# UNIT 6: PROBLEMS BASED ON ACCOUNTING STANDARDS AND GUIDANCE NOTES

## Question 1

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

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

## Answer

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

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

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

(a) The nature of the event;

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

## Question 2

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

## Answer

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

## Question 3

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

## Answer

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

Broadly, these include expenses in connection with:

(a) preliminary analysis of the conceived idea,

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

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

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

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

### Question 4

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

*(10 marks) (Intermediate–Nov. 1996)*

### Answer

(i) Revaluation of fixed Assts

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

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

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

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

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

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

### Questiion 5

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

### Answer

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

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

### Question 6

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

*(2 marks) (Intermediate–May 1998)*

### Answer

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

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

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

## Question 7

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

## Answer

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

1. In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate arration to indicate that the enterprise does not have full ownership thereof.
2. Where an enterprise owns fixed assets jointly with others (otherwise than as a partner in a firm), the extent of its share in such assets, and the proportion in the original cost, accumulated depreciaiton and written down value are stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.
3. Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers.

## Question 8

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

## Answer

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

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

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

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

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

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

## Question 9

*Extraordinary Items to be disclosed as per the Accounting Standard.*

*(3 marks) (Intermediate–Nov. 1994)*

Answer

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

Question 10

*(i)* *A major fire has damaged the assets in a factory of a limited company on 2nd April-two days after the year end closure of account. The loss is estimated at Rs. 20 crores out of which Rs. 12 crores will be recoverable from the insurers. Explain briefly how the loss should be treated in the final accounts for the previous year.*

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

*(8 marks) (Intermediate–May 1995)*

Answer

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

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

Question 11

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

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

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

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

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

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

## Answer

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

## Notes on Accounts :

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

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

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

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

## Question 12

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

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

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

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

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

*You are asked to :*

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

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

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

Answer

In the books of Media Advertisers

Journal Entries

| | | | Dr. Rs. in lakhs | Cr. Rs. in lakhs |
|---|---|---|---|---|
| 1999 | | | | |
| March | Advance for advertisement rights (purchase) A/c | Dr. | 150.00 | |
| | To Bank A/c | | | 150.00 |
| | (Being advance paid for obtaining advertisement rights) | | | |
| | Bank A/c | Dr. | 210.00 | |
| | To Advance for advertisement time (sale) A/c | | | 210.00 |
| | (Being advance received from advertisers amounting to 60% of Rs. 350 lakhs for booking 70% advertisement time) | | | |
| April | Advance for advertisement rights (purchase) A/c | Dr. | 100.00 | |
| | To Bank A/c | | | 100.00 |
| | (Being balance advance i.e., Rs. 250 lakhs less Rs. 150 lakhs paid) | | | |
| | Bank A/c | Dr. | 140.00 | |
| | To Advance for advertisement time (sale) A/c | | | 140.00 |
| | (Being balance advance i.e., Rs. 350 lakhs less Rs. 210 lakhs received from advertisers) | | | |
| | Bank A/c | Dr. | 150.00 | |
| | To Advance for advertisement time (sale) A/c | | | 150.00 |
| | (Being advance received from advertisers in respect of booking of balance 30% time) | | | |
| May | Advertisement rights (purchase) A/c | Dr. | 62.50 | |
| | To Advance for advertisement rights (purchase) A/c | | | 62.50 |
| | (Being cost of advertisement rights used in May i.e., 25% of Rs. 250 lakhs, adjusted against advance paid) | | | |
| | Advance for advertisement time (sale) A/c | Dr. | 125.00 | |
| | To Advertisement time (sale) A/c | | | 125.00 |
| | (Being sale price of advertisement time in May i.e., 25% of Rs. 500 lakhs adjusted, against advance received from advertisers) | | | |
| | Profit and Loss A/c | Dr. | 62.50 | |
| | To Advertisement rights (purchase) A/c | | | 62.50 |

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

(ii) Monthly financial statements

(1) Revenue statement (Rs. in lakhs)

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

| (2) Balance sheet as at | *31.3.99* | *30.4.99* | *31.5.99* | *30.6.99* |
|---|---|---|---|---|
| *Sources of funds:* | | | | |
| Net profit | – | – | 62.50 | 250.00 |
| *Application of funds:* | | | | |
| Current assets, loans and advances: | | | | |
| Advance for advertisement rights | 150.00 | 250.00 | 187.50 | – |

| | | | | |
|---|---|---|---|---|
| Bank Balance | 60.00 | 250.00 | 250.00 | 250.00 |
| | 210.00 | 500.00 | 437.50 | 250.00 |
| *Less:* Current liabilities | | | | |
| Advance for advertisement time | | | | |
| (received from advertisers) | 210.00 | 500.00 | 375.00 | – |
| Net current assets | – | – | 62.50 | 250.00 |

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

## Question 13

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

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

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

## Answer

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

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

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

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

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

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

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

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

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

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

(i) the name of the transacting related party;

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

(iii) a description of the nature of transactions;

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

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

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

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

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

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

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

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

Question 14

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

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

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

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

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

*( 20 marks) (PE-II – Nov. 2002)*

Answer

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

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

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

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

(a) the nature of the products or services;

(b) the nature of the production processes;

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

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

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

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

(a) similarity of economic and political conditions;

(b) relationships between operations in different geographical areas;

(c) proximity of operations;

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

(e) exchange control regulations; and

(f) the underlying currency risks.

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

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

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

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

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

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

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

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

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

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

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

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

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

Question 15

*(a) X Co. Ltd. charged depreciation on its asset on SLM basis. For the year ended 31.3.2003 it changed to WDV basis. The impact of the change when computed from the date of the asset coming to use amounts to Rs. 20 lakhs being additional charge.*

*Decide how it must be disclosed in Profit and loss account. Also, discuss, when such changes in method of depreciation can be adopted by an enterprise as per AS–6.*

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

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

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

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

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

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

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

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

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

Answer

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## Question 16

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

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

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

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

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

*(e) X Limited has recognized Rs. 10 lakhs on accrual basis income from dividend on units of mutual funds of the face value of Rs. 50 lakhs held by it as at the end of the financial year 31st March, 2003. The dividends on mutual funds were declared at the rate of 20% on 15th June, 2003. The dividend was proposed on 10th April, 2003 by the declaring company. Whether the treatment is as per the relevant Accounting Standard? You are asked to answer with reference to provisions of Accounting Standard.*

*(20 marks) (PE-II – Nov. 2003)*

## Answer

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

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

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

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

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

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

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

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

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

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

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

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

(b) purchases or sales of fixed assets;

(c) rendering or receiving of services;

(d) agency arrangements;

(e) leasing or hire purchase arrangements;

(f) transfer of research and development;

(g) license agreements;

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

(i) guarantees and collaterals; and

(j) management contracts including for deputation of employees.

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

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

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

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

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

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

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

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

Question 17

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

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

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

*What will be the value of Closing Stock?*

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

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

*What amount should be capitalized?*

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

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

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

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

Answer

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

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

= 2.4 crores

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

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

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

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

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

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

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

*(i) The Pooling of Interest Method*

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

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

*(ii) The Purchase Method*

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

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

Question 18

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

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

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

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

*Subsequently on a review of the credit period allowed and financial capacity of the customers, the company decided to increase the provision to 8% on debtors as on 31.3.2004. The accounts were not approved by the Board of Directors till the date of decision. While applying the relevant accounting standard can this revision be considered as an extraordinary item or prior period item?*

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

Answer

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

Treatment of interest as per AS 16

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

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

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

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

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

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

Question 19

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

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

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

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

| *Years* | *Sales (Rs. in lakhs)* |
|---|---|
| *I* | *400* |
| *II* | *300* |
| *III* | *200* |
| *IV* | *100* |

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

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

*(c) In April, 2004 a Limited Company issued 1,20,000 equity shares of Rs. 100 each. Rs. 50 per share was called up on that date which was paid by all shareholders. The remaining Rs. 50 was called up on 1.9.2004. All shareholders paid the sum in September, 2004, except one shareholder having 24,000 shares. The net profit for the year ended 31.3.2005 is Rs. 2,64,000 after dividend on preference shares and dividend distribution tax of Rs. 64,000.*

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

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

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

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

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

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

*(4 marks each) (PE-II – May 2005*

Answer

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

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

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

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

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

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

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

Working Note:

Calculation of weighted average number of equity shares

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

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

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

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

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

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

*Alternative 1:*

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

| | | |
|---|---|---|
| 31st March, 2003 | *Less*: Depreciation @ 20% | 192.00 |
| | Book value | 768.00 |
| 31st March, 2004 | *Less*: Depreciation @ 20% | 153.60 |
| 1st April, 2004 | Book value | 614.40 |
| May, 2004 | *Add*: Refund of grant | 300.00 |
| | Revised book value | 914.40 |

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

*Alternative 2:*

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

Question 20

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

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

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

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

*Decide whether a separate disclosure of arrear wages is required.*

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

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

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

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

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

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

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

Answer

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

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

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

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

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

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

(c) AS 26 'Intangible Assets', came into effect for accounting periods commencing on or after 1.4.2003 and is mandatory in nature. Para 67 of the standard provides that if there is persuasive evidence that the life of the intangible asset is 20 years, then no adjustment is required at 1.4.2003. However, para 63 of the standard states that if it cannot be demonstrated that the life of the intangible asset is greater than 10 years, then AS 26 would require the asset to be amortised over not more than 10 years. Since, in the given case, the amortisation period determined by applying para 63 has already expired as on 1.4.2003, the carrying amount of Rs. 16 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1.4.2003.

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

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

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

Question 21

*(a) X Co. Limited purchased goods at the cost of Rs.40 lakhs in October, 2005. Till March, 2006, 75% of the stocks were sold. The company wants to disclose closing stock at Rs.10 lakhs. The expected sale value is Rs.11 lakhs and a commission at 10% on sale is payable to the agent. Advise, what is the correct closing stock to be disclosed as at 31.3.2006.*

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

*(c) Arjun Ltd. sold farm equipments through its dealers. One of the conditions at the time of sale is, payment of consideration in 14 days and in the event of delay interest is chargeable @ 15% per annum. The Company has not realized interest from the dealers in the past. However, for the year ended 31.3.2006, it wants to recognise interest due on the balances due from dealers. The amount is ascertained at Rs.9 lakhs. Decide whether the income by way of interest from dealers is eligible for recognition as per AS 9.*

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

*Advise the Company as per the applicable Accounting Standard.*

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

Answer

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

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

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

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

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

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

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

Question 22

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

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

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

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

Answer

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

Examples of research costs are:

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

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

Examples of development activities/costs are:

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

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

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

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

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

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

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

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

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

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

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

Question 23

*(a) What are the disclosure requirements of AS-7 (Revised)?*

*(b) How would you treat the Government grant received relating to a depreciable asset under the following cases as per AS-12?*

*Case i: Gross value of asset Rs.2 crores and Grant received Rs.20 lakhs only.*

*Case ii: Gross value of asset Rs.2 crores and Grant received Rs.2 crores.*

*(c) Explain the concept of actuarial valuation.*

*(d) What are the information that are to be disclosed in the financial statements as per AS-10? (4x4= 16 Marks) (PE II- May, 2007)*

Answer

(a) According to paragraphs 38, 39 and 41 of AS 7, an enterprise should disclose:

(a) the amount of contract revenue recognized as revenue in the period;

(b) the methods used to determine the contract revenue recognized in the period; and

(c) the methods used to determine the stage of completion of contracts in progress.

