

Accounting Standards and Guidance Notes

BASIC CONCEPTS

ACCOUNTING STANDARDS

A standard means a generally accepted model or an ideal. Accounting standards are therefore generally accepted **model** accounting practices. Unlike GAAPs, accounting standards are written statements of accounting rules or guidelines or practices for preparing the uniform financial statements. Accounting standards are therefore specific codified rules of accounting to be adopted for treatment of items such as valuation of fixed assets, valuation of inventories, depreciation, cash flow statement etc. The purpose or focus of accounting standards is to convey the same meaning of any accounting concept to all users of accounting information so that the same meaning is derived by studying the financial statements. These standards are issued in India by the Institute of Chartered Accountants of India (ICAI). Thus, 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.

GUIDANCE NOTES

Guidance Notes are primarily designed to provide guidance to members of ICAI on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard.

Similarly, in a situation where certain matters are covered by a recommendatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the recommendatory Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard coming into effect, unless otherwise specified in the new Accounting Standard.

In a situation where certain matters are covered by a mandatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the earlier Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard becoming mandatory, unless otherwise specified in the new Accounting Standard.

1.2 Financial Reporting

Question 1

Write short note on the advantages and disadvantages of setting of Accounting Standards.

Answer

The Accounting Standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in companies' economic performance.

The advantages or benefits of accounting standards may be summarized as follows:

- (i) **To improve the credibility and reliability of financial statements:** The accounting standards create an environment of confidence amongst the users of the accounting information by providing a uniform structure of uniform guidelines which provide credibility and reliability to the accounting information. In this way the financial statements present a true and fair view of the financial position and operating results (profit or loss) of a business organisation.
- (ii) **Comparability:** The value of accounting information is enhanced (increased) if it can be compared easily in the same line of business activity. The comparability is possible only when same accounting standards are used in the preparation of the financial statements of different firms in the same industry. It is a positive step to protect the interests of the users of the accounting information.
- (iii) **Benefits to accountants and auditors:** The accounting standards provide a basis for uniform accounting practices. In this way there is a less possibility of frauds to be committed by accountants. There is more transparency in the accounting information. Since the accounting profession follows the accounting standards without any exception, they are helpful not only to an accounting entity but to the accountants and auditors too. Any type of misinformation can lead to strict action against the accountants as well as auditors.
- (iv) **Additional disclosures:** There are certain areas where important information is not required to be disclosed by law. Standards require such additional disclosure such as the methods of depreciation used, change of method of depreciation etc. which help the users of financial statements such as investors, bankers, creditors etc. to take important financial decisions.
- (v) **Evaluation of managerial ability:** Accounting standards are useful in measuring the efficiency of management regarding the profitability, liquidity, solvency and general progress of the enterprise. In the absence of accounting standards, it would be difficult to evaluate the managerial efficiency, because there is no basis of comparing the financial results of one enterprise with that of another. Each enterprise would evolve its own rules

or standards to suit its purpose and users of accounting information would fail to get a true and fair view of the functioning of an enterprise.

- (vi) **Helpful to Government:** The government officials will find the financial information more useful for purposes of economic planning, market analysis and tax collections if it is based on established accounting standards.
- (vii) **Reform in accounting theory:** The development of accounting standards has been very helpful in reforming accounting theory and practice in respect of accounting measurements and financial Information.

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

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

Question 2

- (a) *Briefly indicate the items, which are included in the expression "borrowing cost" as explained in AS 16.*
- (b) *Explain the difference between direct and indirect methods of reporting cash flows from operating activities with reference to Accounting Standard 3 (AS 3) revised.*
- (c) *Write short note on Effect of Uncertainties on Revenue Recognition.*

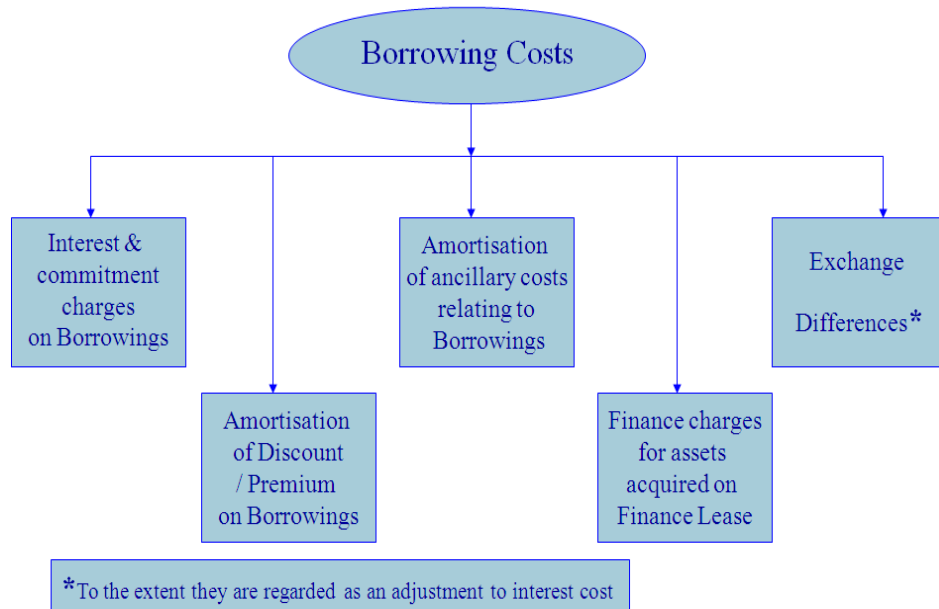
Answer

- (a) **Borrowing costs:** Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

As per para 4 of AS 16 on Borrowing Costs, borrowing costs may include :

- (a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;
- (b) amortisation of discounts or premiums relating to borrowings ;
- (c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;
- (d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and
- (e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Components of Borrowing Costs



(b) 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 is 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 statement 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 activities 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 unrealized 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.

(c) Effect of Uncertainties on Revenue Recognition

Para 9 of AS 9 on "Revenue Recognition" deals with the effect of uncertainties on Revenue Recognition. The para states:

1. Recognition of revenue requires that revenue is measurable and at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.
2. Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc. revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise, revenue only when it is reasonably certain that the ultimate collection will be made. When there is uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.
3. When the uncertainty relating to collectability arises subsequent to the time of sale or rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.
4. An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits; the recognition of revenue is postponed.
5. When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognized.

Question 3

Write short notes on:

- (a) *Impairment of asset and its application to inventory.*
- (b) *Treatment of borrowing costs.*
- (c) *Accounting for investment by a holding company in subsidiaries.*
- (d) *Concept of Materiality.*
- (e) *NACAS.*

Answer

- (a) The objective of AS 28 'Impairment of Assets' is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Statement requires the enterprise to recognize an impairment loss.

.. If carrying amount $\leq$ Recoverable amount : **Asset is not impaired**

.. If carrying amount $>$ Recoverable amount : **Asset is impaired**

Impairment Loss = Carrying Amount – Recoverable Amount

Recoverable amount is the higher of net selling price and its value in use

This standard should be applied in accounting for the impairment of all assets, other than (i) inventories (AS 2, Valuation of Inventories); (ii) assets arising from construction contracts (AS 7, Accounting for Construction Contracts); (iii) financial assets, including investments that are included in the scope of AS 13, Accounting for Investments; and (iv) deferred tax assets (AS 22, Accounting for Taxes on Income). AS 28 does not apply to inventories, assets arising from construction contracts, deferred tax assets or investments because other accounting standards applicable to these assets already contain specific requirements for recognizing and measuring the impairment related to these assets.

.. If carrying amount $\leq$ Recoverable amount : **Asset is not impaired**

.. If carrying amount $>$ Recoverable amount : **Asset is impaired**

Impairment Loss = Carrying Amount – Recoverable Amount

Recoverable amount is the higher of net selling price and its value in use

- (b) According to AS 16,

Meaning of borrowing costs: are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

What it Includes- Borrowing costs may include: (i) interest and commitment charges on bank borrowings and other short-term and long-term borrowings; (ii) amortization of

discounts or premiums relating to borrowings; (iii) amortization of ancillary costs incurred in connection with the arrangement of borrowings; (iv) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and (v) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Treatment as per AS 16

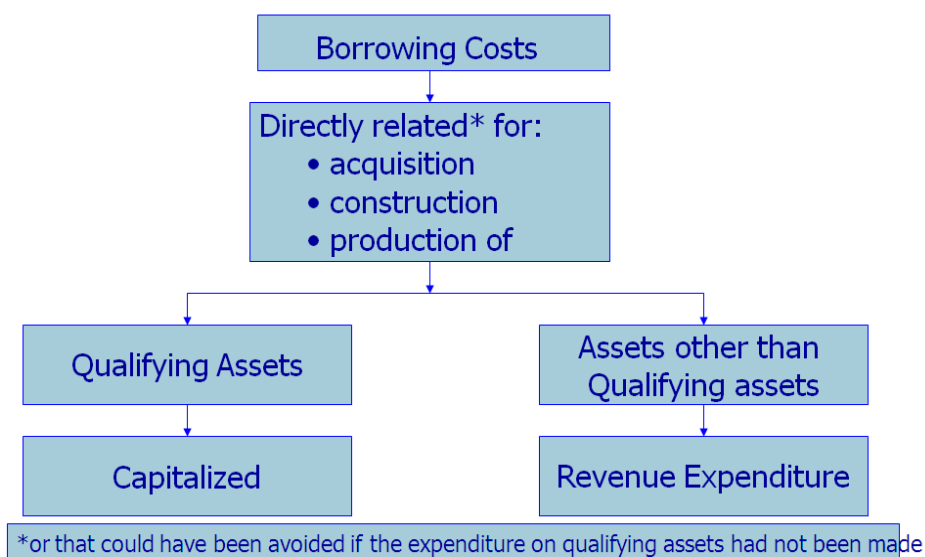
- .. **When to capitalize-** Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset^{*} should be capitalized as part of the cost of that asset.

The capitalization of borrowing costs as part of the cost of a qualifying asset should commence when the conditions as mentioned below as specified in AS 16 are satisfied.

- Expenditure for the acquisition, construction or production of a qualifying asset is being incurred
- Borrowing costs are being incurred
- Activities that are necessary to prepare the asset for its intended use or sale are in progress

- .. **When to expense off-** Other borrowing costs should be recognized as an expense in the period in which they are incurred.

Treatment of Borrowing Costs



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

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

Costs of investment include besides acquisition charges, expenses such as brokerage, fees and duties. If an investment is acquired wholly or partly by an issue of shares or other securities, the acquisition cost is determined by taking the fair value of the shares/securities issued. If an investment were to be acquired in exchange – part or whole – for another asset, the acquisition cost of the investment is determined with reference to the value of the other asset exchanged. Dividends received out of incomes earned by a subsidiary before the acquisition of the shares by the holding company and not treated as income but treated as recovery of cost of the assets (investment made in the subsidiary). The carrying cost for current investment is the lower of cost or fair/market value whereas investment in the shares of the subsidiary (treated as long term) is carried normally at cost.

- (d) Para 17 of AS 1 'Disclosure of Accounting Policies', states that financial statements should disclose all material items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements. Materiality depends on the size of item or error judged in the particular circumstances of its omission or misstatement. From a positive perspective, materiality has to do with the significance of an item or event to warrant attention in the accounting process. From a negative view point, materiality is critical because otherwise a great deal of time might be spent on trivial matters in the accounting process. Individual judgments are required to assess materiality, or to decide what the appropriate minimum quantitative criteria are to be set for given situations. What is material to one organization, may not be material for another organization.

For example, a long term investor is interested in the current value of fixed asset like building, while the banker may not consider it significant for a short-term loan. Similarly a pair of scissors, ball pens, sharpeners, waste-paper baskets could be used for a number of years but still it is treated as an expense and not an asset. The omission of "paise" in the financial statements is also due to their insignificant effect to the users of the financial statement in making a decision.

Example

(Requirements as to Profit & Loss Account; Part II of Revised Schedule VI of the Companies Act)

- Any item under which the income or expenditure exceeds 1 per cent of the revenue or ₹ 1,00,000, whichever is higher, is to be shown as a separate and distinct item against appropriate account head in the Profit & Loss Account.

- Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of financial statements.

The relevance of information is affected by its materiality. Information is material if its misstatements (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

- (e) Under Section 210 A of the Companies Act 1956, the Central Government, by notification, has constituted a committee to advise the Central Government on the formulation of accounting policies and accounting standards for adoption by companies or class of companies specified under the Act. The Advisory Committee shall consist of the following members, namely:
- (i) **a Chairperson** who shall be a person of eminence well versed in accountancy, finance, business administration, business law, economics or similar discipline;
 - (ii) **one member each** nominated by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949, the Institute of Cost and Works Accountants of India constituted under the Cost and Works Accountants Act, 1959 and the Institute of Company Secretaries of India constituted under the Company Secretaries Act, 1980;
 - (iii) **one representative each** of the Central Government, Reserve Bank of India , Comptroller and Auditor-General of India to be nominated by it;
 - (iv) a **person** who holds or has held the office of **professor in accountancy**, finance or business management in any university or deemed university;
 - (v) the **Chairman of the Central Board of Direct Taxes** constituted under the Central Boards of Revenue Act, 1963 or his nominee;
 - (vi) **two members** to represent the chambers of commerce and industry to be nominated by the Central Government, and
 - (vii) **one representative** of the **Securities and Exchange Board of India** to be nominated by it.

The Advisory Committee shall give its recommendations to the Central Government on such matters of accounting policies and standards and auditing as may be referred to it for advice from time to time. The members of the Advisory Committee shall hold office for such terms as may be determined by the Central Government at the time of their appointment and any vacancy in the membership in the Committee shall be filled by the Central Government in the same manner as the member whose vacancy occurred was filled.

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Question 4

Write short notes on:

- (a) *Reversal of an Impairment Loss.*
- (b) *Timing differences and Permanent differences as per AS 22.*
- (c) *Treatment of refund of Government grants.*

Answer

- (a) As per AS 28 on Impairment of Assets, an enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset.

.. If carrying amount $\leq$ Recoverable amount : **Asset is not impaired**

.. If carrying amount $>$ Recoverable amount : **Asset is impaired**

Impairment Loss = Carrying Amount – Recoverable Amount

Recoverable amount is the higher of net selling price and its value in use

In assessing whether there is any indication that an impairment loss recognized for an asset in prior accounting periods may no longer exist or may have decreased, an enterprise should consider, as a minimum, the following indications:

External sources of information

- (a) the asset's market value has increased significantly during the period;
- (b) significant changes with a favourable effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which the asset is dedicated;
- (c) market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially.

Internal sources of information

- (d) significant changes with a favourable effect on the enterprise have taken place during the period, or are expected to take place in the near future, to the extent to which, or manner in which, the asset is used or is expected to be used. These changes include capital expenditure that has been incurred during the period to improve or enhance an asset in excess of its originally assessed standard of performance or a commitment to discontinue or restructure the operation to which the asset belongs; and

- (e) evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected.

