

CHAPTER 2

ACCOUNTING STANDARDS

BASIC CONCEPTS

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. Accounting Standards 4, 5, 11, 12, 16, 19, 20, 26, 29 are covered in this paper.

Question 1

State different types of Leases contemplated in Accounting Standard 19 and discuss briefly.

(May, 2002)

Answer

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 2

- (a) *When capitalisation of borrowing cost should cease as per Accounting Standard 16?*
- (b) *Briefly describe, how do you calculate "Diluted Earnings per Share" as per Accounting Standard 20.*
- (c) *Write short note on Sale and Lease Back Transactions as per Accounting Standard 19.*

(November, 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) 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.

- (c) 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 3

- (a) *Decide when research and development cost of a project can be deferred to future periods as per AS 26.*
- (b) *You are an accountant preparing accounts of A Ltd. as on 31.3.2011. After year end the following events have taken place in April, 2011:*
- (i) *A fire broke out in the premises damaging, uninsured stock worth ₹ 10 lakhs (Salvage value ₹ 2 lakhs).*
 - (ii) *A suit against the company's advertisement was filed by a party claiming damage of ₹ 20 lakhs.*
 - (iii) *Dividend proposed @ 20% on share capital of ₹ 100 lakhs.*

Describe, how above will be dealt within the account of the company for the year ended on 31.3.2011.

(May, 2003)

Answer

- (a) 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.
- (b) 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.

Question 4

How is software acquired for internal use accounted for under AS-26? (November, 2003)

Answer

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.

Question 5

- (a) On 20.4.2010 JLC Ltd. obtained a loan from the Bank for ₹ 50 lakhs to be utilised as under:

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

In March, 2011 construction of shed was completed and machinery installed. Delivery of truck was not received. Total interest charged by the bank for the year ending 31.3.2011 was ₹ 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 2010-2011.

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 31.3.2011. 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?

(November, 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 asset 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	$\left(9 \text{ lakhs} \times \frac{20 \text{ lakhs}}{50 \text{ lakhs}} \right)$ $= ₹ 3.60 \text{ lakhs}$	

(2)	Purchase of machinery	Not qualifying asset*	a	$\left(9 \text{ lakhs} \times \frac{15 \text{ lakhs}}{50 \text{ lakhs}} \right) =$ ₹ 2.70 lakhs.
(3)	Working capital	Not qualifying asset		$\left(9 \text{ lakhs} \times \frac{10 \text{ lakhs}}{50 \text{ lakhs}} \right) =$ ₹ 1.80 lakhs
(4)	Advance for purchase of truck	Not qualifying asset	a	$\left(9 \text{ lakhs} \times \frac{5 \text{ lakhs}}{50 \text{ lakhs}} \right) =$ ₹ 0.90 lakhs
	Total			₹ 3.60 lakhs ₹ 5.40 lakhs

- (b) The preparation of financial statements involves 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 2010-2011. Subsequently in 2011 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.

Question 6

- (a) A major fire has damaged assets in a factory of X Co. Ltd. on 8.4.2011, 8 days after the year end closing of accounts. The loss is estimated to be ₹ 16 crores (after estimating the recoverable amount of ₹ 24 crores from the Insurance Company).

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

Explain, how the loss should be treated in the Final accounts of the year ended 31.3.2011.

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

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

Years	Sales (₹ 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, 2010 a Limited Company issued 1,20,000 equity shares of ₹ 100 each. ₹ 50 per share was called up on that date which was paid by all shareholders. The remaining ₹ 50 was called up on 1.9.2010. All shareholders paid the sum in September, 2010, except one shareholder having 24,000 shares. The net profit for the year ended 31.3.2011 is ₹ 2,64,000 after dividend on preference shares and dividend distribution tax of ₹ 64,000.

Compute basic EPS for the year ended 31.3.2011 as per Accounting Standard 20.

(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 31.3.2011. 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, 2011. 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
	(₹ 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 ₹ 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 ₹ 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 ₹ 45,00,000 has been written off as an expense at the end of third year.

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

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

Working Note:

Calculation of weighted average number of equity shares

	Number of shares	Nominal value of shares	Amount paid
1st April, 2010	1,20,000	100	50
1st September, 2010	96,000	100	100
	24,000	100	50

As per para 19 of AS 20 '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

Question 7

- (a) ABC Ltd. could not recover ₹ 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 31.3.2011 by making a provision @ 20% of the amount due from the said debtor.

The debtor became bankrupt in April, 2011 and nothing is recoverable from him.

Do you advise the company to provide for the entire loss of ₹ 10 lakhs in the books of account for the year ended 31st March, 2011?

- (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 1.4.2006. The arrear wages upto 31.3.2010 amounts to ₹ 80 lakhs. Arrear wages for the period from 1.4.2010 to 30.06.2010 (being the date of agreement) amounts to ₹ 7 lakhs.

Decide whether a separate disclosure of arrear wages is required.

(November, 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, 2011 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 31.3.2011. Therefore, the company should be advised to provide for the entire amount of ₹ 10 lakhs according to para 8 of AS 4.

- (b) It is given that revision of wages took place in June, 2011 with retrospective effect from 1.4.2006. The arrear wages payable for the period from 1.4.2006 to 30.6.2011 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 ₹ 87 lakhs (from 1.4.2006 to 30.6.2011) 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 1.4.2011 to 30.6.2011) amounting ₹ 7 lakhs is not a prior period item hence need not be disclosed separately. This may be shown as current year wages.

Question 8

AB Ltd. launched a project for producing product X in October, 2009. The Company incurred ₹ 20 lakhs towards Research and Development expenses upto 31st March, 2011. 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.

(May, 2006)

Answer

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 ₹ 20 lakhs incurred on the research and development project has to be written off in the current year ending 31st March, 2011.