In case of contract still in progress the following disclosures are required 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 also 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.

(b) In accordance with AS 12, government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the balance sheet at a nominal value.

Alternatively, government grants related to depreciable fixed assets may be treated as deferred income which should be recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged.

Case i

Grant received amounting Rs.20 lakhs is required to be deducted from Rs.2 crores. The balance of Rs.1.80 crores to be shown as an assest in the Balance Sheet and depreciation should also be charged on Rs.1.80 crores.

Case ii

As the grant is received for the entire cost of the asset, the asset shall be recorded at a nominal value of Rs.100 in the Balance sheet so that the existence of the amount is reflected. No depreciation is to be charged in this case.

Note: Alternatively, in both the cases government grant may be treated as deferred income which should be recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

(c) Actuarial valuation is the process used by an actuary* to estimate the present value of benefits to be paid under a retirement scheme and the present values of the scheme assets and, sometimes, of future contributions. In the case of defined benefit scheme the cost of retirement benefits, to be charged to Profit and Loss Account on year to year basis, is determined on actuarial basis. According to paragraph 65 of AS 15 (revised 2005), an enterprise should use the Projected Unit Credit**method

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* Actuary is an expert person who can calculate the liability where the factors affecting the calculation of liability are uncertain and cannot be determined in ordinary course.

** Projected Unit Credit method (sometimes known as the accrued benefit method pro-rated on service or as the benefit/years of service method) considers each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build the final obligation.

to determine the present value of its defined benefit obligations and the related current service cost and, wherever applicable, past service cost.

(d) As per AS 10, the following information should be disclosed in the financial statements :

(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 amount substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of 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.

Question 24

*(a) Explain the treatment of Refund of Government Grants as per AS-12.*

*(b) The Company X Ltd., has to pay for delay in cotton clearing charges. The company up to 31.3.2006 has included such charges in the valuation of closing stock. This being in the nature of interest, X Ltd. decided to exclude such charges from closing stock for the year 2006-07. This would result in decrease in profit by Rs.5 lakhs. Comment.*

*(c) The Board of Directors of X Ltd. decided on 31.3.2007 to increase sale price of certain items of goods sold retrospectively from 1st January, 2007. As a result of this decision the company has to receive Rs.5 lakhs from its customers in respect of sales made from 1.1.2007 to 31.3.2007. But the Company's Accountant was reluctant to make-up his mind. You are asked to offer your suggestion.*

*(d) Briefly explain disclosure requirements for Investments as per AS-13.*

*(4x4 = 16 Marks)(PE II-Nov. 2007)*

Answer

(a) As per para 11 of AS 12 'Accounting for Government Grants', government grant that becomes refundable is treated as an extraordinary item.

The amount refundable in respect of a government grant related to revenue is first applied against any unamortised deferred credit remaining in respect of the grant.

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.

(b) As per para 12 of AS 2 (revised), interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are therefore, usually not included in the cost of inventories. However, X Ltd. was in practice to charge the cost for delay in cotton clearing in the closing stock. As X Ltd. decided to change this valuation procedure of closing stock, this treatment will be considered as a change in accounting policy and such fact to be disclosed as per AS 1. Therefore, any change in amount mentioned in financial statement, which will affect the financial position of the company should be disclosed properly as per AS 1, AS 2 and AS 5.

Also a note should be given in the annual accounts that, had the company followed earlier system of valuation of closing stock, the profit before tax would have been higher by Rs. 5 lakhs.

(c) As per para 10 of AS 9 'Revenue Recognition', the additional revenue on account of increase in sales price with retrospective effect, as decided by Board of Directors of X Ltd., of Rs.5 lakhs to be recognised as income for financial year 2006-07, only if the company is able to assess the ultimate collection with reasonable certainty. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

(d) The disclosure requirements as per para 35 of AS 13 are as follows:

(i) Accounting policies followed for valuation of investments.

(ii) Classification of investment into current and long term in addition to classification as per Schedule VI of Companies Act in case of company.

(iii) The amount included in profit and loss statements for

(a) Interest, dividends and rentals for long term and current investments, disclosing therein gross income and tax deducted at source thereon;

(b) Profits and losses on disposal of current investment and changes in carrying amount of such investments;

(c) Profits and losses and disposal of long term investments and changes in carrying amount of investments.

(iv) Aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments;

(v) Any significant restrictions on investments like minimum holding period for sale/disposal, utilisation of sale proceeds or non-remittance of sale proceeds of investment held outside India.

(vi) Other disclosures required by the relevant statute governing the enterprises.

## Question 25

*Answer any **four** of the following:*

*(i) (a) X Ltd. purchased debentures of Rs.10 lacs of Y Ltd., which are traded in stock exchange. How will you show this item as per AS 3 while preparing cash flow statement for the year ended on 31st March, 2008?*

*(b) 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 1.4.2007 to 30.6.2007. On 1.7.2007, he left the service.*

*Should the relative be identified as a related party at the closing date i.e., on 31.3.2008 for the purpose of AS 18?*

*(ii) A manufacturing company purchased shares of another company from stock exchange on 1st May, 2007 at a cost of Rs.5,00,000. It also purchased Gold of Rs.2,00,000 and Silver of Rs.1,50,000 on 1st*

*April, 2005. How will you treat these investments as per the applicable AS in the books of the company for the year ended on 31st March, 2008, if the values of these investments are as follows:*

| | Rs. |
|---|---|
| *Shares* | *2,00,000* |
| *Gold* | *4,00,000* |
| *Silver* | *2,50,000* |

*(iii) (a) Wye Ltd. received Rs.50 lacs from the Central Government as subsidy for setting up an industry in backward area. How will you treat it in accounts?*

*(b) How Government grant relating to Specific Fixed Assets is treated in the books as per AS 12?*

*(iv) A Ltd. had 6,00,000 equity shares on April 1, 2007. The company earned a profit of Rs.15,00,000 during the year 2007-08. The average fair value per share during 2007-08 was Rs.25. The company has given share option to its employees of 1,00,000 equity shares at option price of Rs.15. Calculate basic EPS and diluted EPS.*

*(v) In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in 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. State with reference to Accounting Standard, how will you value the inventories in this case?*

*(4 x 4= 16 Marks)(PEII-May, 2008)*

Answer

(i) (a) As per AS 3 on 'Cash flow Statement', cash and cash equivalents consists of cash in hand, balance with banks and short-term, highly liquid investments[1]. If investment, of Rs.10 lacs, made in debentures is for short-term period then it is an item of 'cash equivalents'.

However, if investment of Rs.10 lacs made in debentures is for long-term period then as per AS 3, it should be shown as cash flow from investing activities.

(b) 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.

Here, Mr. Raj, who received remuneration of Rs.2,50,000 from the company, is the relative of the key management personnel of that company. And as per para 3 clause (d) of the Standard, 'key management personnel and relatives of such personnel' are said to be in related party relationships. Hence, Mr. Raj, a relative of key management personnel ,should be identified as related party at the closing date i.e. on 31.3.2008.

(ii) As per para 32 of AS 13 on 'Accounting for Investments', any investment of long term period is shown at cost. Hence, the investment in Gold and Silver (purchased on 1st April 2005) shall continue to be shown at cost i.e., Rs.2,00,000 and Rs.1,50,000 respectively as their value have increased.

Also as per AS 13, for investment in shares - if the investment is for short-term period then the loss of Rs.3,00,000 is to be charged to profit & loss account for the year ended 31st March, 2008. If investment is of long term period then it will continue to be shown at cost in the Balance Sheet of the company. However, provision for diminution shall be made to recognize a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

(iii) (a) As per para 10 of AS 12 on 'Accounting for Government Grants', subsidy of Rs.50 lacs from the Central government, for setting up an industry in backward area is a government grant in the nature of promoter's contribution. Such grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

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[1] As per para 6 of AS 3, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say three months or less from the date of acquisition.

(b) According to para 8 of AS 12 on 'Accounting for Government Grants', 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.
- Under the other method, grant related to depreciable asset is treated as deferred income which is recognized in the profit and loss statement on a systematic and rational basis over the useful life of the assets. 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 pending its apportionment to profit and loss account.

(iv) Computation of earnings per share

| | Earnings | Shares | Earnings per share |
|---|---|---|---|
| Net profit for the year 2007-08 | Rs.15,00,000 | | |
| Weighted average number of shares outstanding during year 2007-08 | | 6,00,000 | |
| Basic earnings per share | | | Rs. 2.50 |
| Number of shares under option | | 1,00,000 | |
| Number of shares that would have been issued at fair value: (100,000 x 15.00)/25.00 | * | (60,000) | |
| Diluted earnings per share | Rs. 15,00,000 | 6,40,000 | Rs. 2.34 (approx.) |

*The earnings have not been increased as the total number of shares has been increased only by the number of shares (40,000) deemed for the purpose of the computation to have been issued for no consideration.

(v) As per para 13 of AS 2 (Revised), abnormal amounts of wasted materials, labour and other production costs are excluded from cost of inventories and such costs are recognized 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 × Rs.1,000) will be charged to the profit and loss statement.

