AS-1: DISCLOSURE OF ACCOUNTING POLICIES

Education TREE

- CA Sumit L. Sarda

Accounting Policies

- Principles
- Method of Applying those principles
- E.g..
- Depreciation: Principle prescribed under Schedule VI
  - Method of applying: Revalued amount adjusted by transferring equivalent amount from revaluation reserve

Education TREE

Notes to accounts

- Explanation of management about items of P&L and Balance Sheet.
- Need for disclosure
  - Proper and better understanding
  - SHOULD BE DISCLOSED AT ONE PLACE

Education TREE

Fundamental Assumptions

INDIA

- Going Concern-intention is imp
- Consistency-similar policy
- Accrual-mercantile system

Points to be considered

- Prudence- estimate
- Substance over form
- Materiality- should influence decision of reader

IFRS

- Fair presentation and compliance with IFRS
- Going concern
- Accrual
- Consistency
- Materiality
- Offsetting
- Frequency
- Comparative information

Education TREE

- Going concern
  - Intends to liquidate or has no alternative but to liquidate
  - Uncertainties about entities ability to continue must be disclosed
- Accrual
  - Does not apply to cash flow
- Consistency
  - Must be same unless
  - Significant change in the operations
  - Review is required for fair presentation
  - Required by AS

- Materiality
  - Similar items if material to be presented separately
  - Dissimilar items presented separately
  - Immaterial items even if dissimilar can be aggregated
- Offsetting(IFRS)
  - Presentation of asset and liability as single item
  - Allowed only if permitted by IFRS
  - E.g.: foreign exchange gains or losses arising from diff financial instruments not allowed to offset

Education TREE

Changes in Accounting Policies

- Required by statute
- Compliance with accounting standard
- Appropriate presentation of financial statement
- Method of disclosure
  - Basis on which statements are prepared
  - Reason for departure

Education TREE

Set of financial statements include

- INDIA
  - Balance sheet
  - P&L
  - Cash flow(Only for non-SMC)
  - Accounting policies and notes
- IFRS
  - Statement of financial position
  - Income statement
  - Cash flow
  - Change in stock holders equity
  - Accounting policies and notes

Education TREE

Differences in AS and IFRS

- INDIA
  1. Does not prescribe
  2. Does not require the same

- IAS-1
  1. Prescribes minimum structures
  2. Disclosure of critical judgments made by management

Education TREE

Questions

- All components of financial statements should be prepared under accrual basis of accounting except??
  - Balance sheet
  - P&L
  - Cash flow
  - Explanatory notes

- Which items in trial balance can be aggregated and which needs to be shown separately
  - Administration costs
  - Cost of sales
  - Conference expense
  - Legal fees
  - Depreciation
  - Salary and wages

- Select true statement
  - AS should be applied in presentation of all special financial statement
  - Set of financial statements must include value added report by management
  - Objective of financial statement is to provide information on entities financial position, performance and cash flow
  - AS1 encourages departure from AS where management cannot comply due to undue cost

Education TREE

- AS1 does not require-
  - Information about deviation from accounting policy
  - Detailed analysis of risk management policy
  - Notes must be structured and cross referenced to the face of financial information

- An error amounting to 1.2% of net income was identified as a result of the audit. The error was considered quantitatively immaterial. It was later discovered that the misstatement was intentional as a manager increased sales to reach bonus targets and there was evidence of earnings management. The auditor should:

A Have the Company record the error because there is no materiality threshold for intentional misstatements

B Intentional errors can be passed if they are immaterial so long as the Company concludes that the misstatements are immaterial

C Not perform any further analysis. The errors are quantitatively immaterial.

D Pass on recording the intentional error so long as the error was discovered in a quarter and will be recorded by the fiscal year-end

Education TREE

AS -1 at a glance

OBJECTIVE

To promote better understanding of financial statements by establishing the disclosure of significant accounting policies.

→ Principles & methods of applying such principles

NEED

Alternatively accounting principles & methods of applying them exists.

→ *Examples*
Valuation of inventory, Goodwill
Depreciation methods, etc,.

CONSIDERATION

Ensure true & fair view by

- Prudence
- Substance over form
- Materiality

Fundamental Accounting Assumptions

- ✓ Going concern
- ✓ Consistency
- ✓ Accrual

Disclosures

- ❑ All significant accounting policies
- ❑ Change in accounting policy having material effect along with effect of change
- ❑ Facts of non-disclosure of fundamental accounting assumptions, if any.

AS-2: VALUATION OF INVENTORY

Education TREE

Definition

a) assets held for sale in the ordinary course of business,
b) in the process of production for sale and
c) in the form of materials or supplies to be consumed in the production process in the rendering of services.

- Raw materials
- Work in progress
- Finished goods
- Merchandise
- Amounts allocated to inventory

Education TREE

Not applicable to

- WIP under construction contracts-AS7
- WIP under ordinary course of business for service providers
- FI held as stock in trade
- Producer inventory

Education TREE

Measurement of inventory

- Lower of Cost or NRV
- Costs capitalized as inventory includes all cost incurred directly or indirectly that were necessary to bring the inventory to its present condition and location.
- Costs of purchase
- Costs of conversion
- Other costs
- NRV includes-
  - Estimated selling price in ordinary course of business less estimated cost of completion and estimated cost of sales

Education TREE

Cost of conversion

- Labour costs
- Stores and spares
- Raw Material at Factory
- Repair and Maintenance
- Royalty on Manufactured goods
- Supervisory Staff at Factory
- Depreciation
- Power and Fuel

Education TREE

Assessing NRV

- Unrecoverable
  - Write-down to NRV recognized
- Reversals
  - If circumstances caused for write-down no more exist, reverse above adjustment
- Selling above or below cost
  - Component of inventory is selling below cost, not necessary to write-down if finished product sells above cost.

Education TREE

Allocation of overheads

- Fixed on basis of relative sale value basis less abnormal cost
- Variable on actual production
- In case of by product, NRV of scrap or waste material is deducted from cost of conversion

Education TREEY

ALLOCATION OF FIXED OVERHEADS

NORMAL CAPACITY

Why we use Normal Capacity for allocating Fixed costs

And why not actual production

Fixed overheads	100000	Rs
Normal Capacity	10000	units
Cost Allocated /unit	10	Rs

Absorption when Production is

Production	Available for Allocation to Stock	charged to P& L
3000 units	30000	70000
6000 units	60000	40000
3000 units	30000	70000
12000 units	100000	0

Reason:

Idle Capacity Cost is charged to Profit and Loss Account and not absorbed over the closing stock

Excise duty

- Since the liability for excise duty arises when the manufacture of goods is completed, it is necessary to create a provision for liability of unpaid excise duty on stock lying in factory. Thus to be included in cost of inventory
- CENVAT will be excluded for AS but included in value of inventory for Income tax purpose.

Education TREE

Exclusion

- Abnormal amounts
- Storage cost
- Administration overheads
- Selling and distribution cost
- Interest and borrowing cost(if AS-16 allows to be included , can form part of cost, e.g.. whisky)

Education TREEY

Techniques used for measurement of cost

- Standard method
- Retail method
  - Used by retail industry to measure rapidly changing high volume inventory with similar margin.
  - Cost determined by reducing sale value by appropriate gross margin
- LIFO is prohibited

Education TREE

Simple Average Method

Date	Particu	Purchases			Issues			Balance		
		Qty.	Rate	Value	Qty.	Rate	Value	Qty.	Av Rate	Value
Jan										
1	Pur	200	2	400				200	2.00	400
5	Pur	100	2.2	220				300	2.10	630
				620						630
WEIGHTED AVERAGE										
1	Pur	200	2	400				200	2.00	400
5	Pur	100	2.2	220				300	2.07	620
		300		620						620

Education TREE

Retail method

- **Retail method also known as reverse mark-up method, is based on retail value of the inventory on hand**
- **Adjusted for markdowns related to such items as promotional pricing, special assets, damaged merchandise and style changes**
- **Adjusted retail value is converted to an average cost and a resulting amount of the mark up of costs to retail**

EXAMPLE:

Particulars	At Cost		At Retail	
Beginning Inventory	$ 25,000			$ 39,000
Purchases	$ 35,000			$ 60,000
Markups	---			$ 1,000
Total available for sale	$ 60,000	divided	$100,000	= 60% cost complement
Less: Sales			$ (88,000)	
Less: Markdowns				$ (2,000)
Ending inventory at retail				$ 10,000
				60%
Ending inventory at lower cost or market			$ 6,000	

Education TREE

IFRS

- IAS-2 also considers inventory for service sector industry while AS excludes the same from its purview.

Education TREE

Questions

- Purchase of properties with an intention to resale
  - Classified as Property under AS-10
  - Classified as inventory in AS2
  - Classified as investment property in AS13

Education TREE

- Compute cost of inventory:-
- Purchase price 60,000
- Shipping costs 400
- Import duties 1,000
- taxes recoverable 900
- Transportation costs to the warehouse 300

  Note: 2% discount for immediate payment

Education TREE

- Which of the following forms cost of inventory
  - Labor cost
  - Deprecation of plant and machinery
  - Salary of payroll director
  - Rework cost incurred
  - Rent of factory
  - Maintenance cost of machinery

Education TREE

- Which of the following expense will form cost of inventory for an automobile showroom?
  - Advertisement expense
  - Transportation from one showroom to another
  - Safety material for transport of autos
  - Rent for showroom

Education TREE

- LCD screen of computer sells for Rs.20000 but cost of buying it was Rs.25000. Complete monitor sells for Rs.50000 and cost of manufacturing is Rs.40000. What conclusion do you draw from the facts?

Education TREE

- Determine cost of inventory
  - Cost of software- Rs.10000
  - Cost of making it saleable Rs.1000
  - Selling price- 12000
  - New selling price- Rs.10500

Education TREE

- If in above question sale price increase again over time, what will happen to inventory value above?
- Amit purchased goods worth Rs.100000 and sells them at 10% profit. Company forced him to sell goods at 25% below cost and accordingly gave free goods to cover the loss of 35%, what is the cost of free goods?

Education TREE

- Amit rents some of its equipment, will it be classified as inventory?
- One subsidiary measures inventory at FIFO and another at weighted average, is it permitted?

Education TREE

- Which of the following is accounted under AS2
  - Cows
  - Gold mineral reserves
  - WIP construction
  - Maturing Wine
  - Clothing
  - Lumber of wood distributor

Education TREE

- Company incurred following cost, determine cost of Closing stock
  - Material and Labor 1000/unit
  - FOH 2000000
  - Fixed Admin 500000
  - Capacity 10000 units
  - Actual production 4000 units
  - Closing stock 1000 units

Education TREE

AS-3: CASH FLOW STATEMENT

Education TREE

Introduction

- Cash flow statement is additional information to user of financial statement
- This statement exhibits the flow of incoming and outgoing cash
- This statement assesses the ability of the enterprise to generate cash and cash equivalents
- It also assesses the needs of the enterprise to utilize the cash and cash equivalents generated
- It also assesses the liquidity and solvency of the enterprise.