“ Reversal is not required if value in use increases in subsequent year merely due to pattern of cash flow but not due to increase in the earning potential of the asset

- (b) In current practices, companies, in general, prepare books of accounts as per Companies Act, generating Accounting Profit/Loss and Income Tax Act, generating Taxable Profit/Loss. Accounting income and taxable income for a period are seldom the same.

Permanent differences are those which arise in one period and do not reverse subsequently. For e.g., an income exempt from tax or an expense that is not allowable as a deduction for tax purposes.

Timing differences are those which arise in one period and are capable of reversal in one or more subsequent periods. For e.g., Depreciation, Sales Tax, Bonus etc., U/s 43B

- (c) As per Para 11 of AS 12 “Accounting for Government Grants”, government grant that becomes refundable should be treated as an extraordinary item. The amount refundable in respect of a government grant related to revenue is applied first against any unamortized deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement. The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset. 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.

Question 5

Write short notes on:

- (i) *Disclosure of carrying amounts of financial assets and financial liabilities in Balance Sheet.*
- (ii) *Financial guarantee contract.*
- (iii) *De-recognition of financial liability.*

Answer

- (i) As per AS 32, carrying amounts of each of the following categories, as defined in AS 30, should be **disclosed either on the face of the balance sheet or in the notes:**
- (a) **financial assets at fair value** through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with AS 30;

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- (b) held-to-maturity investments;
 - (c) loans and receivables;
 - (d) available-for-sale financial assets;
 - (e) **financial liabilities at fair value** through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with AS 30; and
 - (f) financial liabilities measured at amortized cost.
- (ii) According to para 8.6 of AS 30, A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
- (iii) In accordance with paragraphs 43 to 45 of AS 30, An entity should remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished i.e., when the obligation specified in the contract is discharged or cancelled or expires.

An exchange between an existing borrower and lender of debt instruments with substantially different terms should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, should be recognized in the statement of profit and loss.

Question 6

- (i) *What are the disclosure and presentation requirements of AS 24 for discontinuing operations?*
- (ii) *What are the different forms of joint ventures? Elucidate the presentation and disclosure norms of Joint Ventures under AS 27.*
- (iii) *Explain the provisions relating to combining of construction contracts.*
- (iv) *Who are related parties under AS 18? What are the related party disclosure requirements?*
- (v) *Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS 24, but that might do so in combination with other circumstances.*

Answer

- (i) An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15) occurs:
- (a) a description of the discontinuing operation(s);
 - (b) the business or geographical segment(s) in which it is reported as per AS 17, Segment Reporting;
 - (c) the date and nature of the initial disclosure event;
 - (d) the date or period in which the discontinuance is expected to be completed if known or determinable;
 - (e) the carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;
 - (f) the amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period;
 - (g) the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto; and
 - (h) the amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.
- (ii) Joint ventures take many different forms and structures. This Statement identifies three broad types – jointly controlled operations, jointly controlled assets and jointly controlled entities – which are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:
- (a) two or more venturers are bound by a contractual arrangement; and
 - (b) the contractual arrangement establishes joint control.

A venturer should disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

- (a) any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;
- (b) its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and
- (c) those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

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A venturer should disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

- (a) any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and
- (b) its share of the capital commitments of the joint ventures themselves.

A venturer should disclose a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence.

A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

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

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

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

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

- (iv) 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.

If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

- (i) the name of the transacting related party;
- (ii) a description of the relationship between the parties;
- (iii) a description of the nature of transactions;
- (iv) volume of the transactions either as an amount or as an appropriate proportion;

- (v) any other elements of the related party transactions necessary for an understanding of the financial statements;
 - (vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and
 - (vii) amounts written off or written back in the period in respect of debts due from or to related parties.
- (v) Para 3 of AS 24 "Discontinuing Operations" explains the criteria for determination of discontinuing operations. According to Paragraph 9 of AS 24, examples of activities that do not necessarily satisfy criterion (a) of paragraph 3, but that might do so in combination with other circumstances, include:
- (i) Gradual or evolutionary phasing out of a product line or class of service;
 - (ii) Discontinuing, even if relatively abruptly, several products within an ongoing line of business;
 - (iii) Shifting of some production or marketing activities for a particular line of business from one location to another; and
 - (iv) Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

Question 7

Distinguish between:

- (i) *Integral foreign operation and Non-integral foreign operation.*
- (ii) *Operating lease and finance lease.*

Answer

(i)

	Integral Foreign Operation	Non-Integral Foreign Operation (NFO)
Meaning	It is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.	It is a foreign operation that is not an integral Foreign Operation.
Business	The business of IFO is carried on as if it were an extension of the reporting enterprise's operations.	The business of NFO is carried on in a substantially independent manner by accumulating cash and other monetary items, incurring expenses, generating income and

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		arranging borrowings, in its local currency.
Example	Sale of goods imported from the reporting enterprise and remittance of proceeds to the reporting enterprise.	Production in a foreign country out of resources available in such nation independent of the reporting enterprise.
Currencies operated	Generally, IFO carries on business in a single foreign currency, i.e. of the country where it is located.	NFO business may also enter into transactions in foreign currencies, including transactions in the reporting currency.
Cash flows from operations	Cash flows from operations of the reporting enterprise are directly and immediately affected by a change in the exchange rate between the reporting currency and the currency in the country of IFO.	Change in the exchange rate between the reporting currency and the local currency, has little or no direct effect on the present and future Cash Flows from Operations of either the NFO or the reporting enterprise.
Effect of Change in Exchange Rate	Change in the exchange rate affects the individual monetary items held by the IFO rather than the reporting enterprise's Net Investment in the IFO.	Change in the exchange rate affects the reporting enterprise's net investment in the NFO rather than the individual monetary and non-monetary items held by that NFO.

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

- “ Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions.
- “ Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

As per AS 19 “Accounting for Lease”, Lease may be of two types: a) Finance Lease b) Operating Lease.

Finance Lease 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.

Operating lease is a lease which does not transfers substantially all the risks and rewards incidental to ownership. To be precise, it is a lease other than “Financial Lease”.

Question 8

Write short notes on:

- (i) *Graded vesting under an employee stock option plan.*
- (ii) *Presentation of MAT credit in the financial statements.*

Answer**(i) Graded vesting under an employee stock option plan**

In case the options/shares granted under an employee stock option plan do not vest on one date but have graded vesting schedule, total plan should be segregated into different groups, depending upon the vesting dates. Each of such groups would be having different vesting period and expected life and, therefore, each vesting date should be considered as a separate option grant and evaluated and accounted for accordingly. For example, suppose an employee is granted 100 options which will vest @ 25 options per year at the end of the third, fourth, fifth and sixth years. In such a case, each tranche of 25 options would be evaluated and accounted for separately.

(ii) Presentation of MAT credit in the financial statements

Balance Sheet : Where a company recognizes MAT credit as an asset on the basis of the considerations specified in the Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961, the same should be presented under the head 'Loans and Advances' since, there being a convincing evidence of realization of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'.

In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph 11 of the Guidance Note.

Profit and Loss Account : According to paragraph 6 of Accounting Standards Interpretation (ASI) 6*, 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognized as an asset in accordance with the recommendations contained

* In the notified standards, the consensus portion of ASI 6 has been included as an explanation to paragraph 21 of AS 22.

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in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein.

Question 9

- (a) *Discuss the concept of cost v/s fair value with reference to Indian Accounting Standards.*
- (b) *What are the types of Employees benefits and what is the objective of Introduction of this Standard i.e. AS-15?*

Answer

(a) Cost vs. Fair value

Cost basis: The term cost refers to cost of purchase, costs of conversion on other costs incurred in bringing the goods to its present condition and location. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Fair value: Fair value of an asset is the amount at which an enterprise expects to exchange an asset between knowledgeable and willing parties in an arm's length transaction.

Accounting Standards are generally based on historical cost with a very few exceptions:

AS 2 "Valuation of Inventories" – Inventories are valued at net realizable value (NRV) if cost of inventories is more than NRV.

AS 10 "Accounting for Fixed Assets" – Items of fixed assets that have been retired from active use and are held for disposal are stated at net realizable value if their net book value is more than NRV.

AS 13 "Accounting for Investments" – Current investments are carried at lower of cost and fair value. The carrying amount of long term investments is reduced to recognize the permanent decline in value.

AS 15 "Employee Benefits" – The provision for defined benefits is made at fair value of the obligations.

AS 26 "Intangible Assets" – If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

AS 28 "Impairment of Assets" – Provision is made for impairment of assets.

On the other hand IFRS and US GAAPs are more towards fair value. Fair value concept requires a lot of estimation and to the extent, it is subjective in nature.

- (b) There are four types of employee benefits according to AS 15 (Revised 2005). They are:
- (a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;
 - (b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care;
 - (c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and
 - (d) termination benefits.

Because each category identified in (a) to (d) above has different characteristics, this Statement establishes separate requirements for each category.

The objective of AS 15 is to prescribe the accounting and disclosure for employee benefits. The statement requires an enterprise to recognise:

- (a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and
- (b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Question 10

XYZ Ltd., with a turnover of ₹ 35 lakhs and borrowings of ₹ 10 lakhs during any time in the previous year, wants to avail the exemptions available in adoption of Accounting Standards applicable to companies for the year ended 31.3.2012. Advise the management the exemptions that are available as per Companies (AS) Rules, 2006.

If XYZ is a partnership firm is there any other exemptions additionally available.

Answer

This case deals with the issue of Applicability of Accounting Standards.

Whether AS are applicable or not, in general following test shall be applied:

Applicability of Accounting Standards

First Test:

Are Equity or Debt Securities are Listed or in the process of Listing?

Is this Banking Co. or a Co-operative Bank or Financial Institution or Enterprise carrying on Insurance Business?

Turnover excluding "other income" is exceeding ₹ 50 crores?

Borrowings exceeded ₹ 10 Crores at any time during the year?

Holding or Subsidiary of any of the above?

Second Test:

Is the Turnover (excluding. Other income) exceeding ₹ 40 lakhs but not ₹ 50 Crores?

Borrowings exceeded ₹ 1 Crores but not ₹ 10 Crores at any time during the year?

Holding or Subsidiary of any of the above?

If answer of all of the above is No, this implies that the given enterprise is small and medium sized enterprise (SME).

Decision:

XYZ Ltd. is a small and medium sized enterprise (SME) company as per Companies (AS) Rules, 2006. The following relaxations and exemptions are available to XYZ Ltd.

1. AS 3 "Cash Flow Statements" is not mandatory.
2. AS 17 "Segment Reporting" is not mandatory.
3. SMEs are exempt from some paragraphs of AS 19 "Leases".
4. SMEs are exempt from disclosures of diluted EPS (both including and excluding extraordinary items).
5. SMEs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique under AS 28 "Impairment of Assets".
6. SMEs are exempt from disclosure requirements of paragraphs 66 and 67 of AS 29 "Provisions, Contingent Liabilities and Contingent Assets".
7. SMEs are exempt from certain requirements of AS 15 "Employee Benefits".
8. Accounting Standards 21, 23, 27 are not applicable to SMEs.

If XYZ is not a company and it will be Partnership Firm as given in the case, then, it will be treated as a level III enterprise instead of level II enterprise; XYZ Ltd. will be exempt from requirements of AS 18 "Related Party Disclosures" and AS 24 "Discontinuing Operations".

Question 11

Omega Company Ltd. has to pay delayed cotton clearing charges over and above the negotiated price for taking delayed delivery of cotton from the Suppliers' godown. Up to 2010-11, the company has regularly included such charges in the valuation of closing stock. This being in the nature of interest the company has decided to exclude it from closing stock valuation for the year 2011-2012. This would result into decrease in profit by ₹ 7.60 lakhs. How would you deal with the following in the annual accounts of a company for the year ended 31st March, 2012?

Answer

Para 29 of AS 5 (Revised) 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' states that a change in an accounting policy should be made only if

- a. It is required by statute, or
- b. for compliance with an accounting standard, or
- c. if it is considered that the change would result in a more appropriate presentation of the financial statements of an enterprise.

Therefore the change in the method of stock valuation is justified in view of the fact that the change is in line with the recommendations of AS 2 (Revised) 'Valuation of Inventories' and would result in more appropriate preparation of the financial statements.

Disclosure: As per AS 2, this accounting policy adopted for valuation of inventories including the cost formulae used should be disclosed in the financial statements in Notes to Accounts.

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

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

Question 12

Sagar Limited belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31.03.2012. You are required to advise the company on the following items from the viewpoint of finalization of accounts, taking note of the mandatory accounting standards.

- (a) *The company undertook a contract for building a crane for ₹ 10 lakhs. As on 31.03.2012 it incurred a cost of ₹ 1.5 lakhs and expects that there will be ₹ 9 lakhs more for completing the crane. It has received so far ₹ 1 lakh as progress payment.*

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- (b) The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employees is estimated to be 6 years.

Answer

- (a) Para 21 of AS 7 (Revised) 'Construction Contracts' provides that when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses respectively with reference to the stage of completion of the contract activity at the reporting date.

Para 35 of AS 7 states that when it is probable that total contract cost will exceed total contract revenue, the expected losses should be recognized as an expense irrespective of :

- Whether or not work has commenced
- Stage of completion of contract
- The amount of profit on other contracts which are not treated as a single contract

Thus, when Estimated Contract Costs > Total Contract Revenue

Expected Loss = Work Certified + Work uncertified + estimated cost to complete the project - Total value of contract

Thus, in the given case ,the foreseeable loss of ₹ 50,000 (expected cost ₹ 10.5 lakhs less contract revenue ₹ 10 lakhs) should be recognized as an expense in the year ended 31st March, 2012.

The following disclosures should also be given in the financial statements:

- the amount of contract revenue recognized as revenue in the period;
 - the aggregate amount of costs incurred and loss recognized upto the reporting date;
 - amount of advances received;
 - amount of retentions; and
 - gross amount due from/due to customers Amount*
- (b) According to para 92 of AS 15 (Revised 2005) 'Employee Benefits', actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus amount of ₹ 6 lakhs is required to be credited to the profit and loss statement of the current year.

* Amount due from/to customers = contract costs + Recognised profits – Recognised losses – Progress billings = ₹ 1.5 + Nil – ₹ 0.5 – ₹ 1.0 = Nil.

Question 13

A Ltd. acquired 25% of shares in B Ltd. as on 31.3.2009 for ₹ 3 lakhs. The Balance Sheet of B Ltd. as on 31.3.2011 is given below:

	₹
Share Capital	5,00,000
Reserves and Surplus	<u>5,00,000</u>
	<u>10,00,000</u>
Fixed Assets	5,00,000
Investments	2,00,000
Current Assets	<u>3,00,000</u>
	<u>10,00,000</u>

During the year ended 31.3.2012 the following are the additional information available:

- (i) A Ltd. received dividend from B Ltd., for the year ended 31.3.2011 at 40% from the Reserves.
- (ii) B Ltd., made a profit after tax of ₹ 7 lakhs for the year ended 31.3.2012.
- (iii) B Ltd., declared a dividend @ 50% for the year ended 31.3.2012 on 30.4.2012.