## Question 26

*Following is the cash flow abstract of Alpha Ltd. for the year ended 31st March, 2008:*

*Cash Flow Abstract*

| *Inflows* | *Rs.* | *Outflows* | *Rs.* |
|---|---|---|---|
| *Opening balance:* | | *Payment to creditors* | *90,000* |
| *Cash* | *10,000* | *Salaries and wages* | *25,000* |
| *Bank* | *70,000* | *Payment of overheads* | *15,000* |
| *Share capital – shares issued* | *5,00,000* | *Fixed assets acquired* | *4,00,000* |
| *Collection from Debtors* | *3,50,000* | *Debentures redeemed* | *50,000* |

| | | | |
|---|---|---|---|
| *Sale of fixed assets* | *70,000* | *Bank loan repaid* | *2,50,000* |
| | | *Taxation* | *55,000* |
| | | *Dividends* | *1,00,000* |
| | | *Closing balance:* | |
| | | *Cash* | *5,000* |
| | | *bank* | *10,000* |
| | *10,00,000* | | *10,00,000* |

*Prepare Cash Flow Statement for the year ended 31st March, 2008 in accordance with Accounting standard – 3.*

*(8 Marks) (PE II- Nov. 2008)*

Answer

Cash Flow Statement

for the year ended 31.3.2008

| | Rs. | Rs. |
|---|---|---|
| **Cash flow from operating activities** | | |
| Cash received from customers | 3,50,000 | |
| Cash paid to suppliers | (90,000) | |
| Cash paid to employees (salaries and wages) | (25,000) | |
| Other cash payments (overheads) | (15,000) | |
| Cash generated from operations | 2,20,000 | |
| Income tax paid | (55,000) | |
| Net cash from operating activities | | 1,65,000 |
| **Cash flow from investing activities** | | |
| Payment for purchase of fixed assets | (4,00,000) | |
| Proceeds from sale of fixed assets | 70,000 | |
| Net cash used in investment activities | | (3,30,000) |
| **Cash flow from financing activities** | | |
| Proceeds from issue of share capital | 5,00,000 | |
| Bank loan repaid | (2,50,000) | |
| Debentures redeemed | (50,000) | |
| Dividends paid | (1,00,000) | |
| Net cash from financing activities | | 1,00,000 |
| Net decrease in cash and cash equivalents | | (65,000) |
| Cash and cash equivalents at the beginning of the year | | 80,000 |
| Cash and cash equivalents at the end of the year | | 15,000 |

Question 27

*(a) B Ltd. undertook a construction contract for Rs. 50 crores in April, 2007. the cost of construction was initially estimated at Rs. 35 crores. The contract is to be completed in 3 years. While executing the contract, the company estimated the cost of completion of the contract at Rs. 53 crores.*

*Can the company provide for the expected loss in the book of account for the year ended 31st March, 2008?*

*(b) List any five related party transactions, which require disclosure as per AS 18.*

*(c) A Government grant of Rs. 25 lakhs received 3 years ago in respect of a machinery which costs Rs. 200 lakhs, became refundable in March, 2008.*

*(i) How the receipt of grant would have been recorded in the books of the recipient?*

*(ii) How the refund of grant would be reflected in the books, at the time of its refund?*

*(d) List the conditions to be fulfilled as per Accounting Standard 14 (AS 14) for an amalgamation to be in the nature of merger, in the case of companies.*

*(e) Discuss the treatment of exchange loss relating to fixed assets as per AS 11 vis – a – vis the Schedule VI disclosure under the Companies Act, 1956.*

*(4 x 5 = 20 Marks) (PE II- Nov. 2008)*

Answer

(a) As per para 35 of AS 7 "Construction Contracts", when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately. Therefore, The foreseeable loss of Rs.3 crores (Rs. 53 crores less Rs. 50 crores) should be recognised as an expense immediately in the year ended 31st march, 2008. The amount of loss is determined irrespective of

(i) Whether or not work has commenced on the contract;

(ii) Stage of completion of contract activity; or

(iii) The amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance with para 8 of AS 7.

(b) Five examples of related party transactions for which disclosure is required according to AS 18 are:

(i) Purchase and/or sales of goods (finished or unfinished)

(ii) Purchase or sale of fixed assets.

(iii) Rendering or receiving of services.

(iv) Agency arrangements.

(v) Leasing or hire purchase arrangements.

(c) The grant is shown as a deduction from the gross value of the asset. Depreciation on machinery would be charged on the reduced value of Rs.175 lakhs. Alternatively, the grant may be treated as deferred income which should be credited to profit and loss statement on a systematic and rational basis over the useful life of the asset.

As per para 21 of AS 12, 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) An amalgamation should be considered to be an amalgamation in the nature of merger if the following conditions are satisfied:

(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.

(e) Schedule VI to The Companies Act, 1956 provides that any increase or decrease in liability due to change in the rate of exchange relating to any fixed asset should be added to or deducted from the cost of the asset. The amount arrived at should be taken to be the cost of the fixed asset.

AS 11 (revised), however, does not require adjustment of exchange difference in the carrying amount of fixed assets. The exchange difference is required to be recognised in the statement of profit or loss since it is felt that this treatment is conceptually preferable to that required in Schedule VI and is in consonance with the international position in this regard.

The provisions of AS 11 will prevail over Schedule VI of the Companies Act. National Advisory Committee on Accounting Standards (NACAS) has notified AS 11 for preparation of financial statements of companies. ICAI has come up with the announcement in this regard, stating that after the notification of AS 11 by NACAS, AS 11 will overrule Schedule VI of the Companies Act.

# 13

# FINANCIAL ANALYSIS

## UNITS 1 & 2 : FUND FLOW STATEMENT AND CASH FLOW STATEMENT

(A) Write short notes on:

### Question 1

*Cash Flow Statement.* *(5 marks) (Intermediate–Nov. 1997)*

### Answer

Cash flow statement is a statement of inflows and outflows of cash and cash equivalents. It starts with the opening balance of cash and cash equivalents at the start of the accounting period. It then gives in a summary form, the inflows and outflows relating to the following three classifications of activities :

(i) **Operating activities :** They are the principal revenue producing activities of the enterprise.

(ii) **Investing activities :** They deal with the acquisition and disposal of long-term assets and long term investments.

(iii) **Financing activities :** They reflect changes in the size and composition of capital in the case of a company this would preference capital and borrowings of the enterprise.

The cash flows arising from extraordinary items are disclosed separately under each of the above three classifications.

Likewise where the amount of significant cash and cash equivalent balances held by an enterprise are not available for use by the enterprise, the same should be disclosed separately together with a commentary by the management.

### Question 2

*In the case of manufacturing company :*

*(i) List the items of 'inflows' of cash receipts from operating activities;*

*(ii) List the items of "outlflows" of investing activities.* *(4 marks) [Intermediate May 1998]*

Answer

(i) Inflows of cash receipts from operating activities :

(a) Cash receipts from the sales of goods;

(b) Royalties, fees, commission and other revenue;

(c) Refunds of income-tax.

(ii) Outflows of investing activities :

(a) Cash payments for acquisition of fixed assets;

(b) Cash payments for acquisition of shares, warrants or debts instruments of other enterprises and interests in joint ventures (other than payments for instruments considered to cash equivalents and those for dealing or trading purposes);

(c) Cash advances and loans to third parties.

Question 3

*Classification of activities (with two examples) as suggested in AS 3, to be used for preparing a cash flow statements.* *(5 marks) (Intermediate–May 2001)*

Answer

AS 3 (Revised) on Cash Flow Statements requires that the cash flow statement should report cash flows by operating, investing and financing activities.

(i) Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities. Cash receipts from sale of goods and cash payments to suppliers of goods are two examples of operating activities.

(ii) Investing activities are acquisition and disposal of long-term assets and other investments not included in cash equivalents. Payment made to acquire machinery and cash received for sale of furniture are examples of investing activities.

(iii) Financial activities are those activities that result in changes in the size and composition of the owner's capital (including preference share capital in the case of a company) and borrowings of the enterprise. Cash proceeds from issue of shares and cash paid to redeem debentures are two examples of financing activities.

Question 4

*Explain the difference between direct and indirect methods of reporting cash flows from operating activities with reference to Accounting Standard 3, (AS 3) revised.*

*(8 marks) (Final Nov. 2001)*

Answer

As per para 18 of AS 3 (Revised) on Cash Flow Statements, an enterprise should report cash flows from operating activities using either :

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

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

The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either :

(a) from the accounting records of the enterprise; or

(b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statment of profit and loss for :

  (i) changes during the period in inventories and operating receivables and payables;

  (ii) other non-cash items; and

  (iii) other items for which the cash effects are investing or financing cash flows.

Under the indirect method, the net cash flow from operating activies is determined by adjusting net profit or loss for the effects of :

(a) changes during the period in inventories and operating receivables and payables;

(b non-cash items such as depreciation, provisions, deferred taxes and unrealised foreign exchange gains and losses; and

(c) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses, excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

*Question 5*

*What all are the differences between Cash Flow statement and Fund Flow statement?*

*(4 Marks) (PE-II – May 2006)*

Answer

Differences between cash flow statement and fund flow statement

(i) Cash flow statement deals with the change in cash position between two points of time. Fund flow statement deals with the changes in working capital position.

(ii) Cash flow statement contains opening as well as closing balances of cash and cash equivalents. The fund flow statement does not contain any such opening and closing balance.

(iii) Cash flow statement records only inflow and outflow of cash. Fund flow statement records sources and application of funds.

(iv) Fund flow statement can be prepared from the cash flow statement under indirect method. However, a cash flow statement cannot be prepared from fund flow statement.

(v) A statement of changes in working capital is usually prepared alongwith fund flow statement. No such statement is prepared along with the cash flow statement.

(B) Practical Questions:

Question 1

*Given below are the condensed Balance Sheets of Lambakadi Ltd. for two years and the statement of Profit and Loss for one year :*

*(Figures Rs. in lakhs)*

| As at 31st March | 1998 | 1997 |
|---|---|---|
| Share Capital | | |
| In equity shares of Rs. 100 each | 150 | 110 |
| 10% redeemable preference shares of Rs. 100 each | 10 | 40 |
| Capital redemption reserve | 10 | — |
| General reserve | 15 | 10 |
| Profit and loss account balance | 30 | 20 |
| 8% debentures with convertible option | 20 | 40 |
| Other term loans | 15 | 30 |
| | 250 | 250 |
| Fixed assets less depreciation | 130 | 100 |
| Long term investments | 40 | 50 |
| Working capital | 80 | 100 |
| | 250 | 250 |

*Statement of Profit and Loss for the year ended 31st March, 1998*

*(Figures Rs. in lakhs)*

| | | |
|---|---|---|
| Sales | | 600 |
| Less : Cost of sales | | 400 |
| | | 200 |
| Establishment charges | 30 | |
| Selling and distribution expenses | 60 | |
| Interest expenses | 5 | |
| Loss on sale of equipment (Book value Rs. 40 lakhs) | 15 | 110 |
| | | 90 |
| Interest income | 4 | |
| Dividend income | 2 | |
| Foreign exchange gain | 10 | |
| Damages received for loss of reputation | 14 | 30 |
| | | 120 |
| Depreciation | | 50 |
| | | 70 |
| Taxes | | 30 |
| | | 40 |
| Dividends | | 15 |
| Net profit carried to Balance Sheet | | 25 |

*Your are informed by the accountant that ledgers relating to debtors, creditors and stock for both the years were seized by the income-tax authorities and it would take atleast two months to obtain copies of the same. However, he is able to furnish the following data :*

*(Figures Rs. in lakhs)*

| | 1998 | 1997 |
|---|---|---|
| Dividend receivable | 2 | 4 |
| Interest receivable | 3 | 2 |
| Cash on hand and with bank | 7 | 10 |
| Investments maturing within two months | 3 | 2 |
| | 15 | 18 |
| Interest payable | 4 | 5 |
| Taxes payable | 6 | 3 |
| | 10 | 8 |
| Current ratio | 1.5 | 1.4 |
| Acid test ratio | 1.1 | 0.8 |

*It is also gathered that debentureholders owning 50% of the debentures outstanding as on 31.3.97 exercised the option for conversion into equity shares during the financial year and the same was put through.*

*You are required to prepare a direct method cash flow statement for the financial year, 1998 in accordance with para 18(a) of Accounting Standard (AS) 3 revised. (20 marks) (Final May 1998)*

Answer

Lambakadi Ltd.

