

PAPER – 1: FINANCIAL REPORTING

Question No. 1 is compulsory.

Attempt any five questions from the remaining six Questions.

Working notes should form part of the answer.

Wherever necessary, suitable assumptions may be made by the candidates.

Question 1

- (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 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:
- Decide whether the stock of empty bottles is an asset of the company;
 - 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 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 01-06-09. By such an acquisition Bright can exercise significant influence over East India Ltd. During the financial year ending on 31-03-09 East India earned profits ₹ 80,000 and declared a dividend of ₹ 50,000 on 12-08-2009. East India reported earnings of ₹ 3,00,000 for the financial year ending on 31-03-10 and declared dividends of ₹ 60,000 on 12-06-2010. Calculate the carrying amount of investment in:
- Separate financial statements of Bright Ltd. as on 31-03-10;
 - Consolidated financial statements of Bright Ltd.; as on 31-03-10;
 - What will be the carrying amount as on 30-06-2010 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

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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 ? (4 × 5 = 20 Marks)

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 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 31.03.10

	₹
Amount paid for investment in Associate (on 1.06.2009)	2,00,000
Less: Pre-acquisition dividend (₹50,000 x 30%)	<u>15,000</u>
Carrying amount as on 31.3.2010 as per AS 13	<u>1,85,000</u>

- (ii) Carrying amount of investment in Consolidated Financial Statements* of Bright Ltd. as on 31.3.2010 as per AS 23

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

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	₹
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 31.3.2010	<u>2,75,000</u>

- (iii) Carrying amount of investment in Consolidated Financial Statement of Bright Ltd. as on 30.6.2010 as per AS 23

	₹
Carrying amount as on 31.3.2010	2,75,000
Less: Dividend received (₹ 60,000 x 30%)	<u>18,000</u>
Carrying amount as on 30.6.2010	<u>2,57,000</u>

- (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 2

Softex Ltd. announced a Stock Appreciation Right (SAR) on 01-04-07 for each of its employees. The scheme gives the employees the right to claim cash payment equivalent to an excess of market price of company shares on exercise date over the exercise price of ₹125 per share in respect of 100 shares, subject to a condition of continuous employment of 3 years. The SAR is exercisable after 31-03-2010 but before 30-06-10.

The fair value of SAR was ₹21 in 2007-08, ₹23 in 2008-09 and ₹24 in 2009-10. In 2007-08 the company estimated that 2% of its employees shall leave the company annually. This was revised to 3% in 2008-09. Actually 15 employees left the company in 2007-08, 10 left in 2008-

* 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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09 and 8 left in 2009-10. The SAR therefore actually vested in 492 employees on 30-06-2010; when SAR was exercised the intrinsic value was ₹25 per share.

Show the provision of SAR account by fair value method. Is this provision a liability or equity?
(16 Marks)

Answer

Provision of SARs Account in the books of Softex Ltd.

Year 2007-08	₹	Year 2007-08	₹
To Balance c/d	<u>3,45,891</u>	By Employees' Compensation A/c	<u>3,45,891</u>
	<u>3,45,891</u>		<u>3,45,891</u>
Year 2008-09		Year 2008-09	
To Balance c/d	7,35,785	By Balance b/d	3,45,891
	_____	By Employees' Compensation A/c	<u>3,89,894</u>
	<u>7,35,785</u>		<u>7,35,785</u>
Year 2009-10		Year 2009-10	
To Balance c/d	11,80,800	By Balance b/d	7,35,785
	_____	By Employees' Compensation A/c	<u>4,45,015</u>
	<u>11,80,800</u>		<u>11,80,800</u>
To Bank A/c	12,30,000	By Balance b/d	11,80,800
	_____	By Employees' Compensation A/c	<u>49,200</u>
	<u>12,30,000</u>		<u>12,30,000</u>

The Provision for Stock Appreciation Rights (SARs) is a liability. SARs are settled through cash payment equivalent to an excess of market price of company's shares over the exercise price on exercise date.