Question 9

- (a) *What are the costs that are to be included in Research and Development costs as per AS 26.*
- (b) *X Ltd. entered into an agreement to sell its immovable property included in the Balance Sheet at ₹ 10 lacs to another company for ₹ 15 lacs. The agreement to sell was concluded on 28th February, 2011 and the sale deed was registered on 1st May, 2011. Comment with reference to AS 4.*

(November, 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 and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
 - Costs of the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.”
- (b) According to para 92 of AS 15 (Revised 2005) on “Employee Benefits”, any actuarial gains and losses should be recognized immediately in the statement of profit and loss account as income or expense.

In the given case, the amount of surplus from pension scheme of ₹ 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).

Question 10

A Ltd. had 6,00,000 equity shares on April 1, 2010. The company earned a profit of ₹ 15,00,000 during the year 2010-11. The average fair value per share during 2010-11 was ₹ 25. The company has given share option to its employees of 1,00,000 equity shares at option price of ₹ 15. Calculate basic EPS and diluted EPS. (May 2008)

Answer

Computation of earnings per share

	Earnings	Shares	Earnings per share
Net profit for the year 2010-11	₹ 15,00,000		
Weighted average number of shares outstanding during year 2010-11		6,00,000	
Basic earnings per share			₹ 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)	
	<u>₹ 15,00,000</u>	<u>6,40,000</u>	
Diluted earnings per share			₹ 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.			

Question 11

Answer the following:

- A major fire has damaged the assets in a factory of a Limited Company on 5th April – five days after the year end and closure of accounts. The loss is estimated at ₹ 10 crores out of which ₹ 7 crores will be recoverable from the insurers. Explain briefly how the loss should be treated in the final accounts for the previous year.
- Explain the types of lease as per AS 19.
- Goods purchased on 24.2.2010 of US \$ 1,000 ₹ 46.60 per US \$
Exchange rate on 31.3.2010 ₹ 47.00 per US \$
Date of actual payment 05.06.2010 ₹ 47.50 per US \$
Calculate the loss/gain for the financial year 2009-2010 and 2010-2011 as per AS 11.

(June, 2009)

Answer

(a) The loss due to break out of fire is an example of event occurring after the balance sheet date. The event does not relate to conditions existing at the balance sheet date. It has not affected the financial position as on the date of 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 occurring after balance sheet date i.e. in subsequent periods that represent unusual changes affecting the existence or substratum of the enterprise after the balance sheet date. In the given case, the amount of loss of assets in a factory is material and may be considered as an event affecting the substratum of the enterprise. Hence, as recommended in paragraph 15 of AS 4, disclosure of the event should be made in the report of the approving authority.

(b) For the purpose of accounting AS 19 'Leases' classify the lease into two categories as follows:

(i) Finance Lease

(ii) Operating Lease

Finance Lease: It is a lease, which transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee by the lessor but not the legal ownership. As per para 8 of the standard, in following situations, the lease transactions are called Finance lease:

- The lessee will get the ownership of leased asset at the end of the lease term.
- The lessee has an option to buy the leased asset at the end of the lease term at price, which is lower than its expected fair value at the date on which option will be exercised.
- The lease term covers the major part of the life of asset even if title is not transferred.
- At the beginning of lease term, present value of minimum lease rental covers the initial fair value.
- The asset given on lease to lessee is of specialized nature and can only be used by the lessee without major modification.

Operating Lease: It is lease, which does not transfer all the risks and rewards incidental to ownership.

(c) As per para 9 of AS 11 on 'The Effects of Changes in Foreign Exchange Rates', a foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

Accordingly, goods purchased on 24.02.2010 and corresponding creditors would be recorded at ₹ 46.60 = 1 US \$ i.e. $1,000 \times 46.60 = ₹ 46,600$.

As per para 11 of AS 11, at balance sheet date all monetary items should be reported using the closing rate, therefore creditors of US\$ 1,000 outstanding on 31.03.2010 will be reported. i.e. $1,000 \times 47.00 = ₹ 47,000$.

Exchange Loss $(47,000 - 46,600) = ₹ 400$ should be debited in Profit and loss Account for the year 2009-2010.

Exchange differences on settlement of monetary items should be transferred to Profit and Loss Account as gain or loss, therefore $1,000 \times 47.50 = 47,500 - 47,000 = ₹ 500$ will be debited to Profit and Loss Account for the year 2010-2011.

Question 12

Answer the following:

- (a) *A Company entered into an agreement to sell its immovable property to another company for ₹ 35 lakhs. The property was shown in the Balance Sheet at ₹ 7 lakhs. The agreement to sell was concluded on 15th February, 2011 and sale deed was registered on 30th April, 2011.*

You are required to state, with reasons, how this event would be dealt with in the financial statements for the year ended 31st March, 2011.

- (b) *Goods of ₹ 5,00,000 were destroyed due to flood in September, 2008. A claim was lodged with insurance company, but no entry was passed in the books for insurance claim.*

In March, 2011, the claim was passed and the company received a payment of ₹ 3,50,000 against the claim. Explain the treatment of such receipt in final accounts for the year ended 31st March, 2011.

(November, 2009)

Answer

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

In the given case, 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 but agreement to sell was effected on 15th February 2011 i.e. before the balance sheet date. Registration of the sale deed on 30th April, 2011, simply provides additional information relating to the conditions existing at the balance sheet date. Therefore, adjustment to assets for sale of immovable property is necessary in the financial statements for the year ended 31st March, 2011.

- (b) As per the provisions of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", prior period items are income or expenses, which arise, in the current period as a result of error or omissions in the preparation of financial

statements of one or more prior periods. Further, the nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on current profit or loss can be perceived.