Direct Method Cash Flow Statement

for the year ended 31st March, 1998

| | | |
|---|---|---|
| | | *(Rs. in lakhs)* |
| **Cash flows from operating activities** | | |
| Cash receipts from customers | 621 | |
| Cash paid to suppliers and employees | (496) | |
| Cash generated from operations | 125 | |
| Taxes paid | (27) | |
| Cash flows before extraordinary item | 98 | |
| Damages received for loss of reputation | 14 | |
| Net cash from operating activities | | 112 |
| **Cash flows from investing activities** | | |
| Purchase of fixed assets | (120) | |
| Proceeds from sale of equipment | 25 | |
| Proceeds from sale of long term investments | 10 | |
| Interest received | 3 | |
| Dividend received | 4 | |
| Net cash used in investing activities | | (78) |
| **Cash flows from financing activities** | | |
| Proceeds from issuance of share capital | 20 | |
| Redemption of preference share capital | (30) | |
| Repayments of term loans | (15) | |
| Interest paid | (6) | |
| Dividend paid | (15) | |
| Net cash used in financing activities | | (46) |
| **Net increase in cash and cash equivalents** | | (12) |
| **Cash and cash equivalents at beginning of period** | | 12 |
| (See Note 1 to the Cash Flow Statement) | | |
| **Cash and cash equivalents at end of the period** | | |
| (See Note 1 to the Cash Flow Statement) | | NIL |

**Notes to the Cash Flow Statement**

| | | |
|---|---|---|
| | | *(Rs. in lakhs)* |
| 1. Cash and Cash Equivalents | *31.3.1998* | *31.3.1997* |
| Cash on hand and with bank | 7 | 10 |
| Short-term investments | 3 | 2 |

| | | |
|---|---|---|
| | 10 | 12 |
| Effect of exchange rate changes | (10) | – |
| Cash and cash equivalents | Nil | 12 |

2. Conversion of debentures into equity shares, a non-cash transaction, amounted to Rs.20 lakhs.

Working Notes :

*(Rs. in lakhs)*

| | | | |
|---|---|---|---|
| 1. | Calculation of debtors, creditors and stock | *31.3.98* | *31.3.97* |
| (a) | Current Ratio | 1.5:1 | 1.4:1 |
| | Working Capital to Current Liabilities Ratio | 0.5:1 | 0.4:1 |
| | Working Capital (Rs.in lakhs) | 80 | 100 |
| | Current Assets (Rs.in lakhs) | $\frac{80 \times 1.5}{0.5} = 240$ | $\frac{10 \times 1.4}{0.4} = 350$ |
| | Current Liabilities (Rs.in lakhs) | 240 – 80 = 160 | 350 – 100 = 250 |
| (b) | Current Ratio | 1.5 | 1.4 |
| | *Less :* Acid Test Ratio | 1.1 | 0.8 |
| | | 0.4 | 0.6 |
| | Stock : Current Liabilities | 0.4:1 | 0.6:1 |
| | Stock (Rs.in lakhs) | 160 × 0.4 = 64 | 250 × 0.6 = 150 |

*(Rs. in lakhs)*

| | | | |
|---|---|---|---|
| (c) | Break-up of Current Assets | | |
| | Stock | 64 | 150 |
| | Debtors (Balancing figures) | 161 | 182 |
| | Other Current Assets | 15 | 18 |
| | | 240 | 350 |
| (d) | Break-up of Current Liabilities | | |
| | Creditors (Balancing figures) | 150 | 242 |
| | Others | 10 | 8 |
| | | 160 | 250 |

| | | | |
|---|---|---|---|
| 2. | Cash receipts from customers | | |
| | Sales | | 600 |
| | *Add:* Debtors at the beginning of the year | | 182 |
| | | | 782 |
| | *Less :* Debtors at the end of the year | | 161 |
| | | | 621 |
| 3. | Cash paid to suppliers and employees | | |
| | Cost of sales | | 400 |
| | Establishment charges | | 30 |
| | Selling and distribution expenses | | 60 |
| | | | 490 |
| | *Add:* Creditors at the beginning of the year | 242 | |
| | Stock at the end of the year | 64 | 306 |
| | | | 796 |
| | *Less :* Creditors at the end of year | 150 | |
| | Stock at the beginning of the year | 150 | 300 |
| | | | 496 |

4. Taxes paid

| | |
|---|---|
| Tax expense for the year | 30 |
| *Add :* Tax liability at the beginning of the year | 3 |
| | 33 |
| *Less :* Tax liability at the end of year | 6 |
| | 27 |

5. Fixed assets acquisitions

| | |
|---|---|
| W.D.V. at 31.3.1998 | 130 |
| *Add back :* Depreciation for the year | 50 |
| Disposals | 40 |
| | 220 |
| *Less :* W.D.V. at 31.3.1997 | 100 |
| Purchase of fixed assets | 120 |

6. Interest received

| | |
|---|---|
| Interest income for the year | 4 |
| *Add :* Amount receivable at the beginning of the year | 2 |
| | 6 |
| *Less :* Amount receivable at the end of the year | 3 |
| | 3 |

7. Dividend received

| | |
|---|---|
| Dividend income for the year | 2 |
| *Add :* Amount receivable at the beginning of the year | 4 |
| | 6 |
| *Less :* Amount receivable at the end of the year | 2 |
| | 4 |

8. Issue of shares

| | |
|---|---|
| Equity share capital at the end of the year | 150 |
| *Less :* Equity share capital at the beginning of the year | 110 |
| | 40 |
| *Less :* Conversion of debentures into equity shares during the year (non-cash transaction) | 20 |
| Cash flow from issue of equity shares | 20 |

9. Interest paid

| | |
|---|---|
| Interest expense for the year | 5 |
| *Add :* Interest payable at the beginning of the year | 5 |
| | 10 |
| *Less :* Interest payable at the end of the year | 4 |
| | 6 |

Notes :

1. It has been assumed that dividends for the year, Rs. 15 lakhs have been paid off.

2. It has been assumed that foreign exchange gain represents the effect of changes in exchange rates on cash and cash equivalents held in a foreign currency.

## Question 2

*The following are the changes in the account balances taken from the Balance Sheets of PQ Ltd. as at the beginning and end of the year. :*

| | *Changes in Rupees in debt or [credit]* |
|---|---|
| *Equity share capital 30,000 shares of Rs. 10 each issued and fully paid* | *0* |
| *Capital reserve* | *]49,200]* |
| *8% debentures* | *[50,000]* |
| *Debenture discount* | *1,000* |
| *Freehold property at cost/revaluation* | *43,000* |
| *Plant and machinery at cost* | *60,000* |
| *Depreciation on plant and machinery* | *[14,400]* |
| *Debtors* | *50,000* |
| *Stock and work-in-progress* | *38,500* |
| *Creditors* | *[11,800]* |
| *Net profit for the year* | *[76,500]* |
| *Dividend paid in respect of earlier year* | *30,000* |
| *Provision for doubtful debts* | *[3,300]* |
| *Trade investments at cost* | *47,000* |
| *Bank* | *[64,300]* |
| | *0* |

*You are informed that.*

*(a) Capital reserve as at the end of the year represented realised profits on sale of one freehold property together with surplus arising on the revaluation of balance of freehold properties.*

*(b) During the year plant costing Rs. 18,000 against which depreciation provision of Rs. 13,500 was lying, was sold for Rs. 7,000.*

*(c) During the middle of the year Rs. 50,000 debentures were issued for cash at a discount of Rs. 1,000.*

*(d) The net profit for the year was after crediting the profit on sale of plant and charging debenture interest.*

*You are required to prepare a statement which will explain, why bank borrowing has increased by Rs. 64,300 during the year end. Ignore taxation. (15 marks)(Final Nov. 1998)*

## Answer

**PQ Ltd.**

**Cash Flow Statement for the year ended...**

| | | *Rs.* |
|---|---|---|
| *Cash flows from operating activities* | | |
| Net profit | 76,500 | |
| Adjustments for : | | |
| Depreciation | 27,900 | |
| Profit on sale of plant | (2,500) | |
| Interest expense | 2,000 | |

| | | |
|---|---|---|
| Operating profit before working capital changes | 1,03,900 | |
| Increase in debtors (less provision) | (46,700) | |
| Increase in stock and work-in-progress | (38,500) | |
| Increase in creditors | 11,800 | |
| Net cash operating activities | | 30,500 |
| *Cash flows from investing activities* | | |
| Purchase of plant and machinery | (78,000) | |
| Proceeds from sale of plant | 7,000 | |
| Proceeds from sale of freehold property | 6,200 | |
| Increase in trade investments | (47,000) | |
| Net cash used in investing activities | | (1,11,800) |
| *Cash flows from financing activities* | | |
| Proceeds from issuance od debentures at discount | 49,000 | |
| Debenture interest paid | (2,000) | |
| Dividend paid in financing activities | (30,000) | |
| Net cash from financing activities | | 17,000 |
| *Excess of outflows over inflows* | | 64,300 |

Thus the shortfall of Rs. 64,300 was made up through borrowing from bank.