A Ltd. is preparing Consolidated Financial Statements in accordance with AS 21 for its various subsidiaries. Calculate:

- (i) Goodwill if any on acquisition of B Ltd.'s shares.
- (ii) How A Ltd., will reflect the value of investment in B Ltd., in the Consolidated Financial Statements?
- (iii) How the dividend received from B Ltd. will be shown in the Consolidated Financial Statements?

Answer

In terms of AS 23, B Ltd. will be considered as an associate company of A Ltd. as shares acquired represent to more than 20%.

(i) Calculation of Goodwill	(₹ in lakhs)
Cost of investment	3.00
Less: Share in the value of Equity of B.Ltd. as at the date of investment [25% of ₹ 10 lakhs (₹ 5 lakhs + ₹ 5 lakhs)]	(2.50)
Goodwill	<u>0.50</u>

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(ii)

A Ltd.
Consolidated Profit and Loss Account
for the year ended 31st March, 2012 (An extract)

		₹ in lakhs
Other income:		
Share of profits in B Ltd.		1.75
Dividend received from B Ltd.	0.50	
Transfer to investment A/c	<u>(0.50)</u>	Nil

(iii)

A Ltd.
Consolidated Balance Sheet as on 31.3.2012 (An extract)

		₹ in lakhs
Non-current investments		
Investment in B Ltd.		
Share in B Ltd.'s Equity	2.50	
Less: Dividend received	<u>(0.50)</u>	
	2.00	
Share of profit for year 2011 – 2012	<u>1.75</u>	
	3.75	
Add: Goodwill	<u>0.50</u>	4.25

Working Notes:

1. Dividend received from B Ltd. amounting to ₹ 0.50 lakhs will be reduced from investment value in the books of A Ltd. However goodwill will not change.
2. B Ltd. made a profit of ₹ 7 lakhs for the year ended 31st March, 2012. A Ltd.'s share in the profits of ₹ 7 lakhs is ₹ 1.75 lakhs. Investment in B Ltd. will be increased by ₹ 1.75 lakhs and consolidated profit and loss account of A Ltd. will be credited with ₹ 1.75 lakhs in the consolidated financial statement of A Ltd.
3. Dividend declared on 30th April, 2012 will not be recognized in the consolidated financial statements of A Ltd.

Question 14

SM company has taken a Transit Insurance Policy. Suddenly in the year 2011-2012 the percentage of accident has gone up to 7% and the company wants to recognize insurance claim as revenue in 2011-2012 in accordance with relevant Accounting Standards. Do you agree? Explain in brief, as per the relevant Accounting Standards.

Answer**When to Recognize Revenue:**

- Revenue recognition is mainly concerned with the **timing of recognition of revenue** in the profit and loss account.
- Where **there is no uncertainty** as to **ultimate collection**, revenue is **recognised at the time of sale or rendering of services**, as the case may be even though payments are made by installments.
- The amount of revenue is usually determined by agreement between the parties to the transaction

It may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made.

In the given case, SM company wants to suddenly recognize Insurance claim because it has increased over the previous year. **But, there are uncertainties involved in the settlement of the claim.** Also, the claim does not seem to be in the course of ordinary activity of the company.

Hence, SM company is not advised to recognize the Insurance claim as revenue.

Question 15

State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 2012 with reference to Accounting Standards:

- (i) *The company finds that the stock sheets of 31.3.2011 did not include two pages containing details of inventory worth ₹ 14.5 lakhs.*
- (ii) *The company had spent ₹ 45 lakhs for publicity and research expenses on one of its new consumer product, which was marketed in the accounting year 2011-2012, but proved to be a failure.*

Answer

- (i) Paragraph 4 of Accounting Standard 5 on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, defines Prior Period items as "income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods".

Rectification of error in stock valuation is a prior period item vide Para 4 of AS 5. ₹ 14.5 lakhs must be added to the opening stock of 1/4/2011. It is also necessary to show ₹ 14.5 lakhs as a prior period adjustment in the Profit and loss Account below the line. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.

- (ii) In the given case, the company spent ₹ 45 lakhs for publicity and research of a new product which was marketed but proved to be a failure. It is clear that in future there will

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be no related further revenue/benefit because of the failure of the product. Thus according to paras 41 to 43 of AS 26 'Intangible Assets', the company should charge the total amount of ₹ 45 lakhs as an expense in the profit and loss account.

Question 16

- (a) Venus Ltd. has a fixed asset, which is carried in the Balance Sheet on 31.3.2012 at ₹ 500 lakhs. As at that date the value in use is ₹ 400 lakhs and the net selling price is ₹ 375 lakhs.

From the above data:

- Calculate impairment loss.
 - Prepare journal entries for adjustment of impairment loss.
 - Show, how impairment loss will be shown in the Balance Sheet.
- (b) Bottom Ltd. entered into a sale deed for its immovable property before the end of the year. But registration was done with registrar subsequent to Balance Sheet date. But before finalization, is it possible to recognize the sale and the gain at the Balance Sheet date? Give your view with reasons.
- (c) In view of the provisions of Accounting Standard 25 on Interim Financial Reporting, on what basis will you calculate, for an interim period, the provision in respect of defined benefit schemes like pension, gratuity etc. for the employees?

Answer

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

\ Recoverable amount = ₹ 400 lakhs

Impairment loss = Carried Amount – Recoverable amount

= ₹ 500 lakhs – ₹ 400 lakhs = ₹ 100 lakhs.

(ii) Journal Entries

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

(iii) **Balance Sheet of Venus Ltd. as on 31.3.2012**

	(₹ in lakhs)
Fixed Asset	
Asset less depreciation	500
Less: Impairment loss	(100)
	<u>400</u>

- (b) Yes, both sales and gain of Bottom Ltd. should be recognized. In accordance with AS 9, at the Balance Sheet date and what was pending was merely a formality to register the deed. It is clear that significant risk and rewards of ownership had passed before the balance sheet date. Further the registration post the balance sheet date confirms the condition of sale at the balance sheet date as per AS 4.
- (c) Accounting Standard 25 suggests that provision in respect of defined benefit schemes like pension and gratuity for an interim period should be calculated based on the year-to-date basis by using the actuarially determined rates at the end of the prior financial year, adjusted for significant market fluctuations since that time and for significant curtailments, settlements or other significant one-time events.

Question 17

In May, 2011, Speed Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2012 and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was ₹ 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2012 amounted to ₹ 25 lakhs. Can ₹ 25 lakhs be treated as part of the cost of factory building and thus be capitalized on the plea that the loan was specifically taken for the construction of factory building?

Answer

AS 16 clearly states that capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are completed. Therefore, interest on the amount that has been used for the construction of the building upto the date of completion (January, 2012) i.e. ₹ 18 lakhs alone can be capitalized. It cannot be extended to ₹ 25 lakhs.

Question 18

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

₹ In lakhs

Particulars	M	N	O	P	Q	R	Total
Segment Assets	40	80	30	20	20	10	200
Segment Results	50	(190)	10	10	(10)	30	(100)
Segment Revenue	300	620	80	60	80	60	1,200

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The Chief accountant is of the opinion that segments "M" and "N" alone should be reported. Is he justified in his view? Discuss.

Answer

As per para 27 of AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

- (i) Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or
- (ii) Its segment result whether profit or loss is 10% or more of:
 - (1) The combined result of all segments in profit; or
 - (2) The combined result of all segments in loss, whichever is greater in absolute amount; or
- (iii) Its segment assets are 10% or more of the total assets of all segments.

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

- (a) On the basis of turnover criteria segments M and N are reportable segments.
- (b) On the basis of the result criteria, segments M, N and R are reportable segments (since their results in absolute amount is 10% or more of ₹ 200 lakhs).
- (c) On the basis of asset criteria, all segments except R are reportable segments.

Since all the segments are covered in atleast one of the above criteria all segments have to be reported upon in accordance with Accounting Standard (AS) 17. Hence, the opinion of chief accountant is wrong.

Question 19

Victory Ltd. purchased goods on credit from Lucky Ltd. for ₹ 250 crores for export. The export order was cancelled. Victory Ltd. decided to sell the same goods in the local market with a price discount. Lucky Ltd. was requested to offer a price discount of 15%. The Chief Accountant of Lucky Ltd. wants to adjust the sales figure to the extent of the discount requested by Victory Ltd. Discuss whether this treatment is justified.

Answer

Lucky Ltd. had sold goods to Victory Ltd on credit worth for ₹ 250 crores and the sale was completed in all respects. Victory Ltd's decision to sell the same in the domestic market at a discount does not affect the amount recorded as sales by Lucky Ltd. The price discount of 15% offered by Lucky Ltd. after request of Victory Ltd. was not in the nature of a discount given during the ordinary course of trade because otherwise the same would have been given

at the time of sale itself. Now, as far Lucky Ltd is concerned, there appears to be an uncertainty relating to the collectability of the debt, which has arisen subsequent to the time of sale therefore, it would be appropriate to make a separate provision to reflect the uncertainty relating to collectability rather than to adjust the amount of revenue originally recorded. Therefore, such discount should be written off to the profit and loss account and not shown as deduction from the sales figure.

Question 20

- (a) *A company had imported raw materials worth US Dollars 6,00,000 on 5th January, 2010, when the exchange rate was ₹ 43 per US Dollar. The company had recorded the transaction in the books at the above mentioned rate. The payment for the import transaction was made on 5th April, 2012 when the exchange rate was ₹ 47 per US Dollar. However, on 31st March, 2012, the rate of exchange was ₹ 48 per US Dollar. The company passed an entry on 31st March, 2012 adjusting the cost of raw materials consumed for the difference between ₹ 47 and ₹ 43 per US Dollar.*

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

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

Comment on the valuation of the stocks by the company.

Answer

- (a) As per AS 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates', monetary items denominated in a foreign currency should be reported using the closing rate at each balance sheet date. The effect of exchange difference should be taken into profit and loss account. Sundry creditors is a monetary item, hence should be valued at the closing rate i.e., ₹ 48 at 31st March, 2012 irrespective of the payment for the same subsequently at lower rate in the next financial year. The difference of ₹ 5 (₹ 48-₹ 43) per US dollar should be shown as an exchange loss in the profit and loss account for the year ended 31st March, 2012 and is not to be adjusted against the cost of raw- materials. In the subsequent year, the company would record an exchange gain of Re.1 per US dollar, i.e., the difference between ₹ 48 and ₹ 47 per US dollar. Hence, the accounting treatment adopted by the company is incorrect.
- (b) Accounting Standard 2 "Valuation of Inventories" states that inventories should be valued at lower of historical cost and net realizable value. AS 9 on "Revenue Recognition" states, "at certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases, when sale is assured under forward contract or a government guarantee or when market

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exists and there is a negligible risk of failure to sell, the goods invoiced are often valued at Net-realisable value."

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

Question 21

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

Is the procedure adopted by the company correct?

- (b) *A company deals in petroleum products. The sale price of petrol is fixed by the government. After the Balance Sheet date, but before the finalisation of the company's accounts, the government unexpectedly increased the price retrospectively. Can the company account for additional revenue at the close of the year? Discuss.*
- (c) *Mohur Ltd. has equity capital of ₹ 40,00,000 consisting of fully paid equity shares of ₹ 10 each. The net profit for the year 2011-12 was ₹ 60,00,000. It has also issued 36,000, 10% convertible debentures of ₹ 50 each. Each debenture is convertible into five equity shares. The tax rate applicable is 30%. Compute the diluted earnings.*

Answer

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

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

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

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

(c)

Interest on Debentures @ 10% for the year		$36,000 \times \frac{10}{100}$
	=	₹ 1,80,000
Tax on interest @ 30%	=	₹ 54,000
Diluted Earnings (Adjusted net profit)	=	(₹ 60,00,000 + ₹ 1,80,000 - ₹ 54,000)
	=	₹ 61,26,000

Question 22

- (a) During the course of the last three years, a company owning and operating Helicopters lost four Helicopters. The company Accountant felt that after the crash, the maintenance provision created in respect of the respective helicopters was no longer required, and proposed to write back to the Profit and Loss account as a prior period item.

Is the Company's proposed accounting treatment correct? Discuss.

- (b) Mr. 'X' as a contractor has just entered into a contract with a local municipal body for building a flyover. As per the contract terms, 'X' will receive an additional ₹ 2 crore if the construction of the flyover were to be finished within a period of two years of the commencement of the contract. Mr. X wants to recognize this revenue since in the past he has been able to meet similar targets very easily.

Is X correct in his proposal? Discuss.

- (c) A Company is in the process of setting up a production line for manufacturing a new product. Based on trial runs conducted by the company, it was noticed that the production lines output was not of the desired quality. However, company has taken a decision to manufacture and sell the sub-standard product over the next one year due to the huge investment involved.

In the background of the relevant accounting standard, advise the company on the cut-off date for capitalization of the project cost.

- (d) A Company has an inter-segment transfer pricing policy of charging at cost less 10%. The market prices are generally 25% above cost. Is the policy adopted by the company correct?

Answer

- (a) The balance amount of maintenance provision written back to profit and loss account, no longer required due to crash of the helicopters, is not a prior period item because there

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was no error in the preparation of previous periods' financial statements. The term 'prior period items', as defined in AS 5 (revised) "Net Profit or Loss for the Period, Prior Period Items and Changes In Accounting Policies", refer only to 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. As per paragraph 8 of AS 5, extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived. The amount so written-back (if material) should be disclosed as an extraordinary item as per AS 5.

- (b) According to para 14 of AS 7 (Revised) 'Construction Contracts', incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when: (i) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and (ii) the amount of the incentive payment can be measured reliably. In the given problem, the contract has not even begun and hence the contractor (Mr. X) should not recognize any revenue of this contract.
- (c) As per provisions of AS 10 'Accounting for Fixed Assets', expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalized as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production *i.e.*, production intended for sale or captive consumption, is not capitalized and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period. In the present case, the company did stop production even if the output was not of the desired quality, and continued the sub-standard production due to huge investment involved in the project. Capitalization should cease at the end of the trial run, since the cut-off date would be the date when the trial run was completed.
- (d) AS 17 'Segment Reporting' requires that inter-segment transfers should be measured on the basis that the enterprise actually used to price these transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements. Hence, the enterprise can have its own policy for pricing inter-segment transfers and hence, inter-segment transfers may be based on cost, below cost or market price. However, whichever policy is followed, the same should be disclosed and applied consistently. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if, followed consistently.

Question 23

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

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

Answer

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

Para 10 of AS 18 'Related Party Disclosures', defines *related party* as one that has at any time during the reporting period, the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Here, *Control* is defined as ownership directly or indirectly of more than one-half of the voting power of an enterprise; and *Significant Influence* is defined as participation in the financial and/or operating policy decisions of an enterprise but not control of those policies.