Working Notes:

Year 2007-08

Number of employees to whom SARs were announced (492+15+10+8) = 525 employees

Number of SARs expected to vest = $(525 \times 0.98 \times 0.98 \times 0.98) \times 100 = 49,413^*$ SARs.

Fair value of SARs = 49,413 SARs × ₹ 21 = ₹ 10,37,673

Vesting period = 3 years

Value of SARs recognised as expense in year 2007 – 08 = ₹ 10,37,673 / 3 years = ₹ 3,45,891

* SARs expected to vest in years 2007-08 and 2008-09 can also be worked out by rounding off the number of employees.

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Year 2008-09

Number of SARs expected to vest

$$= [(525-15) \times 0.97 \times 0.97] \times 100 = 47,986 \text{ SARs}$$

Fair value of SARs = 47,986 SARs $\times$ ₹ 23 = ₹ 11,03,678

Vesting period = 3 years

Number of years expired = 2 years

Cumulative value of SARs to be recognized as expense

$$= ₹ 11,03,678 / 3 \times 2 = ₹ 7,35,785$$

Value of SARs recognized as expense in year 2008 – 09

$$= ₹ 7,35,785 - ₹ 3,45,891 = ₹ 3,89,894$$

Year 2009-10

Fair value of SARs = ₹ 24

SARs actually vested = 492 employees $\times$ 100 = 49,200 SARs

Fair value = 49,200 SARs $\times$ ₹ 24 = ₹ 11,80,800

Cumulative value of SARs to be recognized = ₹ 11,80,800

Value of SARs to be recognized as an expense in = ₹ 11,80,800 – ₹ 7,35,785

$$= ₹ 4,45,015$$

Year 2010 – 11

Cash payment of SARs = 49,200 SARs $\times$ ₹ 25 = ₹ 12,30,000

Value of SARs to be recognized as an expense in 2010 – 11

$$= ₹ 12,30,000 - ₹ 11,80,800 = ₹ 49,200$$

Question 3

Air Ltd., a listed company, entered into an expansion programme on 1st October, 2009. On that date the company purchased from Bag Ltd. its investments in two Private Limited Companies. The purchase was of

(a) the entire share capital of Cold Ltd.

and

(b) 50% of the share capital of Dry Ltd.

Both the investments were previously owned by Bag Ltd. After acquisition by Air Limited, Dry Ltd. was to be run by Air Ltd. and Bag Ltd. as a jointly controlled entity.

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Air Ltd. makes its financial statements upto 30th September each year. The terms of acquisition were:

Cold Ltd.

The total consideration was based on price earnings ratio (P/E) of 12 applied to the reported profit of ₹ 20 lakhs of Cold Ltd. for the year 30 September, 2009. The consideration was settled by Air Ltd. issuing 8% debentures for ₹ 140 lakhs (at par) and the balance by a new issue of ₹ 1 equity shares, based on its market value of ₹ 2.50 each.

Dry Ltd.

The market value of Dry Ltd. on first October, 2009 was mutually agreed as ₹ 375 lakhs. Air Ltd. satisfied its share of 50% of this amount by issuing 75 lakhs ₹ 1 equity shares (market value ₹ 2.50 Each) to Bag Ltd.

Air Ltd. has not recorded in its books the acquisition of the above investments or the discharge of the consideration.

The summarized statements of financial position of the three entities at 30th September, 2010 are:

	Air Ltd.	Cold Ltd.	Dry Ltd.
	₹ in thousands		
Assets			
Tangible Assets	34,260	27,000	21,060
Inventories	9,640	7,200	18,640
Debtors	11,200	5,060	4,620
Cash	-	3,410	40
	<u>55,100</u>	<u>42,670</u>	<u>44,360</u>
Liabilities			
Equity capital:			
₹ 1 Each	10,000	20,000	25,000
Retained earnings	20,800	15,000	4,500
Trade and other payables	17,120	5,270	14,100
Overdraft	1,540	-	-
Provision for taxes	<u>5,640</u>	<u>2,400</u>	<u>760</u>
	<u>55,100</u>	<u>42,670</u>	<u>44,360</u>

The following information is relevant.