Working Notes :

| | |
|---|---|
| (1) *Plant and Machinery* | *Rs* |
| Amount of increase (at cost) | 60,000 |
| *Add :* Disposal (at cost) | 18,000 |
| Acquisition during the year | 78,000 |
| Disposal of plant : | |
| proceeds from sale | 7,000 |
| Net book value (18,000 – 13,500) | 4,500 |
| Profit on sale | 2,500 |
| (2) *Freehold property* | |
| Capital Reserve | 49,200 |
| *Less :* Increase in freehold property (closing balance minus opening balance) | 43,000 |
| Proceeds from sale of freehold property | 6,200 |

*Memorandum Accounts*

*(a)* *Plant and Machinery Account*

| | | *Rs.* | | | *Rs.* |
|---|---|---|---|---|---|
| To | Balance b/d | | By | Bank (Sale proceeds) | 7,000 |
| To | Profit and Loss A/c | 2,500 | By | Provision for Depreciation | 13,500 |
| | (Profit on sale) | | By | Balance c/d | 60,000 |
| To | Bank (Balancing figure) | 78,000 | | | |
| | | 80,500 | | | 80,500 |

*(b)* *Provision for Depreciation (Plant and Machinery) Account*

| | | | | | |
|---|---|---|---|---|---|
| To | Plant and Machinery A/c | 13,500 | By | Balance b/d | |
| To | Balance c/d | 14,400 | By | Profit and Loss A/c | 27,900 |
| | | | | (Balancing figure) | |

| | | | | |
|---|---|---|---|---|
| | 27,900 | | | 27,900 |

*(c)* *Freehold Property Account*

| | | | | | |
|---|---|---|---|---|---|
| To | Balance b/d | — | By | Bank A/c (Balancing figure) | 6,200 |
| To | Capital reserve | 49,200 | By | Balance c/d | 43,000 |
| | | 49,200 | | | 49,200 |

In the absence of information about the opening balances, the entire amount of change has been considered under the closing balances for the purpose of calculation of missing figures.

Notes :

(1) Investment income and dividend pertaining to the current year have not been considered in the absence of any related information.

(2) Debenture interest has been calculated for 6 months @ 8% on Rs. 50,000.

Question 3

*Examine the following schedule prepared by K Ltd.*

*K Ltd.*

*Schedule of funds provided by operations for the year ended 31st July, 1999*

| | | (Rs.'000) | (Rs.'000) |
|---|---|---|---|
| Sales | | 32,760 | |
| Add : Decrease in bills receivable. | | 1,000 | |
| Less : Increase in accounts receivable | | (626) | |
| Inflow from operating revenues | | | 33,134 |
| Cost of goods sold | 18,588 | | |
| Less : Decrease in inventories | (212) | | |
| Add : Decrease in trades payable | 81 | 18,457 | |
| Wages and Salaries | 5,284 | | |
| Less : Increase in wages payable | (12) | 5,272 | |
| Administrative Expenses | 3,066 | | |
| Add : Increase in prepaid expenses | 11 | 3,077 | |
| Property taxes | | 428 | |
| Interest expenses | 532 | | |
| Add : Amortisation of premium on bonds payable | 20 | 552 | |
| Outflow from operating expenses | | | 27,786 |
| From operations | | | 5,348 |
| Rent Income | 207 | | |
| Add : Increase in unearned rent | 3 | | 210 |
| | | | 5,558 |
| Income tax | 1,330 | | |
| Less : Increase in deferred tax | 50 | | 1,280 |

| | |
|---|---|
| *Funds from operations* | *4,278* |

*Required :*

*(i) What is the definition of funds shown in the schedule?*

*(ii) What amount was reported as gross margin in the income statement?*

*(iii) How much cash was collected from the customers?*

*(iv) How much cash was paid for the purchases made?*

*(v) As a result of change in inventories, did the working capital increase or decrease and by what amount?*

*(vi) How much rent was actually earned during the year?*

*(vii) What was the amount of tax expenses reported on the income statement?*

*Can you reconcile the profit after tax-with the funds provided by the operations?*

*(16 marks)(Final May 2000)*

Answer

(i) 'Funds' shown in the schedule refer to the cash and cash equivalents [as defined in AS 3 (Revised) on Cash Flow Statements].

(ii) Gross margin in the income statement :

| | Rs. ('000) |
|---|---|
| Sales | 32,760 |
| Cost of goods sold | 18,588 |
| | 14,172 |

| | | |
|---|---|---|
| (iii) | Cash collected from the customers | 33,134 |
| (iv) | Cash paid for purchases made | 18,457 |
| (v) | Change in inventories would reduce the working capital by | 212 |
| (vi) | Rental income earned during the year | 207 |
| (vii) | Tax expenses reported in the income statement | 1330 |

(Viii) Reconciliation Statement

| | *Rs.('000)* |
|---|---|
| Profit after tax (See W.N.) | 3,719 |
| Decrease in bills receivable | 1,000 |
| Increase in accounts receivable | (626) |
| Decrease in inventories | 212 |
| Decrease in trades payable | (81) |
| Increase in wages payable | 12 |
| Increase in prepaid expenses | (11) |
| Increase in unearned rent | 3 |
| Increase in deferred tax | 50 |
| Funds from operations as shown in the schedule (i.e. cash and cash equivalents) | 4,278 |

Working Note :

| *Calculation of Profit after Tax* | | *Rs. ('000)* |
|---|---|---|
| Sales | | 32,760 |
| *Less :* Cost of goods sold | | 18,588 |
| Gross margin | | 14,172 |
| *Add :* Rental income | | 207 |
| | | 14,379 |
| *Less :* Wages and salaries | 5,284 | |
| Administrative expenses | 3,066 | |
| Property taxes | 428 | |
| Interest expenses | 532 | |
| Amortisation of premium on bonds payable | 20 | |
| | | 9,330 |
| Profit before tax | | 5,049 |
| *Less :* Income tax | | 1,330 |
| Profit after tax | | 3,719 |

Question 4

*Ms. Joyti of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year 2000 :*

| | *(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 2000 in accordance with AS 3, Cash Flow Statements issued by the Institute of Chartered Accountants of India. (make necessary assumptions).(16 marks)(Final May 2001)*

Answer

Star Oils Limited

Cash Flow Statement

for the year ended 31st December, 2000

*(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 |

Working note :

| | |
|---|---|
| Book value of the assets sold | 185 |
| *Less :* Loss on sale of assets | 40 |
| Proceeds on sale | 145 |

Assumption :

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

Question 5

*From the following Summary Cash Account of X Ltd. prepare Cash Flow Statement for the year ended 31st March, 2001 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 31.3.2001*

| | *Rs. '000* | | *Rs. '000* |
|---|---|---|---|
| *Balance on 1.4.2000* | *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 31.3.2001* | *150* |
| | *3,250* | | *3,250* |

*(8 marks)(Final Nov. 2001)*

Answer

X Ltd.

Cash Flow Statement for the year ended 31st March, 2001

(Using the direct method)

| | *Rs. '000* | *Rs.'000* |
|---|---|---|
| Cash flows from operating activities | | |
| 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 | 500 | |
| Income tax paid | (250) | |
| Net cash from operating activities | | 250 |
| 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 |

Question 6

*From the following details relating to the Accounts of Grow More Ltd. prepare Cash Flow Statement:*

| *Liabilities* | *31.03.2002 (Rs.)* | *31.03.2001 (Rs.)* |
|---|---|---|
| *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* | *7,00,000* | *8,20,000* |
| | *25,00,000* | *20,00,000* |
| *Assets* | | |
| *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* | *2,00,000* | *2,00,000* |
| | *25,00,000* | *20,00,000* |

*(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.*

*Prepare Cash flow Statement.* *(16 marks) (PE-II–Nov. 2002)*

Answer

Grow More Ltd

Cash Flow Statement

for the year ended 31st March, 2002

Cash Flow from Operating Activities

| | |
|---|---|
| Net Profit | 40,000 |
| Proposed Dividend | 2,00,000 |
| Provision for taxation | 80,000 |
| Transfer to General Reserve | 50,000 |
| Depreciation | 1,25,000 |
| Profit on sale of Plant and Machinery | (15,000) |
| Operating Profit before Working Capital changes | 4,80,000 |
| Increase in Stock | (2,00,000) |
| Decrease in debtors | 2,00,000 |
| Decrease in creditors | (1,20,000) |

| | | | |
|---|---|---|---|
| Cash generated from operations | | 3,60,000 | |
| Income tax paid | | (50,000) | |
| Net Cash from operating activities | | | 3,10,000 |
| Cash Flow from Inventing Activities | | | |
| Purchase of fixed assets | (3,45,000) | | |
| Expenses on building | (2,00,000) | | |
| Increase in investments | (1,00,000) | | |
| Sale of old machine | 35,000 | | |
| Net Cash used ininvesting activities | | | (6,10,000) |
| Cash Flow from financing activities: | | | |
| Proceeds from issue of shares | 2,00,000 | | |
| Proceeds from issue of debentures | 2,00,000 | | |
| Dividend paid | (1,00,000) | | |
| Net cash used in financing activities | | | 3,00,000 |
| Net increase in cash or cash equivalents | | | NIL |
| Cash and Cash equivalents at the beginning of the year | | | 2,00,000 |
| Cash and Cash equivalents at the end of the year | | | 2,00,000 |

Working Notes:

Provision for taxation account

| | | *Rs.* | | | *Rs.* |
|---|---|---|---|---|---|
| To | Cash (Paid) | 50,000 | By | Balance b/d | 70,000 |
| To | Balance c/d | 1,00,000 | By | Profit and Loss A/c (Balancing figure) | 80,000 |
| | | 1,50,000 | | | 1,50,000 |

Plant and Machinery account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| To | Balance b/d | 5,00,000 | By | Depreciation | 1,25,000 |
| To | Cash (Balancing figure) | 3,45,000 | By | Cash (sale of machine) | 20,000 |
| | | | By | Balance c/d | 7,00,000 |
| | | 8,45,000 | | | 8,45,000 |

Question 7

From the following Balance Sheet and information, prepare Cash Flow Statement of Ryan Ltd. for the year ended 31st March, 2003:

*Balance Sheet*

| | *31st March, 2003* | *31st March, 2002* |
|---|---|---|
| | *Rs.* | *Rs.* |
| *Liabilities* | | |
| *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* | *90,000* | *60,000* |
| | *15,00,000* | *12,50,000* |

| | *31st March, 2003* | *31st March, 2002* |
|---|---|---|
| | *Rs.* | *Rs.* |
| *Assets* | | |
| *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* | *1,25,000* | *65,000* |
| | *15,00,000* | *12,50,000* |

*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, 2002 a 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. (20 marks) (PE-II–May 2003)*