Education FREELY

Applicability

- This standard applies to the enterprises:
  - Having turnover more than Rs. 50 Crores in a financial year;
  - Listed companies;
    - Cash flow statement of listed companies shall be presented only under the indirect method as prescribed in AS 3

Education TREE

Features

- Explains cash movement under following-
  - Operating activities
  - Investment activities
  - Financing activities
- Cash means cash in hand and bank and demand deposits
- Cash equivalent is liquid investment having maturity less than 3 months

Education TREE

- Cash flow from operating activities can be derived in 2 methods
  - Direct method- Cash receipts and cash payments are disclosed
  - Indirect method- Profit and loss account adjusted with non cash expenses.

Education TREE

Definition

- Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

Education TREE

- Cash flows are inflows and outflows of cash and cash equivalents.

- Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

- Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

- Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Education TREE

Operating activity

- These are principal revenue producing activities of the enterprise.

- Examples:
  - Cash receipts from sale of goods / rendering services;
  - Cash receipts from royalties, fees, commissions and other revenue;
  - Cash payments to suppliers of goods and service;
  - Cash payments to and on behalf of employees.

Education TREE

Investment activity

- The activities of acquisition and disposal of long term assets and other investments not included in cash equivalent are investing activities.
- It includes making and collecting loans, acquiring and disposal of debt and equity instruments, property and fixed assets etc.
- Examples of cash flows arising from investing activities are as follows:
  - Cash payments to acquire fixed assets
  - Cash receipts from disposal of fixed assets
  - Cash payments to acquire shares, warrants or debt instruments of other enterprises and interest in joint ventures
  - Cash receipt from disposal of above investments

Education TREE

Financing activity

- Those activities that result in changes in size and composition of owners capital and borrowing of the organization.

- It includes receipts from issuing shares, debentures, bonds, borrowing and payment of borrowed amount, loan etc.
  - Sale of share
  - Buy back of shares
  - Redemption of preference shares
  - Issue / redemption of debentures
  - Long term loan / payment thereof
  - Dividend / interest paid

Education TREE

Interest and Dividend

- Interest received
  - From investment will be investment activity
  - Short term investment will be operating activity
- Interest paid
  - Loans/debts- financing activity
  - Working capital loan- Operating activity
- Dividend received- investment activity
- Paid- financing activity

Education TREE

Foreign exchange

- In case of profit/loss same should be deducted/added to P&L adjustment and while calculating cash and cash equivalent, should be valued at today's price.

Education TREE

Non cash transactions

- These should be excluded from the cash flow statement
- These transactions should be disclosed in the financial statements.
- Examples
  - Acquisition of assets by assuming directly related liabilities
  - Acquisition of an enterprise by means of issue of equity shares
  - Conversion of debt to equity

Education TREE

Cash flow relating to associate, joint venture and subsidiaries

Investment type	Accounting method	Reporting in the statement of cash flows
Subsidiary	Consolidation	Include all cash flows of the subsidiary except those that are intragroup.
Associate	Equity method	The cash flows between itself and the investee e.g. dividends and advances.
Jointly controlled entity (JV) –	Proportionate consolidation	Includes the entity's proportionate share of the jointly controlled entity's cash flows.
Jointly controlled entity (JV)	Equity method	The cash flows between itself and the investee e.g. dividends and advances.

- Cash flow from acquisition and disposal of subsidiary in investment activity

Significant differences in AS and IFRS

INDIA	IAS-7
• Interest and dividend not classified as operating activity	• Interest and dividend classified as operating activity
• Disclosure of extraordinary items	• Disclosure not required

Education TREE

Questions

- Describe as operating, finance and investment activity
  - Profit before tax
  - Proceeds from disposal of asset
  - Profit on disposal of property
  - Increase in long term liability
  - Depreciation
  - Decrease in trade receivables
  - Income tax paid
  - Cash proceeds from repurchase of company bonds

Education TREE

AS4- CONTINGENCIES AND EVENTS OCCURING AFTER THE BALANCE SHEET DATE

Education TREEY

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Contingencies

- Contingencies are no more dealt with by Accounting Standard – 4 after coming into force of Accounting Standard – 29 on Provisions, Contingent Liabilities and Contingent Assets

Education TREE

Events occurring after balance sheet date

- Events which occur between

  The Balance Sheet date

  &

  The date on which the financial statements are approved

Education TREE

Adjusting events

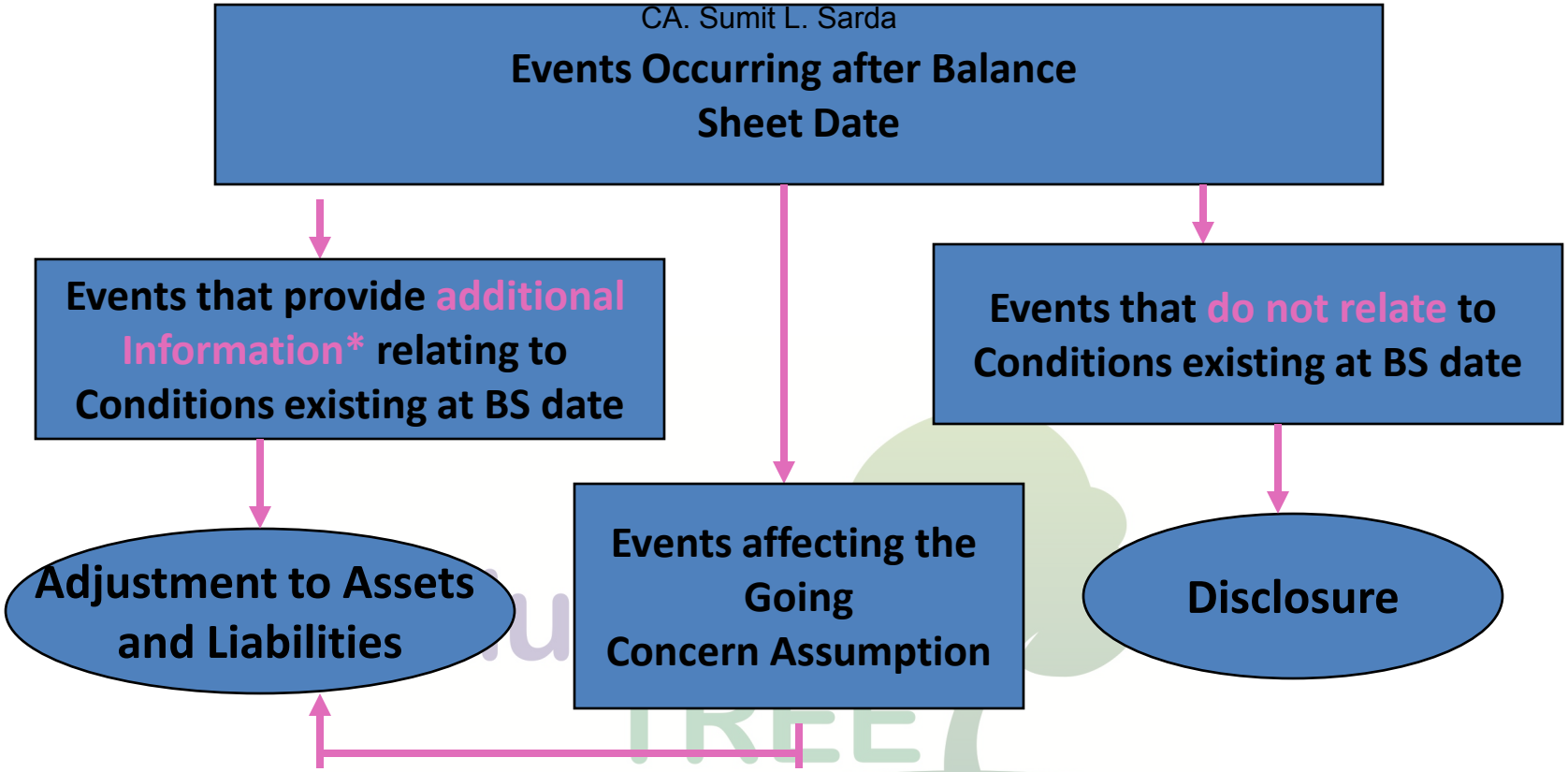
- Adjusting events are those events where conditions giving rise to the event existed at the end of the reporting period. Amounts recognized in the financial statements must be amended to reflect adjusting events. Here are some examples of adjusting events.
  - Court case
  - Bankruptcy of customer
  - Sale of inventories below net realizable value
  - Proceeds of asset sale or purchase determined
  - Bonuses determined
  - Fraud or errors

Education TREE

What is a non-adjusting event?

- Non-adjusting events are those events where conditions giving rise to the event arose after the end of the reporting period. Amounts recognized in the financial statements must not be amended for non-adjusting events.
  - Fall in the market value of investments
  - Destruction of Plant & Machinery – Going Concern Assumption not impaired

Education FREE



*Additional information materially affecting the determination of the amounts relating to conditions existing at the BS date

Proposed Dividend

- Proposed dividend in respect of period covered by financial statement declared after the balance sheet date but before approval of accounts should be adjusted in accounts

Education TREE

Going concern

- If the going concern assumption becomes inappropriate due to an adjusting or non-adjusting event after the reporting period, the financial statements cannot be prepared on a going concern basis.

Education TREE

IFRS

INDIA	IAS-10
• Proposed dividend should be adjusted	• Proposed dividend not an adjusting event
• Disclose date when financial statement were authorized- **not required**	• Disclose date when financial statement were authorized- **required**

Education TREE

Questions

- There is a fire in the painting gallery on 3rd April, loss estimated is about Rs.12 crore, Insurance recovery of Rs.9 crore, what should be the treatment for the same in balance sheet ending 31st March previous year?

Education TREE

- Due to fire above the building got completely damaged and it has become difficult to continue business, what should be done in such circumstances?
  - Impair building and paintings recorded in FA
  - Need to disclose that company has ceased trading
  - Disclose nature of fire, its financial effects and that company has ceased trading
  - Re prepare financial statements as non-going concern

Education TREE

- Speed Ltd. Sells bikes, shortly after year end, they recognized that an employee had stolen 5 bikes which were included in stock. Later that week management approved year end bonus. Which of these is adjusting event?
  - None
  - Discovering stolen motorbikes
  - Approval of year end bonus
  - Both

Education TREE

- Veekay Ltd. Runs 5 steel plants, on 5th April it announced closure of one of its subsidiary, 9th April they came to know they have lost a court case, which of these is a non adjusting event?
  - None
  - Announcing closure of subsidiary
  - Court case
  - Both

Education TREE

- Sticky ltd. Manufactures glue, on 2nd April, its lorry crashed and tons of glue spilled in local river, estimated cleaning cost is Rs. 1 crore. How to disclose same in financial statement?
  - No disclosure required
  - It is an adjusting event
  - A vehicle accident in April resulted in glue spillage
  - A vehicle accident in April resulted in glue spillage and estimated contingent liability is Rs. 1 crore.