- The book values of the net assets of Cold Ltd. and Dry Ltd. on the date of acquisition were considered to be a reasonable approximation to their fair values.
- The current profits of Cold Ltd. and Dry Ltd. for the year ended 30th September, 2010 were ₹ 80 lakhs and ₹ 20 lakhs respectively. No dividends were paid by any of the companies during the year.

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- (c) Dry Ltd., the jointly controlled entity, is to be accounted for using proportional consolidation, in accordance with AS-27 "Interests in joint venture".
- (d) Goodwill in respect of the acquisition of Dry Ltd. has been impaired by ₹10 lakhs at 30th September, 2010. Gain on acquisition, if any, will be separately accounted.

Prepare the consolidated Balance Sheet of Air Ltd. and its subsidiaries as at 30th September, 2010. (16 Marks)

Answer

Consolidated Balance Sheet of Air Ltd. with its Subsidiary Cold Ltd. and Jointly controlled Dry Ltd. as on 30th September, 2010

		₹ in thousands
<i>Liabilities</i>	<i>Assets</i>	
Equity Capital (10,000 + 4,000 + 7,500) (Out of the above 11,500 thousand shares have been issued for consideration other than cash)	21,500 Tangible Assets (34,260+27,000+10,530)	71,790
Retained Earnings (W.N.4)	Goodwill (W.N.6)	4,000
Capital Reserve (W.N.5)	Inventories (9,640 + 7,200 + 9,320)	26,160
Securities Premium	Debtors (11,200+5,060+2,310)	18,570
8% Debentures	Cash (3,410 + 20)	3,430
Trade and other payables (17,120 + 5,270 + 7,050)		
Overdraft		
Provision for taxes (5,640 + 2,400 + 380)		
	<u>8,420</u>	
	<u>1,23,950</u>	<u>1,23,950</u>

Working Notes:

- Purchase consideration paid to Cold Ltd.

Earnings per share for the year 30th September, 2009

$$= \frac{20,00,000}{2,00,00,000} = ₹ 0.10 \text{ per share}$$

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Market price per share = ₹ 0.10 x 12 (i.e. P/E ratio) = ₹ 1.20 per share

Purchase consideration = ₹ 1.20 x 2,00,00,000 shares = ₹ 2,40,00,000

Purchase consideration to be paid as under:

8% Debentures	₹ 1,40,00,000
Equity Shares (40,00,000 shares of ₹ 2.50 each)	₹ <u>1,00,00,000</u>
	₹ <u>2,40,00,000</u>

Purchase consideration paid to Cold Ltd. will be ₹ 24,000 thousands.

2. Consideration paid to Dry Ltd.

	₹ in thousands
Total market value (as given)	37,500
50% Shares acquired by Air Ltd. (75,00,000 shares @ ₹ 2.50 each)	18,750

3. Analysis of retained earnings of Cold Ltd. as on 30.9.2010

	₹ in thousands
Retained earnings given in balance sheet on 30.9.10	15,000
Less: Current profits for the year ended 30.9.10 (Post acquisition)	<u>8,000</u>
Pre acquisition retained earnings	<u>7,000</u>
Air Ltd. has 100% share in pre and post acquisition profits of Cold Ltd.	

4. Retained Earnings in the Consolidated Balance Sheet

	₹ in thousands
Balance in Air Ltd. balance sheet	20,800
Add: Share in post acquisition profits of Cold Ltd.	8,000
Add: Share in post acquisition profits of Dry Ltd. (joint venture)	<u>1,000</u>
	29,800
Less: Goodwill (written off)	<u>1,000</u>
	<u>28,800</u>

5. Capital Reserve

	₹ in thousands
Amount Paid	24,000
Less: Paid up value of shares	20,000
Pre-acquisition profit	<u>7,000</u>
Capital Reserve	<u>3,000</u>

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6. Goodwill

	₹ in thousands
Amount paid for shares of Dry Ltd (₹ 37,500 x 50%)	18,750
Less: Paid up value of shares (₹ 25,000 x 50%)	12,500
Pre-acquisition profit (₹ 2,500 x 50%)	<u>1,250</u>
Goodwill	5,000
Less: Impairment (Written off)	<u>1,000</u>
	<u>4,000</u>

Question 4

The following are the Balance Sheets of X Ltd. and Y Ltd. as on 31st December, 2009.