Answer

Cash Flow Statement of Ryan Limited

For the year ended 31st March, 2003

| Cash flow from operating activities | *Rs.* | *Rs.* |
|---|---|---|
| Net Profit before taxation | 2,45,000 | |
| Adjustment for | | |
| Depreciation | 1,35,000 | |
| Preliminary expenses | 15,000 | |
| Profit on sale of plant | (40,000) | |
| Profit on sale of investments | (20,000) | |
| Interest on debentures | 18,000 | |
| Operating profit before working capital changes | 3,53,000 | |
| Increase in inventory | (5,000) | |
| Decrease in bills receivable | 5,000 | |
| Increase in debtors | (45,000) | |
| Increase in creditors | 15,000 | |
| Decrease in bills payable | (10,000) | |
| Increase in accrued liabilities | 10,000 | |
| Cash generated from operations | 3,23,000 | |
| Income taxes paid | (1,00,000) | |
| | 2,23,000 | |
| Voluntary separation payments | (1,10,000) | |
| Net cash from operating activities | | 1,13,000 |
| Cash flow from investing activities | | |
| Proceeds from sale of land | 1,50,000 | |
| Proceeds from sale of plant | 90,000 | |
| Proceeds from sale of investments | 70,000 | |

| | | |
|---|---|---|
| Purchase of plant | (3,50,000) | |
| Purchase of investments | (25,000) | |
| Pre-acquisition dividend received | 5,000 | |
| Net cash used in investing activities | | (60,000) |
| **Cash flow from financing activities** | | |
| Proceeds from issue of equity shares | 1,00,000 | |
| Proceeds from issue of debentures | 1,00,000 | |
| Redemption of preference shares | (2,00,000) | |
| Dividends paid | (60,000) | |
| Interest paid on debentures | (18,000) | |
| Net cash used in financing activities | | (78,000) |
| Net decrease in cash and cash equivalents | | (25,000) |
| Cash and cash equivalents at the beginning of the year | | 90,000 |
| **Cash and Cash equivalents at the end of the year** | | 65,000 |

Working Notes:

1.

| | *Rs.* |
|---|---|
| Net profit before taxation | |
| Retained profit | 70,000 |
| Less: Balance as on 31.3.2002 | (50,000) |
| | 20,000 |
| Provision for taxation | 1,35,000 |
| Proposed dividend | 90,000 |
| | 2,45,000 |

2. Land and Building Account

| | | *Rs.* | | | *Rs.* |
|---|---|---|---|---|---|
| To | Balance b/d | 2,00,000 | By | Cash (Sale) | 1,50,000 |
| To | Capital reserve (Profit on sale) | 30,000 | By | Balance c/d | 1,50,000 |
| To | Capital reserve (Revaluation profit) | 70,000 | | | |
| | | 3,00,000 | | | 3,00,000 |

3. Plant and Machinery Account

| | | *Rs.* | | | *Rs.* |
|---|---|---|---|---|---|
| To | Balance b/d | 5,00,000 | By | Cash (Sale) | 90,000 |
| To | Profit and loss account | 40,000 | By | Depreciation | 1,35,000 |
| To | Debentures | 1,00,000 | By | Balance c/d | 7,65,000 |
| To | Bank | 3,50,000 | | | |
| | | 9,90,000 | | | 9,90,000 |

4. Investments Account

| | | *Rs.* | | | *Rs.* |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| To | Balance b/d | 80,000 | By | Cash (Sale) | 70,000 |
| To | Profit and loss account | 20,000 | By | Dividend | |
| To | Bank (Balancing figure) | 25,000 | | (Pre-acquisition) | 5,000 |
| | | | By | Balance c/d | 50,000 |
| | | 1,25,000 | | | 1,25,000 |

5. Capital Reserve Account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| To | Balance c/d | 1,00,000 | By | Profit on sale of land | 30,000 |
| | | | By | Profit on revaluation of land | 70,000 |
| | | 1,00,000 | | | 1,00,000 |

6. General Reserve Account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| To | Voluntary separation cost | 50,000 | By | Balance b/d | 2,50,000 |
| To | Capital redemption reserve | 1,00,000 | | | |
| To | Balance c/d | 1,00,000 | | | |
| | | 2,50,000 | | | 2,50,000 |

7. Proposed Dividend Account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| To | Bank (Balancing figure) | 60,000 | By | Balance b/d | 60,000 |
| To | Balance c/d | 90,000 | By | Profit and loss account | 90,000 |
| | | 1,50,000 | | | 1,50,000 |

8. Provision for Taxation Account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| To | Bank (Balancing figure) | 1,00,000 | By | Balance b/d | 60,000 |
| To | Balance c/d | 95,000 | By | Profit and loss account | 1,35,000 |
| | | 1,95,000 | | | 1,95,000 |

9. Voluntary Separation Payments Account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| To | Balance b/d | 65,000 | By | General reserve | 50,000 |
| To | Bank (Balancing figure) | 1,10,000 | By | Balance c/d | 1,25,000 |
| | | 1,75,000 | | | 1,75,000 |

**Note:** Cash Flow statement has been prepared using 'indirect method'.

## Question 8

*The Balance Sheet of New Light Ltd. for the years ended 31st March, 2001 and 2002 are as follows:*

| *Liabilities* | *31st March 2001* | *31st March 2002* | *Assets* | *31st March 2001* | *31st March 2002* |
|---|---|---|---|---|---|

| | (Rs.) | (Rs.) | | (Rs.) | (Rs.) |
|---|---|---|---|---|---|
| *Equity share capital* | *12,00,000* | *16,00,000* | *Fixed Assets* | *32,00,000* | *38,00,000* |
| *10% Preference* | | | *Less: Depreciation* | *9,20,000* | *11,60,000* |
| *share capital* | *4,00,000* | *2,80,000* | | *22,80,000* | *26,40,000* |
| *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* | | | |
| | *38,80,000* | *43,20,000* | | *38,80,000* | *43,20,000* |

*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.*

*(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 31.3.2001 was Rs. 2,16,000. The stock on 31.3.2002 was correctly valued at Rs. 3,00,000.*

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

*(16 marks) (PE-II–Nov. 2003)*

Answer

New Light Ltd.

Cash Flow Statement for the year ended 31st March, 2002

| | | Rs. | Rs. |
|---|---|---|---|
| A. | Cash Flow from operating activities | | |
| | 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 | 3,40,000 | |
| | 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 | 6,000 | |
| | Operating profit before working capital changes | 10,88,000 | |
| | Increase in current liabilities (Rs.5,20,000 –Rs.4,80,000) | 40,000 | |
| | Increase in other current assets [Rs.13,10,000 – (Rs.11,10,000 + Rs.24,000)] | (1,76,000) | |
| | Cash generated from operations | 9,52,000 | |
| | Income taxes paid | (3,60,000) | |
| | 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 | 1,20,000 | |
| | 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 (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 | (1,04,000) | |
| | Net Cash from financing activities | | 44,000 |
| | Net increase/decrease in cash and cash equivalent during the year | | Nil |
| | Cash and cash equivalent at the beginning of the year | | 10,000 |
| | Cash and cash equivalent at the end of the year | | 10,000 |

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:

Rs. 11,10,000 + Rs. 24,000 = 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

Rs. 2,40,000 + Rs. 24,000 = Rs. 2,64,000

2. Investment Account

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

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 (balancing figure being assets purchased) | 8,56,000 | By | Accumulated depreciation A/c | 80,000 | |
| | | | By | Profit and loss A/c(loss on sale of assets) | 20,000 | 2,00,000 |
| | | | By | Accumulated depreciation A/c | 40,000 | |
| | | | By | Profit and loss A/c (assets written off) | 16,000 | 56,000 |
| | | | By | Balance c/d | | 38,00,000 |
| | | 40,56,000 | | | | 40,56,000 |

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) | 3,60,000 |
| To | Balance c/d | 11,60,000 | | | |
| | | 12,80,000 | | | 12,80,000 |

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.

## Question 9

*ABC Ltd. gives you the following informations. You are required to prepare Cash Flow Statement by using indirect methods as per AS 3 for the year ended 31.03.2004:*

*Balance Sheet as on*

| *Liabilities* | *31st March 2003* | *31st March 2004* | *Assets* | *31st March 2003* | *31st March 2004* |
|---|---|---|---|---|---|
| | *Rs.* | *Rs.* | | *Rs.* | *Rs.* |
| *Capital* | *50,00,000* | *50,00,000* | *Plant & Machinery* | *27,30,000* | *40,70,000* |
| *Retained Earnings* | *26,50,000* | *36,90,000* | *Less: Depreciation* | *6,10,000* | *7,90,000* |
| *Debentures* | – | *9,00,000* | | *21,20,000* | *32,80,000* |
| *Current Liabilities* | | | *Current Assets* | | |
| *Creditors* | *8,80,000* | *8,20,000* | *Debtors* | *23,90,000* | *28,30,000* |
| *Bank Loan* | *1,50,000* | *3,00,000* | *Less: Provision* | *1,50,000* | *1,90,000* |
| *Liability for expenses* | *3,30,000* | *2,70,000* | | *22,40,000* | *26,40,000* |
| *Dividend payable* | *1,50,000* | *3,00,000* | *Cash* | *15,20,000* | *18,20,000* |
| | | | *Marketable securities* | *11,80,000* | *15,00,000* |
| | | | *Inventories* | *20,10,000* | *19,20,000* |
| | | | *Prepaid Expenses* | *90,000* | *1,20,000* |

| | | | | |
|---|---|---|---|---|
| | *91,60,000* | *1,12,80,000* | *91,60,000* | *1,12,80,000* |

*Additional Information:*

*(i) Net profit for the year ended 31st March, 2004, after charging depreciation Rs. 1,80,000 is Rs. 22,40,000.*

*(ii) Debtors of Rs. 2,30,000 were determined to be worthless and were written off against the provisions for doubtful debts account during the year.*