In the present case, control of P Ltd. in R Ltd. directly and through Q Ltd., does not go beyond 26%. However, as per para 12 of AS 18, significant influence may be exercised as an investing party (P Ltd.) holds, directly or indirectly through intermediaries 20% or more of the voting power of the R Ltd. As R Ltd. is a listed company and regularly supplies goods to P Ltd. therefore, related party disclosure, as per AS 18, is required.

Question 24

X Ltd. began construction of a new building on 1st January, 2012. It obtained ₹ 1 lakh special loan to finance the construction of the building on 1st January, 2012 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

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

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

	₹
January 2012	2,00,000
April 2012	2,50,000
July 2012	4,50,000
December 2012	1,20,000

Building was completed by 31st December, 2012. Following the principles prescribed in AS 16 'Borrowing Cost,' calculate the amount of interest to be capitalized and pass one Journal Entry for capitalizing the cost and borrowing cost in respect of the building.

Answer**(i) Computation of average accumulated expenses**

		₹
₹ 2,00,000 x 12 / 12	=	2,00,000
₹ 2,50,000 x 9 / 12	=	1,87,500
₹ 4,50,000 x 6 / 12	=	2,25,000
₹ 1,20,000 x 1 / 12	=	<u>10,000</u>
		<u>6,22,500</u>

(ii) Calculation of average interest rate other than for specific borrowings

Amount of loan (₹)	Rate of interest	Amount of interest (₹)
5,00,000	11% =	55,000
9,00,000	13% =	<u>1,17,000</u>
14,00,000		<u>1,72,000</u>
Weighted average rate of interest ($\frac{1,72,000}{14,00,000} \times 100$)	=	12.285% (approx)

(iii) Interest on average accumulated expenses

		₹
Specific borrowings (₹ 1,00,000 X 10%)	=	10,000
Non-specific borrowings (₹ 5,22,500* X 12.285%)	=	<u>64,189</u>
Amount of interest to be capitalized	=	<u>74,189</u>

(iv) Total expenses to be capitalized for building

	₹
Cost of building ₹ (2,00,000 + 2,50,000 + 4,50,000 + 1,20,000)	10,20,000
Add: Amount of interest to be capitalised	<u>74,189</u>
	<u>10,94,189</u>

(v) Journal Entry

Date	Particulars		Dr. (₹)	Cr. (₹)
31.12.2012	Building account	Dr.	10,94,189	
	To Bank account			10,94,189
	(Being amount of cost of building and borrowing cost thereon capitalized)			

* (₹ 6,22,500 – ₹ 1,00,000)

Question 25

- (a) *U.K. International Ltd. is developing a new production process. During the financial year ending 31st March, 2011, the total expenditure incurred was ₹ 50 lakhs. This process met the criteria for recognition as an intangible asset on 1st December, 2010. Expenditure incurred till this date was ₹ 22 lakhs. Further expenditure incurred on the process for the financial year ending 31st March, 2012 was ₹ 80 lakhs. As at 31st March, 2012, the recoverable amount of know-how embodied in the process is estimated to be ₹ 72 lakhs. This includes estimates of future cash outflows as well as inflows.*

You are required to calculate:

- (i) *Amount to be charged to Profit and Loss A/c for the year ending 31st March, 2011 and carrying value of intangible as on that date.*
- (ii) *Amount to be charged to Profit and Loss A/c and carrying value of intangible as on 31st March, 2012.*

Ignore depreciation.

- (b) *Mini Ltd. took a factory premises on lease on 1.4.11 for ₹ 2,00,000 per month. The lease is operating lease. During March, 2012, Mini Ltd. relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2014. The lease cannot be cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months upto 31.12.2014 should be provided in the accounts for the year ending 31.3.2012. Mini Ltd. seeks your advice.*

Answer**(a) As per AS 26 'Intangible Assets'**

- (i) For the year ending 31.03.2011

- (1) Carrying value of intangible as on 31.03.2011:

At the end of financial year 31st March 2011, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of ₹ 28 lakhs (expenditure incurred since the date the recognition criteria were met, i.e., from 1st December 2010).

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

The ₹ 22 lakhs is recognized as an expense because the recognition criteria were not met until 1st December 2011. This expenditure will not form part of the cost of the production process recognized in the balance sheet.

- (ii) For the year ending 31.03.2012

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

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	(₹ in lakhs)
Carrying Amount as on 31.03.2011	28
Expenditure during 2011 – 2012	<u>80</u>
Total book cost	108
Recoverable Amount	<u>(72)</u>
Impairment loss	<u>36</u>

₹ 36 lakhs to be charged to Profit and loss account for the year ending 31.03.2012.

(2) Carrying value of intangible as on 31.03.2012:

	(₹ in lakhs)
Total Book Cost	108
Less: Impairment loss	<u>(36)</u>
Carrying amount as on 31.03.2012	<u>72</u>

- (b) In accordance with AS 29 'Provisions, Contingent Liabilities and Contingent Assets' and ASI 30 'Applicability of AS 29 to Onerous Contracts', if an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision. In the given case, the operating lease contract has become onerous* as the economic benefit of lease contract for next 33 months up to 31.12.2014 will be nil. However, the lessee, Mini Ltd., has to pay lease rent of ₹ 66,00,000 (i.e. 2,00,000 p.m. for next 33 months).

Therefore, provision on account of ₹ 66,00,000 is to be provided in the accounts for the year ending 31.03.12. Hence auditor is right.

Question 26

From the following information of Beta Ltd. calculate Earning Per Share (EPS) in accordance with AS-20:

		(₹) Year 31.3.12	(₹) Year 31.3.11
1.	Net profit before tax	3,00,000	1,00,000
2.	Less: Current tax	(40,000)	(30,000)
	Tax relating to earlier years	(24,000)	13,000
	Deferred tax	(30,000)	(10,000)
3.	Profit after tax	2,06,000	73,000

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

4.	Other information:		
(a)	Profit includes compensation from Central Government towards loss on account of earthquake in 2009 (non-taxable)	1,00,000	NIL
(b)	Outstanding convertible 6% Preference shares 1,000 issued and paid on 30.9.2010. Face value ₹ 100, conversion ratio 15 equity shares for every preference share.		
(c)	15% convertible debentures of ₹ 1,000 each total face value ₹ 1,00,000 to be converted into 10 Equity shares per debenture issued and paid on 30.6.2010.		
(d)	Total number of equity shares outstanding as on 31.3.2012, 20,000 including 10,000 bonus shares issued on 1.1.2012, face value ₹ 100.		

Answer**(a) Calculation of Earning Per Share (EPS) of Beta Ltd.**

		₹ Year ended 31.3.12	₹ Year ended 31.3.11
1.	A. Earning after extra ordinary items (₹2,06,000–₹6,000)(₹73,000 – ₹3,000)	2,00,000	70,000
	B. No. of Equity Shares	20,000	20,000
	C. Basic Earnings Per share [A/B]	10.00	3.50
	A. Earning before extra ordinary items	1,00,000	70,000
	B. No. of Equity Shares	20,000	20,000*
	C. Basic Earnings Per share [A/B]	5.00	3.50
2.	Tax rate applicable		
	₹40,000 + ₹30,000/₹2,00,000×100	35%	
	₹30,000 + ₹10,000/₹1,00,000×100		40%
3.	A. Dividend on Weighted Average Preference Shares	6,000	3,000
	B. Incremental shares	15,000	7,500
	C. EPS on Incremental Shares [A/B]	0.40	0.40

* Since the bonus issue is without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2011.

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4.	Convertible Debentures	(dilutive)	(dilutive)
A.	Increase in earnings		
	$(1,00,000 \times \frac{15}{100} \times .65)$	9,750	
	$1,00,000 \times \frac{15}{100} \times .60 \times \frac{9}{12}$		6,750
B.	Increase in shares	1,000	750
C.	Increase in EPS [A/B]	9.75	9.00
		(Anti dilutive)	(Anti dilutive)

It is anti-dilutive as it increases the EPS from continuing ordinary operations (Para 39, AS 20)

Calculation of Diluted EPS		Year ended 31.3.12 (₹)	Year ended 31.3.11 (₹)
A.	Profit from continuing ordinary activities before Preference Dividend	1,06,000	73,000
	No. of ordinary equity shares	20,000	20,000
	Adjustment for dilutive potential of 6% convertible pref. shares	15,000	7,500
B.	Total no. of shares	35,000	27,500
C.	Diluted EPS from continuing ordinary operations [A/B]	3.02	2.65
D.	Profit including extra ordinary items	2,06,000	73,000
E.	Adjusted No. of shares	35,000	27,500
F.	Diluted EPS including extra ordinary items [D/E]	5.88	2.65

Disclosure of EPS in accordance with AS 20 in the Profit and Loss Account

Earning per share (Face value ₹ 100)	31.3.12 (₹)	31.3.11 (₹)
Basic EPS from continuing ordinary operations	5.00	3.50
Diluted EPS from continuing ordinary operations	3.02	2.65

Question 27

- (a) Golden Eagle Ltd., has been successful jewellers for the past 100 years and sales are against cash only. The company diversified into apparels. A young senior executive was put in charge of Apparels business and sales increased 5 times. One of the conditions

for sales is that dealers can return the unsold stocks within one month of the end of season. Sales return for the year was 25% of sales. Suggest a suitable Revenue Recognition Policy, with reference to AS 9.

- (b) A company has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company rule and to a lump-sum payment to cover expenses on food and stay during the travel. Alternatively employees can claim a lump sum amount equal to one month pay last drawn.

The company's contentions in this matter are:

- (i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the Travel rule of the company or where option for lump-sum payment is exercised, equal to the last pay drawn.
- (ii) Since it is not related to the length of service of the employees, it is accounted for on claim basis.

State whether the contentions of the company are correct as per relevant Accounting Standard. Give reasons in support of your answer.

Answer

- (a) As per AS 9 "Revenue recognition", revenue recognition is mainly concerned with the timing of recognition of revenue in statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by the agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

Effect of Uncertainty- In the case of the jewellery business the company is selling for cash and returns are negligible. Hence, revenue can be recognized on sales. **On the other hand, in Apparels Industry, the dealers have a right to return the unsold goods within one month of the end of the season.** In this case, the company is bearing the risk of sales return and therefore, the company should not recognize the revenue to the extent of 25% of its sales. The company may disclose suitable revenue recognition policy in its financial statements separately for both Jewellery and Apparels business.

- (b) The present case falls under the category of defined benefit scheme under Para 49 of AS 15 (Revised) "Employee Benefits". The said para encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires

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estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,

- (1) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15 (Revised).
- (2) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.
- (3) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

Question 28

- (a) *The borrowings profile of Santra Pharmaceuticals Ltd. set up for the manufacture of antibiotics at Navi Mumbai is as under:*

Date	Nature of borrowings	Amount borrowed (₹)	Purpose of borrowings	Incidental expenses
1 st January, 2011	15% demand loan	60 lakhs	Acquisition of fixed assets	8.33%
1 st July, 2011	14.5% Term loan	40 lakhs	Acquisition of plant and machinery	5%
1 st October, 2011	14% bonds	50 lakhs	Acquisition of fixed assets	8%

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

Fixed assets considered as qualifying assets are as under:

	(₹)
Sterile Manufacturing shed	10,00,000
Plant and machinery (total)	90,00,000
Other fixed assets	10,00,000

The Project is completed on 1st January, 2012 and is ready for commercial production. Show the capitalization of the borrowing costs.

- (b) *A company is engaged in the business of ship building and ship repair. On completion of the repair work, a work completion certificate is prepared and countersigned by ship owner (customer). Subsequently, invoice is prepared based on the work completion certificate describing the nature of work done together with the rate and the amount. Customer scrutinizes the invoice and any variation is informed to the company.*

Negotiations take place between the company and the customer. Negotiations may result in a deduction being allowed from the invoiced amount either as a lumpsum or as a percentage of the invoiced amount. The accounting treatment followed by the company is as follows:

- (i) When the invoice is raised, the customer's account is debited and ship repair income account is credited with the invoiced amount.
- (ii) Deduction, if any, arrived after negotiation is treated as trade discount by debiting the ship repair income account.
- (iii) At the close of the year, negotiation in respect of certain invoices had not been completed. In such cases, based on past experience, a provision for anticipated loss is created by debiting the Profit and Loss account. The provision is disclosed in Balance Sheet.

Following two aspects are settled in the negotiations:

- (i) Errors in billing arising on account of variation between the quantities as per work completion certificate and invoice and other clerical errors in preparing the invoice.
- (ii) Disagreement between the company and customer about the rate/cost on which prior agreement has not been reached between them.

Comment:

- (i) Whether the accounting treatment of deduction as trade discount is correct? If not, state the correct accounting treatment.
- (ii) Whether the disclosure of the provision for anticipated loss in Balance Sheet is correct; if not, statement correct accounting treatment.

Answer

(a) Specific Borrowings

	₹
14.5% Term Loan for acquisition of Plant & Machinery	
Interest from 1st July, 2011 to 31st December, 2011	
$= ₹ 40,00,000 \times 14.5\% \times \frac{6}{12}$	2,90,000
Incidental Expenses	<u>2,00,000</u>
Total	<u>4,90,000</u>
General Borrowings	
15% Demand Loan	
Interest from 1st January, 2011 to 31st December, 2011	9,00,000
$= ₹ 60,00,000 \times 15\%$	
Incidental Expenses	<u>5,00,000</u>
Sub Total (A)	<u>14,00,000</u>

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14% Bonds	
Interest from 1st October, 2011 to 31st December, 2011	
$= ₹ 50,00,000 \times 14\% \times \frac{3}{12}$	1,75,000
Incidental Expenses	<u>4,00,000</u>
Sub Total (B)	<u>5,75,000</u>
Total General Borrowing Cost (A+B)	19,75,000
Total Average Outstanding Borrowings will be as under:	
$\frac{(60,00,000 \times 12 + 50,00,000 \times 3)}{12}$	72,50,000
Weighted Average Borrowing Cost (WABC) = $\frac{\text{Total Borrowing Cost} \times 100}{\text{Total Average Outstanding}}$	
$\frac{19,75,000 \times 100}{72,50,000}$	= 27.24%

Allocation of General Borrowing Fund

Item	Cost (₹)	Specific Borrowing (₹)	Net of specific borrowing (₹)
Sterile Manufacturing Shed	10,00,000	Nil	10,00,000
Plant & Machinery	90,00,000	40,00,000	50,00,000
Other Fixed Assets	10,00,000	Nil	10,00,000

Item	Expenditure on qualifying asset out of general borrowing (₹)	Capitalization Rate	Cost eligible for capitalization (₹)
Sterile Manufacturing Shed	10,00,000	27.24	2,72,400
Plant & Machinery	50,00,000	27.24	13,62,000
Other Fixed Assets	10,00,000	27.24	2,72,400

Borrowing Costs to be Capitalized

Assets	Specific Borrowing Cost (₹)	General Borrowing Cost (₹)	Total (₹)
Sterile Manufacturing shed	Nil	2,72,400	2,72,400
Plant & Machinery	4,90,000	13,62,000	18,52,000
Other Fixed Assets	Nil	2,72,400	2,72,400
Total	4,90,000	19,06,800	23,96,800

Borrowing cost capitalized on general borrowings is ₹19,06,800 which is less than the actual borrowing cost.