Education TREE

- Management announces restructuring of the company after year end, however the financial effect of same cannot be arrived at, what should be done?

Education TREE

AS-5: NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGE IN ACCOUNTING POLICIES

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Education TREE

definition

- **Ordinary activities** are any activities and other incidental activities which are undertaken by an enterprise as part of its business.
- **Extraordinary items** are income or expenses that arise from non recurring events and transactions.
- **Prior period items** are income or expenses, which arise, in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.
- **Accounting policies** are the specific accounting principles and the methods of applying those principles in the preparation and presentation of financial statements

Education TREE

Components of net profit

- Profit or loss from ordinary activities
- Extraordinary items- clearly distinct from ordinary activities
  - –Loss due to earthquake
  - –Govt. grant being refundable

Education TREE

Prior period items

- Income or expense arising in current financial year as a result of **error or omission** in preparation of financial statement in previous year.
- Should be disclosed separately in P&L such that impact on current profit or loss can be perceived

Education TREE

Change in accounting estimate

- The estimation process involves making judgments based on the latest, reliable information
  - When would an estimate be required?
  - Do initial estimates ever require revision?
  - What's the difference between a change in accounting estimate and change in accounting policy?

Education TREE

- Should be applied prospectively
- Can effect current period and future period
- Disclosure is required
- If it relates to extraordinary item, reflect the same as extraordinary item

Education TREE

Changes in Accounting policies

- Can be made when
  - Required by standard
  - Compliance of statute of law
  - Better and appropriate presentation of financial statements
- What should be disclosed-
  - Reason for change
  - Amount of adjustment in current period and prior period

Education TREE

Disclosure requirement

- **<u>Extraordinary items</u>**: 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.

Education TREE

IFRS

INDIA	IAS-8
• Prior period items are disclosed separately in current P&L	• Error is restated in comparatives and retained earnings
• Allows extraordinary items	• Prohibits extraordinary item
• Adjustment of change in accounting policy is done in current year	• Adjustment retrospectively to be done. Only for transitional provision items, prospective effect

Education TREE

Questions

- Which of the following is change in accounting policy and change in estimate?
  - Inventory valuation changes from FIFO to weighted average
  - Doubtful debt changes
  - Depreciation rate change
  - Investment property is revalued from fair value to cost

Education TREE

- **Which is policy, estimate or error?**

- **Transaction 1:** During 2005 expenditure to the value of Rs.500,000 on improvements was incorrectly debited to repairs and maintenance of manufacturing equipment.
- **Transaction 2:** An entity has in previous years created a provision for warranties on sales based on the following formula:
  - - 5% of the total sales per annum.

  During the current year due to the fact that management realised that the actual expense had been higher than the provision in the past 3 years, the entity re-evaluated the provision policy to 7.5% of total sales value per annum.
- **Transaction 3:** An entity has previously valued its investment properties at cost less accumulated depreciation and accumulated impairments. During the current financial year management has decided to change the method of valuation of all its investment properties to fair value
- **Transaction 4:** An entity decides in the current year to start capitalising borrowing costs on assets that qualify under *AS 16: Borrowing costs.*

Education TREE

- Arrears of salary and wages for previous year will be paid in current year as per court judgment delivered. No provision was made for the same
  - Prior period item
  - Change in estimate
  - Extraordinary item
  - None of these

Education TREE

AS-6: DEPRECIATION ACCOUNTING

Education TREE

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Why should an asset be depreciated?

- The economic future benefits embodied in an item of property, plant and equipment are consumed by the entity principally through the use of the asset.
- Depreciation is the recognition of the economic benefits of the asset consumed during each period.

Education TREE

Applicability

- This Statement applies to all depreciable assets, except :—
  - (i) forests, plantations ;
  - (ii) Minerals and Natural Gas;
  - (iii)expenditure on research and development;
  - (iv) goodwill;
  - (v) live stock – Cattle, Animal Husbandry.

Education TREE

- This statement also does not apply to land unless it has a limited useful life for the enterprise.

Depreciable assets

- (i) are expected to be used during more than one accounting period; and
- (ii) have a limited useful life; and
- (iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business

Education TREE

How is an asset depreciated?

- An asset is depreciated by allocating the depreciable amount of the asset on a systematic basis over its useful life. The depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
- The depreciation charge for each period should be recognized as an expense unless another AS allows it to be capitalized in the carrying amount of an asset.

Education TREE

- **Useful life** of a depreciable asset should be estimated based on :
  - Expected physical wear & tear;
  - Obsolescence;
  - Legal & other limits on the use of assets.
- **The useful life of a depreciable assets is shorter than its physical life**. This is due to:
  - Legal & contractual limits, such as the expiry of related leases;
  - Extent of use & physical deterioration;
  - Obsolescence arising from technological changes, change in market demands, legal & other restriction

Education TREE

Depreciation on addition

- Any addition or extension which **becomes an integral part** of the existing asset should be depreciated over the remaining useful life of that asset. The depreciation on such addition or extension provided at the rate applied to the existing asset.
- Where an addition or extension **retains a separate identity** and is capable of being used after the existing asset is disposed of, depreciation should be provided independently on the basis of an estimate of its own useful life.

Education TREE

Methods of depreciation

- There are several method of depreciation:
  - Straight Line Method (SLM)
  - Written Down Method (WDV)
  - Sum of year Digits Method
  - Annuity Method
  - Machine Hour Method
  - Production Hour Method

Education TREE

Changes in depreciation method

- For compliance of statute
- For compliance of Accounting standard
- Appropriate presentation of financial statement
- To be recalculated from date of acquisition
- Difference should be credited/debited in current year P&L

Education TREEY

Change in historical cost due to foreign exchange

- To be added/subtracted from outstanding WDV
- Depreciation to be provided prospectively
- Addition attachment to be depreciated prospectively
- Demolished asset difference to be transferred to P&L

Education TREE

disclosure

- If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.
- The following information should be disclosed in the financial statements:
  - (i) the historical cost or other amount substituted for historical cost (i.e. revalued amount) of each class of depreciable assets;
  - (ii) total depreciation for the period for each class of assets; and
  - (iii) the related accumulated depreciation.

Education TREE

Minimum depreciation

- The Department of Company Affairs has clarified that the rates contained in Schedule XIV to the Company Act, 1956 should be viewed as the minimum rates, and, therefore, company cannot charge depreciation at rates lower than specified in the Schedule in relation to the assets. However, if on technical evaluation, higher rate of depreciation are justified, the higher rates should be applied.
- Where rates other than Schedule XIV rates are applied, **Appropriate disclosers** in the notes to the accounts would be required

Education FREE

Items below Rs.5000

- As per Schedule XIV of the Companies Act, individual items of fixed assets below Rs. 5000/- should be depreciated at 100%.
- For Exp,
  - An item of furniture such as a chair or table is capable of being used independently, therefore each chair or table will have to be provided 100% depreciation if its individual value does not exceed Rs. 5000. The 100% provision cannot be avoided by arguing that the furniture can be used only as a set, i.e. a set of chairs, which in aggregate cost more than Rs. 5000.

Education TREE

- **In case of Plant and Machinery:**
  - Where the aggregate actual cost of individual items of plant and machinery costing Rs. 5000 or less constitutes more than 10% of total actual cost of plant and machinery, normal Schedule XIV rates should be used. (Note number 8 of Schedule XIV of the Companied Act, 1956)

Education IREE

IFRS

INDIA	IAS-16
• Change in depreciation method is change in accounting policy thus change is made retrospectively	• Change in depreciation method is change in accounting estimate thus retrospective change not required

Education TREE

example

- Info ltd. Has acquired on a 999 year lease a huge piece of land for Rs. 999 lakhs from the Government. The land along with any construction thereon will revert to the Government after 999 years. Since the said period is very long and is akin to owning the land, Info Ltd does not wish to amortize the consideration.

Education TREE

- AS- 19 “Leases” does not apply to lease agreement to use lands. AS 6 ‘ Depreciation Accounting”, does not apply to land unless it has a limited useful life for the enterprise. In other words, if the life of land is limited than AS 6 would apply. In the given case, 999 years though very long is still limited. Therefore, AS 6 would apply. Therefore each year Info Ltd will have to charge Rs. 1 lakh to the income statement as amortization expenses.

Education TREE

Questions

- An entity acquires a machine which it is planning to use over a period of five years.
- It is estimated that the machine has a capacity of 100,000 hours. The entity used the machine for 30,000 hours in year 1. It is estimated that the machine will produce 40,000 units. 5,000 units were produced in year 1. The cost of the machine is Rs.500,000 and it has a residual value of zero.
- What will the depreciation charge in year 1 be if the machine is depreciated using:
- a straight line method
- the number of hours used
- the number of units of production made?

Education TREE

- Machine was purchased which has a useful life of 15 years
- A part of the machine needs to be replaced every 4 years
- What is the proper depreciation treatment

Education TREE

- A computer purchased during the year was kept idle the whole year. It was tested when it was purchased. How should it be depreciated?
  - No depreciation
  - 6 month depreciation
  - Full year depreciation

Education TREE

AS-7: CONSTRUCTION CONTRACTS

Education TREE

Applicable to

- Construction of Buildings / residential colonies
- Machines / plants
- Bridge
- Dam
- Pipeline
- Road
- Ship
- In the books of CONTRACTORS

Education TREE

Definition

- **A CONSTRUCTION CONTRACT** is a contract for the construction of an asset or of a combination of assets which together constitute a single project
- Example
  - Single assets – construction of bridge, building, dam, pipeline, road, ship, tunnel etc
  - Combination of assets - Construction of Refineries or other complex pieces of plant or equipment

Education TREE

- A construction contract may be a **fixed price contract** or a **cost plus contract**
- In order to reflect the substance of a contract or a group of contracts, it is sometimes necessary to apply *AS7*:
  - separately to each one of a group of construction contracts, or to the separately identifiable components of a single contract (**segmenting**), or
  - to a group of contracts together (**combining**)

Education TREEY

Identification of contracts…

CA Sumit L. Sarda

CONTRACTS

Group of assets	Group of contracts
Construction of each asset to be treated as separate contact if:	*With single or several customers to be treated as single contract if:*
▪ Separate proposals for each asset ▪ Separate negotiation for each asset with acceptance / rejection possible for part of the contract ▪ Identification of costs and revenues of each asset	▪ Negotiated as a single package ▪ Contracts closely interrelated and in substance part of a single project with an overall profit margin ▪ Contracts performed concurrently or in a continuous sequence

Education TREE

Percentage of completion method

Revenue is recognized as the contract activity progresses based on the stage of completion.

