii) Normal Profit

Average dividend for the last 4 years $\left(\frac{10+10+15+15}{4} \right) = 12.5\%$

Market price of share Rs. 125

Normal rate of return = $\frac{12.5}{125} \times 100 = 10\%$

Normal profit (10% of Rs. 66,20,000) = Rs. 6,62,000

(iv) Valuation of goodwill

	Rs.
Future maintainable profit	14,36,600
Less: Normal profit	<u>6,62,000</u>
Super profit	<u>7,74,600</u>
Goodwill at 3 years' purchase of super profits (Rs. 7,74,600 × 3)	<u>23,23,800</u>

4.

X Ltd.
Balance Sheet as at 1st April, 2009

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital:			
Shares	5,00,000	Fixed Assets	78,00,000
Shares issued in lieu of purchase consideration	<u>33,466</u>	Less :Revaluation loss	<u>1,80,000</u>
(Shares of Rs.10 each)	5,33,466		76,20,000
	53,34,660	Sundry Debtors (35,00,000+5,00,000)	40,00,000
General Reserve	50,00,000	Less: Mutual Debts	<u>1,00,000</u>
Capital Reserve	13,20,000		39,00,000
Profit and Loss Account	20,00,000	Inventories (30,00,000+25,00,000)	55,00,000
Less: unrealized profit on stock	<u>25,000</u>	Less: Unrealised profit on stock	<u>25,000</u>
	19,75,000		54,75,000
Securities Premium (33,466×20)	6,69,320	Cash at Bank	27,03,980
Secured Loans (20,00,000 + 2,50,000)			
	22,50,000		
Current Liabilities (30,00,000 + 2,50,000)	32,50,000		
Less: Mutual Debts	<u>1,00,000</u>		
	<u>31,50,000</u>		
	<u>1,96,98,980</u>		<u>1,96,98,980</u>

Working Notes:-

(1) Yield of Y Ltd.

$$\text{Average of Pre Tax Profit} = \frac{12 + 18 + 24}{3} = \text{Rs.18 lakhs}^*$$

* By setting the trend, weighted average profit can also be calculated.

$$\text{Yield} = 18 \times \frac{50}{100} = \text{Rs.9 lakhs}$$

- (2) Price per share of Y Ltd:-

$$\text{Capitalised value of yield of Y Ltd.} = \frac{9 \text{ lakhs}}{15} \times 100 = 60 \text{ lakhs.}$$

$$\text{No. of shares} = 1,00,000$$

$$\text{Price per share} = \frac{60 \text{ lakhs}}{1 \text{ lakh}} = \text{Rs.60 per share}$$

- (3) Purchase consideration for 40% of share capital of Y Ltd.

$$= 1,00,000 \times 60 \times \frac{40}{100} = \text{Rs.24,00,000}$$

- (4) Calculation of intrinsic value of shares of X Ltd.

	Rs.
Total Assets excluding Investments in Y Ltd.	1,64,00,000
Value of Investment $60,000 \times 60$	<u>36,00,000</u>
	2,00,00,000

Less: Outside Liabilities:

Secured Loan	20,00,000	
Current Liabilities	<u>30,00,000</u>	<u>50,00,000</u>

Net Assets 1,50,00,000

$$\begin{aligned} \text{Intrinsic value per share} &= \frac{\text{Net Assets}}{\text{No. of Shares}} \\ &= \frac{\text{Rs.1,50,00,000}}{5,00,000} = \text{Rs.30 per share} \end{aligned}$$

- (5) Discharge of purchase consideration by X Ltd.

	Equity share capital	Cash	Total
	Rs.	Rs.	Rs.
(i) Payment of Tax $(24 - 4.40) \times \frac{20}{100} =$	---	3,92,000	3,92,000
(ii) Issue of shares to foreign company [50% of $(24 - 3.92) = 10.04$ lakhs]			

No. of shares issued by X Ltd.

$$\frac{10,04,000}{30} = 33,466.6666 \text{ shares}$$

Value of shares capital = 33,466 × 30 =	10,03,980	---	10,03,980
(iii) Cash Payment [50% of (24 – 3.92) = 10.04 lakhs]	---	10,04,000	10,04,000
(iv) Cash for fractional shares = 0.6666 × 30	---	<u>20</u>	<u>20</u>
Total	<u>10,03,980</u>	<u>13,96,020</u>	<u>24,00,000</u>

(6) Calculation for Goodwill/Capital Reserve to X Ltd.

		Rs.
Total of Assets as per Balance Sheet of Y Ltd.		50,00,000
Less: 10% Reduction in the value of Fixed Assets		
$(\frac{10}{100} \times 18,00,000)$		<u>1,80,0000</u>
		48,20,000
Less: Secured Loan	2,50,000	
Current Liabilities	<u>2,50,000</u>	<u>5,00,000</u>
Net Assets		43,20,000
Less: Purchase consideration (outside shareholders)		<u>24,00,000</u>
		19,20,000
Less: Investment in Y Ltd. as per Balance Sheet of X Ltd.		<u>6,00,000</u>
Capital Reserve		<u>13,20,000</u>

(7) Cash and Bank Balance of X Ltd. after acquisition of shares

		Rs.
Opening Balance (X Ltd.)		39,00,000
Cash and Bank Balance of Y Ltd.		<u>2,00,000</u>
		41,00,000
Less: Remittance to the foreign company		<u>10,04,020</u>
		30,95,980
Less: T.D.S. paid to Government		<u>3,92,000</u>
		<u>27,03,980</u>

(8) Unrealized profit included in stock of X Ltd. = $1,50,000 \times \frac{20}{120} = \text{Rs.}25,000$

5.