In the given instance, it is clearly a case of error in preparation of financial statements for the year 2008-09. Hence, claim received in the financial year 2010-11 is a prior period item and should be separately disclosed in the statement of Profit and Loss.

Question 13

Answer the following:

- (a) *Supriya Ltd. received a grant of ₹ 2,500 lakhs during the last accounting year (2008-09) from government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilization. However, during the year 2009-10, it was found that the conditions of grants were not complied with and the grant had to be refunded to the government in full. Elucidate the current accounting treatment, with reference to the provisions of AS-12.*
- (b) *S.T.B. Ltd. makes provision for expenses worth ₹ 7,00,000 for the year ending March 31, 2009, but the actual expenses during the year ending March 31, 2010 comes to ₹ 9,00,000 against provision made during the last year. State with reasons whether difference of ₹ 2,00,000 is to be treated as prior period item as per AS-5.*

(May, 2010)

Answer

- (a) As per AS 12 'Accounting for Government Grants', Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item as per AS 5.

The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

In the present case, the amount of refund of government grant should be shown in the profit & loss account of the company as an extraordinary item during the year 2009-10

- (b) As per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', as a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

Estimates may have to be revised, if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments.

As per the standard, the effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate. Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. Thus revision of an estimate by its nature, i.e. the difference of ₹ 2 lakhs is not a prior period item.

Therefore, in the given case expenses amounting ₹ 2,00,000 (i.e. ₹ 9,00,000 – ₹ 7,00,000) relating to the previous year recorded in the current year, should not be regarded as prior period item.

Question 14

- (i) *In Raj Co. Ltd., theft of cash of ₹ 2 lakhs by the cashier in January, 2011 was detected in May, 2011. The accounts of the company were not yet approved by the Board of Directors of the company.*

Whether the theft of cash has to be adjusted in the accounts of the company for the year ended 31.3.2011. Decide.

- (ii) *Goverdhan Ltd. has equity capital of ₹ 20,00,000 consisting of fully paid equity shares of ₹ 10 each. The net profit for the year 2010-11 was ₹ 30,00,000. It has also issued 18,000, 10% convertible debentures of ₹ 50 each. Each debenture is convertible into five equity shares. The tax rate applicable is 30%. Compute the diluted earnings.*

(May, 2010)

Answer

- (i) As per para 13 of AS 4 (revised), 'Contingencies and Events Occurring After the Balance Sheet Date', assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date.

Though the theft, by the cashier ₹ 2,00,000, was detected after the balance sheet date (before approval of financial statements) but it is an additional information materially affecting the determination of the cash amount relating to conditions existing at the balance sheet date. Therefore, it is necessary to make the necessary adjustments in the financial statements of the company for the year ended 31st March, 2011 for recognition of the loss amounting ₹ 2,00,000.

(ii) Calculation of diluted earnings

	₹
Interest on debentures @ 10% for the year (18,000 debentures × ₹ 50 × 10%)	90,000
Less: Tax on interest @ 30%	<u>(27,000)</u>
	63,000
Add: Net profit for the year 2010-2011	<u>30,00,000</u>
Diluted earnings	<u>30,63,000</u>

Question 15

- (a) A Ltd. purchased fixed assets costing ₹ 6,000 lakhs on 1.1.2010. This was financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = ₹ 40 and ₹ 45 as on 1.1.2010 and 31.12.2010 respectively. First instalment was paid on 31.12.2010.

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

- (b) X Ltd. has its financial year ended 31.3.2011, fifteen law suits outstanding, none of which has been settled by the time the accounts are approved by the directors. The directors have estimated that the probable outcomes as below:

Result	Probability	Amount of Loss ₹
For first ten cases:		
Win	0.6	----
Loss-low damages	0.3	90,000
Loss-high damages	0.1	2,00,000
For remaining five cases:		
Win	0.5	----
Loss-low damages	0.3	60,000
Loss-high damages	0.2	1,00,000

The directors believe that the outcome of each case is independent of the outcome of all the others.

Estimate the amount of contingent loss and state the accounting treatment of such contingent loss.
(May, 2010)

Answer

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

Calculation of exchange difference:

$$\text{Foreign Exchange Loan} = \frac{6,000}{40} = \text{US \$ 150 lakhs}$$

$$\text{Exchange Difference} = \text{US \$ 150 lakhs} \times (45 - 40) = \text{₹ 750 lakhs.}$$

Loss due to exchange difference amounting ₹ 750 lakhs should be charged to profit and loss account for the year ended 31st December, 2010.

- (b) According to AS 29 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:
- (i) There is a present obligation arising out of past events but not recognized as provision.
 - (ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
 - (iii) The possibility of an outflow of resources embodying economic benefits is also remote.
 - (iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning first 10 cases is 60% and for remaining five cases is 50%. In other words, probability of losing the cases is 40% and 50% respectively. According to AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the probability or possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore, disclosure by way of note of contingent liability amount may be calculated as under:

$$\begin{aligned}\text{Expected loss in first ten cases} &= [\text{₹ } 90,000 \times 0.3 + \text{₹ } 2,00,000 \times 0.1] \times 10 \\ &= [\text{₹ } 27,000 + \text{₹ } 20,000] \times 10 \\ &= \text{₹ } 47,000 \times 10 = \text{₹ } 4,70,000\end{aligned}$$

$$\text{Expected loss in remaining five cases} = [\text{₹ } 60,000 \times 0.3 + \text{₹ } 1,00,000 \times 0.2] \times 5$$

$$\begin{aligned}
 &= [₹ 18,000 + ₹ 20,000] \times 5 \\
 &= ₹ 38,000 \times 5 = ₹ 1,90,000 \\
 \text{Total contingent liability} &= ₹ 4,70,000 + ₹ 1,90,000 \\
 &= ₹ 6,60,000.
 \end{aligned}$$

Question 16

NDA Corporation is engaged in research on a new process design for its product. It had incurred an expenditure of ₹ 530 lakhs on research upto 31st March, 2010.