This method can be used only if the outcome of the contract can be reliably estimated.

Normally, the profit is not recognized in fixed price contracts unless the work on a contract has progressed to a reasonable extent (20 to 25% of the work)

Education TREE

Measurement of completion

TAKING INTO ACCOUNT ALL RELEVANT FACTORS

1. The proportion that costs incurred to date bear to the estimated total costs of the contract.

2. By the surveys which measure work performed.

Education TREEY

While recognizing the profit under percentage of completion method, an appropriate allowance for future unforeseeable factors should be made on either a specific or a percentage basis.

Segmenting

- When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:
- separate proposals have been submitted for each asset
- 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**
- the costs and revenues of each asset can be identified

Education TREE

Contract Revenue

- Contract revenue should comprise:
- 1. the initial amount of revenue agreed in the contract, **and**
  2. variations in contract work, claims and incentive payments:
- to the extent that is probable that they will result in revenue, **and**
- they are capable of being reliably measured

Education TREE

Contract cost

- Contract costs should comprise:
- costs that relate directly to the specific contract
- costs that are attributable to contract activity in general and can be allocated to the contract, **and**
- such other costs as are specifically chargeable to the customer under the terms of the contract

Education TREE

Non allocable cost

- Costs not allocable - examples
  - General administration and R&D costs (unless reimbursable)
  - Selling costs
  - Depreciation of idle P&M not used on a particular contract
- Cost of securing the contract are includible if:
  - Separately identifiable
  - Reliably measurable
  - Probable that contract will be obtained

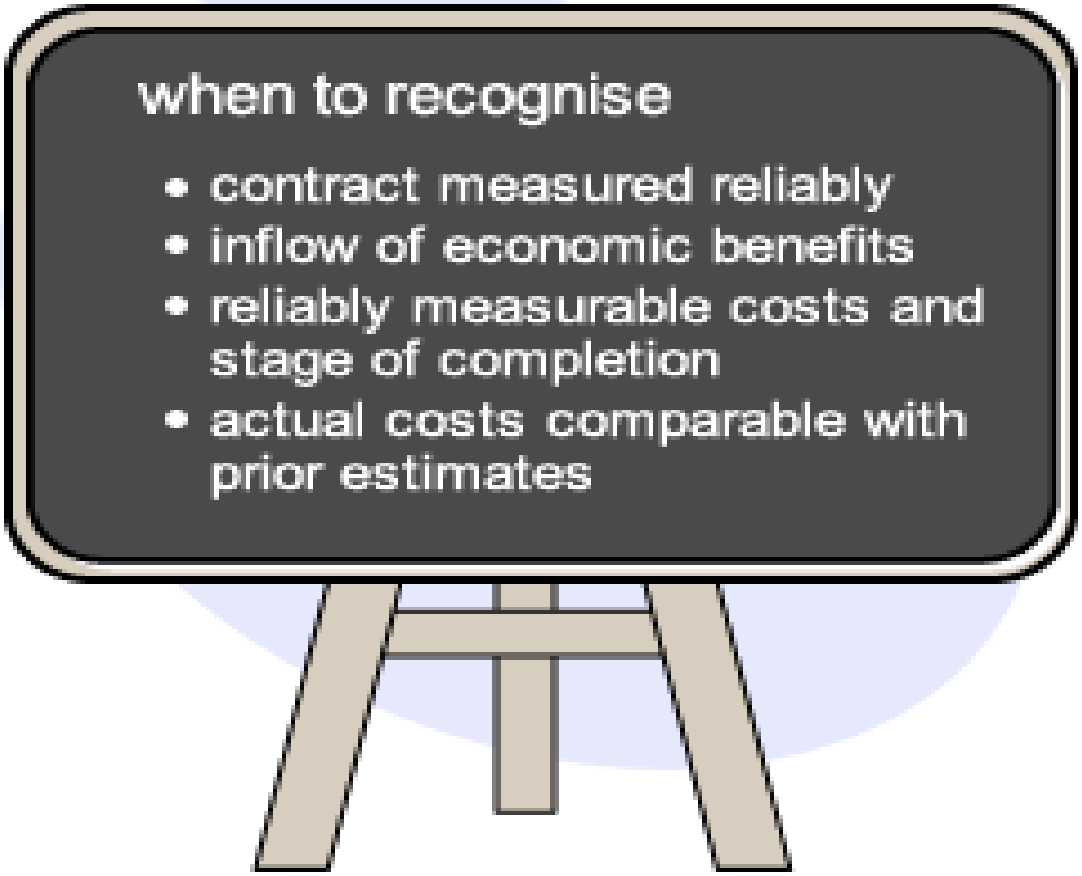
Education TREE

Recognition

- Contract revenue and contract costs associated with a construction contract should be recognized as revenue and expenses respectively by reference to the **stage of completion** of the contract activity at the end of the reporting period when the outcome of the contract can be **estimated reliably**.

Education TREE

Recognizing fixed price contract revenue

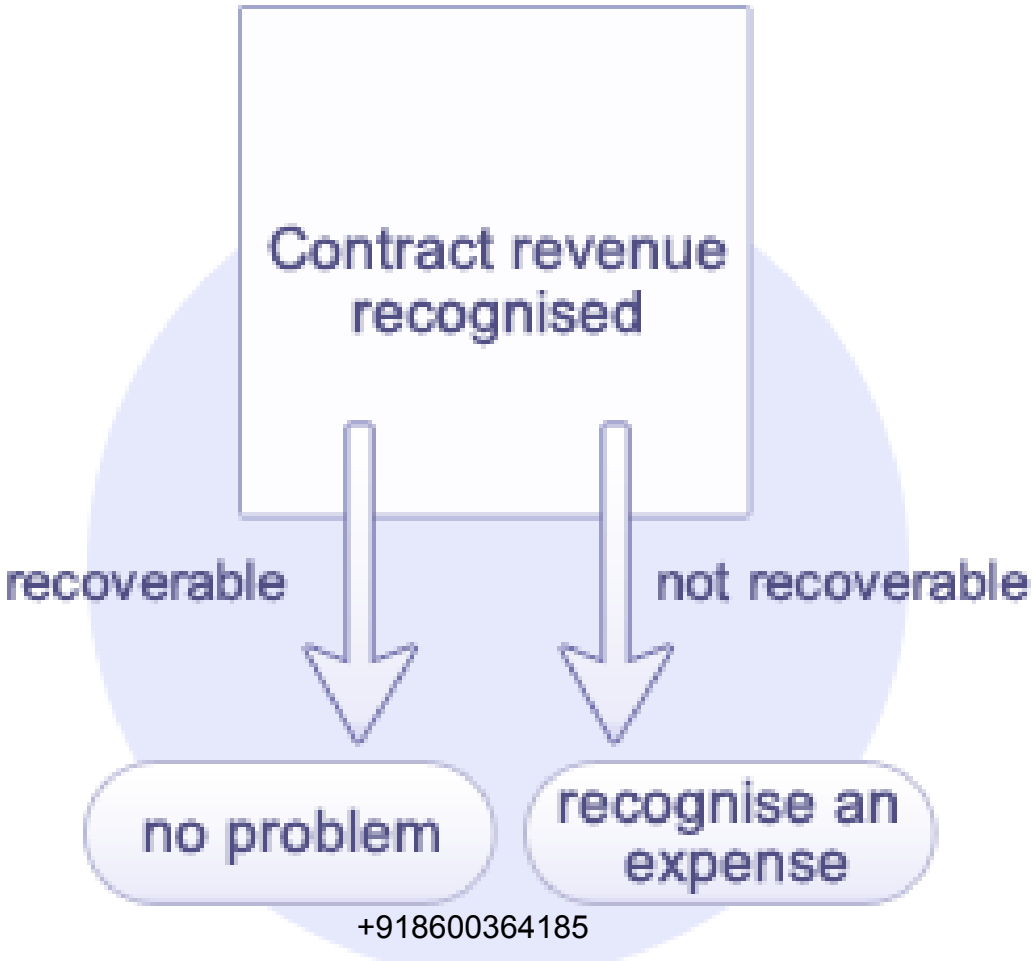


Cost plus contract

- In the case of a cost plus contract, the outcome can be estimated reliably when **all** of the following conditions are satisfied:
- it is probable that the economic benefits associated with the contract will flow to the enterprise, **and**
- contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably

Education TREE

Capitalization of cost



Recognition of revenue and cost

- When the outcome of a construction contract **cannot be estimated reliably:**
- revenue should be recognized **only to the extent of contract costs incurred** and if recovery is probable, **and**
- contract costs should be recognized as an expense in the period in which they are incurred.
- If this is the case, no profit is recognized. Once the outcome of a construction contract **can** be estimated reliably, profit can be recognized.