Brightex Co. Ltd

Value Added Statement

For the year ended 31st December, 2008

	Rs. In Thousands	Rs. In thousands	%
Sales		6,240	
Less: Cost of bought in material and services:			
Production and operational expenses (4,320 – 8 – 620)	3,692		
Administration expenses (180 – 5)	175		
Interest on bank overdraft	109		
Interest on working capital loan	20		
Excise duties (Refer to working note)	180		
Other/miscellaneous charges(444 – 180)	<u>264</u>	<u>4,440</u>	
Value added by manufacturing and trading activities		1,800	
Add: Other income		<u>55</u>	
Total Value Added		<u>1,855</u>	
Application of Value Added:			
To pay Employees :			
Salaries to Administrative staff		620	33.42
To pay Directors:			
Salaries and Commission		5	0.27
To Pay Government :			
Local Tax	8		
Income Tax	<u>55</u>	63	3.40
To Pay Providers of Capital :			
Interest on Fixed Loan	51		
Dividend	<u>160</u>	211	11.37
To provide For Maintenance and Expansion of the Company :			
Depreciation	16		
Fixed Assets Replacement Reserve	400		
Retained Profit (600 - 60)	<u>540</u>	<u>956</u>	<u>51.54</u>
		<u>1,855</u>	<u>100.00</u>

Reconciliation Between Total Value Added and Profit Before Taxation:

	Rs. In Thousands	Rs. In thousands
Profit before Tax		1,155
Add back:		
Depreciation	16	
Salaries to Administrative Staff	620	
Director's Remuneration	5	
Interest on Fixed Loan	51	
Local Tax	8	<u>700</u>
Total Value Added		<u>1,855</u>

Working Note :

Calculation of Excise Duty

		Rs. In thousands
Interest and other charges		624
Less : Interest on bank overdraft	109	
Interest on loan from ICICI	51	
Interest on loan from IFCI	<u>20</u>	<u>180</u>
Excise duties and other/miscellaneous charges		<u>444</u>

Assuming that these miscellaneous charges have to be taken for arriving at Value Added (in the first part of Value Added Statement), the excise duty will be computed as follows.

Let excise duty be x; thus miscellaneous/ other charges = 444 - x

Thus $x = \frac{1}{10} \times [6,240 - \{3692 + 175 + 109 + 20 + x + (444 - x)\}]$

$= \frac{1}{10} \times [6240 - 4440] = 180$

Other/ miscellaneous charges = 444 - 180 = 264

The above solution is given accordingly.

However, if other/miscellaneous charges are taken as any type of application of Value Added.

(i.e, to be taken in the application part), then excise duty (x) will be computed as follows:

$x = \frac{1}{10} \times [6240 - (3692 + 175 + 109 + 20 + x)]$

$x = \frac{1}{10} \times [2244 - x]$

$11x = 2244$

$x = 204$

And thus total value added will be 2040 + 55 (other income) = 2095

And accordingly, application part will be prepared, taking miscellaneous charges.

Rs('000) 240 [i.e, 444 - 204] as the application of value added.

6. (a) Various advantages of preparation of Value Added (VA) Statements are as under:
1. Reporting on VA improves the attitude of employees towards their employing companies. This is because the VA statement reflects a broader view of the company's objectives and responsibilities.
 2. VA statement makes it easier for the company to introduce a productivity linked bonus scheme for employees based on VA. The employees may be given productivity bonus on the basis of VA / Payroll Ratio.
 3. VA based ratios (e.g. VA / Payroll, taxation / VA, VA / Sales etc.) are useful diagnostic and predictive tools. Trends in VA ratios, comparisons with other companies and international comparisons may be useful.
 4. VA provides a very good measure of the size and importance of a company. To use sales figure or capital employed figures as a basis for company's rankings can cause distortion. This is because sales may be inflated by large bought-in expenses or a capital-intensive company with a few employees may appear to be more important than a highly skilled labour-intensive company.
 5. VA statement links a company's financial accounts to national income. A company's VA indicates the company's contribution to national income.
 6. VA statement is built on the basic conceptual foundations which are currently accepted in balance sheets and income statements. Concepts such as going concern, matching, consistency and substance over form are equally applicable to VA statement.