- (b) (i) As per AS 9 "Revenue Recognition", revenue is recognized at the time when the invoice is raised to the customers; however the treatment of deduction as trade discount is not as per AS 9. Considering the treatment prescribed by AS 4 "Contingencies and Events occurring after the Balance Sheet Date", the correct treatment of the difference between the invoice amount and finally settled amount should be under:

The adjustment of the difference between the invoiced amount and the amount finally settled against "Ship Repair Income" account is in order. Events occurring up to the date of approval of the accounts by the Board of Directors should be taken into consideration in determining the amount of adjustment to be made in this regard. The description of the difference as "trade discount" is not appropriate.

- (ii) In respect of ship repair jobs for which negotiations between the ship owners and the company are not over, the accounting treatment is not appropriate. Instead, the amount of difference between the invoiced amount and the amount likely to be finally settled (as estimated on the basis of past experience) should be adjusted in the "Ship Repair Income" by a corresponding credit to the accounts of the respective ship owners. Consequently, the figure of sundry debtors included in the balance sheet would be net of adjustment for such difference. In other words, the amount of the difference would be neither shown under the head provisions nor shown as a deduction from the sundry debtors in the balance sheet.

Question 29

- (a) *Good Drugs and Pharmaceuticals Ltd. acquired a sachet filling machine on 1st April, 2011 for ₹ 60 lakhs. The machine was expected to have a productive life of 6 years. At the end of financial year 2011-2012 the carrying amount was ₹ 41 lakhs. A short circuit occurred in this financial year but luckily the machine did not get badly damaged and was still in working order at the close of the financial year. The machine was expected to fetch ₹ 36 lakhs, if sold in the market. The machine by itself is not capable of generating cash flows. However, the smallest group of assets comprising of this machine also, is capable of generating cash flows of ₹ 54 crore per annum and has a carrying amount of ₹ 3.46 crore. All such machines put together could fetch a sum of ₹ 4.44 crore if disposed. Discuss the applicability of Impairment loss.*
- (b) *EXOX Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2011. The company seeks your advice on the following:*
- (i) *The Company's sales tax assessment for assessment year 2008-09 has been completed on 14th February, 2011 with a demand of ₹ 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.*

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- (ii) *The Company has entered into a wage agreement in May, 2011 whereby the labour union has accepted a revision in wage from June, 2010. The agreement provided that the hike till May, 2011 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 2011.*

Answer

- (a) As per provisions of Para 91(b) of AS 28 "Impairment of Assets", impairment loss is not to be recognized for a given asset if its cash generating unit (CGU) is not impaired. In the given question, the related cash generating unit which is group of asset to which the damaged machine belongs is not impaired; and the recoverable amount is more than the carrying amount of group of assets. Hence there is no need to provide for impairment loss on the damaged sachet filling machine.
- (b) (i) Since the company is not appealing against the addition of ₹ 0.66 crore the same should be provided for in its accounts for the year ended on 31st March, 11. The amount paid under protest can be kept under the heading 'Loans & Advances' and disclosed along with the contingent liability of ₹ 2.10 crore.
- (ii) The arrears for the period from June, 2010 to March, 2011 are required to be provided for in the accounts of the company for the year ended on 31st March, 2011.

Question 30

AS Ltd. leased a machine to SB Ltd. on the following terms:

	(₹ in lakhs)
Fair value of the machine	4.00
Lease term	5 years
Lease Rental Per annum	1.00
Guaranteed Residual value	0.20
Expected Residual value	0.40
Internal Rate of Return	15%

Depreciation is provided on straight line method at 10 per cent per annum. Ascertain Unearned Financial Income. Necessary Journal entries in the books of the Lessee in first year may be shown.

Answer

As per AS 19 on Leases, **unearned finance income** is the difference between (a) the **gross investment** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

Where:

- (a) **Gross investment** in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

Gross investment = Minimum lease payments + Unguaranteed residual value

= [Total lease rent + Guaranteed residual value (GRV)] + Unguaranteed residual value (URV)

= [(₹ 1,00,000 × 5 years) + ₹ 20,000] + ₹ 20,000 = ₹ 5,40,000 (a)

- (b) Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV).

Year	M.L.P. inclusive of URV ₹	Internal rate of return (Discount factor @ 15%)	Present Value ₹
1	1,00,000	0.8696	86,960
2	1,00,000	0.7561	75,610
3	1,00,000	0.6575	65,750
4	1,00,000	0.5718	57,180
5	1,00,000	0.4972	49,720
	<u>20,000</u> (GRV)	0.4972	<u>9,944</u>
	5,20,000		3,45,164 (i)
	<u>20,000</u> (URV)	0.4972	<u>9,944</u> (ii)
	<u>5,40,000</u>	(i) + (ii)	<u>3,55,108</u> (b)

Unearned Finance Income = (a) – (b) = ₹ 5,40,000 – ₹ 3,55,108 = ₹ 1,84,892

Journal Entries in the books of SB Ltd.

	₹	₹
<i>At the inception of lease</i>		
Machinery account To AS Ltd.'s account (Being lease of machinery recorded at present value of minimum lease payments)	Dr. 3,45,164*	3,45,164*

* As per para 11 of AS 19, the lessee should recognize the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payments from the standpoint of lessee, the amount recorded should be the present value of these minimum lease payments. Therefore, in this case, as the fair value of ₹ 4,00,000 is more than the present value amounting ₹ 3,45,164, the machinery has been recorded at ₹ 3,45,164 in the books of SB Ltd. (the lessee) at the inception of the lease. According to para 13 of the standard, at the inception of the lease, the asset and liability for the future lease payments are recognised in the balance sheet at the same amounts.

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<i>At the end of the first year of lease</i>			
Finance charges account (Refer Working Note) To AS Ltd.'s account (Being the finance charges for first year due)	Dr. 51,775		51,775
AS Ltd.'s account To Bank account (Being the lease rent paid to the lessor which includes outstanding liability of ₹ 48,225 and finance charge of ₹ 51,775)	Dr. 1,00,000		1,00,000
Depreciation account [£] To Machinery account (Being the depreciation provided @ 10% p.a. on straight line method)	Dr. 34,516		34,516
Profit and loss account To Depreciation account To Finance charges account (Being the depreciation and finance charges transferred to profit and loss account)	Dr. 86,291		34,516 51,775

Working Note:

Table showing apportionment of lease payments by SB Ltd. between the finance charges and the reduction of outstanding liability

Year	Outstanding liability (opening balance)	Minimum lease payments	Finance charges	Reduction in principal amount	Outstanding liability (closing balance)
	₹	₹	₹	₹	₹
1	3,45,164	1,00,000	51,775	48,225	2,96,939
2	2,96,939	1,00,000	44,541	55,459	2,41,480
3	2,41,480	1,00,000	36,222	63,778	1,77,702

[£] Depreciation has been provided on the basis that the machine has been leased at the beginning of the year.

4	1,77,702	1,00,000	26,655	73,345	1,04,357
5	1,04,357	1,00,000	15,654	84,346	20,011

Question 31

Pankaj Ltd. is a company engaged in manufacture of Nuclear Power Stations. The Company usually resorts to long term Foreign Currency borrowings for its fund requirements. The Company had on 1st April, 2005 borrowed U.S. \$100 million from Global Fund Consortium based in Washington, USA. The funds were used by Pankaj Ltd. for purposes OTHER THAN acquiring 'Depreciable Capital Assets'. The loan carries an interest rate of 3 per cent on reducing balance and is repayable in two instalments, the first one due on 1st April, 2010 and the next on 1st April, 2012. The interest due on the loan has been paid in full on 31st March of each year. The exchange rate on the date of borrowing was 1 U.S. \$ = INR 40.

The accounting treatment followed by the Company, for the subsequent three years with exchange rates prevailing on those dates, were as under:

Year ended	Exchange Rate	Accounting Treatment
31 st March, 2006	1 US \$ = 41	Forex Loss of ₹ 10 crores charged to Profit and Loss account;
31 st March, 2007	1 US \$ = 39	Forex gain of ₹ 20 crores recognised in Profit and Loss Account;
31 st March, 2008	1 US \$ = 48	Forex Loss of ₹ 90 crores charged to Profit and Loss account;
31 st March, 2009	1 US \$ = 50	Forex Loss of ₹ 20 crores charged to Profit and Loss account;
31 st March, 2010	1 US \$ = 51	Forex Loss of ₹ 10 crores charged to Profit and Loss account;

Note: Interest payment were charged to Profit and Loss account of each year at transaction value on payment dates.

Pankaj Ltd. is in the process of finalising its accounts for the year ended 31st March, 2009 and understands that AS 11 has been amended and opts to follow the Companies (Accounting Standards) Amendment Rules, 2009.

- (i) You are required to show treatment of the Forex Losses/gains in the light of the above amendment to AS 11 for the years 2005-06; 06-07; 07-08; 08-09; 09-10 & 10-11. The exchange rate to 1 US Dollar on 31st March, 2011 is ₹ 52. Assuming that the rates of Exchange on 31st March, 2012 will be ₹ 53, the accounting for the forex losses/gains may be shown for this year also.

* The difference between this figure and guaranteed residual value (₹ 20,000) is due to approximation in computing the interest rate implicit in the lease.

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- (ii) What are the disclosure requirements to be complied with by Pankaj Ltd. as a result of having opted to follow the amendment in the Companies (Accounting Standard) Rules, 2006.
- (iii) Would your answer to (i) above be different if Pankaj Ltd. was not a Company and were a Co-operative Society.

Answer

Central Govt. in consultation with National advisory Committee on Accounting Standards made an amendment to AS 11 "The Effects of Changes in Foreign Exchange Rates" vide Notification No. G.S.R.225(E), dated 31st March, 09 in the form of Companies (Accounting Standards) Amendment Rules, 2009. According to the Notification, any exchange gain or loss resulting from the translation of foreign currency monetary items not attributable to a depreciable asset should be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) Account and should be written off over the useful life of the assets but not beyond 31st March, 2011. The treatment availed at the option of the company shall be irrevocable and shall be exercised till 31st March, 2011. Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously, recognised in the profit and loss account before the exercise of the option shall be reversed in case of non-depreciable asset by transfer to Foreign Currency Monetary Item Translation Difference (FCMITD) Account, and by debit or credit, as the case may be, to the general reserve.

Ministry of Corporate Affairs vides its notification number G.S.R. (E).- dated 11th May, 2011, has partially amended the notification number GSR No. 225(E) dated 31.03.2009. Through this notification, the MCA has extended the option (for the enterprises) to capitalize the exchange differences arising on reporting of long term foreign currency monetary items till 31st March 2012 instead of 31st March 2011. Therefore, the treatment availed at the option of the company shall be irrevocable and shall be exercised till 31st March, 2012.

(i) Table showing the treatment of forex losses/gains as per amendment to AS 11

Year ended	Opening Balance in FCMITD A/c (₹ in crores)	Exchange Gain/ (Loss) (₹ in crores)	Total (₹ in crores)	Amount Recognised in P&L A/c (₹ in crores)	Closing Balance in FCMITD A/c (₹ in crores)
31 st March, 06	Nil	(10)	(10)	(10)	NIL
31 st March, 07	NIL	20		20	NIL
31 st March, 08	NIL	(90)		(18) ¹	(72)
31 st March, 09	(72)	(20)	(92)	(23) ²	(69)

¹ Total loss of ₹90 crores will be amortised over 5 years till 2012. The amount of ₹72 crores would be credited to General reserve and debited to FCMITD Account in the year 2008-09.

² Amount written off in 2008-09 is 23 crores [1/5 of ₹ 90 crores + 1/4 of ₹ 20 crores]

31 st March, 10	(69)	(10)	(79)	(26.33) ³	(52.67)
31 st March, 11	(52.67)	(5) ⁴	(57.67)	(28.835) ⁵	(28.835)
31 st March, 12	(28.835)	(5)	(33.835)	(33.835) ⁶	Nil

(ii) Disclosure Requirements:

1. The company has chosen to avail the option provided by way of amendment in the Companies (AS) Amendment Rules, 2009 and 2011.
2. According to AS 1 "Disclosure of Accounting Policies", Exercise of option due to amendment in AS 11 is a change in accounting policy.
3. The amount amortized to profit and loss account and the amount carried forwarded in each year till 31st March, 2012 should be disclosed.

(iii) Notification No. G.S.R.225(E) is relevant only for companies. If Pankaj Ltd. is a co-operative society, then the said notification would not be applicable. In that case, option to amortise FOREX losses over the period till 31.03.2012 will not be available to it. The amounts charged to Profit and loss account would be same as shown in the column carrying the heading "Exchange gain/Loss" in the table given under (i).

Question 32

- (a) On 30.6.2011, Asmitha Ltd. incurred ₹ 2,00,000, net loss from disposal of a business segment. Also, on 30.7.2011, the company paid ₹ 60,000 for property taxes assessed for the calendar year 2011. How the above transactions should be included in determination of net income of Asmitha Ltd. for the six months interim period ended on 30.9.2011.
- (b) M/s XYZ Ltd. has three segments namely X, Y, Z. The total Assets of the Company are ₹ 10.00 crores. Segment X has ₹ 2.00 crores, segment Y has ₹ 3.00 crores and segment Z has ₹ 5.00 crores. Deferred tax assets included in the assets of each segments are X- ₹ 0.50 crores, Y—₹ 0.40 crores and Z—₹ 0.30 crores. The accountant contends that all the three segments are reportable segments. Comment.
- (c) M/s Dinesh & Company signed an agreement with workers for increase in wages with retrospective effect. The outflow on account of arrears was for 2008-09—₹ 10.00 lakhs, for 2009-10—₹ 12.00 lakhs and for 2010-11—₹ 12.00 lakhs. This amount is payable in September, 2011. The accountant wants to charge ₹ 22.00 lakhs as prior period charges in financial statement for 2011-12. Discuss.
- (d) M/s Prima Co. Ltd. sold goods worth ₹ 50,000 to M/s Y and Company. M/s Y and Co. asked for discount of ₹ 8,000 which was agreed by M/s Prima Co. Ltd. the sale was

³ Amount written off in 2009-10 is 26.33 crores

[1/5 of ₹ 90 crores + 1/4 of ₹ 20 crores + 1/3 of ₹ 10 crores]

⁴ First instalment of loan paid on 1st April, 2010 and the balance of loan account is US\$ 50 million.