Education TREE

Revenue and costs recognition…

Basis of recognition

<u>Outcome of contract reliably estimated</u>

- Apply percentage of completion method (POC)
- Expected loss to be recognized immediately as expense

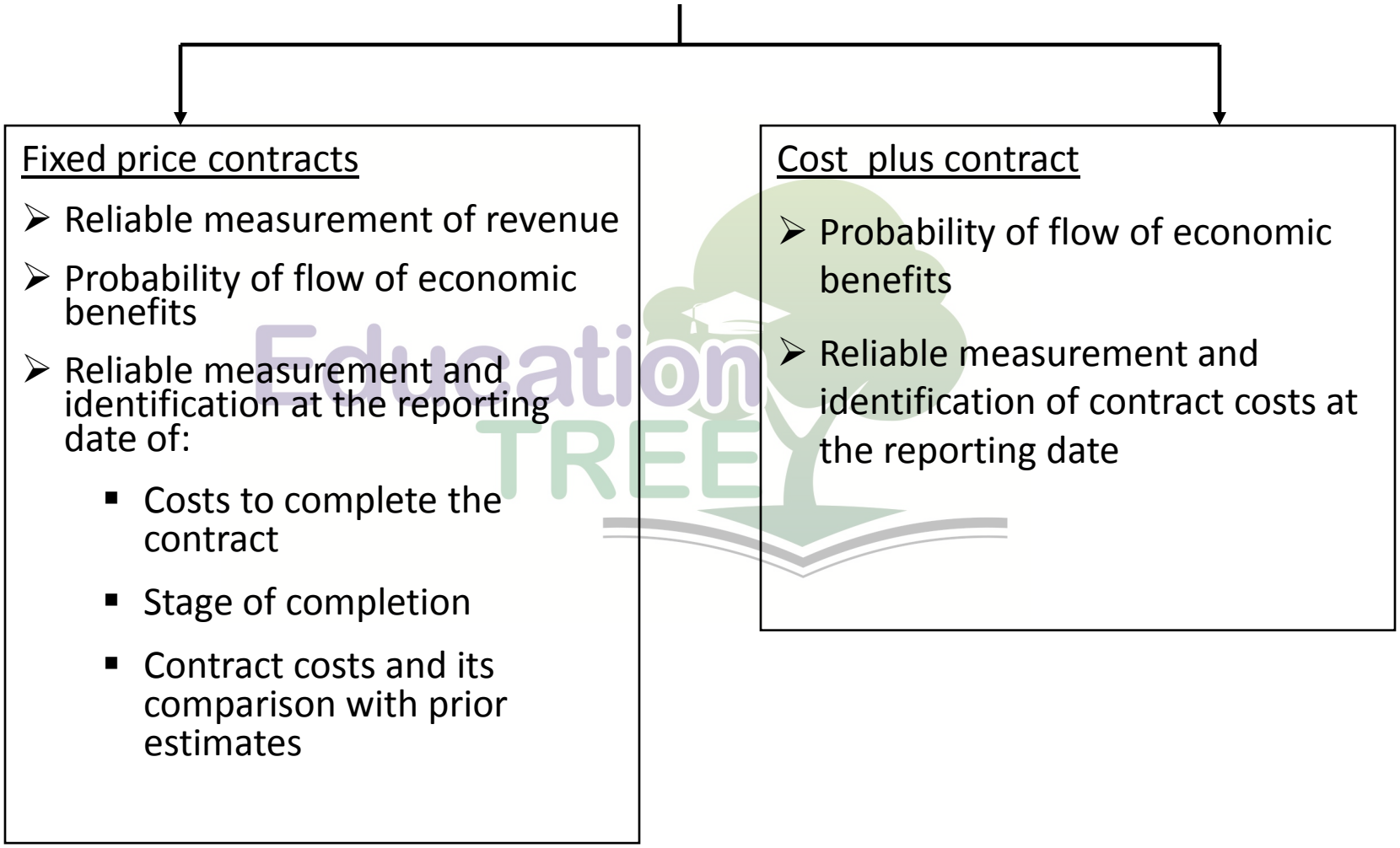
<u>Outcome of contract not reliably estimated</u>

- Profit not recognized
- Recognize contract revenue to the extent of contract costs incurred of which recovery is probable
- Recognize contract costs as an expense when incurred
- Expected loss to be recognized immediately as expense

Education TREE

…Revenues & costs recognition

Conditions to be satisfied for reliable estimation of outcome



Fixed price contracts

- Reliable measurement of revenue
- Probability of flow of economic benefits
- Reliable measurement and identification at the reporting date of:
  - Costs to complete the contract
  - Stage of completion
  - Contract costs and its comparison with prior estimates

Cost plus contract

- Probability of flow of economic benefits
- Reliable measurement and identification of contract costs at the reporting date

Education TREE

POC method: Stage of Completion

Methods for determination of stage of completion:

Input measures:

- Contract costs for the work performed as a proportion of the estimated total contract costs (basis most widely used)

Cumulative contract cost

Incurred up to reporting date **X Total contract revenue** **(-) Revenues recognized in Earlier period**

Total estimated contract cost

(Cost Incurred + costs to complete)

Education TREE

Output measures:

- Proportion of the physical completion of the contract work or surveys of the work performed, required technical estimate

Expected losses

- When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.
- The amount of such a loss is determined irrespective of:
  - whether or not work has commenced on the contract
  - the stage of completion of contract activity, **or**
  - the amount of profits expected to arise on other contracts which are not treated as a single construction contract

Education TREE

disclosure

- The amount of construction work-in-progress
- Progress payments received and advances and retentions on account of contracts included in construction work-in-progress
- The amount receivable in respect of income accrued under cost plus contracts not included in construction work-in-progress.

Education TREE

Questions

- Identify type of contract
- **Contract 1:**
  - Customer: Crane and Cía
  - Objective: The construction of three houses.
  - Total price of the contract: Rs.600,000
  - Period: 2 years.
  - Other details: The prices for the houses will be distributed as follows: House A – Rs.200,000; House B – Rs.150,000; House C – Rs.250,000. Estimated costs of each house are: House A – Rs.150,000; House B – Rs.120,000; House C – Rs.170,000.

Education TREE

- **Contract 2:**
-
  - Customer: Government
  - Objective: The construction of a tunnel through East Mountain
  - Total price of the contract: Government will pay a margin of 12% on the budgeted costs defined in the contract as follows:
-
- - Excavation costs: Rs.1,200,000
- - Personnel costs: Rs.800,000
- - Illumination costs: Rs.300,000
- - Labour costs: Rs.1,600,000
- - Asphalt: Rs.1,000,000
-
  - Period: 3 years.

Education TREE

- **Contracts 3 and 4:**
-
  - Customer: Timba & Timba.
  - Objective: Construction of a road and bridge performed concurrently.
-
  - **Contract 3:**
- - Objective: Construction of a road
- - Duration: 3 years.
- - Total price of contract 3: Rs.5,000,000
-
  - **Contract 4:**
- - Objective: Construction of a bridge at one end of a road.
- - Duration: 3 years.
- - Total price of contract 4: Rs.300,000 per year.
-
  - Both contracts have been negotiated together and price of contract 3 and 4 is Rs.5,300,000 in total.

Education TREE

- The amount of an invoice corresponding to a variation agreed by a customer will depend on the outcome of negotiations. There are three possibilities: Rs.100,000 with a probability of 60%, Rs.250,000 with a probability of 30% and Rs.150,000 with a probability of 10%
- How much revenue should be recognized?

100,000

250,000

150,000

125,000

None of the above

Education TREE

- The construction of a ship involves the following costs: **materials**, **building design**, **labor costs** and **selling costs**.
- Which of these costs do you think could be included as contract costs?

All of them

Materials and building design that relate to the contract

Materials, building design and labor costs that relate to the contract

Labour and selling costs that relate to the contract

Education TREE

- A poorly-budgeted contract has a fixed price of Rs.300,000 and estimated costs of Rs.400,000. Costs incurred at year-end are Rs.100,000. What is the correct accounting?
- Recognize an income of Rs.100,000
- Do nothing, as it is expected that the additional amount will be charged to the client
- Recognize an additional expense of Rs.100,000
- Recognize a total expense of Rs.200,000 and revenue of Rs.100,000

Education TREE

AS-9: REVENUE RECOGNITION

Education TREE

How should revenue be measured

- Fair value of consideration received or receivable
- Agreement between the parties
- In case of uncertainty, following should be recognized
  - the uncollectable amount, **or**
  - the amount in respect of which recovery has ceased to be probable

Education TREEY

- This statement **does not deal with** the following aspects:
  - Revenue arising from construction contracts.
  - Revenue arising from hire-purchase, lease agreements.
  - Revenue arising from government grants and other similar subsidies.
  - Revenue of insurance companies arising from insurance contracts.

Education TREE

Exchange of goods and services

- Similar good- not regarded as transaction
- Dissimilar goods- recognized at fair value
  - If cannot be measured reliably, value of goods or service given should be valued

Education TREE

Sale of goods

- Revenue from the sale of goods should be recognized when **all five** of the following conditions have been satisfied:
  - the enterprise has transferred to the buyer the significant **risks and rewards** of ownership of the goods
  - the enterprise retains neither continuing **managerial involvement** to the degree usually associated with ownership, nor **effective control** over the goods sold
  - the amount of revenue can be **measured reliably**
  - it is probable that **economic benefits** associated with the transaction will flow to the enterprise
  - the costs incurred or to be incurred, in respect of the transaction, can be measured reliably

Education FREE

Transfer of ownership

- Sold car on hire purchase, legal title still with seller
- Sale of goods in ship FOB
- Sale of goods on ship CIF
- transfer of risks and rewards coincides with:
  - the transfer of the legal title, **or**
  - the passing of possession to the buyer

Education TREEY

Product return

- Revenue would be recognized provided:
  - the goods have been delivered and the seller can reliably estimate future returns and recognizes a liability for returns based on previous experience and other relevant factors; OR
  - where there is uncertainty about return and the shipment has been formally accepted by the buyer or the goods have been delivered and the time period for return has elapsed.

Education TREE

Bill on hold sales

- It is probable that the delivery will be made
- Item is in hand, ready for delivery
- Buyer acknowledges the deferred delivery instructions
- Usual payment terms apply

Education TREE

Customer loyalty program

- Consideration received or receivable from a sales transaction as part of a customer loyalty program is allocated to the award credits granted by reference to their fair value
- The amount of revenue recognized is based on the number of awards that have been redeemed relative to the total number expected to be redeemed

Education TREE

Revenue from rendering services

- On the basis of proportionate completion method
  - Installation fees- installation is complete
  - Advertisement-appears before public
  - Insurance- renewal date of policies

Education TREE

- Revenue from interest- On time proportion basis
- Royalty- on accrual basis
- Dividend- when company declares dividend

Education TREEY

IFRS

INDIA

- Service revenue- proportionate completion method
- Interest revenue- accrual basis

IAS-18

- Service revenue- percentage of completion method
- Interest revenue- effective interest method

Education TREE

Questions

- If an enterprise retains the significant risks of ownership, the transaction is not considered a sale and revenue is not recognized. Assuming that the transaction fulfils all the other revenue recognition conditions, in which of the following situations would you generally recognize revenue?
  - The product has a standard guarantee
  - The receipt of the revenue is contingent on the buyer selling the goods
  - The goods are subject to installation, which can only be done by the seller. Until they are installed, the goods cannot be used. The installation is a significant part of the contract, and it has not been completed
  - The buyer has the right to rescind the contract and the seller is uncertain about the probability of return

Education TREE

- Revenue and expenses that relate to the same transaction or event are recognized simultaneously. This is called the **matching of revenues and expenses**.
- What do you think happens when the expenses cannot be measured reliably?
  - The revenue is recognized and the expenses are estimated, based on the previous year's experience
  - No transactions are recorded in the P&L
  - Any consideration already received for the sale of the goods is recognized as a liability

Education TREE

- Multibusiness Inc and Make-up Ltd signed a consignment agreement stating that Make-up Ltd will act as agent of Multibusiness Inc. When should revenue be recognised?
  - When goods are delivered to agent
  - When goods are sold by agent to third party
  - Will depend on delivery clauses between Mutibusiness and Make-up.