*(ii) ABC Ltd. declared dividend of Rs. 12,00,000 for the year 2003-2004.*

*(16 marks) (PE-II–May 2004)*

Answer

Cash flow Statement of ABC Ltd. for the year ended 31.3.2004

| Cash flows from Operating activities | | *Rs.* | *Rs.* |
|---|---|---|---|
| Net Profit | | 22,40,000 | |
| *Add:* Adjustment for Depreciation (Rs.7,90,000 – Rs.6,10,000) | | 1,80,000 | |
| Operating profit before working capital changes | | 24,20,000 | |
| *Add:* Decrease in Inventories (Rs.20,10,000 – Rs.19,20,000) | | 90,000 | |
| Increase in provision for doubtful debts (Rs. 4,20,000 – Rs.1,50,000) | | 2,70,000 | |
| | | 27,80,000 | |
| *Less:* Increase in Current Assets: | | | |
| Debtors (Rs. 30,60,000 – Rs.23,90,000) | 6,70,000 | | |
| Prepaid expenses (Rs. 1,20,000 – Rs.90,000) | 30,000 | | |
| Decrease in current liabilities: | | | |
| Creditors (Rs. 8,80,000 – Rs. 8,20,000) | 60,000 | | |
| Expenses outstanding (Rs. 3,30,000 – Rs.2,70,000) | 60,000 | 8,20,000 | |
| *Net cash from operating activities* | | | 19,60,000 |
| Cash flows from Investing activities | | | |
| Purchase of Plant & Equipment (Rs. 40,70,000 – Rs.27,30,000) | | 13,40,000 | |
| *Net cash used in investing activities* | | | (13,40,000) |
| Cash flows from Financing Activities | | | |
| Bank loan raised (Rs. 3,00,000 – Rs. 1,50,000) | | 1,50,000 | |
| Issue of debentures | | 9,00,000 | |
| Payment of Dividend (Rs. 12,00,000 – Rs. 1,50,000) | | (10,50,000) | |
| *Net cash used in financing activities* | | | NIL |
| Net increase in cash during the year | | | 6,20,000 |
| *Add:* Cash and cash equivalents as on 1.4.2003 | | | |

| | |
|---|---|
| (Rs. 15,20,000 + Rs.11,80,000) | 27,00,000 |
| Cash and cash equivalents as on 31.3.2004 | |
| (Rs. 18,20,000 + Rs.15,00,000) | 33,20,000 |

**Note:** Bad debts amounting Rs. 2,30,000 were written off against provision for doubtful debts account during the year. In the above solution, Bad debts have been added back in the balances of provision for doubtful debts and debtors as on 31.3.2004. Alternatively, the adjustment of writing off bad debts may be ignored and the solution can be given on the basis of figures of debtors and provision for doubtful debts as appearing in the balance sheet on 31.3.2004.

Question 10

*From the following balance sheets of Sneha Ltd. as on 31.3.2003 and 31.3.2004 prepare a statement of sources and applications of fund and a schedule of changes in working capital for the year ending 31.3.2004:*

Balance Sheets

| *Liabilities* | *31.3.2003* | *31.3.2004* | *Assets* | *31.3.2003* | *31.3.2004* |
|---|---|---|---|---|---|
| | *Rs.* | *Rs.* | | *Rs.* | *Rs.* |
| *Equity share capital* | *13,00,000* | *16,90,000* | *Goodwill* | *65,000* | *42,500* |
| *Profit and loss account* | *4,90,100* | *8,77,500* | *Building* | *11,70,000* | *11,37,500* |
| *10% Debentures* | *16,25,000* | *13,00,000* | *Machinery* | *16,18,500* | *21,38,500* |
| *Creditors* | *9,00,000* | *10,00,000* | *Non-trade investments* | *5,07,000* | *3,93,250* |
| *Bills payable* | *42,500* | *1,70,000* | *Debtors* | *4,16,000* | *11,70,000* |
| *Provision for tax* | *2,60,000* | *9,75,000* | *Stock* | *5,07,000* | *7,99,500* |
| *Dividend payable* | – | *42,250* | *Cash* | *2,60,000* | *2,92,500* |
| | | | *Prepaid expenses* | *42,250* | *52,000* |
| | | | *Debenture discount* | *31,850* | *29,000* |
| | *46,17,600* | *60,54,750* | | *46,17,600* | *60,54,750* |

*The following additional information is given:*

*(i)*

| | *Building* | *Machinery* |
|---|---|---|
| | *Rs.* | *Rs.* |
| *Accumulated depreciation 31.3.2003* | *4,87,500* | *15,92,500* |
| *Accumulated depreciation 31.3.2004* | *5,20,000* | *15,66,500* |
| *Depreciation for 2003-2004* | *32,500* | *1,36,500* |

*(ii)* *Profit and loss account for 2003-2004 is as follows:*

| | *Rs.* |
|---|---|
| *Balance as on 31.3.2003* | *4,90,100* |
| *Add: Profit for 2003-2004* | *4,71,900* |
| | *9,62,000* |
| *Less: Dividend* | *84,500* |
| | *8,77,500* |

*(iii)* *During 2003-2004 machinery costing Rs. 2,92,500 was sold for Rs. 97,500.*

*(iv)* *Investments which were sold for Rs. 1,17,000 had cost Rs. 97,500.*

*(v)* *Provision for Taxation and Dividend are to be taken as Non-current liabilities.*

*(20 marks) (PE-II–Nov. 2004)*

Answer

(a)

Sneha Ltd.
Fund Flow Statement
for the year ended 31st March, 2004

| | Amount (Rs.) |
|---|---|
| *Sources of funds* | |
| Share capital | 3,90,000 |
| (Rs. 16,90,000 – Rs. 13,00,000) | |
| Sale of machinery | 97,500 |
| Sale of investments | 1,17,000 |
| Funds from operation (W.N. 1) | 16,70,500 |
| | 22,75,000 |
| *Applications of funds* | |
| Debentures redeemed | 3,25,000 |
| (Rs. 16,25,000 – Rs. 13,00,000) | |
| Machinery purchased (W.N. 4) | 7,86,500 |
| Tax paid* | 2,60,000 |
| Dividend (Rs. 84,500 – Rs. 42,250) | 42,250 |
| Increase in working capital | 8,61,250 |
| | 22,75,000 |

Schedule of Changes in Working Capital
for the year ended 31st March, 2004

| | | Balance as on | | Changes in working capital | |
|---|---|---|---|---|---|
| | | 1.4.2003 | 31.3.2004 | Increase | Decrease |
| | | Rs. | Rs. | Rs. | Rs. |
| *Current Assets:* | | | | | |
| Debtors | | 4,16,000 | 11,70,000 | 7,54,000 | – |
| Stock | | 5,07,000 | 7,99,500 | 2,92,500 | – |
| Cash | | 2,60,000 | 2,92,500 | 32,500 | – |
| Prepaid expenses | | 42,250 | 52,000 | 9,750 | – |
| | A | 12,25,250 | 23,14,000 | | |
| *Current Liabilities:* | | | | | |
| Creditors | | 9,00,000 | 10,00,000 | | 1,00,000 |
| Bills payable | | 42,500 | 1,70,000 | | 1,27,500 |
| | B | 9,42,500 | 11,70,000 | 10,88,750 | 2,27,500 |
| Working capital (A – B) | | 2,82,750 | 11,44,000 | | |
| Increase in working capital | | | | — | 8,61,250 |
| | | | | 10,88,750 | 10,88,750 |

* The provision for taxation has been treated as a non-current liability as per the requirement of the question. Last year's provision for taxation amounting Rs. 2,60,000 has been assumed to be paid in the current year ended 31st March, 2004.

Working Notes:

1. Statement showing funds generated from operations

| | | | | (Rs.) |
|---|---|---|---|---|
| Increase in profit and loss account during the year (Rs. 8,77,500 – Rs. 4,90,100) | | | | 3,87,400 |
| *Add:* Non-cash expenditures | | | | |
| (1) | Loss on sale of machinery (W.N. 4) | | 32,500 | |
| (2) | Investments written off (W.N. 2) | | 16,250 | |
| (3) | Provision for tax | | 9,75,000 | |
| (4) | Depreciation | | | |
| | on building (Rs. 11,70,000 – Rs. 11,37,500) | 32,500 | | |
| | on machinery (W.N. 3) | 1,36,500 | 1,69,000 | |
| (5) | Goodwill written off (Rs. 65,000 – Rs. 42,500) | | 22,500 | |
| (6) | Debenture discount written off (Rs. 31,850 – Rs. 29,000) | | 2,850 | |
| (7) | Dividend | | 84,500 | 13,02,600 |
| | | | | 16,90,000 |
| *Less:* Non-cash incomes | | | | |
| (1) | Profit on sale of investments (Rs. 1,17,000 – Rs. 97,500) | | | 19,500 |
| Funds from operations | | | | 16,70,500 |

2. Non Trade Investment Account

| *Dr.* | | *Rs.* | | *Cr.* | *Rs.* |
|---|---|---|---|---|---|
| To | Balance b/d | 5,07,000 | By | Bank -Sale | 1,17,000 |
| To | Profit on sale (Rs. 1,17,000 – Rs. 97,500) | 19,500 | By | Profit and loss account – written off (balancing figure) | 16,250 |
| | | | By | Balance c/d | 3,93,250 |
| | | 5,26,500 | | | 5,26,500 |

3. Provision for Depreciation on Machinery Account

| Dr. | | Rs. | | | Cr. Rs. |
|---|---|---|---|---|---|
| To | Machinery -sale (balancing figure) | 1,62,500 | By | Balance b/d | 15,92,500 |
| | | | By | Depreciation | 1,36,500 |
| To | Balance c/d | 15,66,500 | | | |
| | | 17,29,000 | | | 17,29,000 |

4. Machinery Account

| Dr. | | | Rs. | | | | Cr. Rs. |
|---|---|---|---|---|---|---|---|
| To | Balance b/d | 16,18,500 | | By | Bank (sale) | | 97,500 |
| | *Add:* Provision for depreciation | 15,92,500 | 32,11,000 | By | Depreciation | | 1,62,500 |
| | | | | By | Loss on sale | | 32,500 |
| To | Bank -purchase (balancing figure) | | 7,86,500 | By | Balance c/d W.D.V. | 21,38,500 | |
| | | | | | *Add:* Provision for depreciation | 15,66,500 | 37,05,000 |
| | | | 39,97,500 | | | | 39,97,500 |

## Question 11

*The following figures have been extracted from the Books of X Limited for the year ended on 31.3.2004. You are required to prepare a cash flow statement.*

*(i)* *Net profit before taking into account income tax and income from law suits but after taking into account the following items was Rs. 20 lakhs:*

*(a)* *Depreciation on Fixed Assets Rs. 5 lakhs.*

*(b)* *Discount on issue of Debentures written off Rs. 30,000.*

*(c)* *Interest on Debentures paid Rs. 3,50,000.*

*(d)* *Book value of investments Rs. 3 lakhs (Sale of Investments for Rs. 3,20,000).*

*(e)* *Interest received on investments Rs. 60,000.*

*(f)* *Compensation received Rs. 90,000 by the company in a suit filed.*

*(ii)* *Income tax paid during the year Rs. 10,50,000.*

*(iii)* *15,000, 10% preference shares of Rs. 100 each were redeemed on 31.3.2004 at a premium of 5%. Further the company issued 50,000 equity shares of Rs. 10 each at a premium of 20% on 2.4.2003. Dividend on preference shares were paid at the time of redemption.*

*(iv)* *Dividends paid for the year 2002-2003 Rs. 5 lakhs and interim dividend paid Rs. 3 lakhs for the year 2003-2004.*

*(v)* *Land was purchased on 2.4.2003 for Rs. 2,40,000 for which the company issued 20,000 equity shares of Rs. 10 each at a premium of 20% to the land owner as consideration.*

*(vi)* *Current assets and current liabilities in the beginning and at the end of the years were as detailed below:*

| | As on 31.3.2003 | As on 31.3.2004 |
|---|---|---|
| | Rs. | Rs. |
| Stock | 12,00,000 | 13,18,000 |
| Sundry Debtors | 2,08,000 | 2,13,100 |
| Cash in hand | 1,96,300 | 35,300 |
| Bills receivable | 50,000 | 40,000 |
| Bills payable | 45,000 | 40,000 |
| Sundry Creditors | 1,66,000 | 1,71,300 |
| Outstanding expenses | 75,000 | 81,800 |

*(20 marks) (PE-II – May 2005)*

Answer

X Ltd.