The development of the process began on 1st April, 2010 and Development phase expenditure was ₹ 360 lakhs upto 31st March, 2011 which meets assets recognition criteria.

From 1st April, 2011, the company will implement the new process design which will result in after tax saving of ₹ 80 lakhs per annum for the next five years.

The cost of capital of company is 10%.

Explain:

- (1) Accounting treatment for research expenses.
- (2) The cost of internally generated intangible asset as per AS 26.
- (3) The amount of amortization of the assets. (The present value of annuity factor of ₹ 1 for 5 years @ 10% = 3.7908) **(November, 2010)**

Answer

- (i) **Research Expenditure** - According to para 41 of AS 26 'Intangible Assets', the expenditure on research of new process design for its product ₹ 530 lakhs should be charged to Profit and Loss Account in the year in which it is incurred. It is presumed that the entire expenditure is incurred in the financial year 2009-10. Hence, it should be written off as an expense in that year itself.
- (ii) **Cost of internally generated intangible asset** - The question states that the development phase expenditure amounting ₹ 360 lakhs incurred upto 31st March, 2011 meets asset recognition criteria. As per AS 26 for measurement of such internally generated intangible asset, fair value can be estimated by discounting estimated future net cash flows.

Savings (after tax) from implementation of new design for next 5 years	80 lakhs p.a.
Company's cost of capital	10 %
Annuity factor @ 10% for 5 years	3.7908
Present value of net cash flows (₹ 80 lakhs x 3.7908)	303.26 lakhs

The cost of an internally generated intangible asset would be lower of cost value ₹ 360 lakhs or present value of future net cash flows ₹ 303.26 lakhs.

Hence, cost of an internally generated intangible asset will be ₹ 303.26 lakhs.

The difference of ₹ 56.74 lakhs (i.e. ₹ 360 lakhs – ₹ 303.26 lakhs) will be amortized by the enterprise for the financial year 2010-11.

(iii) **Amortisation** - The company can amortise ₹ 303.26 lakhs over a period of five years by charging ₹ 60.65 lakhs per annum from the financial year 2011-12 onwards.

Question 17

“While calculating diluted earning per share, effect is given to all dilutive potential equity shares that were outstanding during that period.” Explain. Also calculate the diluted earnings per share from the following information:

Net profit for the current year	₹	85,50,000
No. of equity shares outstanding		20,00,000
No. of 8% convertible debentures of ₹ 100 each		1,00,000
Each debenture is convertible into 10 equity shares		
Interest expenses for the current year	₹	6,00,000
Tax relating to interest expenses		30%
(November, 2010)		

Answer

“In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period.” As per para 26 of AS 20 ‘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 for the purpose of calculation of diluted earnings per share.

Computation of diluted earnings per share
$$\frac{\text{Adjusted net profit for the current year}}{\text{Weighted average number of equity shares}}$$

Adjusted net profit for the current year

	₹
Net profit for the current year (assumed to be after tax)	85,50,000
Add: Interest expense for the current year	6,00,000
Less: Tax relating to interest expense (30% of ₹ 6,00,000)	<u>(1,80,000)</u>
Adjusted net profit for the current year	<u>89,70,000</u>

* Weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

Weighted average number of equity shares

Number of equity shares resulting from conversion of debentures

$$= \frac{1,00,000 \times 100}{10} = 10,00,000 \text{ Equity shares}$$

Weighted average number of equity shares used to compute diluted earnings per share

$$= [(20,00,000 \times 12) + (10,00,000 \times 9^{**})]/12 = 27,50,000 \text{ shares}$$

$$\text{Diluted earnings per share} = \frac{89,70,000}{27,50,000 \text{ shares}} = ₹ 3.26 \text{ per share}$$

Question 18

A Ltd. purchased a machinery for ₹ 40 lakhs. (Useful life 4 years and residual value ₹ 8 lakhs) Government grant received is ₹ 16 lakhs.

Show the Journal Entry to be passed at the time of refund of grant and the value of the fixed assets, if:

- (1) *the grant is credited to Fixed Assets A/c.*
- (2) *the grant is credited to Deferred Grant A/c.*

(November, 2010)

Answer

In the books of A Ltd.

Journal Entries (at the time of refund of grant)

If the grant is credited to Fixed Assets Account:

		₹	₹
I	Fixed Assets A/c To Bank A/c (Being grant refunded)	Dr. 12 lakhs	12 lakhs

- II The balance of fixed assets after two years depreciation will be ₹ 16 lakhs (W.N.1) and now it will become (₹ 16 lakhs + ₹ 12 lakhs) = ₹ 28 lakhs on which depreciation will be charged for remaining two years. Depreciation = $(28-8)/2 = ₹ 10 \text{ lakhs p.a.}$ will be charged for next two years.

****** Interest on debentures for full year amounts to ₹ 8,00,000 (i.e. 8% of ₹ 1,00,00,000). However, interest expense amounting ₹ 6,00,000 has been given in the question. It may be concluded that debentures have been issued during the year and interest has been provided for 9 months.

If the grant is credited to Deferred Grant Account:

As per para 14 of AS 12 'Accounting for Government Grants,' income from Deferred Grant Account is allocated to Profit and Loss account usually over the periods and in the proportions in which depreciation on related assets is charged. Accordingly, in the first two years ($\text{₹ } 16 \text{ lakhs} / 4 \text{ years}$) = $\text{₹ } 4 \text{ lakhs p.a.} \times 2 \text{ years} = \text{₹ } 8 \text{ lakhs}$ were credited to Profit and Loss Account and $\text{₹ } 8 \text{ lakhs}$ was the balance of Deferred Grant Account after two years.