	X Ltd.	Y Ltd.
Assets		
Fixed Assets	7,00,000	2,50,000
Stock	2,40,000	3,20,000
Debtors	3,60,000	1,90,000
Bills Receivable	60,000	20,000
Cash at Bank	1,10,000	40,000
Investments in :		
6000 shares of Y Ltd.	80,000	
5000 shares of X Ltd.		<u>80,000</u>
	<u>15,50,000</u>	<u>9,00,000</u>
Liabilities		
Share Capital:		
Equity shares of ₹ 10 Each	6,00,000	3,00,000
10% preference shares of ₹ 10 each	2,00,000	1,00,000
Reserve and Surplus	3,00,000	2,00,000
12% Debentures	2,00,000	1,50,000
Sundry Creditors	2,20,000	1,25,000
Bills payable	<u>30,000</u>	<u>25,000</u>
	<u>15,50,000</u>	<u>9,00,000</u>

Fixed assets of both the companies are to be revalued at 15% above book values and stock and debtors are to be taken over at 5% less than their book values. Both the companies are to pay 10% equity dividends, preference dividends having been paid already.

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After the above transactions are given effect to, X Ltd. will absorb Y Ltd. on the following terms:

- (i) 8 equity shares of ₹10 each will be issued by X Ltd. at par against 6 shares of Y Ltd.
- (ii) 10% preference shares of Y Ltd. will be paid off at 10% discount by issue of 10% preference shares of ₹100 each of X Ltd. at par.
- (iii) 12% Debentureholders of Y Ltd. are to be paid off at a 8% premium by 12% debentures in X Ltd. issued at a discount of 10%.
- (iv) ₹30,000 to be paid by X Ltd. to Y Ltd. for liquidation expenses.
- (v) Sundry creditors of Y Ltd. include ₹10,000 due to X Ltd.

Prepare:

- (a) A statement of purchase consideration payable by X Ltd.
- (b) A Balance Sheet of X Ltd. after its absorption of Y Ltd. (16 Marks)

Answer

- (a) Statement of Purchase Consideration payable by X Ltd.

- (i) 8 Equity Shares of X Ltd. for every 6 Equity Shares of Y Ltd.

30,000 shares x $\frac{8}{6}$ =	40,000 shares
Less: 1/5 already held by X Ltd. of Y Ltd.	<u>8,000 shares</u>
	32,000 shares
Less: 5,000 Shares of X Ltd. with Y Ltd.	<u>5,000 shares</u>
	<u>27,000 Shares</u>
27,000 equity shares at ₹ 10	₹ 2,70,000

- (ii) Payment of 10% Preference Shares at 10% discount by issue of 10% Preference Shares of X Ltd. of ₹ 100 each

$(1,00,000 \times \frac{90}{100})$	₹ <u>90,000</u>
	₹ <u>3,60,000</u> *

*Reimbursement of liquidation expenses by X Ltd. to Y Ltd. has not been considered as part of purchase consideration. Alternatively, this can be included in computation of purchase consideration.

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(b) Balance Sheet of X Ltd. after its absorption of Y Ltd.