Education TREE

- Big Store written policy states that it will refund the cost of a purchase if the customer is not satisfied. The maximum period for which this policy applies is one month after purchase. When to recognise revenue
  - One month after date of sale
  - Recognise revenue at time of sale if liability can be estimated reliably
  - Recognise revenue regardless of liability being recognised reliably.

Education TREE

- Board decided to increase the sale price of certain items retrospectively, on 31st March, should the revenue be recognized in previous year?
- Sale includes Rs.200 lakhs as income from foreign sales but exchange permission was denied to the company.

Education TREE

- Pick & Pay donates certain perishable food products, which have reached their sell-by date, but are still fit for human consumption, to the Rescue Shelter for Homeless people.

Education TREE

- Company A sells goods “free on board” (FOB) destination, which means that title does not pass to the buyer until delivery, and Company A is responsible for any loss in transit. To protect itself from loss, Company A contracts with the shipping company for the shipping company to assume total risk of loss while the goods are in transit. May Company A recognize revenue when the goods are shipped?

Education TREE

- A sales contract requires payment of 90 % on completion of delivery and installation of a machine, and remaining 10 % at the earlier of customer acceptance or 90 days. Assume installation is not separately accounted for. How should revenue be recognized?

Education TREE

Answer

- Since installation is not a component of revenue to be accounted for separately, 100 % of revenue should be recognized when the significant risks and rewards of ownership of the machine have been transferred to the buyer
- Revenue recognition is not affected by settlement terms unless there is uncertainty regarding the flow of the economic benefits related to the transaction to the entity.

Education TREE

AS-10: ACCOUNTING FOR FIXED ASSETS

Education TREEY

- CA Sumit L. Sarda

Definition

- **Fixed asset** is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

- **Fair Market Value** is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length.

- **Gross Book Value** of a fixed asset is its historical cost or other amount substituted for historical cost in the books of accounts. When this amount is shown net of accumulated depreciation, it is termed as **net book value**.

Recognition principal

- An item of property, plant and equipment should be recognized as an asset when:
  - it is probable that future economic benefits associated with the asset will flow to the entity, **and**
  - the cost of the asset can be measured reliably

Education TREE

Does not apply to

- P&M held fro sale
- Biological assets
- Mineral rights and reserves
- Investment property

Education TREE

Capitalization of costs

- purchase price, including import duties and non-refundable purchase taxes, after deducting any trade discounts and rebates
- any directly attributable costs to bring the asset to the location and working condition necessary for it to be capable of operating as intended by management
- the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period

Education TREE

Costs not attributable

- Opening new site
- Introducing new product or service
- Conducting business in new location or new customer
- Admin or general overhead cost
- Initial operation losses
- Cost of relocating

Education TREEY

Self constructed asset

- The cost of a self-constructed fixed asset should comprise those costs that relate **directly** to the specific asset and those that are **attributable** to the construction activity in general and **can be allocated** to the specific asset.

Education TREE

Method of acquiring asset

- Deferral- Cost on asset recognized and difference in cash payment, accounting as per AS-16 borrowing cost.
- Exchange of assets- fair value unless it is not measurable
- Equity instrument- fair value of plant, if not measurable fair value of equity

Education TREE

Assets acquired on Hire Purchase: recorded at their cash value with a suitable disclosure, that the enterprise does not have full ownership thereof.

Assets owned jointly with others: recorded in the Balance sheet to the extent of the enterprise's share in such assets, original cost, accumulated depreciation and written down value. Alternatively, the pro rata cost of those assets may be grouped together with similar fully owned assets with an appropriate disclosure.

Assets purchased for a consolidated price: Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis determined by competent values

Education TREE

Accounting for revaluation

- First time reval
  - Increase: credit to reval reserve
  - Decrease: debit to P&L
- Second time reval upward, first time downward
  - Increase P&L by amount debited, balance to Reval reserve
- Second time reval downward, first time upward
  - Decrease reval reserve, then transfer to P&L

Education TREE

Subsequent expenditure

- Capitalize if future economic benefits are probable to flow
- An item of property, plant and equipment should be derecognized on:
  - disposal, **or**
  - when no future economic benefits are expected from its use or disposal
- If sale and lease back, account as per AS-19, Leases

Education TREE

Accounting for retirement/disposal

Any profit/loss arising from retirement or disposal of fixed assets should be dealt as below:

-Losses arising from retirement or gains/losses arising from disposal of a fixed asset which is carried at cost should be recognized in the profit and loss account.

-Where a revalued item of fixed asset is disposed off, any loss or gain should be charged or credited to the profit and loss account. However, to the extent that such loss is related to an upward revaluation which has not been subsequently reversed or utilized, it may be charged directly to that account.

Education TREE

Disclosure

- Gross and net book values of fixed assets at the beginning and end of an accounting period along with additions, disposals, acquisitions and other movements during the year.

- Expenditure incurred in the course of construction or acquisition.

- Revalued amounts substituted for historical costs of fixed assets, the method adopted for revaluation, the nature of indices used, the year of any appraisal made and whether an external value was involved in carrying out the revaluation.

Education TREE

Questions

- Flight company incurred various training cost for different employees, which cost should be capitalized?
  - Pilot training
  - Cabin crew training
  - Baggage handling training
  - None

Education TREE

- New building needs to be constructed for office purpose, but there is already a dead structure in the premises, cost of dismantling is Rs.100,000. How to account for the same?

Education TREE

- Item description: Engine
  Cost: Rs.1,000,000
  Accumulated depreciation: Rs.900,000
  Selling Price: Rs.70,000
  Payment Period: 2 equal installments over next 2 years, interest free
  Cash equivalent discount per year: 10 %
- Item description: Building
  Revalued amount: Rs.32,000,000
  Accumulated depreciation: Rs.1,000,000
  Total related revaluation surplus: Rs.1,950,000
  Selling Price: Rs.31,500,000

Education TREE

- Company sets up a factory at Rs.2 crore, they were asked to clean up pollution caused by factory at the end of five years which will cost Rs.50 lakhs at that time, present value of same is Rs.40lakhs today. What cost to capitalize?

Education TREE

AS-11: FOREIGN EXCHANGE RATES

Education TREEY

- CA Sumit L. Sarda

Introduction

- *AS 11* is applied when:
  - accounting for most transactions and balances in foreign currencies
  - translating the results and financial position of foreign operations

Education TREE

Transactions

- buy or sell goods or services in a foreign currency
- acquire or dispose of assets, or incur or settle liabilities, in a foreign currency
- translating the financial statements of foreign operations.

Education TREE

Exclusions

- does not apply on restatements
- does not apply on cash flow statements
- does not deal with exchange differences relating to interest on foreign currency borrowings to the extent related to adjustment in interest (AS-16)

Education TREE

Issues involved

- which exchange rate to use.
- financial effect of changes in exchange rates.

Education TREE

Initial recognition of transactions

- as per exchange rate at the date of transaction
- average rate if not too much fluctuation.

Education TREE

Initial recognition of foreign currency transaction

- Company buys inventory worth $5000, the spot rate is $1=Rs.45, transaction will be recorded as:

Education TREE

- Inventory dr. Rs.225000

  To Creditors Rs.225000

Reporting at the end of subsequent period

- Monetary items
  - Using the closing rate
- Non monetary items
  - Historical cost for integral operations and closing rate for non integral
- Re valued non monetary items
  - On fair value on the date of revaluation for integral operations and closing rate for non integral
- Contingent liability- closing rate

Education TREE

Non integral operations

- <u>indicators of non integral foreign operations -</u>
- 1. autonomy of operations
- 2. no or little correlation of cash flows of reporting enterprise and foreign operation
- 3. financing of activities of foreign operation by its local resources (and not by reporting enterprise)

Education TREE

Several exchange rates

- Eg. Lower of cost or NRV
  - Lower of assets previous carrying amount and its recoverable amount
- Cost to be determined as per date of transaction i.e. rate at transaction date
- NRV translated at exchange rate on the date of determination

Education TREE

Recognition of exchange difference

- Recognized in P&L for integral operations
- Recognized in reserves for non integral operations

Education TREE

Example

	TRANSACTION DATE @ 42/-	CLOSING DATE@ 45/-
PURCHASES DR.$1000	42,000	42,000 - INVENTORY
TO PAYABLE $ 1000	42,000	45,000 difference to go to exchange fluctuation , value of inventory or purchases not to be adjusted.

Education TREE

PROFIT & LOSS A/C

PURCHASES	42,000	VALUE OF CLOSING STOCK	42,000
EXCHANGE FLUCTUATION	3,000		

BALANCE SHEET

PAYABLES	45,000	CLOSING STOCK	42,000

Education TREE

Forward exchange contracts

- transaction to be recoded at exchange rate of transaction date

- premium or discount relating to forward exchange contract - to be recognized as income or expense over the life of the contract - period wise

Education TREE

Disclosures

- amount of exchange differences included in p & l a/c.
- net exchange difference accumulated in "foreign currency translation reserve"
- amount of exchange differences in respect of forward exchange contracts

- foreign exchange risk management policy.

Education TREE

IFRS

INDIA

- Uses only “Reporting currency”
- Covers forward contract

IAS 21

- Uses “Functional currency”, “Presentation currency” and “Recording currency”
- Does not include forward contract

Education TREE

Questions

- Current exchange rate 1$=Rs.44
- Creditors recorded earlier of $10,000 at Rs.45 on the date of purchase
- Inventory recorded at historical cost Rs.450,000 has a fair value today of $10,200
- Also show impact on financial statement

Education TREEY

AS-12: Government Grants

Education TREE

- CA Sumit L. Sarda

Meaning

- For past or future compliances
- Does not include transactions with government
- Recognition criteria
  - Comply with conditions

Education TREE

Types of grants

- Fixed assets
- Revenue
- Promoters contribution

Education TREE

- Uncovered
  - government assistance other than in the form of government grants;
  - government participation in the ownership of the enterprise.

Definition

The following terms are used in this Statement with the meanings specified:

(i) *Government* refers to government, government agencies and similar bodies whether local, national or international.

(ii) *Government grants* are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Education TREE

Method of accounting

- Fixed assets
  - On purchase of asset, debit FA and on receipt of grant credit FA.
  - Debit FA and Credit Government grant, depreciate FA and amortize GG.
- Revenue- credit to P&L in the corresponding period to which it relates
- Promoters contribution(Capital subsidy)- credited to Capital Reserve

Education TREE

Recognition of government grants

- Government grants available to the enterprise are considered for inclusion in accounts:

(i) where there is reasonable assurance that the enterprise will comply with the conditions attached to them; and

(ii) where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

Education TREE

Mere receipt of a grant is not necessarily a conclusive evidence that conditions attaching to the grant have been or will be fulfilled.