Cash Flow Statement

for the year ended 31st March, 2004

| | Rs. | Rs. |
|---|---|---|
| Cash flow from Operating Activities | | |
| Net profit before income tax and extraordinary items: | | 20,00,000 |
| Adjustments for: | | |
| Depreciation on fixed assets | 5,00,000 | |
| Discount on issue of debentures | 30,000 | |
| Interest on debentures paid | 3,50,000 | |
| Interest on investments received | (60,000) | |
| Profit on sale of investments | (20,000) | 8,00,000 |
| Operating profit before working capital changes | | 28,00,000 |
| Adjustments for: | | |
| Increase in stock | (1,18,000) | |
| Increase in sundry debtors | (5,100) | |
| Decrease in bills receivable | 10,000 | |
| Decrease in bills payable | (5,000) | |
| Increase in sundry creditors | 5,300 | |
| Increase in outstanding expenses | 6,800 | |
| | | (1,06,000) |
| Cash generated from operations | | 26,94,000 |
| Income tax paid | | (10,50,000) |
| | | 16,44,000 |
| Cash flow from extraordinary items: | | |
| Compensation received in a suit filed | | 90,000 |
| Net cash flow from operating activities | | 17,34,000 |

| | | |
|---|---|---|
| Cash flow from Investing Activities | | |
| Sale proceeds of investments | 3,20,000 | |
| Interest received on investments | 60,000 | |
| Net cash flow from investing activities | | 3,80,000 |
| Cash flow from Financing Activities | | |
| Proceeds by issue of equity shares at 20% premium | 6,00,000 | |
| Redemption of preference shares at 5% premium | (15,75,000) | |
| Preference dividend paid | (1,50,000) | |
| Interest on debentures paid | (3,50,000) | |
| Dividend paid (5,00,000 + 3,00,000) | (8,00,000) | |
| Net cash used in financing activities | | (22,75,000) |
| Net decrease in cash and cash equivalents during the year | | (1,61,000) |
| *Add*: Cash and cash equivalents as on 31.3.2003 | | 1,96,300 |
| Cash and cash equivalents as on 31.3.2004 | | 35,300 |

Note: Purchase of land in exchange of equity shares (issued at 20% premium) has not been considered in the cash flow statement as it does not involve any cash transaction.

### Question 12

*Raj Ltd. gives you the following information for the year ended 31st March, 2006:*

*(i) Sales for the year Rs.48,00,000. The Company sold goods for cash only.*

*(ii) Cost of goods sold was 75% of sales.*

*(iii) Closing inventory was higher than opening inventory by Rs.50,000.*

*(iv) Trade creditors on 31.3.2006 exceed the outstanding on 31.3.2005 by Rs.1,00,000.*

*(v) Tax paid during the year amounts to Rs.1,50,000.*

*(vi) Amounts paid to Trade creditors during the year Rs.35,50,000.*

*(vii) Administrative and Selling expenses paid Rs.3,60,000.*

*(viii) One new machinery was acquired in December, 2005 for Rs.6,00,000.*

*(ix) Dividend paid during the year Rs.1,20,000.*

*(x) Cash in hand and at Bank on 31.3.2006 Rs.70,000.*

*(xi) Cash in hand and at Bank on 1.4.2005 Rs.50,000.*

*Prepare Cash Flow Statement for the year ended 31.3.2006 as per the prescribed Accounting standard.*
*(12 Marks) (PE-II – May 2006)*

Answer

Cash flow statement of Raj Limited
for the year ended 31.3.2006

*Direct Method*

| | Rs. | Rs. |
|---|---|---|
| ***Cash flow from operating activities:*** | | |
| Cash receipt from customers (sales) | 48,00,000 | |
| Cash paid to suppliers and expenses (Rs.35,50,000 + Rs.3,60,000) | 39,10,000 | |
| Cash flow from operation | 8,90,000 | |
| *Less:* Tax paid | 1,50,000 | |
| Net cash from operating activities | | 7,40,000 |
| ***Cash flow from investing activities:*** | | |
| Purchase of fixed assets | (6,00,000) | |
| Net cash used in investing activities | | (6,00,000) |
| ***Cash flow from financing activities:*** | | |
| Dividend Paid | (1,20,000) | |
| Net cash from financing activities | | (1,20,000) |
| | | 20,000 |
| *Add:* Opening balance of Cash in Hand and at Bank | | 50,000 |
| Cash in Hand and at Bank on 31.3.2006 | | 70,000 |

Question 13

*The following are the summarized Balance Sheets of 'X' Ltd. as on March 31, 2005 and 2006:*

| *Liabilities* | *As on 31.3.2005 (Rs.)* | *As on 31.3.2006 (Rs,.)* |
|---|---|---|
| *Equity share capital* | *10,00,000* | *12,50,000* |
| *Capital Reserve* | *---* | *10,000* |
| *General Reserve* | *2,50,000* | *3,00,000* |
| *Profit and Loss A/c* | *1,50,000* | *1,80,000* |
| *Long-term loan from the Bank* | *5,00,000* | *4,00,000* |
| *Sundry Creditors* | *5,00,000* | *4,00,000* |
| *Provision for Taxation* | *50,000* | *60,000* |
| *Proposed Dividends* | *1,00,000* | *1,25,000* |
| | *25,50,000* | *27,25,000* |

| *Assets* | *Year 2005 (Rs.)* | *Year 2006 (Rs.)* |
|---|---|---|
| *Land and Building* | *5,00,000* | *4,80,000* |
| *Machinery* | *7,50,000* | *9,20,000* |
| *Investment* | *1,00,000* | *50,000* |
| *Stock* | *3,00,000* | *2,80,000* |
| *Sundry Debtors* | *4,00,000* | *4,20,000* |
| *Cash in Hand* | *2,00,000* | *1,65,000* |
| *Cash at Bank* | *3,00,000* | *4,10,000* |
| | *25,50,000* | *27,25,000* |

*Additional Information:*

*(i) Dividend of Rs.1,00,000 was paid during the year ended March 31, 2006.*

*(ii) Machinery during the year purchased for Rs.1,25,000.*

*(iii) Machinery of another company was purchased for a consideration of Rs.1,00,000 payable in equity shares.*

*(iv) Income-tax provided during the year Rs.55,000.*

*(v) Company sold some investment at a profit of Rs.10,000, which was credited to Capital reserve.*

*(vi) There was no sale of machinery during the year.*

*(vii) Depreciation written off on Land and Building Rs.20,000.*

*From the above particulars, prepare a cash flow statement for the year ended March, 2006 as per AS 3 (Indirect method). (16 Marks) (PE-II - Nov. 2006)*

Answer

Cash Flow Statement for the year ending on March 31, 2006

| | | Rs. | Rs. |
|---|---|---|---|
| I. | Cash flows from Operating Activities | | |
| | Net profit made during the year (W.N.1) | 2,60,000 | |
| | Adjustment for depreciation on Machinery (W.N.2) | 55,000 | |
| | Adjustment for depreciation on Land & Building | 20,000 | |
| | Operating profit before change in Working Capital | 3,35,000 | |
| | Decrease in Stock | 20,000 | |
| | Increase in Sundry Debtors | (20,000) | |
| | Decrease in Sundry Creditors | (1,00,000) | |
| | Income-tax paid | (45,000) | |
| | Net cash from operating activities | | 1,90,000 |
| II. | Cash flows from Investing Activities | | |
| | Purchase on Machinery | (1,25,000) | |
| | Sale of Investments | 60,000 | (65,000) |
| III. | Cash flows from Financing Activities | | |
| | Issue of equity shares (2,50,000-1,00,000) | 1,50,000 | |
| | Repayment of Long term loan | (1,00,000) | |
| | Dividend paid | (1,00,000) | (50,000) |
| Net increase in cash and cash equivalent | | | 75,000 |
| Cash and cash equivalents at the beginning of the period | | | 5,00,000 |
| Cash and cash equivalents at the end of the period | | | 5,75,000 |

Working Notes:

(i) Net Profit made during the year ended 31.3.2006

| | | |
|---|---|---|
| Increase in P & L (Cr.) Balance | | 30,000 |
| *Add:* | Transfer to general reserve | 50,000 |
| *Add:* | Provision for taxation made during the year | 55,000 |
| *Add:* | Provided for proposed dividend during the year | 1,25,000 |
| | | 2,60,000 |

(ii) Machinery Account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| To | Balance b/d | 7,50,000 | By | Depreciation (Bal. Fig.) | 55,000 |
| To | Bank | 1,25,000 | By | Balance c/d | 9,20,000 |
| To | Equity share capital | 1,00,000 | | | |
| | | 9,75,000 | | | 9,75,000 |

(iii) Provision for Taxation Account

| | | *Rs.* | | | *Rs.* |
|---|---|---|---|---|---|
| To | Cash (Bal. Fig.) | 45,000 | By | Balance b/d | 50,000 |
| To | Balance c/d | 60,000 | By | P & L A/c | 55,000 |
| | | 1,05,000 | | | 1,05,000 |

(iv) Proposed Dividend Account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| To | Bank | 1,00,000 | By | Balance b/d | 1,00,000 |
| To | Balance c/d | 1,25,000 | By | P & L A/c (Bal. Fig.) | 1,25,000 |
| | | 2,25,000 | | | 2,25,000 |

(v) Investment Account

| | | *Rs.* | | | *Rs.* |
|---|---|---|---|---|---|
| To | Balance b/d | 1,00,000 | By | Bank A/c (Balancing figure for investment sold) | 60,000 |
| To | Capital Reserve A/c (Profit on sale of investment) | 10,000 | | | |
| | | | By | Balance c/d | 50,000 |
| | | 1,10,000 | | | 1,10,000 |