(b) E.V.A. = NOPAT – COCE

NOPAT = Net Operating Profit after Tax

COCE = Cost of Capital Employed

COCE = Weighted Average Cost Of Capital $\times$ Average Capital Employed
 = WACC $\times$ Capital Employed

Debt Capital Rs.2,000 crores

Equity capital 500 + 7,500 = Rs.8,000 crores

Capital employed = 2,000+8,000 = Rs.10,000 crores

Debt to capital employed = $\frac{2,000}{10,000} = 0.20$

Equity to Capital employed = $\frac{8,000}{10,000} = 0.80$

Debt cost before Tax 12%

Less: Tax (30% of 12%) 3.6%

Debt cost after Tax 8.4%

According to Capital Asset Pricing Model (CAPM)

Cost of Equity Capital = Risk Free Rate + Beta × Equity Risk Premium

Or

= Risk Free Rate + Beta (Market Rate – Risk Free Rate)

= 9 + 1.05 × (19-9)

= 9 + 1.05 × 10 = 19.5%

WACC = Equity to CE × Cost of Equity capital + Debt to CE × Cost of debt

= 0.8 × 19.5% + 0.20 × 8.40%

= 15.60% + 1.68% = 17.28%

COCE = WACC × Capital employed

= 17.28% × 10,000 crores = 1728 crores

E.V.A. = NOPAT – COCE

= Rs. 2,100 – Rs. 1,728 = Rs. 372 crores

7.

Capital Base = Rs.1,00,00,000

Actual Profit = Rs. 11,00,000

Target Profit @ 12.5% = Rs. 12,50,000

Expected Profit on employing the particular executive

= Rs.12,50,000 + 2,50,000 = Rs.15,00,000

Additional Profit = Expected Profit – Actual Profit

= 15,00,000 – 11,00,000 = Rs.4,00,000

Maximum bid price = $\frac{\text{Additional Profit}}{\text{Rate of Return on Investment}}$

= $\frac{4,00,000}{12.5} \times 100 = \text{Rs.}32,00,000$

Maximum salary that can be offered = 12.5% of Rs.32,00,000 i.e., 4,00,000

Maximum salary can be offered to that particular executive upto the amount of additional profit i.e., Rs.4,00,000.

8. (a) (i) Earning value means the value of an equity share calculated by taking the average profits after tax as reduced by preference dividend and adjustments for extraordinary and non-recurring items of the immediately three preceding years and further divided by the number of equity shares and capitalised at the following rate:

Predominantly manufacturing company	8%
Predominantly trading company	10%
Any other company including NBFC	12%

Earning value is zero in a loss making company.

- (ii) 'Subordinated Debt' means a fully paid-up capital instrument, which is unsecured and is subordinated to the claims of other creditors and is free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the supervisory authority of the NBFC. The book value of such instrument shall be subjected to discounting as provided hereunder:

Remaining Maturity of the instruments	Rate of discount
(a) Upto one year	100%
(b) More than one year but upto two years	80%
(c) More than two years but upto three years	60%
(d) More than three years but upto four years	40%
(e) More than four years but upto five years	20%

to the extent such discounted value does not exceed fifty per cent of Tier-I capital.

- (b) Statement Showing Computation of Tier-I Capital

	(Rs. in lakhs)
Paid up Equity Capital	100
Free Reserve	<u>500</u>
	(A) 600
Deduct deferred expenditure	(B) <u>200</u>
	(C) <u>400</u>
Investments	
In shares of subsidiaries and Group Companies	100
In Debenture of subsidiaries and Group Companies	<u>100</u>
	<u>200</u>
10% (C)	(D) <u>40</u>
Excess of Investment over 10% of (C) = (E)	<u>160</u>
Tier-I Capital [(C – E)]	<u>240</u>

9.

M/s P Ltd.

Profit & Loss Account as on 31.03.2008

	Rs.
Sales	20,00,000
Less: Cost of sales (Refer W.N. 1)	<u>14,40,000</u>
Gross Profit	5,60,000
Less: Depreciation (Refer W.N. 2)	<u>1,75,000</u>
Profit before Interest	3,85,000
Less: Debenture Interest (Refer W.N. 3)	<u>1,35,000</u>
Profit after charging depreciation and interest	<u>2,50,000</u>

Replacement Reserve

	Realised Gain Rs.	Unrealised Gain Rs.
Stock:		
Sold (Rs. 14,40,000 – Rs. 12,00,000)	2,40,000	
Unsold goods 12,000 x (Rs. 140 – Rs. 120)		2,40,000
Plant & Machinery Depreciation (Rs. 1,75,000 – Rs.1,50,000)	25,000	
Book value of asset		
[(Rs.20,00,000- Rs.2,00,000) less (Rs.15,00,000- Rs.1,50,000)]	<u> </u>	<u>4,50,000</u>
	<u>2,65,000</u>	<u>6,90,000</u>

Replacement Reserve = Rs. 2,65,000 +Rs. 6,90,000 = Rs. 9,55,000

Working Notes:

1. Sales and Cost of sales

Sale Price @ 40% profit on Selling Price = Rs. 12,00,000 x (100/60) = Rs. 20,00,000

Cost of Sales = 12,000 x Rs. 120 = Rs. 14,40,000

2. Depreciation under replacement cost basis

Under replacement cost basis, depreciation is calculated (on average basis) which can be shown as follows:

$$\frac{15,00,000 + 20,00,000}{2} = 10\% \text{ of Rs. } 17,50,000 = \text{Rs. } 1,75,000$$