⁵ Amount written off in 2010-11 is 28.835 crores

[1/5 of ₹ 90 crores + 1/4 of ₹ 20 crores + 1/3 of ₹ 10 crores + 1/2 of ₹ 5 crores]

⁶ Entire balance including exchange loss of current year is fully amortized.

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affected and goods were dispatched. After receiving goods worth ₹ 7,000 was found defective which they returned immediately. They made the payment of ₹ 35,000 to M/s Prima Co. Ltd. Accountant booked the sales for ₹ 35,000. Please discuss.

- (e) *Himalayas Ltd. is showing an intangible Asset at ₹ 72 lakhs as on 01.04.2012 and that item was required for ₹ 96 lakhs on 01.04.2009 which was available for use from that date. Himalayas Ltd. has been following the policy of amortisation of the intangible asset over a period of 12 years on straight line basis. Comment on the accounting treatment of the above with reference to relevant accounting standard.*

Answer

- (a) According to Para 10 of AS 25 "Interim Financial Reporting", if an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements. As on 30.9.2011, Asmitha Ltd., would report the entire ₹ 2,00,000 loss on the disposal of its business segment since the loss was incurred during interim period. A cost charged as an expense in an annual period should be allocated to Interim periods on accrual basis. Since ₹ 60,000 Property Tax payment relates to entire calendar year 2011, ₹ 30,000 would be reported as an expense for six months ended on 30th September, 2011 while remaining ₹ 30,000 would be reported as prepaid expenses.
- (b) According to AS 17 "Segment Reporting", segment assets do not include income tax assets. Therefore, the revised total assets are ₹8.8 crores [₹10 crores – (₹0.5+₹0.4+₹0.3)]. Segment X holds total assets of ₹1.5 crores (₹2 crores – ₹0.5 crores); Segment Y holds ₹2.6 crores (₹3 crores – ₹0.4 crores); and Segment Z holds ₹4.7 crores (₹5 crores – ₹0.3 crores). Thus all the three segments hold more than 10% of the total assets, all segments are reportable segments.
- (c) According to AS 5 (Revised) "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", the term prior period item refers only to income or expenses which arise in the current period as a result of errors or omission in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods are determined in the current period. The full amount of wage arrears paid to workers will be treated as an expense of current year and it will be charged to profit and loss account as current expenses and not as prior period expenses.

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

- (d) As per Para 4.1 of AS 9 "Revenue Recognition", revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends.

In the given case, M/s Prima Co. Ltd. should record the sales at gross value of ₹ 50,000. Discount of ₹ 8,000 in price and goods returned worth ₹ 7,000 are to be adjusted by suitable provisions. M/s Prime Co. Ltd. might have sent the credit note of ₹ 15,000 to M/s Y & Co. to account for these adjustments. The contention of the accountant to book the sales for ₹ 35,000 is not correct.

- (e) As per Para 63 of AS 26 "Intangible Assets", the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

Himalayas Ltd. has been following the policy of amortisation of the intangible asset over a period of 12 years on straight line basis. The period of 12 years is more than the maximum period of 10 years specified under AS 26. Accordingly, Himalayas Ltd. would be required to restate the carrying amount of intangible asset as on 1.4.2012 at ₹ 96 lakhs less ₹ 28.8 lakhs ($₹ 9.6 \text{ lakhs} \times 3 \text{ years}$) = ₹ 67.2 lakhs. If amortisation had been as per AS 26, the carrying amount would have been ₹ 67.2 lakhs. The difference of ₹ 4.8 lakhs i.e. ($₹ 72 \text{ lakhs} - 67.2 \text{ lakhs}$) would be required to be adjusted against the opening balance of revenue reserves. The carrying amount of ₹ 67.2 lakhs would be amortized over 7 (10 less 3) years in future.

Question 33

- (a) From the following details of an asset

- (i) Find out impairment loss
- (ii) Treatment of impairment loss
- (iii) Current year depreciation

Particulars of asset:

Cost of asset	₹ 56 lakhs
Useful life period	10 years
Salvage value	Nil
Current carrying value	₹ 27.30 lakhs
Useful life remaining	3 years
Recoverable amount	₹ 12 lakhs
Upward revaluation done in last year	₹ 14 lakhs

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- (b) Rainbow Limited borrowed an amount of ₹ 150 crores on 1.4.2010 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of Rainbow Ltd. capitalized ₹ 19.50 crores for the accounting period ending on 31.3.2011. Due to surplus fund out of ₹ 150 crores an income of ₹ 3.50 crores was earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard.
- (c) Suraj Limited wishes to obtain a machine costing ₹ 30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 5 years. It enters into an agreement with Ashok Ltd., for a lease rental for ₹ 3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The chief accountant of Suraj Limited is not sure about the treatment of these lease rentals and seeks your advise.
- (d) Omega Limited is working on different projects which are likely to be completed within 3 years period. It recognizes revenue from these contracts on percentage of completion method for financial statements during 2010, 2011 and 2012 for ₹ 11,00,000, ₹ 16,00,000 and ₹ 21,00,000 respectively. However, for Income-tax purpose, it has adopted the completed contract method under which it has recognized revenue of ₹ 7,00,000, ₹ 18,00,000 and ₹ 23,00,000 for the years 2010, 2011 and 2012 respectively. Income-tax rate is 35%. Compute the amount of deferred tax asset/liability for the years 2010, 2011 and 2012.
- (e) While preparing its final accounts for the year ended 31st March, 2012, a company made a provision for bad debts @ 5% of its total debtors. In the last week of February 2012, a debtor for 2 lakhs had suffered heavy loss due to earthquake. The loss was not covered by any insurance policy. In April, 2012, the debtor became bankrupt. Can the company provide for full loss arising out of insolvency of debtor in the final accounts for year ended 31st March, 2012?

Answer

- (a) According to AS 28 "Impairment of Assets", an impairment loss on a revalued asset is recognised as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

Impairment Loss and its treatment	₹
Current carrying amount (including revaluation amount of ₹ 14 lakhs)	27,30,000
Less: Current recoverable amount	(12,00,000)
Impairment Loss	15,30,000
Impairment loss charged to revaluation reserve	14,00,000
Impairment loss charged to profit and loss account	1,30,000

After the recognition of an impairment loss, the depreciation (amortization) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

In the given case, the carrying amount of the asset will be reduced to ₹ 12,00,000 after impairment. This amount is required to be depreciated over remaining useful life of 3 years (including current year). Therefore, the depreciation for the current year will be ₹ 4,00,000.

- (b) Para 10 of AS 16 'Borrowing Costs' states "To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings." The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. Hence, in the above case, treatment of accountant of Rainbow Ltd. is incorrect. The amount of borrowing costs capitalized for the financial year 2010-11 should be calculated as follows:

	₹ in crores
Actual interest for 2010-11 (11% of ₹ 150 crores)	16.50
Less: Income on temporary investment from specific borrowings	(3.50)
Borrowing costs to be capitalized during year 2010-11	13.00

- (c) As per AS 19 'leases', a lease will be classified as finance lease if at the inception of the lease, the present value of minimum lease payment^{*} amounts to at least substantially all of the fair value of leased asset. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. In the given case, the implicit rate of interest is given at 15%. The present value of minimum lease payments at 15% using PV- Annuity Factor can be computed as:

Annuity Factor (Year 1 to Year 5 ₹ 3 lakhs each year)	₹ 3.36 lakhs (approx.)
Present Value of minimum lease payments	₹ 10.08 lakhs (approx.)

Thus present value of minimum lease payments is ₹ 10.08 lakhs and the fair value of the machine is ₹ 30 lakhs. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. However, in the given case, the effective useful life of the machine is 14 years while the lease is only for five years. Therefore lease agreement is an operating lease. Lease payments under an operating lease should be recognized as an expense in the statement of profit and loss on a

^{*} In calculating the present value of the of minimum lease payments, the discount rate is the interest rate implicit in the lease.

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straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

(d) Omega Limited.

Calculation of Deferred Tax Asset/Liability

Year	Accounting Income	Taxable Income	Timing Difference (balance)	Deferred Tax Liability (balance)
2010	11,00,000	7,00,000	4,00,000	1,40,000
2011	16,00,000	18,00,000	2,00,000	70,000
2012	21,00,000	23,00,000	NIL	NIL
	48,00,000	48,00,000		

- (e) As per Para 8.2 and 13 of Accounting Standard 4 'Contingencies and Events occurring after the Balance Sheet Date', assets and liabilities should be adjusted for events occurring after the date of balance sheet, that provide additional evidence to assist estimation of amounts relating to conditions existing at the Balance Sheet date. Therefore, in the given case, full provision for bad debt amounting ₹ 2 lakhs should be made to cover the loss arising due to insolvency in the final accounts for the year ended 31st March, 2012 as earthquake took place before the balance sheet date.

Question 34

- (a) The following data apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.12, calculate the actual return on plan assets :

- Benefits paid	2,00,000
- Employer contribution	2,80,000
- Fair market value of plan assets on 31.03.12	11,40,000
- Fair market value of plan assets as on 31.03.11	8,00,000

- (b) U.S.A Ltd. purchased raw material @ ₹ 400 per kg. Company does not sell raw material but uses in production of finished goods. The finished goods in which raw material is used are expected to be sold at below cost. At the end of the accounting year, company is having 10,000 kg of raw material in stock. As the company never sells the raw material, it does not know the selling price of raw material and hence can not calculate the realizable value of the raw material for valuation of inventories at the end of the year. However replacement cost of raw material is ₹ 300 per kg. How will you value the inventory of raw material?
- (c) Moon Ltd. entered into agreement with Sun Ltd. for sale of goods of ₹ 8 lakhs at a profit of 20 % on cost. The sale transaction took place on 1st February, 2011. On the same day Sun Ltd. entered into another agreement with Moon Ltd. to resell the same goods at ₹ 10.80 lakhs on 1st August, 2011. State the treatment of this transaction in the financial statements of Moon Ltd. as on 31.03.11. The pre-determined re-selling price covers the

holding cost of Sun Ltd. Give the Journal Entries as on 31.03.11 in the books of Moon Ltd.

Answer

(a)

		₹
Fair value of plan assets on 31.3.11		8,00,000
Add: Employer contribution		2,80,000
Less: Benefits paid		<u>2,00,000</u>
	(A)	<u>8,80,000</u>
Fair market value of plan assets at 31.3.12	(B)	<u>11,40,000</u>
Actual return on plan assets	(B-A)	<u>2,60,000</u>

- (b) As per Para 24 of AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. Therefore, in this case, USA Ltd. will value the stock of raw material at ₹ 30,00,000 (10,000 Kg. @ ₹ 300 per kg.).
- (c) In the given case, Moon Ltd. concurrently agreed to repurchase the same goods from Sun Ltd. on 1st Feb., 2011. Also the re-selling price is pre-determined and covers purchasing and holding costs of Sun Ltd. Hence, the transaction between Moon Ltd. and Sun Ltd. on 1st Feb., 2011 should be accounted for as financing rather than sale. The resulting cash flow of ₹ 9.60 lakhs received by Moon Ltd., cannot be considered as revenue as per AS 9 "Revenue Recognition".

Journal Entries in the books of Moon Ltd.

			(₹ in lakhs)	
1.02.11	Bank Account To Advance from Sun Ltd*. (Being advance received from Sun Ltd amounting [₹ 8 lakhs + 20% of ₹ 8 lakhs= 9.60 lakhs] under sale and re-purchase agreement)	Dr.	9.60	9.60

* The balance of Sun Ltd. account will be disclosed as an advance under the heading liabilities in the balance sheet of Moon Ltd. as on 31st March, 2011.

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31.03.11	Financing Charges Account To Sun Ltd. (Financing charges for 2 months at ₹ 1.20 lakhs [10.80 – 9.60] i.e. 1.2 lakhs x 2/6)	Dr.	0.40	0.40
31.03.11	Profit and Loss Account To Financing Charges Account (Being amount of finance charges transferred to P& L Account)	Dr.	0.40	0.40

Question 35

- (a) Mr. A bought a forward contract for three months of US \$ 1,00,000 on 1st December at 1 US \$ = ₹ 47.10 when exchange rate was US \$ 1 = ₹ 47.02. On 31st December when he closed his books, exchange rate was US \$ 1 = ₹ 47.15. On 31st January, he decided to sell the contract at ₹ 47.18 per dollar. Show how the profits from contract will be recognised in the books.
- (b) Sun Ltd. has entered into a sale contract of ₹ 5 crores with X Ltd. during 2010-11 financial year. The profit on this transaction is ₹ 1 crore. The delivery of goods to take place during the first month of 2011-12 financial year. In case of failure of Sun Ltd. to deliver within the schedule, a compensation of ₹ 1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 2010-11 financial year. As on balance sheet date (31.3.2011), the goods were not manufactured and it was unlikely that Sun Ltd. will be in a position to meet the contractual obligation.
- (i) Should Sun Ltd. provide for contingency as per AS 29?
- (ii) Should provision be measured as the excess of compensation to be paid over the profit?
- (c) Rainbow Limited borrowed an amount of ₹ 150 crores on 1.4.2011 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. The weighted average cost of capital is 13% p.a. The accountant of Rainbow Ltd. capitalised interest of ₹ 19.50 crores for the accounting period ending on 31.3.2012. Due to surplus fund out of ₹ 150 crores an income of ₹ 3.50 crores was earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard.
- (d) Y Ltd. is a full tax free enterprise for the first ten years of its existence and is in the second year of its operation. Depreciation timing difference resulting in a tax liability in year 1 and 2 is ₹ 200 lakhs and ₹ 400 lakhs respectively. From the third year it is expected that the timing difference would reverse each year by ₹ 10 lakhs. Assuming tax rate of 40%, find out the deferred tax liability at the end of the second year and any charge to the Profit and Loss account.

Answer

- (a) It is apparent from the facts given in the question that Mr. A entered into forward exchange contract for speculation purpose*. According to paragraphs 38 and 39 of AS 11(Revised) 'The Effects of Changes in Foreign Exchange Rates', gain or loss on forward exchange contracts intended for trading or speculation purpose should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss for the period and the premium or discount on the forward exchange contract is ignored and not recognised separately. In recording such contract, at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Thus, the premium on contract i.e., the difference between the contract rate and the spot rate amounting ₹ 8,000 [US \$ 1,00,000 x (₹ 47.10 – ₹ 47.02)] will be ignored and not be recorded in the books. However, the profit on contract i.e. the difference between the sale rate and contract rate amounting ₹ 8,000 [US\$ 1,00,000 x 0.08* (₹ 47.18 – ₹ 47.10)] will be recognized in the books of Mr. A on 31st January.