Liabilities	₹	Assets	₹
Share Capital		Fixed Assets	10,92,500
		(8,05,000 + 2,87,500)	
87,000 Equity Shares of ₹ 10 each	8,70,000	Stock	5,44,000
		(2,40,000 + 3,04,000)	
(Out of the above, 27,000 equity shares have been issued for consideration other than cash)		Debtors	5,30,500
		(3,60,000 + 1,80,500 – 10,000)	
10% Preference shares of ₹ 10 each	2,00,000	Bills Receivable	80,000
		(60,000 + 20,000)	
10% Preference shares of ₹ 100 each	90,000		
Reserves and Surplus		Cash at Bank(W.N. 3)	41,000
Revaluation Reserve	1,05,000	Discount on Issue of	18,000
(15% of 7,00,000)		Debentures	
Capital Reserve (W. N.1)	25,000	[1,50,000 x 108% x (10/90)]	
Other Reserves (W.N.4)	2,46,000		
12% Debentures	3,80,000		
$\frac{₹ 2,00,000 + \frac{₹ 1,62,000 \times 100}{90\%}}{₹}$			
Sundry Creditors	3,35,000		
(2,20,000 + 1,25,000 – 10,000)			
Bills Payable (30,000 + 25,000)	55,000		
	<u>23,06,000</u>		<u>23,06,000</u>

Working Notes:

1. Calculation of Capital Reserve

Net Assets taken over from Y Ltd.	₹
Fixed Assets (2,50,000 × 115%)	2,87,500
Stock (3,20,000 × 95%)	3,04,000
Debtors (1,90,000 × 95%)	1,80,500
Bills Receivable	20,000
Cash at Bank	<u>15,000</u>
Total Assets (A)	<u>8,07,000</u>

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Less: Liabilities taken over		
Debentures (1,50,000 x 108%)		1,62,000
Sundry Creditors		1,25,000
Bills Payable		<u>25,000</u>
Total Liabilities (B)		<u>3,12,000</u>
Net Asset taken over (A – B)		4,95,000
Less: Investment cancelled		<u>80,000</u>
		4,15,000
Purchase Consideration		<u>3,60,000*</u>
Capital Reserve		55,000
Less: Liquidation expenses reimbursed to Y Ltd.		<u>30,000*</u>
		<u>25,000</u>
2. Cash taken over from Y Ltd.		
		₹
Cash balance given in Balance Sheet of Y Ltd.		40,000
Add: Dividend received from X Ltd.		<u>5,000</u>
		45,000
Less :Dividend paid		<u>30,000</u>
		<u>15,000</u>
3. Cash balance in Balance Sheet (after absorption)		
		₹
Cash balance given in Balance Sheet of X Ltd.		1,10,000
Add: Cash taken over from Y Ltd.		<u>15,000</u>
		1,25,000
Less: Dividend paid	60,000	
Expenses on liquidation	<u>30,000</u>	<u>90,000</u>
		35,000
Add: Dividend from Y Ltd.		<u>6,000</u>
		<u>41,000</u>

* Reimbursement of liquidation expenses by X Ltd. to Y Ltd. has not been considered as part of purchase consideration. If these expenses are included in computation of purchase consideration, then ₹30,000 will not be deducted.

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4. Other Reserves in the Balance Sheet (after absorption)

	₹
Reserves given in the Balance Sheet of X Ltd.	3,00,000
Dividend from Y Ltd.	<u>6,000</u>
	3,06,000
Less: Dividend declared	<u>60,000</u>
	<u>2,46,000</u>

Question 5

(a) From the following information, calculate the value of a share if you want to

- (i) buy a small lot of shares;
- (ii) buy a controlling interest in the company.

Year	Profit (₹)	Capital Employed (₹)	Dividend %
2007	55,00,000	3,43,75,000	12
2008	1,60,00,000	8,00,00,000	15
2009	2,20,00,000	10,00,00,000	18
2010	2,50,00,000	10,00,00,000	20

The market expectation is 12%.

(b) On February 1, 2009, Future Ltd. entered into a contract with Son Ltd. to receive the fair value of 1000 Future Ltd.'s own equity shares outstanding as on 31-01-2010 in exchange for payment of ₹1,04,000 in cash i.e., ₹104 per share. The contract will be settled in net cash on 31.01.2010.