3. Debenture Interest

$$30,000 \times \text{Rs. } 50 \times 9\% = \text{Rs. } 1,35,000$$

10. Journal Entries in the Books of ABC Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.3.2005	Employees compensation expenses account Dr.	48,000	
	To Employees stock option outstanding account		48,000
	(Being compensation expenses recognized in respect of the employees stock option i.e. 1,000 options granted to employees at a discount of Rs. 120 each, amortised on straight line basis over $2\frac{1}{2}$ years)		
	Profit and loss account Dr.	48,000	
	To Employees compensation expenses account		48,000
	(Being expenses transferred to profit and loss account at the end of the year)		
31.3.2006	Employees compensation expenses account Dr.	48,000	
	To Employees stock option outstanding account		48,000
	(Being compensation expenses recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a discount of Rs. 120 each, amortised on straight line basis over $2\frac{1}{2}$ years)		
	Profit and loss account Dr.	48,000	
	To Employees compensation expenses account		48,000

(Being expenses transferred to profit and loss account at the end of the year)

31.3.2007	Employees stock option outstanding account (W.N.)	Dr.	12,000	
	To General Reserve account (W.N.)			12,000
	(Being excess of employees compensation expenses transferred to general reserve account)			
30.6.2007	Bank A/c (600 x Rs.40)	Dr.	24,000	
	Employee stock option outstanding account (600 x Rs.120)	Dr.	72,000	
	To Equity share capital account (600 x Rs. 10)			6,000
	To Securities premium account (600 x Rs.150)			90,000
	(Being 600 employees stock option exercised at an exercise price of Rs. 40 each)			
01.10.2007	Employee stock option outstanding account	Dr.	12,000	
	To General reserve account			12,000
	(Being Employees stock option outstanding A/c transferred to General Reserve A/c, on lapse of 100 options at the end of exercise of option period)			

Working Note:

On 31.3.2007, ABC Ltd. will examine its actual forfeitures and make necessary adjustments, if any to reflect expenses for the number of options, that have actually vested. 700 employees stock options have completed 2.5 years vesting period, the expense to be recognized during the year is in negative i.e.

	Rs.
No. of options actually vested (700 x Rs.120)	84,000
Less: Expenses recognized Rs.(48,000 + 48,000)	<u>96,000</u>
Excess expenses transferred to general reserve	<u>12,000</u>

11. The interest rate swap is used to hedge fair value of fixed-rate debt. This is a case of fair value hedge.

In the books of Omega Ltd.

Journal Entries

		Rs. in lakh	Rs. in lakh	
Interest A/c	Dr.	0.35		$10 \times 7\% \times 6/12$
To Cash A/c			0.35	
(Being interest on fund borrowed for first half-year 2007-08)				
Loss on valuation of debt A/c	Dr.	0.20		$10.2 - 10$
To Loan A/c			0.20	
(Being increase in value of debt recognised)				
Swap Hedge A/c	Dr.	0.20		
To Gain on Swap Hedge A/c			0.20	
(Being increase in value of swap recognised)				
Cash A/c	Dr.	0.05		$10 (7\% - 6\%) \times 6/12$
To Interest A/c			0.05	
(Being swap settlement received for first half-year 2007-08)				
Interest A/c	Dr.	0.35		$10 \times 7\% \times 6/12$
To Cash A/c			0.35	
(Being interest on fund borrowed for second half-year 2007-08)				
Loan A/c	Dr.	0.30		$10.2 - 9.9$
To Gain on valuation of debt			0.30	
(Being decrease in value of debt recognised)				
Loss on Swap Hedge A/c	Dr.	0.30		$0.2 - (-0.1)$
To Swap Hedge A/c			0.30	
(Being cumulative loss on swap recognised)				

Interest A/c	Dr.	0.05	10 (8% – 7%) × 6/12
To Cash A/c			0.05
(Being swap settlement paid for second half-year 2007-08)			

12. Intangibles are not easily measurable and it poses severe challenges in valuation of brands also. Some of the difficulties faced by the accountants in brand valuation are as follows:
 1. Distinctiveness: Brands need to be valued distinctively as different from other intangibles such as Goodwill etc. For instance, any attempt to commonly treat brand as a part of Goodwill as is done at present may create serious distortions in accounting position. Besides, this would create handicaps in brand accounting.
 2. Disclosure: There is always a problem of making disclosure of brand values in financial statements. This is because, there is no standard accounting practice requiring statement and disclosure of brand values in a particular way.
 3. Uncertainty: The problem that is associated with the brand, as an item of intangibles, is that its possible returns are uncertain, immeasurable and non-current in nature. Any expected on such intangibles are usually either written off or treated as Deferred Revenue Expenditure.
 4. The Dilemma: Another area of challenge posing brand accounting is whether to amortise or capitalise the value of brand. There is no question of amortising brand values as either the economic life of the brand cannot be determined in advance or its value depreciates over time.
 5. No Market: The prevailing practice is that the intangibles are not required to be revalued according to some accounting standards on account of the non-existence of an active secondary market for them. In fact, the need for brand accounting arises mainly on account of conditions warranted by acquisition and merger.
 6. Joint Costs: It is very difficult to segregate and account for joint costs that are incurred and the cost of brand developed as a result of general operations of the business.
13. During the initial years of SEBI's working, its function 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. 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).

SEBI has also appointed certain expert committees from time to time to use the power to direct changes in the disclosure requirements effectively.

14.

	Indian Accounting Standards	IFRS / IAS	US GAAPs
Changes in accounting policy	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.	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.	Similar to IFRS from the date of adoption of FAS 154.
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. 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.