Therefore, on refund in the 3rd year, following entry will be passed:

			₹	₹
I	Deferred Grant A/c	Dr.	8 lakhs	
	Profit & Loss A/c	Dr.	4 lakhs	
	To Bank A/c			12 lakhs
	(Being Government grant refunded)			

II Deferred grant account will become Nil. The fixed assets will continue to be shown in the books at $\text{₹ } 24 \text{ lakhs}$ (W.N.2) and depreciation will continue to be charged at $\text{₹ } 8 \text{ lakhs per annum}$.

Working Notes:**1. Balance of Fixed Assets after two years but before refund (under first alternative)**

Fixed assets initially recorded in the books = $\text{₹ } 40 \text{ lakhs} - \text{₹ } 16 \text{ lakhs} = \text{₹ } 24 \text{ lakhs}$

Depreciation p.a. = $(\text{₹ } 24 \text{ lakhs} - \text{₹ } 8 \text{ lakhs}) / 4 \text{ years} = \text{₹ } 4 \text{ lakhs per year}$

Value of fixed assets after two years but before refund of grant

= $\text{₹ } 24 \text{ lakhs} - (\text{₹ } 4 \text{ lakhs} \times 2 \text{ years}) = \text{₹ } 16 \text{ lakhs}$

2. Balance of Fixed Assets after two years but before refund (under second alternative)

Fixed assets initially recorded in the books = $\text{₹ } 40 \text{ lakhs}$

Depreciation p.a. = $(\text{₹ } 40 \text{ lakhs} - \text{₹ } 8 \text{ lakhs}) / 4 \text{ years} = \text{₹ } 8 \text{ lakhs per year}$

Book value of fixed assets after two years = $\text{₹ } 40 \text{ lakhs} - (\text{₹ } 8 \text{ lakhs} \times 2 \text{ years})$

= $\text{₹ } 24 \text{ lakhs}$

Note : It is assumed that the question requires the value of fixed assets is to be given after refund of government grant.

Question 19

Answer the following questions:

- (i) Sterling Ltd. purchased a plant for US \$ 20,000 on 31st December, 07 payable after 4 months. The company entered into a forward contract for 4 months @ $\text{₹ } 48.85 \text{ per dollar}$. On 31st December, 07, the exchange rate was $\text{₹ } 47.50 \text{ per dollar}$.

How will you recognize the profit or loss on forward contract in the books of Sterling Limited for the year ended 31st March, 2008.

- (ii) *A company created a provision of ₹ 75,000 for staff welfare while preparing the financial statements for the year 2007-08. On 31st March, in a meeting with staff welfare association, it was decided to increase the amount of provision for staff welfare to ₹ 1,00,000. The accounts were approved by Board of Directors on 15th April, 2008.*

Explain the treatment of such revision in financial statements for the year ended 31st March, 2008.

- (iii) *A company entered into an agreement to sell its immovable property to another company for 35 lakhs. The property was shown in the Balance Sheet at ₹ 7 lakhs. The agreement to sell was concluded on 15th February, 2008 and sale deed was registered on 30th April, 2008. The financial statements for the year 2007-08 were approved by the board on 12th May, 08.*

You are required to state, how this transaction would be dealt with in the financial statements for the year ended 31st March, 2008.

- (iv) *X Ltd. received a revenue grant of ₹ 10 crores during 2006-07 from Government for welfare activities to be carried on by the company for its employees. The grant prescribed the conditions for utilization.*

However during the year 2008-09, it was found that the prescribed conditions were not fulfilled and the grant should be refunded to the Government.

State how this matter will have to be dealt with in the financial statements of X Ltd. for the year ended 2008-09.

(November, 2009)

Answer

- (i) **Calculation of profit or loss to be recognised in the books of Sterling Limited**

Forward contract rate	₹ 48.85
Less: Spot rate	₹ 47.50
Loss	₹ 1.35
Forward Contract Amount	\$20,000
Total loss on entering into forward contract = (\$20,000 × ₹ 1.35)	₹ 27,000
Contract period	4 months
Loss for the period 1 st January, 2008 to 31 st March, 2008 i.e. 3 months falling in the year 2007-2008 will be $₹ 27,000 \times \frac{3}{4} =$	₹ 20,250

Balance loss of ₹ 6,750 (i.e. ₹ 27,000 – ₹ 20,250) for the month of April, 2008 will be recognised in the financial year 2008-2009.

- (ii) As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", the change in amount of staff welfare provision amounting ₹ 25,000 is neither a prior period item nor an extraordinary item. It is a change in estimate, which has been occurred in the year 2007-2008.

As per the provisions of the standard, normally, all items of income and expense which are recognised in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates. However, the effect of such change in accounting estimate should be classified using the same classification in the statement of profit and loss, as was used previously, for the estimate.

- (iii) Sale of Immovable Property was concluded before approval by the Board. This is clearly an event occurring after the balance sheet date but agreement to sell was entered into before the balance sheet date. Registration of the sales deed simply provides additional information relating to the conditions existing at the balance sheet date.

So, adjustments to the assets are necessary in the financial statements for the year ended 31.3.2008, as per para 13 of AS 4 (Revised) "Contingencies and Events occurring after the Balance Sheet Date."

- (iv) As per para 11 of AS 12 "Government Grants", a grant that became refundable should be treated as an extra-ordinary item as per Accounting Standard 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies". The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement. Therefore, refund of grant of ₹ 10 crores should be shown in the profit and loss account of the company as an extra-ordinary item during the financial year 2008-09.