The fair value of this forward contract on the different dates were:

- (i) Fair value of forward on 01-02-2009 Nil
- (ii) Fair value of forward on 31-12-2009 ₹ 6,300
- (iii) Fair value of forward on 31-01-2010 ₹ 2,000

Presuming that Future Ltd. closes its books on 31st December each year, pass entries:

- (i) If net settled is in cash
- (ii) If net is settled by Son Ltd. by delivering shares of Future Ltd. (8 + 8 = 16 Marks)

Answer

(a) (i) Buying a small lot of shares

If the purpose of valuation is to provide data base to aid a decision of buying a small (non-controlling) position of the equity of a company, dividend yield method is most

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appropriate. Dividend rate is rising continuously, weighted average will be more appropriate for calculation of average dividend.

Year	Rate of dividend	Weight	Product
2007	12	1	12
2008	15	2	30
2009	18	3	54
2010	20	<u>4</u>	<u>80</u>
		<u>10</u>	<u>176</u>

$$\text{Average dividend} = \frac{176}{10} = 17.6\%$$

Value of share on the basis of dividend for buying a small lot of shares will be

$$\frac{\text{Average dividend rate}}{\text{Market expectation rate}} \times 100 = \frac{17.6}{12} \times 100 = ₹146.67 \text{ per share.}$$

(ii) **Buying a controlling interest in the company**

If the purpose of valuation is to provide data base to aid a decision of buying controlling interest in the company, total profit will be relevant to determine the value of shares as the shareholders have capacity to influence the decision of distribution of profit. As the profit is rising, weighted average will be more appropriate for calculation of average profit/yield.

Year	Yield % (Profit/Capital employed) x100	Weight	Product
2007	16	1	16
2008	20	2	40
2009	22	3	66
2010	25	<u>4</u>	<u>100</u>
		<u>10</u>	<u>222</u>

$$\text{Average yield} = \frac{222}{10} = 22.2\%$$

If controlling interest in the company is being taken over, then the value per share

$$\text{will be} = \frac{\text{Average yield rate}}{\text{Market expectation rate}} \times 100 = \frac{22.2}{12} \times 100 = ₹ 185 \text{ per share.}$$

(b) **If net is settled in cash**

(i) **1.2.2009**

No entry is required because fair value of derivative is zero and no cash is paid or received.

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₹
₹

(ii)	31.12.2009				
		Forward Contract (Asset) A/c	Dr.	6,300	
		To Profit and Loss A/c			6,300
		(Gain recorded due to increase in <u>fair value of the forward contract</u>)			
(iii)	31.01.2010				
		Profit and Loss A/c	Dr.	4,300	
		To Forward Contract (Asset) A/c			4,300
		(Loss recorded due to decrease in <u>fair value of the forward contract</u>)			
(iv)					
		Cash A/c	Dr.	2,000	
		To Forward Contract (Asset) A/c			2,000
		<u>(Being forward contract settled in cash)</u>			
If net is settled by delivery of shares					
First three entries will be same. Entry no. (iv) will change as under:					
		Equity A/c	Dr.	2,000	
		To Forward Contract (Asset) A/c			2,000
		(Being forward contract settled by delivery of shares)			

Question 6

- (a) On 1st April, 2008 Sigma Ltd. issued 6% Convertible debentures of face value of ₹ 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31-03-2012 or these may be converted into ordinary shares at the option of the holder, the interest rate for equivalent debentures without conversion rights would have been 10%. Being a compound financial instrument, you are required to separate equity and debt portions as on 01-04-2008. Equity portion is ₹1,85,400. Find out the debt portion (Debenture amount). The present value of ₹1 receivable at the end of each year based on discount rates of 6% and 10% can be taken as:

End of year	6%	10%
1	0.94	0.91
2	0.89	0.83
3	0.84	0.75
4	0.79	0.68

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- (b) (i) What is the meaning of 'valuation of liabilities'?
- (ii) State the purpose of valuation of liabilities in financial accounting and reporting.
- (iii) How is liability determined in the case of a finance lease? (8+ 8 = 16 Marks)

Answer

- (a) Assume that total proceeds of the issue is = ₹M

Hence, interest payable every year = 6% of ₹ M = 0.06M

Present value of interest (10% discount factor) = 0.06M x cumulative discount factor of 4 years = 0.06M x 3.17 = 0.1902M.