15. (i) "Asset management company" means a company formed and registered under the Companies Act, 1956 and approved as such by the Securities and Exchange Board of India to manage the funds of a mutual fund.

- (ii) The capital adequacy requirement specified in regulation 7 shall not be less than the net worth of the person making the application for grant of registration. For the purpose, the net worth shall be as follows :

Category	Minimum Amount Rs.
Category I (Merchant bankers who carry on activity of the issue management, which will, inter alia, consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of subscriptions; and act as advisor, consultant, manager, underwriter, portfolio manager)	5,00,00,000
Category II (Merchant bankers who act as advisor, consultant, co-manager, underwriter, portfolio manager)	50,00,000
Category III (Merchant bankers who act as underwriter, advisor, consultant to an issue)	20,00,000
Category IV (Merchant bankers who act only as advisor or consultant to an issue)	NIL

- (iii) 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 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.

- (iv) Of late there is a growing trend of shift from the traditional focus on financial reporting of quantifiable resources (which can be measured in monetary terms) to a more comprehensive approach of reporting under which human resources are also

considered as measurable assets. Having followed the methods of accounting of fixed assets, one can take into account the employee-related costs like cost of recruitment, training and orientation of employees, for the purpose of capitalization and then the appropriate portion thereof can be amortised each year over the estimated years of effect of such costs.

The relevance of human resource information lies in the fact that it concerns organizational changes in the firm's human resources. The ratio of human to non-human capital indicates the degree of labour intensity of an organization. Comparison of the specific values of human capital based on the organisation's scales of wages and salaries with the general industry standards, can be a good source of information to the management. There is no standard human capital reporting format as employment reporting is relatively a new form of reporting. Usually, the report inter alia contains data pertaining to employee numbers, employment and training policies, collective bargaining arrangements, industrial disputes, pension and pay arrangement and disabled employee numbers.

Human capital reporting provides scope for planning and decision-making in relation to proper manpower planning. Also, such reporting can bring out the effect of various rules, procedures and incentives relating to work force, and in turn, can act as an eye opener for modifications of existing statutes, laws and the like.

16. (i)

	Integral Foreign Operation (NFO)	Non-Integral Foreign Operation (NFO)
Meaning	It is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.	It is a foreign operation that is not an integral Foreign Operation.
Business	The business of IFO is carried on as if it were an extension of the reporting enterprise's operations.	The business of NFO is carried on in a substantially independent manner by accumulating cash and other monetary items, incurring expenses, generating income and arranging borrowings, in its local currency.
Example	Sale of goods imported from the reporting enterprise and remittance of proceeds to the reporting enterprise.	Production in a foreign country out of resources available in such nation independent of the reporting enterprise.
Currencies operated	Generally, IFO carries on business in a single foreign currency, i.e. of the country	NFO business may also enter into transactions in foreign currencies, including transactions

	where it is located.	in the reporting currency.
Cash flows from operations	Cash flows from operations of the reporting enterprise are directly and immediately affected by a change in the exchange rate between the reporting currency and the currency in the country of IFO.	Change in the exchange rate between the reporting currency and the local currency, has little or no direct effect on the present and future Cash Flows from Operations of either the NFO or the reporting enterprise.
Effect of Change in Exchange Rate	Change in the exchange rate affects the individual monetary items held by the IFO rather than the reporting enterprise's Net Investment in the IFO.	Change in the exchange rate affects the reporting enterprise's net investment in the NFO rather than the individual monetary and non-monetary items held by that NFO.

- (ii) Leases are classified based on the extent to which risks and rewards incident to ownership of a leased asset lie with the Lessor or the Lessee.

Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions.

Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

A lease is called 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 called an Operating Lease if it does not transfer substantially all the risks and rewards incident to ownership.

17. (a) Investments by a holding company in the shares of its subsidiary company are normally considered as long term investments. Indian holding companies shows investment in subsidiary just like any other investment and is generally classified as trade investments. As per AS 13 'Accounting for Investments', investments are classified as long term and current investments. A current investment is an investment that by its nature is readily realizable and is intended to be held for more than one year from the date of acquisition. A long term investment is one that is not a current one.

Costs of investment include besides acquisition charges, expenses such as brokerage, fees and duties. If an investment is acquired wholly or partly by an issue of shares or other securities, the acquisition cost is determined by taking the fair value of the shares/securities issued. If an investment were to be acquired in exchange – part or whole – for another asset, the acquisition cost of the investment

is determined with reference to the value of the other asset exchanged. Dividends received out of incomes earned by a subsidiary before the acquisition of the shares by the holding company and not treated as income but treated as recovery of cost of the assets (investment made in the subsidiary). The carrying cost for current investment is the lower of cost or fair/market value whereas investment in the shares of the subsidiary (treated as long term) are carried normally at cost.