Question 20

Answer the following:

- (i) *Axe Limited began construction of a new plant on 1st April, 2008 and obtained a special loan of ₹ 4,00,000 to finance the construction of the plant. The rate of interest on loan was 10%.*

The expenditure that were made on the project of plant were as follows:

	₹
1 st April, 2008	5,00,000
1 st August, 2008	12,00,000
1 st January, 2009	2,00,000

The company's other outstanding non-specific loan was ₹ 23,00,000 at an interest rate of 12%.

The construction of the plant completed on 31st March, 2009. You are required to:

- (a) Calculate the amount of interest to be capitalized as per the provisions of AS 16 "Borrowing Cost".
 - (b) Pass a journal entry for capitalizing the cost and the borrowing cost in respect of the plant.
- (ii) Compute Basic Earnings per share from the following information:

Date	Particulars	No. of shares
1 st April, 2008	Balance at the beginning of the year	1,500
1 st August, 2008	Issue of shares for cash	600
31 st March, 2009	Buy back of shares	500

Net profit for the year ended 31st March, 2009 was ₹ 2,75,000.

(November, 2009)

Answer

- (i) Total expenses to be capitalised for borrowings as per AS 16 "Borrowing Costs":

	₹
Cost of Plant (5,00,000 + 12,00,000 + 2,00,000)	19,00,000
Add: Amount of interest to be capitalised (W.N.2)	<u>1,54,000</u>
	<u>20,54,000</u>

Journal Entry

		₹	₹
31 st March, 2009	Plant A/c Dr.	20,54,000	
	To Bank A/c		20,54,000
	[Being amount of cost of plant and borrowing cost thereon capitalised]		

Working Notes:

1. Computation of average accumulated expenses

		₹
1 st April, 2008	$\text{₹ } 5,00,000 \times \frac{12}{12}$	5,00,000
1 st August, 2008	$\text{₹ } 12,00,000 \times \frac{8}{12}$	8,00,000
1 st January, 2009	$\text{₹ } 2,00,000 \times \frac{3}{12}$	
		<u>50,000</u>
		<u>13,50,000</u>

2. Amount of interest capitalised

	₹
On specific borrowing (₹ 4,00,000 × 10%)	40,000
On non-specific borrowings (₹ 13,50,000 – ₹ 4,00,000) × 12%	<u>1,14,000</u>
Amount of interest to be capitalised	<u>1,54,000</u>

(ii) Computation of weighted average number of shares outstanding during the period

Date	No. of equity shares	Period outstanding	Weights (months)	Weighted average number of shares
(1)	(2)	(3)	(4)	(5) = (2) × (4)
1 st April, 2008	1,500 (Opening)	12 months	12/12	1,500
1 st August, 2008	600 (Additional issue)	8 months	8/12	400
31 st March, 2009	500 (Buy back)	0 months	0/12	-
Total				1,900

$$\text{Basic Earnings Per Share} = \frac{\text{Net Profit or Loss for the period attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares outstanding during the period}}$$

$$= \frac{2,75,000}{1,900 \text{ shares}} = \text{₹ } 144.74$$

Question 21

Answer the following questions:

- (i) Santosh Ltd. has received a grant of ₹ 8 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed ₹ 2 crores as dividend. Also, Santosh Ltd. received land free of cost from the State Government but it has not recorded it at all in the books as no money has been spent. In the light of AS 12 examine, whether the treatment of both the grants is correct.
- (ii) Rohini Limited has obtained loan from an Institution for ₹ 500 lacs for modernization and renovation of its plant and machinery. The installation of plant and machinery was completed on 31.3.2009 amounting to ₹ 320 lacs and ₹ 50 lacs were advanced to suppliers of additional assets and the balance of ₹ 130 lacs has been utilized for working capital requirements. Total interest paid for the above loan amounted to ₹ 65 lacs during 2008-09. You are required to state how the interest on institutional loan is to be accounted for in the year 2008-09.
- (iii) A Company follows April to March as its financial year. The Company recognizes cheques dated 31st March or before, received from customers after balance sheet date, but before approval of financial statement by debiting 'Cheques in hand account' and crediting 'Debtors account'. The 'cheques in hand' is shown in the Balance Sheet as an item of cash and cash equivalents. All cheques in hand are presented to bank in the month of April and are also realised in the same month in normal course after deposit in the bank. State with reasons, whether the collection of cheques bearing date 31st March or before, but received after Balance Sheet date is an adjusting event and how this fact is to be disclosed by the company?
- (iv) Closing stock for the year ending on 31.3.2010 is ₹ 50,000 which includes stock damaged in a fire in 2008-09. On 31.3.2009, the estimated net realisable value of the damaged stock was ₹ 12,000. The revised estimate of net realisable value of damaged goods amounting ₹ 4,000 has been included in closing stock of ₹ 50,000 as on 31.3.2010.

Find the value of closing stock to be shown in Profit and Loss account for the year 2009-10.
(May, 2010)

Answer

- (i) As per AS 12 'Accounting for Government Grants', when government grant is received for a specific purpose, it should be utilised for the same. So the grant received for setting up a factory is not available for distribution of dividend.

In the second case, even if the company has not spent money for the acquisition of land, land should be recorded in the books of accounts at a nominal value. The treatment of both the grants is incorrect as per AS 12.

- (ii) As per AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets* should be capitalised as part of the cost of that asset. Other borrowing costs are recognized as expense in the period in which they are incurred.