- A contingency related to a government grant, arising after the grant has been recognized, is treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.

Education TREE

Non monetary grant

- Government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value.

Education FREE

Refund of grant

- Treated as extra ordinary item
- For FA, increase value of FA and charge depreciation prospectively

Education TREE

Disclosure

The following disclosures are appropriate:

(i) the accounting policy adopted for government grants, including the methods of presentation in the financial statements;

(ii) the nature and extent of government grants recognized in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

Education TREEY

IFRS

INDIA

- Promoters contribution treated as Capital Reserve
- Refund of grant is extraordinary item

IAS-20

- Promoters contribution is amortized
- It is change in estimate

Education TREE

AS-13: ACCOUNTING FOR INVESTMENTS

Education TREE

- From 1.4.2011 AS-30 stands mandatory to follow thus AS-13 stands withdrawn except accounting for investment properties

Education TREE

Introduction

- Property can be classified as:
  - owner-occupied property (it is used in the production of goods and services)
  - investment property (it is rented out)
  - held for sale (it is inventory)
  - multi-use property (it is a combination of the above)

Education TREE

- Owner occupied property- dealt in AS-10
- Investment property- owners earn income either by renting out or selling it
- Held for sale- dealt in AS-2 will be carried at lower of cost or NRV. Building given on contract for construction dealt in AS-7
- Multi purpose property- portion used by company itself will be accounted here if separable. If non separable will be accounted here but if only insignificant portion dealt with will be ignored

Education TREE

- Under construction- intention of party is important
- Classify
  - Property being constructed on behalf of another
  - Old investment property being redeveloped
  - New head quarter is one of its old investment property
  - Warehouse is under operating lease
  - Empty building to be leased out under operating lease

Education TREE

When to recognize an investment property

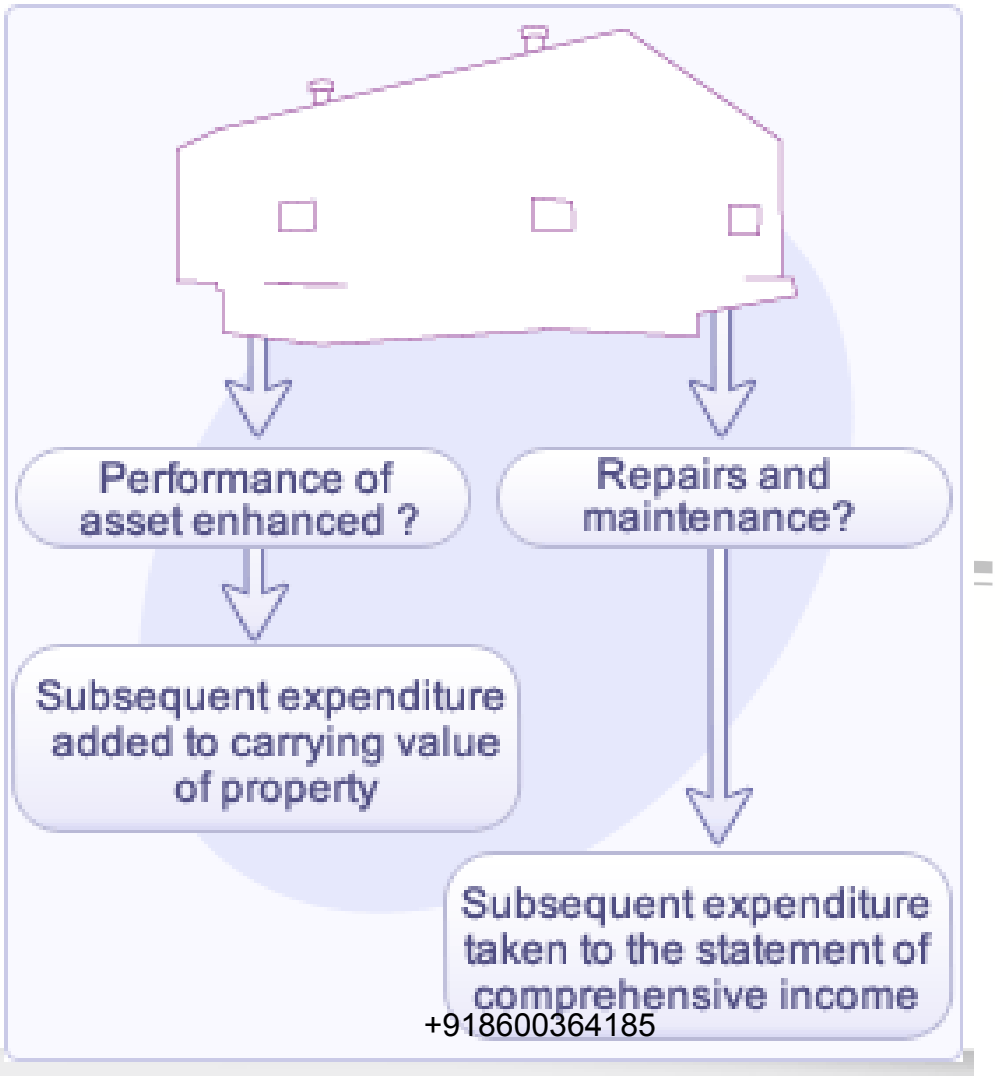
- It is probable that future economic benefits will flow
- Cost can be measured reliably
- Attributable cost
  - Cost of site preparation
  - Initial delivery and handling cost
  - Installation and assembly cost
  - Testing cost
  - Professional fees

Education TREE

- Excluded cost
  - Initial losses
  - Abnormal amounts like wastage
- Self constructed property
  - Cost or NRV whichever is low
- Purchased property
  - Purchase price and related cost

Education TREE

Subsequent expenditure



AS-14: ACCOUNTING FOR AMALGAMATION

Education TREE

Introduction

- Transaction or other event in which acquirer obtains control of one or more businesses
  - Business becomes subsidiary of acquirer
  - Business is legally merged
  - One entity transfers its net assets to another
  - Two or more entity's together form a new entity
  - **If the other entity continues to exist, same is not covered under this standard**

Education TREE

Types of merger

- Pooling of interest
  - All assets and liabilities taken over at book value
  - At least 90% shareholders retain(held by transferee not counted)
  - Consideration paid only in equity
  - Business intended to be carried on

- Purchase method

Education TREE

Goodwill

- Amortize over a period of 5 years or less.
- Purchase consideration
  - Equity
  - Contingent consideration
  - Assets exchanged
- Excluded cost
  - Acquisition related cost
  - Separate transactions

Education TREE

IFRS

INDIA

- Recognises 2 methods
- Assets and liabilities at carrying value
- Amortise goodwill
- Negative goodwill to be credited to Capital Reserve
- Does not deal with reverse acquisition

IAS-22/IFRS-3

- Only purchase method
- Asstes amd liabilities at fair value
- Goodwill to be tested for impairment
- Negative goodwill to be credited to P&L
- Deals with reverse acquisition

Education TREE

Questions

- Which of the following forms part of purchase consideration?
  - Equity shares issued
  - Cash
  - Contingent consideration based on future profits
  - Admin cost of acquisition factory
  - Valuation fees
  - Due diligence cost
  - Finance agreement cost
  - Future loss of a customer as it is acquirers competitor
  - Cost of issue of shares
  - Payment to key employees to retain

Education TREE

- Which of the following are identifiable asset?
  - Registered trademark
  - Sale order backlog
  - Licensed customer list
  - Potential contracts with prospective customers
  - Franchisee agreement with a company

Education TREE

AS-15: EMPLOYEE BENEFITS

Education TREE

- CA Sumit L. Sarda

Short term employee benefit

- Fall due within 12 months
  - Wages
  - Compensated absences
  - Bonus payable
  - Non monetary benefits
- Unpaid to be recognized as a liability if it is obligatory to pay the same in future date

Education TREE

- Salaries, wages and other non-monetary Benefits:
  - To Account for in Current Period
  - Not To Discount
- Leaves : Fully En cashable - Full Provision
  Lapsing - No Provision
  Accumulating - Provision for Expected Liabilities
- Bonus : May be contingent upon future service
  To provide for expected liability.

Education TREE

Post employment/other long term benefits

- Post employment
  - Gratuity
  - Pension
  - Life insurance
  - Medical care
- Other
  - Jubilee
  - Long service bonus
  - Long term disability benefits

Education TREE

Does not cover

- It does not cover
  - Profit Sharing Plans &
  - Employee benefit Plans e.g., ESOP
  - Covered by guidance notes

Education TREE

- Defined contribution plans
  - Pays to a separate entity
  - No legal constructive obligation to pay further
- Defined benefit plans
  - Other than those meeting above def.

Education TREE

Defined benefit plans

- Multi employer plans
  - Pool of assets contributed by various entities not under common control
  - Use those assets to benefit more than one entity employees
- State plans
  - Legislation bodies
- Insured plans

Education TREE

- Employer pays 3% of salary in a state plan. Employees on retirement receive monetary benefit from the plan
- Employees are entitled to 1% of bonus salary on completion of 15yrs. Of service

Education TREE

Attributing benefits

- Actuarial technique is used to make reliable estimate
- This requires benefits to be attributed to years of service
- E.g.. Post employment medical reimbursement is 10% of medical cost for 10yrs of service and 50% for 20yrs of service
  - First the probability of employees leaving before 20yrs is calculated
  - Then present value of expected medical reimbursement will be required

Education TREE

  - This present value will be attributed over the years at 2.5% for 20yrs for employees leaving after 20yrs and 1% for 10yrs. For employees leaving after 10yrs

- Then the market value of the plan is checked and if the same is not available, fair value is estimated
  - This can be done by discounting future expected cash flows which reflects risk associated and maturity

Education TREE

- Changes in obligation and fair value/market value are netted off to determine actuarial gain or loss. Such gains or loss must be recognized during the period
- Items in P&L
  - Present value of current year obligation
  - Actuarial gain/loss
- Items in Balance sheet
  - Present value of obligations plus actuarial gain/(loss)
  - Less current service reimbursements

Education TREE

Entry for contribution to benefits plan

- Suppose Rs.1000 paid
  - Plan assets dr. 1000

    To Cash 1000

Actuarial gains or losses

- They comprise
  - Effects of previous actuarial assumption and what actual occurred
  - Effects of change in actuarial assumption
- Actuarial assumptions are
  - Best estimates of variables that determine the ultimate cost of providing post employment benefit
    - E.g.. Mortality, employee turnover, disability, discount rate, future salary, expected rate of return

Education TREE

Why gain or losses occur

- Actual return differs from expected return
- Actual rate of employee turnover differs from expected rate
- Change in forecast salary increase
- Change in the discount rate

Education TREEY

	Present value of obligation	Fair value of assets
Brought forward @ start of period	(X)	X
Interest cost	(X)	-
Expected return on plan assets	-	X
Contributions paid	-	X
Benefits paid	X	(X)
Current service cost	(X)	-
Past service cost	(X)	-
Actuarial gain (loss)	X/(X)	X/(X)
Carried forward @ end of period	(X)	X

Total actuarial gains (losses) =
- actuarial gain (loss) on the present value of the obligation
- plus actuarial gain (loss) on the fair value of the plan assets.