- (b) (i) AS 29 "Provisions, Contingent Liabilities and Contingent Assets" provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognised. Sun Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Sun Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Sun Ltd. should provide for the contingency amounting ₹ 1.5 crores as per AS 29.
- (ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 2011 and no profit had accrued for the financial year 2010-2011. Therefore, provision should be made for the full amount of compensation amounting ₹ 1.50 crores.
- (c) Para 10 of the AS 16 'Borrowing Cost' states, "To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary

* The forward contract is sold before its due date, hence considered as speculative.

* The current market value of the forward contract on 31st December has not been given in the question. Therefore, no gain or loss can be recognised in the books on 31st December. The profit amounting ₹ 8,000 will be recognised in the year of sale only.

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investment of those borrowings". The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. In the given case, the amount of ₹ 150 crores was specifically borrowed for construction of boiler plant. Therefore, treatment of accountant of Rainbow Ltd. is not correct and the amount of borrowing costs to be capitalised for the financial year 2011-12 should be calculated as follows:

	(₹ in crores)
Interest paid for 2011-12 (11% on ₹ 150 crores)	16.50
Less: Income on temporary investment from specific borrowings	<u>(3.50)</u>
Borrowing costs to be capitalised during 2011-12	<u>13.00</u>

- (d) As per Accounting Standards Interpretation (ASI) 5* "Accounting for Taxes on Income in the situations of Tax Holiday under sections 10A and 10B of the Income-tax Act, 1961 Accounting Standard (AS) 22, Accounting for Taxes on Income", deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Income-tax Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22. For this purpose, the timing differences which originate first should be considered to reverse first.

Out of ₹ 200 lakhs depreciation, timing difference amounting ₹ 80 lakhs (₹ 10 lakhs x 8 years) will reverse in the tax holiday period and therefore, should not be recognised. However, for ₹ 120 lakhs (₹ 200 lakhs – ₹ 80 lakhs), deferred tax liability will be recognised for ₹ 48 lakhs (40% of ₹ 120 lakhs) in first year. In the second year, the entire amount of timing difference of ₹ 400 lakhs will reverse only after tax holiday period and hence, will be recognised in full. Deferred tax liability amounting ₹ 160 lakhs (40% of ₹ 400 lakhs) will be created by charging it to profit and loss account and the total balance of deferred tax liability account at the end of second year will be ₹ 208 lakhs (48 lakhs + 160 lakhs).

Question 36

- (a) *Night Ltd. sells beer to customers; some of the customers consume the beer in the bars run by Night Limited. While leaving the bars, the consumers leave the empty bottles in the bars and the company takes possession of these empty bottles. The company has*

* This ASI has been incorporated as an explanation to para 13 of the notified AS 22.

laid down a detailed internal record procedure for accounting for these empty bottles which are sold by the company by calling for tenders. Keeping this in view:

- (i) *Decide whether the stock of empty bottles is an asset of the company;*
 - (ii) *If so, whether the stock of empty bottles existing as on the date of Balance Sheet is to be considered as inventories of the company and valued as per AS-2 or to be treated as scrap and shown at realizable value with corresponding credit to 'Other Income'?*
- (b) *AS 4 prescribes that 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 amount relating to conditions existing at the Balance sheet date-generally called adjusting events. "Proposed Dividend" is shown and adjusted in the Balance Sheet even if it is not an adjusting event as per AS 4 because it is proposed by the Board of Directors of the company after the Balance sheet date.*

Keeping this in view, is it not a violation of AS 4 to show proposed dividends as current liabilities and provisions? Comment.

- (c) *Bright Ltd. acquired 30% of East India Ltd. Shares for ₹ 2,00,000 on 01-06-11. By such an acquisition Bright can exercise significant influence over East India Ltd. During the financial year ending on 31-03-11 East India earned profits ₹ 80,000 and declared a dividend of ₹ 50,000 on 12-08-2011. East India reported earnings of ₹ 3,00,000 for the financial year ending on 31-03-12 and declared dividends of ₹ 60,000 on 12-06-2012.*

Calculate the carrying amount of investment in:

- (i) *Separate financial statements of Bright Ltd. as on 31-03-12;*
 - (ii) *Consolidated financial statements of Bright Ltd.; as on 31-03-12;*
 - (iii) *What will be the carrying amount as on 30-06-2012 in consolidated financial statements?*
- (d) *An asset does not meet the requirements of environment laws which have been recently enacted. The asset has to be destroyed as per the law. The asset is carried in the Balance Sheet at the year end at ₹ 6,00,000. The estimated cost of destroying the asset is ₹ 70,000. How is the asset to be accounted for?*

Answer

- (a) (i) *Tangible objects or intangible rights carrying probable future benefits, owned by an enterprise are called assets. Night Ltd. sells these empty bottles by calling tenders. It means further benefits are accrued on its sale. Therefore, empty bottles are assets for the company.*
- (ii) *As per AS 2 "Valuation of Inventories", inventories are assets held for sale in the ordinary course of business. Stock of empty bottles existing on the Balance Sheet date is the inventory and Night Ltd. has detailed controlled recording and accounting*

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procedure which duly signify its materiality. Hence stock of empty bottles cannot be considered as scrap and should be valued as inventory in accordance with AS 2.

- (b) As per para 8 of 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. Accordingly, proposed dividend is not an adjusting event. However, para 14 of the standard states that dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted in the financial statements. Schedule VI of the Companies Act 1956 also prescribes that proposed dividend should be shown under the heading 'Current Liabilities and Provisions' in the balance sheet. Therefore, showing proposed dividends as 'current liability and provision' by adjusting it in the Balance Sheet is not in violation of AS 4.

- (c) (i) **Carrying amount of investment in Separate Financial Statement of Bright Ltd. as on 31.03.12**

	₹
Amount paid for investment in Associate (on 1.06.2011)	2,00,000
Less: Pre-acquisition dividend (₹50,000 x 30%)	<u>(15,000)</u>
Carrying amount as on 31.3.2012 as per AS 13	<u>1,85,000</u>

- (ii) **Carrying amount of investment in Consolidated Financial Statements* of Bright Ltd. as on 31.3.2012 as per AS 23**

	₹
Carrying amount as per separate financial statements	1,85,000
Add: Proportionate share of profit of investee as per equity method (30% of ₹3,00,000)	<u>90,000</u>
Carrying amount as on 31.3.2012	<u>2,75,000</u>

- (iii) **Carrying amount of investment in Consolidated Financial Statement of Bright Ltd. as on 30.6.2012 as per AS 23**

	₹
Carrying amount as on 31.3.2012	2,75,000
Less: Dividend received (₹ 60,000 x 30%)	<u>(18,000)</u>
Carrying amount as on 30.6.2012	<u>2,57,000</u>

* It is assumed that Bright Ltd. has a subsidiary company and it is preparing Consolidated Financial Statements.

- (d) As per AS 28 "Impairment of Assets", impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount, where, recoverable amount is the higher of an asset's net selling price* and its value in use[†]. In the given case, recoverable amount will be nil [higher of value in use (nil) and net selling price (₹70,000)]. Thus impairment loss will be calculated as ₹ 6,00,000 [carrying amount (₹6,00,000) – recoverable amount (nil)]. Therefore, asset is to be fully impaired and impairment loss of ₹ 6,00,000 has to be recognized as an expense immediately in the statement of Profit and Loss as per para 58 of AS 28.

Question 37

X Ltd. sold its building to Mini Ltd. for ₹ 60 lakhs on 30.09-2011 and gave possession of the property to Mini Ltd. However, documentation and legal formalities are pending. Due to this, the company has not recorded the sale and has shown the amount received as an advance. The book value of the building is ₹ 25 lakhs as on 31st March, 2012. Do you agree with this treatment? If you do not agree, explain the reasons with reference to the accounting standard.

Answer

Principles of prudence, substance over form and materiality should be looked into, to ensure true and fair consideration in a transaction. In the given case, the economic reality and substance of the transaction is that the rights and beneficial interest in the property has been transferred although legal title has not been transferred. Hence, X Ltd. should record the sale and recognize the profit of ₹ 35 lakhs in its financial statements for the year ended 31st March, 2012; value of building should be removed from the balance sheet. Therefore the treatment given by the company is not correct.

Question 38

Southern Tower Ltd. purchased a plant from M/s Tatamaco Ltd. on 30-09-2011 with a quoted price of ₹ 180 lakhs. Tatamaco offer 3 months credit with a condition that discount of 1.25% will be allowed if the payment were made within one month. VAT is 12.5% on the quoted price. Company incurred 2% on transportation costs and 3% on erection costs of the quoted price. Preoperative cost amount to ₹ 1.50 lakhs. To finance the purchase of the machinery, company took a term bank loan of ₹ 125 lakhs at an interest rate of 14.50% per annum. The machine was ready for use on 31-12-2011; however, it was put to use only on 01-04-2012.

- (i) Find out the original cost.

*Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. In the given case, Net Selling Price = Selling price – Cost of disposal = Nil – ₹70,000 = (₹ 70,000)

[†] Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. In the given case, value in use is nil.

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- (ii) Suggest the accounting treatment for the cost incurred during the period between the date the machine was ready for use and the actual date the machine was put to use.

Answer

(i) Original cost of the machine

Particulars	₹ in lakhs	₹ in lakhs
Quoted price	180.00	
Less: Discount @1.25%	<u>(2.25)</u>	177.75
Add: VAT @12.5%		22.50
Transportation @ 2%		3.60
Erection cost @ 3%		5.40
Pre-operative cost		1.50
Finance cost (14.5% on ₹125 lakhs for the period 01.10.11 to 31.12.11)		<u>4.53</u>
Total		<u>215.28</u>

(ii) Cost incurred during the period between the date the machine was ready for use and the actual date the machine was put to use

Finance cost amounting ₹ 4.53 lakhs (14.50% on ₹ 125 lakhs for the period 01.01.2012 to 31.03.2012) will be charged to profit and loss account as per AS 16 "Borrowing Costs".

Question 39

S. Square Private Limited has taken machinery on lease from S.K. Ltd. The information is as under:

Lease term = 4 years

Fair value at inception of lease = ₹ 20,00,000

Lease rent = ₹ 6,25,000 p.a. at the end of year

Guaranteed residual value = ₹ 1,25,000

Expected residual value = ₹ 3,75,000

Implicit interest rate = 15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively.

Calculate the value of the lease liability as per AS-19.

Answer

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the finance lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	Minimum Lease Payment ₹	Internal rate of return (Discount rate @5%)	Present value ₹
1	6,25,000	0.8696	5,43,500
2	6,25,000	0.7561	4,72,563
3	6,25,000	0.6575	4,10,937
4	<u>7,50,000*</u>	0.5718	<u>4,28,850</u>
Total	<u>26,25,000</u>		<u>18,55,850</u>

Present value of minimum lease payments ₹18,55,850 is less than fair value at the inception of lease i.e. ₹ 20,00,000, therefore, the lease liability should be recognized at ₹18,55,850 as per AS 19.

Question 40

- (a) The fair value of plan assets of Anupam Ltd. was ₹ 2,00,000 in respect of employee benefit pension plan as on 1st April, 2011. On 30th September, 2011 the plan paid out benefits of ₹ 25,000 and received inward contributions of ₹ 55,000. On 31st March, 2012 the fair value of plan assets was ₹ 3,00,000. On 1st April, 2011 the company made the following estimates, based on its market studies and prevailing prices.

	%
Interest and dividend income (after tax) payable by fund	10.25
Realized gains on plan assets (after tax)	3.00
Fund administrative costs	<u>(3.00)</u>
Expected rate of return	<u>10.25</u>

Calculate the expected and actual returns on plan assets as on 31st March, 2012, as per AS 15.

* Minimum Lease Payment of 4th year includes guaranteed residual value amounting ₹1,25,000.

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(b) HSL Ltd., is manufacturing goods for local sale and exports. As on 31st March, 2011, it has the following finished stock in the factory warehouse:

(i) Goods meant for local sales ₹ 100 lakhs (cost ₹ 75 lakhs)

(ii) Goods meant for exports ₹ 50 lakhs (cost ₹ 20 lakhs)

Excise duty is payable at the rate of 12%. The company's Managing Director says that excise duty is payable only on clearance of goods and hence not a cost. Please advise HSL using guidance note, if any issued on this, including valuation of stock.

(c) Rama Ltd, has provided the following information:

	₹
Depreciation as per accounting records	= 2,00,000
Depreciation as per income tax records	= 5,00,000
Unamortized preliminary expenses as per tax record	= 30,000

There is adequate evidence of future profit sufficiency. How much deferred tax asset/liability should be recognized as transition adjustment? Tax rate 50%.

Answer

(a) Computation of Expected Returns on Plan Assets as on 31st March, 2012, as per AS 15

	₹
Return on opening value of plan assets of ₹ 2,00,000 (held for the year) @ 10.25%	20,500
Add: Return on net gain of ₹ 30,000 (i.e. ₹ 55,000 – ₹ 25,000) during the year i.e. held for six months @ 5% (equivalent to 10.25% annually, compounded every six months)	1,500
Expected return on plan assets as on 31 st March, 2012	22,000

Computation of Actual Returns on Plan Assets as on 31st March, 2012, as per AS 15

	₹	₹
Fair value of Plan Assets as on 31 st March, 2012		3,00,000
Less: Fair value of Plan Assets as on 1 st April, 2011	(2,00,000)	
Add: Contribution received as on 30 th September, 2011	55,000	(2,55,000)
		45,000
Add: Benefits paid as on 30 th September, 2011		25,000
Actual returns on Plan Assets as on 31 st March, 2012		70,000

- (b) According to Central Excise Rules, 2002, excise duty is levied upon the manufacture or production of goods. However, it is collected only at the time of removal of goods from factory premises or factory warehouse.

Guidance Note on 'Accounting Treatment for Excise Duty' says that excise duty is a duty on manufacture or production of excisable goods in India.

As explained in the Guidance Note, the liability for excise duty arises at the point of time at which the manufacture is completed. The excise duty paid or provided on finished goods should, therefore, be included in inventory valuation.

Further, the Guidance Note states that excise duty should be considered as a manufacturing expense and like other manufacturing expenses are considered as an element of cost for the purpose of inventory valuation, excise duty should also be considered as an element of cost while valuing the inventory.

Therefore, in the given case of HSL Ltd., the Managing Director's contention that "excise duty is payable only on clearance of goods and hence is not a cost" is incorrect. Excise duty on the goods meant for local sales should be provided for at the rate of 12% on the selling price, that is on ₹ 100 lakhs for valuation of stock.

Excise duty on goods meant for exports, should also be provided for, since the liability for excise duty arises when the manufacture of the goods is completed. However, if it is assumed that all the conditions specified in Rule 19 of the Central Excise Rules, 2002 regarding export of excisable goods without payment of duty are fulfilled by HSL Ltd. excise duty may not be provided for.