- (b) (i) Losses sustained as a result of enemy action constitute an extraordinary item since it is an event which is clearly distinct from the ordinary activities of the enterprise and is not expected to recur frequently or regularly. As per AS 5, the nature and amount of each extraordinary item should be separately disclosed in a manner that its impact on current profit or loss can be perceived.
- (ii) AS 13 on "Accounting for Investments" requires that on disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to profit and loss account. AS 5 (Revised) requires separate disclosure of items of income/expense from ordinary activities if their size, nature or incidence makes their disclosure relevant to explain entity's performance. The disposal of long-term investments, may fall in this category requiring separate disclosure particularly in view of the fact that "disposal of long-term investments" is visualized as one of the circumstances in AS 5 itself.
- (c) The amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount should be charged to profit and loss statement. The amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.
- (d) The disclosure requirements under AS 22 are as under:
 - (a) Deferred tax assets and liabilities should be distinguished from current tax assets and liabilities. 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.

A deferred tax asset is more liquid as compared to fixed assets and investments and less liquid as compared to current assets. Thus, in case of a company, it should be presented after the head 'Investments'. Similarly, a deferred tax liability should be presented after the head 'Unsecured Loans'. (ASI 7 issued by Council of ICAI).

- (b) 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.
- (c) The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.
- (e) According to AS 18, "Parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions."

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

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

- ◆ Purchases or sales of goods (finished or unfinished);
- ◆ Purchases or sales of fixed assets;
- ◆ Rendering or receiving of services;
- ◆ Agency arrangements;
- ◆ Leasing or hire purchase arrangements;
- ◆ Transfer of research and development;
- ◆ Licence agreements;
- ◆ Finance (including loans and equity contributions in cash or in kind);
- ◆ Guarantees and collateral etc.
- ◆ Management contracts including for deputation of employees.

18. (a) Cash Flow Statement

Cash flows from operating activities:	(Rs. in lacs)
Net Profit	60,000
Less: Exchange gain	<u>(8,000)</u>
	52,000
Less: Profit on sale of investments	<u>(12,000)</u>
	40,000

Add: Depreciation on Assets		<u>11,000</u>
Change in current assets and current liabilities		51,000
(-) Increase in Debtors	(8,000)	
(+) Decrease in Stock	12,000	
(-) Decrease in creditors	<u>(6,000)</u>	<u>(2,000)</u>
Net cash from Operating activities (A)		49,000
Cash flows from Investing activities:		
Sale of Investments	70,000	
Less: Purchase of Fixed Assets	<u>(65,000)</u>	
Net cash from Investing activities (B)		5,000
Cash flows from Financing activities:		
Issue of preference shares	9,000	
Add: Loan raised	<u>4,500</u>	
	13,500	
Less: Redemption of Debentures	<u>(5,700)</u>	
	7,800	
Less: Interest paid	<u>(945)</u>	
	6,855	
Less: Dividend paid	<u>(1,400)</u>	
Net cash from Financing activities (C)		<u>5,455</u>
Net increase in Cash & Cash Equivalents		59,455
Add: Opening cash and cash equivalents		<u>12,341</u>
Closing cash and cash equivalents		<u>71,796</u>

- (b) P Ltd. has direct economic interest in R Ltd to the extent of 14%, and through Q Ltd. in which it is the majority shareholders, it has further control of 12% in R Ltd. (60% of Q Ltd's 20%). These two taken together (14% + 12%) make the total control of 26%.

AS 18 defines related party as one that has at any time during the reporting period, the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Here, Control is defined as ownership directly or indirectly of more than one-half of the voting power of an enterprise; and

Significant Influence is defined as participation in the financial and/or operating policy decisions of an enterprise but not control of those policies.

In the present case, control of P Ltd. in R Ltd. directly and through Q Ltd., does not go beyond 26%. However, significant influence may be exercised as an investing party (P Ltd.) holds, directly or indirectly through intermediaries 20% or more of the voting power of the R Ltd.

As R Ltd. is a listed company and regularly supplies goods to P Ltd. Hence, related party disclosure, as per AS 18, is required.

19. (a) As per para 21 of AS 6 on Depreciation Accounting, when a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In the given case, there is a surplus of Rs. 26.30 lakhs on account of change in the method of depreciation, which will be credited to Profit and Loss Account. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed
- (b) As per para 27 of AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:
 - (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 atleast 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.

- (c) Disclosure of Current and Deferred Tax balances will be on the basis of principles laid down in AS-22. These are:
- Current tax assets and liabilities can be set off, if the enterprise has a legally enforceable right to set off the recognized amounts and intends to settle them on a net basis.
 - Deferred tax assets and liabilities can be set off, if the items relate to taxes on income levied by the same governing taxation laws.

Applying these principles, the required disclosures will be as follows:

Liabilities		Rs.	Rs.	Assets		Rs.	Rs.
Deferred tax liabilities	tax	100		Current assets, loans and advances			
Less:Deferred assets	tax	<u>20</u>	80	Advance tax paid		795	
				Less:Provisions		<u>750</u>	45

20. (a) As per AS 26 'Intangible Assets'

- (i) For the year ending 31.03.2007

- (1) Carrying value of intangible as on 31.03.2007:

At the end of financial year 31st March 2007, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of Rs. 28 lakhs (expenditure incurred since the date the recognition criteria were met, i.e., on 1st December 2006).

- (2) Expenditure to be charged to Profit and Loss account:

Rs. 22 lakhs is recognized as an expense because the recognition criteria were not met until 1st December 2007. This expenditure will not form part of the cost of the production process recognized in the balance sheet.