The treatment for total interest amount of ₹ 65 lakhs can be given as:

<i>Purpose</i>	<i>Nature</i>	<i>Interest to be capitalised (₹ in lakhs)</i>		<i>Interest to be charged to Profit and Loss A/c (₹ in lakhs)</i>	
Installation of Plant and Machinery	Qualifying asset	$320 \times \frac{65}{500} =$	41.60		
Advance to suppliers for additional assets	Qualifying asset	$50 \times \frac{65}{500} =$	6.50		
Working Capital	Not a qualifying asset			$130 \times \frac{65}{500} =$	16.90
			48.10		16.90

- (iii) Even if the cheques bear the date 31st March or before, the cheques received after 31st March do not represent any condition existing on the balance sheet date i.e. 31st March. Thus, the collection of cheques after balance sheet date is not an adjusting event. Cheques that are received after the balance sheet date should be accounted for in the period in which they are received even though the same may be dated 31st March or before as per AS 4 "Contingencies and Events Occurring after the Balance Sheet Date". Moreover, the collection of cheques after balance sheet date does not represent any material change affecting financial position of the enterprise, so no disclosure in the Director's Report is necessary.
- (iv) The fall in estimated net realisable value of damaged stock ₹ 8,000 is the effect of change in accounting estimate. As per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the effect of a change in accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

* A qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use or sale.

Thus, the value of closing stock for the year 2009-10 will be as follows:

	₹
Closing Stock (including damaged goods)	50,000
Less: Revised value of damaged goods	<u>(4,000)</u>
Closing stock (excluding damaged goods)	<u>46,000</u>

Question 22

B&P Ltd. availed a lease from N&L Ltd. The conditions of the lease terms are as under:

- Lease period is 3 years, in the beginning of the year 2009, for equipment costing ₹10,00,000 and has an expected useful life of 5 years.*
- The Fair market value is also ₹10,00,000.*
- The property reverts back to the lessor on termination of the lease.*
- The unguaranteed residual value is estimated at ₹1,00,000 at the end of the year 2011.*
- 3 equal annual payments are made at the end of each year.*

Consider IRR = 10%.

The present value of Re.1 due at the end of 3rd year at 10% rate of interest is ₹0.7513.

The present value of annuity of Re.1 due at the end of 3rd year at 10% IRR is ₹2.4868.

State whether the lease constitute finance lease and also calculate unearned Finance income.

(May, 2010)

Answer

(i) Computation of annual lease payment to the lessor

	₹
Cost of equipment	10,00,000
Unguaranteed residual value	1,00,000
Present value of residual value after third year @ 10% (₹ 1,00,000 × 0.7513)	75,130
Fair value to be recovered from lease payments (₹ 10,00,000 – ₹75,130)	9,24,870
Present value of annuity for three years is 2.4868	
Annual lease payment = ₹ 9,24,870/ 2.4868	3,71,911.70

The present value of lease payment i.e., ₹ 9,24,870 equals 92.48% of the fair market value i.e., ₹ 10,00,000. As the present value of minimum lease payments substantially

covers the initial fair value of the leased asset and lease term (i.e. 3 years) covers the major part of the life of asset (i.e. 5 years). Therefore, it constitutes a finance lease.

(ii) Computation of Unearned Finance Income

	₹
Total lease payments (₹ 3,71,911.70 x 3)	11,15,735
Add: Unguaranteed residual value	<u>1,00,000</u>
Gross investment in the lease	1,215,735
Less: Present value of investment (lease payments and residual value) (₹ 75,130 + ₹ 9,24,870)	<u>(10,00,000)</u>
Unearned finance income	<u>2,15,735</u>

Question 23

While preparing its final accounts for the year ended 31st March 2010, a company made a provision for bad debts @ 4% of its total debtors (as per trend follows from the previous years). In the first week of March 2010, a debtor for ₹ 3,00,000 had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 2010 the debtor became a bankrupt. Can the company provide for the full loss arising out of insolvency of the debtor in the final accounts for the year ended 31st March, 2010. (November, 2010)

Answer

As per para 8 of AS 4 'Contingencies and Events Occurring After the Balance Sheet Date', adjustment 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.

A debtor for ₹ 3,00,000 suffered heavy loss due to earthquake in the first week of March, 2010 and he became bankrupt in April, 2010 (after the balance sheet date). The loss was also not covered by any insurance policy. Accordingly, full provision for bad debts amounting ₹ 3,00,000 should be made, to cover the loss arising due to the insolvency of a debtor, in the final accounts for the year ended 31st March 2010.

Question 24

Answer the followings:

- (a) *Ram Ltd. had 12,00,000 equity shares on April 1, 2009. The company earned a profit of ₹ 30,00,000 during the year 2009-10. The average fair value per share during 2009-10 was ₹ 25. The company has given share option to its employees of 2,00,000 equity shares at option price of ₹ 15. Calculate basic E.P.S. and diluted E.P.S.*

(b) On 1st April, 2009, Amazing Construction Ltd. obtained a loan of ₹ 32 crores to be utilized as under:

(i) Construction of sealink across two cities:

(work was held up totally for a month during the year : ₹ 25 crores
due to high water levels)

(ii) Purchase of equipments and machineries : ₹ 3 crores

(iii) Working capital : ₹ 2 crores

(iv) Purchase of vehicles : ₹ 50,00,000

(v) Advance for tools/cranes etc. : ₹ 50,00,000

(vi) Purchase of technical know-how : ₹ 1 crores

(vii) Total interest charged by the bank for the year ending : ₹ 80,00,000
31st March, 2010

Show the treatment of interest by Amazing Construction Ltd.

(c) M Ltd. launched a project for producing product A in Nov. 2008. The company incurred ₹ 30 lakhs towards Research and Development expenses upto 31st March, 2010. Due to unfavourable market conditions the management feels that it is not possible to manufacture and sell the product in the market for next so many years.

The management hence wants to defer the expenditure write off to future years.