- (c) Table showing calculation of deferred tax asset / liability

Particulars	Amount	Timing differences	Deferred tax	Amount @ 50%
	₹			₹
Excess depreciation as per tax records (₹ 5,00,000 – ₹ 2,00,000)	3,00,000	Timing	Deferred tax liability	1,50,000
Unamortised preliminary expenses as per tax records	30,000	Timing	Deferred tax asset	(15,000)
Net deferred tax liability				<u>1,35,000</u>

Question 41

- (a) Anil Pharma Ltd. ordered 16,000 kg of certain material at ₹ 160 per unit. The purchase price includes excise duty ₹ 10 per kg in respect of which full CENVAT credit is admissible. Freight incurred amounted to ₹ 1,40,160. Normal transit loss is 2%. The company actually received 15,500 kg and consumed 13,600 kg of material. Compute cost of inventory under AS 2 and amount of abnormal loss.

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- (b) Jain Construction Co. Ltd. undertook a contract on 1st January, 2012 to construct a building for ₹80 lakhs. The company found on 31st March, 2012 that it had already spent ₹58,50,000 on the construction. Prudent estimate of additional cost for completion was ₹31,50,000.

What amount should be charged to revenue and what amount of contract value to be recognized as turnover in the final accounts for the year ended 31st March 2012 as per provisions of AS 7 (revised)?

- (c) Kumar Ltd., is in engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹2 lakhs instead of ₹5 lakhs. The average remaining life of the employee is estimated to be 6 years.

You are required to advise the company.

- (d) An enterprise reports quarterly, estimates an annual income of ₹10 lakhs. Assume tax rates on 1st ₹5,00,000 at 30% and on the balance income at 40%. The estimated quarterly income are ₹75,000, ₹2,50,000, ₹3,75,000 and ₹3,00,000.

Calculate the tax expense to be recognized in each quarter.

Answer

(a) Calculation of total cost of material

	₹
Purchase price (16,000 kg. x ₹ 160)	25,60,000
Less : CENVAT credit (16,000 kg. x ₹ 10)	<u>(1,60,000)</u>
	24,00,000
Add : Freight	<u>1,40,160</u>
Total material cost	<u>25,40,160</u>

Number of units after normal loss = 16,000 kg. x (100-2)% = 15,680 kg

Revised cost per kg. = $\frac{25,40,160}{15,680 \text{ kg}}$ = ₹ 162

Closing inventory = Material actually received – Material consumed
= 15,500 kg – 13,600 kg = 1,900 kg

Value of closing stock = 1,900 kg x ₹ 162 = ₹ 3,07,800

Abnormal loss in kg = 15,680 kg. – 15,500 kg = 180 kg.

Abnormal loss in value = 180 kg x ₹ 162 = ₹ 29,160

(b)

	₹
Cost incurred till 31 st March, 2012	58,50,000
Prudent estimate of additional cost for completion	<u>31,50,000</u>
Total cost of construction	90,00,000
Less: Contract price	<u>(80,00,000)</u>
Total foreseeable loss	<u>10,00,000</u>

As per para 35 of AS 7 (Revised) '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.

Accordingly, the loss of ₹ 10,00,000 is required to be recognized as an expense in the year 2011-12.

Also as per para 21 of the said standard when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date.

Accordingly,

$$\text{Contract work in progress} = \frac{58,50,000 \times 100}{90,00,000} = 65\%$$

$$\begin{aligned} \text{Proportion of total contract value to be recognized as turnover} \\ = 65\% \text{ of ₹ } 80,00,000 = ₹ 52,00,000 \end{aligned}$$

- (c) According to para 92 of AS 15 (Revised) "Employee Benefits", actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus of ₹ 6 lakhs in the pension scheme on its actuarial valuation is required to be credited to the profit and loss statement of the current year. Hence, Kumar Ltd. cannot spread the actuarial gain of ₹ 6 lakhs over the next 2 years by reducing the annual contributions to ₹ 2 lakhs instead of ₹ 5 lakhs. It has to contribute ₹ 5 lakhs annually for its pension schemes.
- (d) As per para 29 of AS 25 'Interim Financial Reporting', income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

	₹
Estimated Annual Income (A)	<u>10,00,000</u>
Tax expense:	
30% on ₹ 5,00,000	1,50,000

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40% on remaining ₹ 5,00,000	<u>2,00,000</u>
(B)	<u>3,50,000</u>

$$\text{Weighted average annual income tax rate} = \frac{B}{A} = \frac{3,50,000}{10,00,000} = 35\%$$

Tax expense to be recognised in each of the quarterly reports	₹
Quarter I - ₹ 75,000 x 35%	26,250
Quarter II - ₹ 2,50,000 x 35%	87,500
Quarter III - ₹ 3,75,000 x 35%	1,31,250
Quarter IV - ₹ <u>3,00,000</u> x 35%	<u>1,05,000</u>
₹ <u>10,00,000</u>	<u>3,50,000</u>

Question 42

- (a) A plant was acquired 15 years ago at a cost of ₹ 5 crores. Its accumulated depreciation as at 31st March, 2011 was ₹ 4.15 crores. Depreciation estimated for the financial year 2011-12 is ₹ 25 lakhs. Estimated Net Selling Price as on 31st March, 2011 was ₹ 30 lakhs, which is expected to decline by 20 per cent by the end of the next financial year.

Its value in use has been computed at ₹ 35 lakhs as on 1st April, 2011, which is expected to decrease by 30 per cent by the end of the financial year.

- (i) Assuming that other conditions for applicability of the impairment Accounting Standard are satisfied, what should be the carrying amount of this plant as at 31st March, 2012?
 - (ii) How much will be the amount of write off for the financial year ended 31st March, 2012?
 - (iii) If the plant had been revalued ten years ago and the current revaluation reserves against this plant were to be ₹ 12 lakhs, how would you answer to questions (i) and (ii) above?
 - (iv) If the value in use was zero and the enterprise were required to incur a cost of ₹ 2 lakhs to dispose of the plant, what would be your response to questions (i) and (ii) above?
- (b) 'Suram' Ltd. wants to re-classify its Investment in accordance with AS 13. Decide on the treatment to be given in each of the following cases:
- (1) A portion of Current Investments purchased for ₹ 20 lakhs to be reclassified as long-term Investments, as the company has decided to retain them. The market value as on the date of Balance Sheet was ₹ 25 lakhs.
 - (2) Another portion of Current Investments purchased for ₹ 15 lakhs has to be reclassified as Long-term Investments. The market value of these investments as on

the date of Balance Sheet was ₹ 6.5 lakhs.

- (3) Certain Long-term Investments no longer considered for holding purposes have to be re-classified as Current Investments. The original cost of these was ₹ 18 lakhs but they had been written down to ₹ 12 lakhs to recognize permanent decline as per AS 13.
- (c) On 1st December, 2011, "Sampath" Construction Company Limited undertook a contract to construct a building for ₹ 108 lakhs. On 31st March, 2012 the company found that it had already spent ₹ 83.99 lakhs on the construction. A prudent estimate of additional cost for completion was ₹ 36.01 lakhs.

What is the provision for foreseeable loss, which must be made in the Final Accounts for the year ended 31st March, 2012 based on AS 7 "Accounting for Construction Contracts."

Answer

- (a) As per AS 28 "Impairment of Assets", if the recoverable amount* of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount and that reduction is an impairment loss. An impairment loss on a revalued asset is recognised as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

In the given case, recoverable amount (higher of asset's net selling price and value in use) will be ₹ 24.5 lakhs on 31.3.2012 according to the provisions of AS 28 [Refer working note].

(₹ in lakhs)	
(i) Carrying amount of plant (after impairment) as on 31 st March, 2012	24.50
(ii) Amount of write off (impairment loss) for the financial year ended 31 st March, 2012 [₹ 60 lakhs – ₹ 24.5 lakhs]	35.50
(iii) If the plant had been revalued ten years ago	
Debit to revaluation reserve	12.00
Amount charged to profit and loss account (₹ 35.50 lakhs – ₹ 12 lakhs)	23.50
(iv) If Value in use is zero	
Value in use (a)	Nil
Net selling price (b)	(-)2.00
Recoverable amount [higher of (a) and (b)]	Nil
Carrying amount (closing book value)	Nil
Amount of write off (impairment loss)(₹ 60 lakhs – Nil)	60.00
Entire book value of plant will be written off and charged to profit and loss account.	

* Recoverable amount is the higher of an asset's net selling price and its value in use.

Working Note:**Calculation of Closing Book Value, Estimated Net Selling Value and Estimated Value in Use of Plant at 31st March, 2012.**

	(₹ in lakhs)
Opening book value as on 1.4.2011 (₹ 500 lakhs – ₹ 415 lakhs)	85
Less: Depreciation for financial year 2011–12	<u>(25)</u>
Closing book value as on 31.3.2012	<u>60</u>
Estimated net selling price as on 1.4.2011	30
Less: Estimated decrease during the year (20% of ₹ 30 lakhs)	<u>(6)</u>
Estimated net selling price as on 31.3.2012	<u>24</u>
Estimated value in use as on 1.4.2011	35.0
Less: Estimated decrease during the year (30% of ₹ 35 lakhs)	<u>(10.5)</u>
Estimated value in use as on 31.3.2012	<u>24.5</u>

- (b) As per Para 24 of AS 13 'Accounting for Investments', where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

In the first case, the market value* of the investment is ₹ 25 lakhs, which is higher than its cost i.e. ₹ 20 lakhs. Therefore, the transfer to long term investments should be carried at cost i.e. ₹ 20 lakhs.

In the second case, the market value* of the investment is ₹ 6.5 lakhs, which is lower than its cost i.e. ₹ 15 lakhs. Therefore, the transfer to long term investments should be carried in the books at the market value i.e. ₹ 6.5 lakhs. The loss of ₹ 8.5 lakhs should be charged to profit and loss account.

As per para 23 of AS 13, where long-term investments are re-classified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

In the third case, the book value of the investment is ₹ 12 lakhs, which is lower than its cost i.e. ₹ 18 lakhs. Here, the transfer should be at carrying amount and hence this re-classified current investment should be carried at ₹ 12 lakhs.

- (c) **Calculation of foreseeable loss for the year ended 31st March, 2012**
(as per AS 7 "Construction Contracts")

	(₹ in lakhs)
Cost incurred till 31 st March, 2012	83.99
Prudent estimate of additional cost for completion	<u>36.01</u>
Total cost of construction	120.00

* It is assumed that the market value has been determined in an arm's length transaction between knowledgeable and willing buyer and seller.

Less: Contract price	(108.00)
Foreseeable loss	<u>12.00</u>

According to para 35 of AS 7 (Revised 2002) "Construction Contracts", when it is probable that total contract costs will exceed total contract revenue; the expected loss should be recognized as an expense immediately. Therefore, amount of ₹12 lakhs is required to be provided for in the books of Sampath Construction Company for the year ended 31st March, 2012.

Exercises

Question 1

Summarize the recommendations of the Institute of Chartered Accountants of India regarding accounting treatment of excise duty.

Question 2

A company obtained term loan during the year ended 31st March, 2011 in an extent of ₹ 650 lakhs for modernisation and development of its factory. Buildings worth ₹ 120 lakhs were completed and Plant and Machinery worth ₹ 350 lakhs were installed by 31st March, 2011. A sum of ₹ 70 lakhs has been advanced for Assets the installation of which is expected in the following year. ₹ 110 lakhs has been utilised for Working Capital requirements. Interest paid on the loan of ₹ 650 lakhs during the year 2011-2012 amounted to ₹ 58.50 lakhs. How should the interest amount be treated in the Accounts of the Company?

[Answer: Interest to be capitalized ₹ 48.6 lakhs, Interest to be charged to profit and loss account ₹ 9.9 lakhs]

Question 3

A Limited Company finds that the stock sheets as on 31.3.2011 had included twice an item the cost of which was ₹ 20,000. You are asked to suggest, how the error would be dealt with in the accounts of the year ended 31.3.2012.

[Answer: ₹ 20,000 should be deducted from opening stock in the profit and loss account. and ₹ 20,000 should be charged as prior period adjustment in the profit and loss account for the year ended 31st March 2012 in accordance with para 15 of AS 5 (Revised)]

Question 4

M Ltd. Group has three divisions A, B and C. Details of their turnover, results and net assets are given below:

	(₹ '000)
Division A	
Sales to B	3,050

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Other Sales (Home)	60
Export Sales	<u>4,090</u>
	<u>7,200</u>
Division B	
Sales to C	30
Export Sales to Europe	<u>200</u>
	<u>230</u>
Division C	
Export Sales to America	<u>180</u>

Divisions

	Head Office ₹ ('000)	A Rs('000)	B ₹ ('000)	C ₹ ('000)
Operating Profit or Loss before tax		160	20	(8)
Re-allocated cost from Head Office		48	24	24
Interest cost		4	5	1
Fixed assets	50	200	40	120
Net current assets	48	120	40	90
Long-term liabilities	38	20	10	120

Prepare a Segmental Report for publication in M Ltd. Group.

Question 5

Arrange and redraft the following Cash Flow Statement in proper order keeping in mind the requirements of AS 3:

		(₹ in lacs)	₹ (in lacs)
Net Profit			60,000
Add:	Sale of Investments	70,000	
	Depreciation on Assets	11,000	
	Issue of Preference Shares	9,000	
	Loan raised	4,500	
	Decrease in Stock	<u>12,000</u>	<u>1,06,500</u>
			1,66,500
Less:	Purchase of Fixed Assets	65,000	
	Decrease in Creditors	6,000	
	Increase in Debtors	8,000	

	Exchange gain	8,000	
	Profit on sale of investments	12,000	
	Redemption of Debenture	5,700	
	Dividend paid	1,400	
	Interest paid	<u>945</u>	<u>(1,07,045)</u>
			59,455
Add:	Opening cash and cash equivalent		12,341
	Closing cash and cash equivalent		71,796

[Answer: Net cash from operating activities ₹ 49,000 lakhs, Net cash from Investing activities ₹ 5,000 lakhs , Net cash from financing activities ₹ 5,455 lakhs]

Question 6

Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being ₹ 7,00,000. The economic life of the machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays ₹ 3,00,000. Guaranteed Residual Value (GRV) is ₹ 22,000 on expiry of the lease. Implicit Rate of Return (IRR) is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.

Calculate the value of machine to be considered by Lessee Ltd. and the interest (Finance charges) in each year.

[Answer: Value of machine will be taken as ₹ 6,99,054; Finance charges- year 1 ₹ 1,04,858 , year 2 ₹ 75,587, year 3 ₹ 41,925]

Question 7

A Cosmetic articles producing company provides the following information:

	Cold Cream	Vanishing Cream
January, 2011 – September, 2011 per month	2,00,000	2,00,000
October, 2011 – December, 2011 per month	1,00,000	3,00,000
January, 2012- March, 2012 per month	0	4,00,000

The company has enforced a gradual change in product-line on the basis of an overall plan. The Board of Directors of the company has passed a resolution in March, 2009 to this effect. The company follows calendar year as its accounting year. Should this be treated as a discontinuing operation? Give reasons in support of your answer.

[Answer: Change over is not a discontinuing operation]