- (ii) For the year ending 31.03.2008

- (1) Expenditure to be charged to Profit and Loss account:

	(Rs. in lakhs)
Carrying Amount as on 31.03.2007	28
Expenditure during 2007 – 2008	<u>80</u>

Total book cost	108
Recoverable Amount	<u>72</u>
Impairment loss	<u>36</u>
Rs. 36 lakhs to be charged to Profit and loss account for the year ending 31.03.2008.	

(2) Carrying value of intangible as on 31.03.2008:

	(Rs. in lakhs)
Total Book Cost	108
Less: Impairment loss	<u>36</u>
Carrying amount as on 31.03.2008	<u>72</u>

- (b) Accounting Standard 2 "Valuation of Inventories" states that inventories should be valued at lower of historical cost and net realisable value. AS 9 on "Revenue Recognition" states, "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 forward contract or a government guarantee or when market exists and there is a negligible risk of failure to sell, the goods invoiced are often valued at Net-realisable value."

Terry Towels do not fall in the category of agricultural crops or mineral ores. Accordingly, taking into account the facts stated, the closing stock of finished goods (Fancy terry towel) should have been valued at lower of cost and net-realisable value and not at net realisable value. Further, export incentives are recorded only in the year the export sale takes place. Therefore, the policy adopted by the company for valuing its closing stock of inventories of finished goods is not correct.

- (c) According to paras 55 and 56 of AS 26 'Intangible Assets', "expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset".

In the given case, advertisement expenditure of Rs. 2 crores had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of Rs.25 crores. Here, no intangible asset or other asset is acquired or created that can be recognised. Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of Rs.2 crores to the Profit and Loss account of the year is correct.

- (d) According to para 8 of AS 4 (Revised 1995), the unexpected increase in sale price of petrol by the government after the balance sheet date cannot be regarded as an event occurring after the Balance Sheet date, which requires an adjustment at the Balance Sheet date, since it does not represent a condition present at the balance sheet date. The revenue should be recognized only in the subsequent year with

proper disclosures. The retrospective increase in the petrol price should not be considered as a prior period item, as per AS 5, because there was no error in the preparation of previous period's financial statements.

21. (a) 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.

- (b) In the case of tax free companies, no deferred tax liability is recognized, in respect of timing differences that originate and reverse in the tax holiday period. Deferred tax liability or asset is created in respect of timing differences that originate in a tax holiday period but are expected to reverse after the tax holiday period. For this purpose, adjustments are done in accordance with the FIFO method.

Of Rs.200 lakhs, Rs.80 lakhs will reverse in the tax holiday period. Therefore, Deferred Tax Liability will be created on Rs.120 lakhs @ 35% (i.e.) Rs.42 lakhs.

In the second year, the entire Rs.400 lakhs will reverse only after the tax holiday period.

Therefore, deferred tax charge in the Profit and Loss Account will be $\text{Rs.}400 \times 35\% = 140$ lakhs and deferred tax liability in the Balance Sheet will be $(42+140) = \text{Rs.}182$ lakhs.

- (c) 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).

22. (a)

	Rs.
Cost incurred till 31 st March, 2009	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.

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

- (b) In accordance with AS 29 'Provisions, Contingent Liabilities and Contingent Assets' and ASI 30 'Applicability of AS 29 to Onerous Contracts', if an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision. In the given case, the operating lease contract has become onerous* as the economic benefit of lease contract for next 33 months up to 31.12.2010 will be nil. However, the lessee, Mini Ltd., has to pay lease rent of Rs. 66,00,000 (i.e. 2,00,000 p.m. for next 33 months).

Therefore, provision on account of Rs. 66,00,000 is to be provided in the accounts for the year ending 31.03.08. Hence auditor is right.

- (c) Computation of Basic Earnings Per Share
(as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)

	Year 2007	Year 2008
	Rs.	Rs.
EPS for the year 2007 as originally reported		
=	$\frac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$	

* For a contract to qualify as an onerous contract, the unavoidable costs of meeting the obligation under the contract should exceed the economic benefits expected to be received under it.

$$= (\text{Rs. } 20,00,000 / 10,00,000 \text{ shares}) \quad 2.00$$

EPS for the year 2007 restated for rights issue

$$= [\text{Rs. } 20,00,000 / (10,00,000 \text{ shares} \times 1.04^*)] \quad 1.92$$

(approx.)

EPS for the year 2008 including effects of rights issue

$$\frac{\text{Rs. } 30,00,000}{(10,00,000 \text{ shares} \times 1.04 \times 3/12) + (12,50,000 \text{ shares} \times 9/12)}$$

$$\frac{\text{Rs. } 30,00,000}{11,97,500 \text{ shares}} \quad 2.51$$

(approx.)

Working Notes:

1. Computation of theoretical ex-rights fair value per share

Fair value of all outstanding shares immediately prior to exercise of rights + Total amount received from exercise

Number of shares outstanding prior to exercise + Number of shares issued in the exercise

$$= \frac{(\text{Rs. } 25 \times 10,00,000 \text{ shares}) + (\text{Rs. } 20 \times 2,50,000 \text{ shares})}{10,00,000 \text{ shares} + 2,50,000 \text{ shares}}$$

$$= \frac{\text{Rs. } 3,00,00,000}{12,50,000 \text{ shares}} = \text{Rs. } 24$$

2. Computation of adjustment factor

$$= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex - rights value per share}}$$

$$= \frac{\text{Rs. } 25}{\text{Rs. } 24 \text{ (Refer Working Note 1)}} = 1.04 \text{ (approx.)}$$

23. (a) (i) Present value of residual value = Rs. 40,000 × 0.7513 = Rs. 30,052
Present value of lease payments = Rs. 3,00,000 – Rs. 30,052 = Rs. 2,69,948.