Advise the company as per the applicable Accounting Standard. **(November, 2010)**

Answer

(a) Computation of Earnings Per Share

	Earnings ₹	Shares	Earnings per share ₹
Net Profit for the year 2009-10	30,00,000		
Weighted average number of shares outstanding during the year 2009-10		12,00,000	
Basic Earning Per Share			2.50
= $\frac{30,00,000}{12,00,000}$			
Number of shares under option		2,00,000	
Number of shares that would have been issued at fair value (As indicated in Working Note)			

$[2,00,000 \times \frac{15}{25}]$		(1,20,000)	
Diluted Earnings Per Share	<u>30,00,000</u>	<u>12,80,000</u>	2.34
$[\frac{30,00,000}{12,80,000}]$			

Working Note:

The earnings have not been increased as the total number of shares has been increased only by the number of shares (80,000) deemed for the purpose of the computation to have been issued for no consideration.

- (b) According to para 3 of AS 16 'Borrowing costs', qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use.

As per para 6 of the standard, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

The treatment of interest by Amazing Construction Ltd. can be shown as:

	Qualifying Asset	Interest to be capitalized ₹	Interest to be charged to Profit & Loss A/c ₹	
Construction of sea-link	Yes	62,50,000		$[80,00,000 \times (25/32)]$
Purchase of equipments and machineries	No		7,50,000	$[80,00,000 \times (3/32)]$
Working capital	No		5,00,000	$[80,00,000 \times (2/32)]$
Purchase of vehicles	No		1,25,000	$[80,00,000 \times (.5/32)]$
Advance for tools, cranes etc.	No.		1,25,000	$[80,00,000 \times (.5/32)]$
Purchase of technical know-how	No		<u>2,50,000</u>	$[80,00,000 \times (1/32)]$
Total		<u>62,50,000</u>	<u>17,50,000</u>	

- (c) As per para 41 of AS 26 "Intangible Assets", expenditure on research should be recognised 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

the provisions of AS 26. Therefore, the management cannot defer the expenditure write off to future years and the company is required to expense the entire amount of ₹ 30 lakhs in the Profit and Loss account of the year ended 31st March, 2010.

Question 25

	Exchange Rate per \$
Goods purchased on 1.1.2011 of US \$ 10,000	₹ 45
Exchange rate on 31.3.2011	₹ 44
Date of actual payment 7.7.2011	₹ 43

Ascertain the loss/gain for financial years 2010-11 and 2011-12, also give their treatment as per AS 11. **(November, 2008)**

Answer

As per AS 11 on 'The Effects of Changes in Foreign Exchange Rates', all foreign currency transactions should be recorded by applying the exchange rate on the date of transactions. Thus, goods purchased on 1.1.2011 and corresponding creditor would be recorded at ₹ 4,50,000 (i.e. \$10,000 × ₹ 45)

According to the standard, at the balance sheet date all monetary transactions should be reported using the closing rate. Thus, creditor of US \$10,000 on 31.3.2011 will be reported at ₹ 4,40,000 (i.e. \$10,000 × ₹ 44) and exchange profit of ₹ 10,000 (i.e. 4,50,000 – 4,40,000) should be credited to Profit and Loss account in the year 2010-11.

On 7.7.2011, creditor of \$10,000 is paid at the rate of ₹ 43. As per AS 11, exchange difference on settlement of the account should also be transferred to Profit and Loss account. Therefore, ₹ 10,000 (i.e. 4,40,000 – 4,30,000) will be credited to Profit and Loss account in the year 2011-12.

Question 26

From the following information relating to Y Ltd. Calculate Earnings Per Share (EPS):

	₹ in crores
Profit before V.R.S. payments but after depreciation	75.00
Depreciation	10.00
VRS payments	32.10
Provision for taxation	10.00
Fringe benefit tax	5.00
Paid up share capital (shares of ₹ 10 each fully paid)	93.00

(November, 2007)

Answer

		₹ in crores
Profit after depreciation but before VRS Payment		75.00
Less: Depreciation – No. adjustment required	-	
VRS payments	32.10	
Provision for taxation	10.00	
Fringe benefit tax	<u>5.00</u>	<u>47.10</u>
Net Profit		<u>27.90</u>

No. of shares

9.30 crores

$$\begin{aligned}
 \text{EPS} &= \frac{\text{Net profit}}{\text{No. of shares}} \\
 &= \frac{27.90}{9.30} \\
 &= ₹ 3 \text{ per share.}
 \end{aligned}$$

Question 27

From the following information relating to X Ltd., calculate Diluted Earnings Per Share as per AS 20:

Net Profit for the current year	₹ 2,00,00,000
Number of equity shares outstanding	40,00,000
Basic earnings per share	₹ 5.00
Number of 11% convertible debentures of ₹ 100 each	50,000
Each debenture is convertible into 8 equity shares.	
Interest expense for the current year	₹ 5,50,000
Tax saving relating to interest expense (30%)	₹ 1,65,000

(June 2009)

Answer

Adjusted Net profit for the current year

$$= 2,00,00,000 + 5,50,000 - 1,65,000 = ₹ 2,03,85,000$$

Number of equity shares resulting from conversion of debentures

$$= 50,000 \times 8 = 4,00,000 \text{ equity shares}$$

Total number of equity shares resulting from conversion of debentures

$$= 40,00,000 + 4,00,000 = 44,00,000 \text{ shares}$$

$$\text{Diluted Earnings per share} = \frac{2,03,85,000}{44,00,000} = ₹ 4.63 \text{ (Approximately)}$$

EXERCISES

1. *The difference between actual expense or income and the estimated expense or income as accounted for in earlier years' accounts, does not necessarily constitute the item to be a prior period item comment.*

(Hints: The statement given in the question is correct .)

2. (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 ₹ 20 crores out of which ₹ 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 ₹ 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 ₹ 2 crores of the demand. State how the matter will have to be dealt with in the final accounts for the year.*

(Hints: (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 conditions existing at the balance sheet date. **(ii)** Company should disclose the disputed part of sales tax liability of ₹ 2 crore as contingent liability in their financial statements of the year.)