Present value of the principal repayable after four years [1.10 M x 0.68(10% discount factor)] = 0.748 M

Total present value of debentures (value of debt component) = 0.1902M + 0.748M = 0.9382M

Hence, amount of equity = M - 0.9382M = ₹1,85,400

$$0.0618M = ₹1,85,400$$

$$M = 1,85,400 / 0.0618 = ₹30,00,000$$

Therefore, total proceeds of the issue is ₹30,00,000

Debt portion (Debenture amount) = ₹30,00,000 - ₹1,85,400 = ₹28,14,600.

- (b) (i) Valuation of liabilities is the measurement of liabilities in monetary terms. It may be measured at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business or required to settle the obligation currently in the normal course of business. It may also be carried at the present value of the future net cash flows that are expected to be required to settle the liabilities in the normal course of business.
- (ii) Proper valuation of liabilities is required to ensure true and fair financial position of the business entity. In other words, all matters which affect the financial position of the business have to be disclosed. Under or over valuation of liabilities may not only affect the operating results and financial position of the current period but will also affect the operating results and financial position for the next accounting periods.
- (iii) In case of financial lease, the lessee should recognize a liability equal to the fair value of the leased asset at the inception of the lease. As per AS 19, "Leases", if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine, if not, the lessee's incremental borrowing rate should be used.

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Question 7

Answer any *four* of the following:

- (a) M/s TS Ltd. has entered into a contract by which it has the option to sell its specified asset to NB Ltd. for ₹100 lakhs after 3 years whereas the current market price is ₹ 150 lakhs. Company always settles account by delivery. What type of option is this? Is it a financial instrument? Explain with reference to the relevant accounting standard.
- (b) Assam Ltd. purchased an oil well for \$ 100 million. It estimates that the well contains 250 million barrels of oil. The oil well has no salvage value. If the company extracts and sells 10,000 barrels of oil during the first year, how much depletion expense should be recognized as per IFRS 6?
- (c) X Ltd. sold its building to Mini Ltd. for ₹ 60 lakhs on 30.09-2009 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, 2010. Do you agree with this treatment? If you do not agree, explain the reasons with reference to the accounting standard.
- (d) Southern Tower Ltd. purchased a plant from M/s. Tatamaco Ltd. on 30-09-2008 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 31-12-2008; however, it was put to use only on 01-04-2009.
- (i) Find out the original cost.
- (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.
- (e) 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%

FINAL (NEW) EXAMINATION : NOVEMBER, 2010

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. (4 × 4 =16 Marks)

Answer

- (a) As per AS 31 "Financial Instruments: Presentation", a financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. In the given case, M/s TS Ltd. has entered into a contract with NB Ltd. and company settles its account by delivery, and does not give rise to any financial asset or financial liability. Hence there is no option.

Since, the above transaction does not give rise to a financial asset of one entity and a financial liability or equity instrument of another entity; this is not a financial instrument. It is only a financial contract.

- (b) As per IFRS 6 "Exploration for and Evaluation of Mineral Resources", depletion rate and depletion expense can be computed as:

$$\begin{aligned}\text{Depletion rate} &= \text{Current period production} / \text{Total barrels of production} \\ &= 10,000 \text{ barrels} / 250,000,000 \text{ barrels} \\ &= 0.00004\end{aligned}$$

$$\begin{aligned}\text{Depletion expense for the first year} &= \text{Purchase price} \times \text{Depletion rate} \\ &= \$100,000,000 \times 0.00004 \\ &= \$ 4,000.\end{aligned}$$

- (c) 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, 2010; value of building should be removed from the balance sheet. Therefore the treatment given by the company is not correct.

- (d) (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

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Finance cost (14.5% on ₹ 125 lakhs for
the period 01.10.08 to 31.12.08) 4.53

Total 215.28

- (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 01.01.2009 to 31.03.2009) will be charged to profit and loss account as per AS 16 "Borrowing Costs".

- (e) 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	Present value
	₹	(Discount rate @5%)	₹
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.

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