* Refer working note 2.

The present value of lease payments being 89.98% $\left(\frac{2,69,948}{3,00,000} \times 100 \right)$ of the fair value, i.e. being a substantial portion thereof, the lease constitutes a finance lease.

(ii) Calculation of unearned finance income

	Rs.
Gross investment in the lease [(Rs.1,08,552* × 3) + Rs. 40,000]	3,65,656
Less: Cost of the equipment	<u>3,00,000</u>
Unearned finance income	<u>65,656</u>

Note: In the above solution, annual lease payment has been determined on the basis that the present value of lease payments plus residual value is equal to the fair value (cost) of the asset.

- (b) (i) Recoverable amount is higher of value in use Rs. 400 lakhs and net selling price Rs. 375 lakhs.

∴ Recoverable amount = Rs. 400 lakhs

Impairment loss = Carried Amount – Recoverable amount

= Rs. 500 lakhs – Rs. 400 lakhs = Rs. 100 lakhs.

(ii) Journal Entries

Particulars		Dr.	Cr.
		Amount	Amount
		Rs. in lakhs	Rs. in lakhs
(i) Impairment loss account	Dr.	100	
To Asset			100
(Being the entry for accounting impairment loss)			
(ii) Profit and loss account	Dr.	100	
To Impairment loss			100
(Being the entry to transfer impairment loss to profit and loss account)			

* Annual lease payments = $\frac{\text{Rs. } 2,69,948}{2.4868} = \text{Rs. } 1,08,552$ (approx.)

(iii) Balance Sheet of Venus Ltd. as on 31.3.2005

		Rs. in lakhs
	Asset less depreciation	500
	Less: Impairment loss	<u>100</u>
		<u>400</u>
(c) (i)	Computation of average accumulated expenses	Rs.
	Rs. 2,00,000 x 12 / 12	= 2,00,000
	Rs. 2,50,000 x 9 / 12	= 1,87,500
	Rs. 4,50,000 x 6 / 12	= 2,25,000
	Rs. 1,20,000 x 1 / 12	= <u>10,000</u>
		<u>6,22,500</u>
(ii)	Calculation of average interest rate other than for specific borrowings	
	Amount of loan (in Rs.)	Rate of interest
	5,00,000	11% = 55,000
	<u>9,00,000</u>	13% = <u>1,17,000</u>
	<u>14,00,000</u>	<u>1,72,000</u>
	Weighted average rate of interest	=
	($\frac{1,72,000}{14,00,000} \times 100$)	12.285% (approx)
(iii)	Interest on average accumulated expenses	
		Rs.
	Specific borrowings (Rs. 1,00,000 X 10%)	= 10,000
	Non-specific borrowings (Rs. 5,22,500* X 12.285%)	= <u>64,189</u>
	Amount of interest to be capitalized	= <u>74,189</u>
(iv)	Total expenses to be capitalized for building	
		Rs.
	Cost of building Rs.(2,00,000 + 2,50,000 + 4,50,000 + 1,20,000)	10,20,000
	Add: Amount of interest to be capitalised	<u>74,189</u>
		<u>10,94,189</u>

* (Rs. 6,22,500 – Rs. 1,00,000)

(v) Journal Entry			
Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.12.2007	Building account	Dr. 10,94,189	
	To Bank account		10,94,189
	(Being amount of cost of building and borrowing cost thereon capitalized)		

- (d) 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:
- Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable.
 - Royalties: on an accrual basis in accordance with the terms of the relevant agreement.
24. 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.
25. (a) 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.

- (b) 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.

List of Institute's Publications relevant for Students

The following List of Institute's Publications is relevant for the forthcoming examination i.e. June, 2009.

Final Examination (New Course)

Paper 1: Financial Reporting

- I. Statements and Standards
 1. Framework for the Preparation and Presentation of Financial Statements
 2. Accounting Standards – AS 1 to AS 29.
- II. Guidance Notes on Accounting Aspects
 1. Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets.
 2. Guarantees and Counter-Guarantees Given by Companies.
 3. Guidance Note on Treatment of Expenditure during Construction Period.
 4. Guidance Note on Accrual Basis of Accounting.
 5. Guidance Note on Accounting Treatment for Excise Duty.
 6. Guidance Note on Accounting for Depreciation in Companies.
 7. Guidance Note on Availability of Revaluation Reserve for Issue of Bonus shares.
 8. Guidance Note on Accounting Treatment for MODVAT/CENVAT.
 9. Guidance Note on Accounting for Securitisation.

10. Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options (2003).
11. Guidance Note on Accounting for Corporate Dividend Tax.
12. Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds.
13. Guidance Note on Accounting for Employee Share-based Payments.
14. Guidance Note on Accounting for Fringe Benefits Tax.
15. Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961.