- ***Balances***
- Contributions paid to the fund (in cash) in 2007: 180,000
- Benefits paid to the employees in 2007: 300,000
- Current service cost in 2007: 260,000
-
- **Present value of obligation**
- 31 December 2006: 2,000,000
- 31 December 2007: 2,282,000
-
- **Fair value of plan assets**
- 31 December 2006: 2,100,000
- 31 December 2007: 2,184,000
-
- Net cumulative unrecognized actuarial gains at 31 December 2006: 360,000
- The average remaining working life of employees at 31 December 2006 is 10 years.

Education TREE

- Expected discount rate determined on 1 January 2007: 10%
- Actual discount rate for 2007: 14.32%
- Expected rate of return on plan assets determined on 1 January 2007: 12%
- Actual rate of return on plan assets for 2007: 9.71%

Education TREE

	Present value of obligation	Fair value of assets
Beginning bal.	(20,00,000)	21,00,000
Interest cost		
Expected return on plan assets		
Contribution paid		
Benefits paid		
Current service cost		
Past service cost		
Actuarial gain/(loss)		
Closing balance	(22,82,000)	21,84,000

	Present value of obligation	Fair value of assets
Beginning bal.	(20,00,000)	21,00,000
Interest cost		
Expected return on plan assets		
Contribution paid	0	1,80,000
Benefits paid	3,00,000	(3,00,000)
Current service cost		
Past service cost		
Actuarial gain/(loss)		
Closing balance	(22,82,000)	21,84,000

	Present value of obligation	Fair value of assets
Beginning bal.	(20,00,000)	21,00,000
Interest cost		
Expected return on plan assets		
Contribution paid	0	1,80,000
Benefits paid	3,00,000	(3,00,000)
Current service cost	(2,60,000)	
Past service cost		
Actuarial gain/(loss)		
Closing balance	(22,82,000)	21,84,000

	Present value of obligation	Fair value of assets
Beginning bal.	(20,00,000)	21,00,000
Interest cost	(2,00,000)	
Expected return on plan assets		252000
Contribution paid	0	1,80,000
Benefits paid	3,00,000	(3,00,000)
Current service cost	(2,60,000)	
Past service cost		
Actuarial gain/(loss)		
Closing balance	(22,82,000)	21,84,000

	Present value of obligation	Fair value of assets
Beginning bal.	(20,00,000)	21,00,000
Interest cost	(2,00,000)	
Expected return on plan assets		252000
Contribution paid	0	1,80,000
Benefits paid	3,00,000	(3,00,000)
Current service cost	(2,60,000)	
Past service cost		
Actuarial gain/(loss)	(1,22,000)	(48,000)
Closing balance	(22,82,000)	21,84,000

- Fair value of plan assets
- at 31 December 2006: 10000
- at 31 December 2007: 15000

Education TREE

- Benefits paid by plan: 1900
- Contributions paid to plan by company: 4900
- Expected return on plan assets:10.25%
- Actuarial loss on obligation for 2006: Rs.60

Fair value of plan asset-opening	10,000
Add: Contribution paid	4,900
Less: Benefits paid	(1,900)
Closing	15,000
Net return on planned assets	2000
Expected return=10,000*10.25%+	1175
3000*10.25*6/12	
Actuarial gain/loss	825
Less: Loss obligation	(60)
Net gain	765

Termination Benefits:

- To be Accounted for expenses immediately.

- VRS is a termination benefit.

Education TREE

Curtailment

- Present obligation as requirement of statute or otherwise
- To be reduced from the obligation of benefits to be paid
- E.g. NPV of obligation is Rs.1000 and fair value of plan assets is Rs.820. The business stands discontinued. Curtailment reduces present obligation to Rs.900. Unrecognized service cost is Rs.50

Education TREE

	Before curtailment	Curtailment	After Curtailment
PV of obligation	(1000)	100	(900)
Fair value of plan asset	820		820
Liability	(180)	100	(80)
Unrecognized past service cost	50	(5)	45
Net liability	(130)	95	(35)

Disclosures

- Nature of Defined Benefit plans and effect of changes if any.
- Break up and reconciliation of different components of defined benefit obligation.
- Break up and reconciliation of different components or plan assets and return on assets.
- Expenses recognized in P& L Account in different components.
- Main Actuarial assumptions used.

Education TREE

IFRS

INDIA

- Actuarial gain or losses directly attributed to P&L
- Termination benefits recognized if employer accepts the offer and amount can be reasonably recognized

IAS-19

- Actuarial gain or loss attributed as per 'Corridor Approach'
- Termination benefits to be recognized if employee or group of employees are to be terminated and termination benefits to be paid

Education TREE

Questions

- Define as benefit, contribution or other long term benefit-
- Employer pays 10% of remuneration in fund every year. On retirement remuneration paid is on no. of years of service and final salary
- On retirement employees receive 1% of salary for each year of service
- Employing entity has to pay 1% of salary each year in a plan, no further liability remains due on retirement

Education TREEY

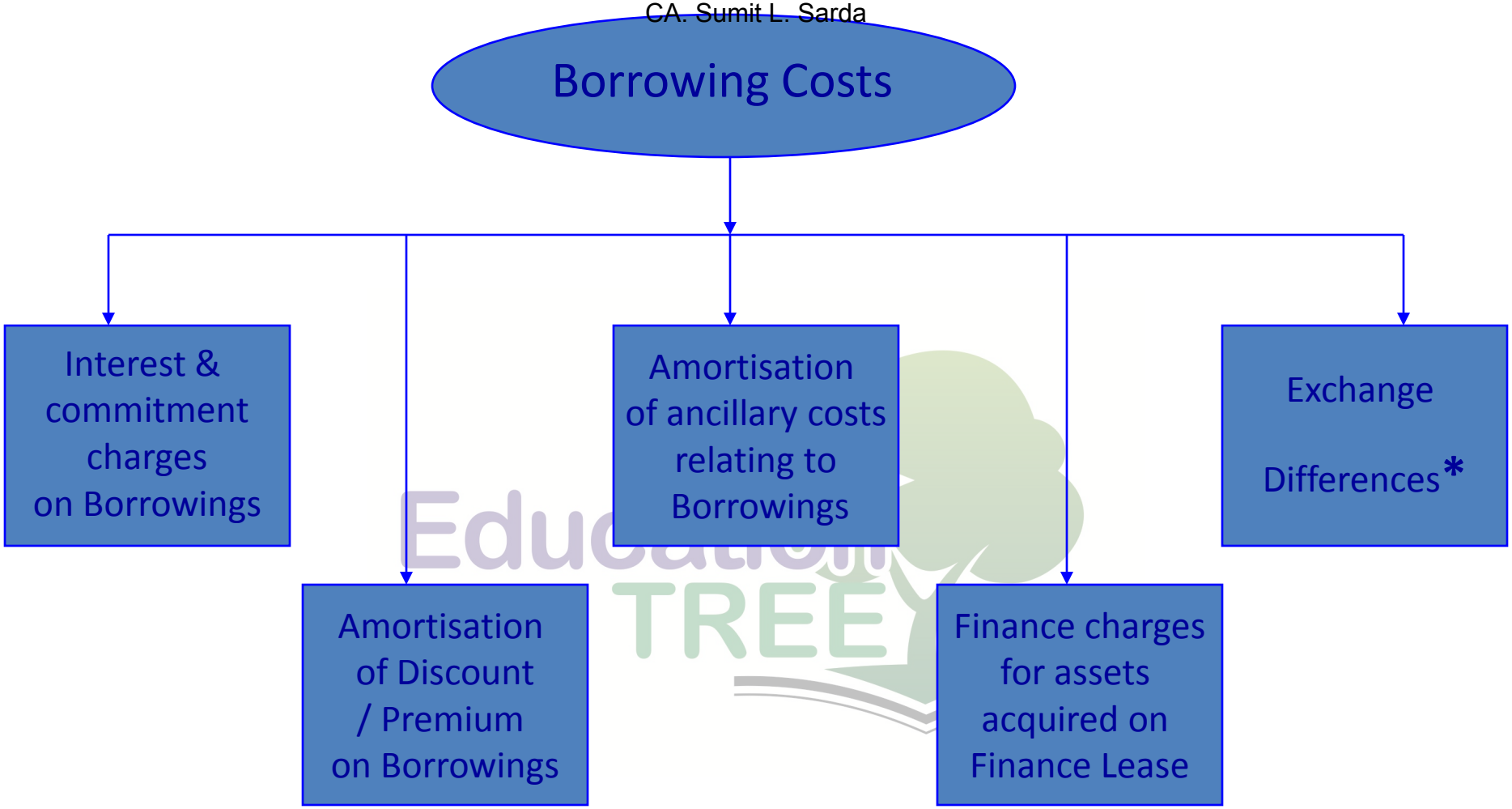
- Which of the following are actuarial gain or loss?
  - An increase in the present value of the obligation due to a difference between the actual discount rate and the expected rate.
  - An increase in the present value of the obligation due to the expected interest cost for the year.
  - A decrease in the fair value of the plan assets due to a difference between the expected return on plan assets and the actual return.
  - A decrease in the present value of the obligation due to a difference between the actual rate of employee turnover and the expected rate.
  - A reduction in the obligation due to changes in the forecast mortality rates of past employees.
  - An increase in the fair value of plan assets due to contributions paid during the year.

Education TREE

- Present value of defined benefit obligation
- at 31 December 2006: 1,200,000
- at 31 December 2007: 1,300,000
-
- Fair value of plan assets
- at 31 December 2006: 1,190,000
- at 31 December 2007: 1,210,000
-
- Current service cost: 170,000
- Benefits paid by plan: 320,000
- Contributions paid to plan by company: 130,000
- Interest cost: 144,000
- Expected return on plan assets: 131,000

Education TREE

AS-16: Borrowing cost



Education TREE

*To the extent they are regarded as an adjustment to interest cost

Qualifying asset

- a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale(12 months or more)
- E.g. Investment property under development
  - Development of new process over a substantial period of time
  - Construction of a manufacturing plant
  - Inventory that requires substantial period of time to make it saleable

Education TREE

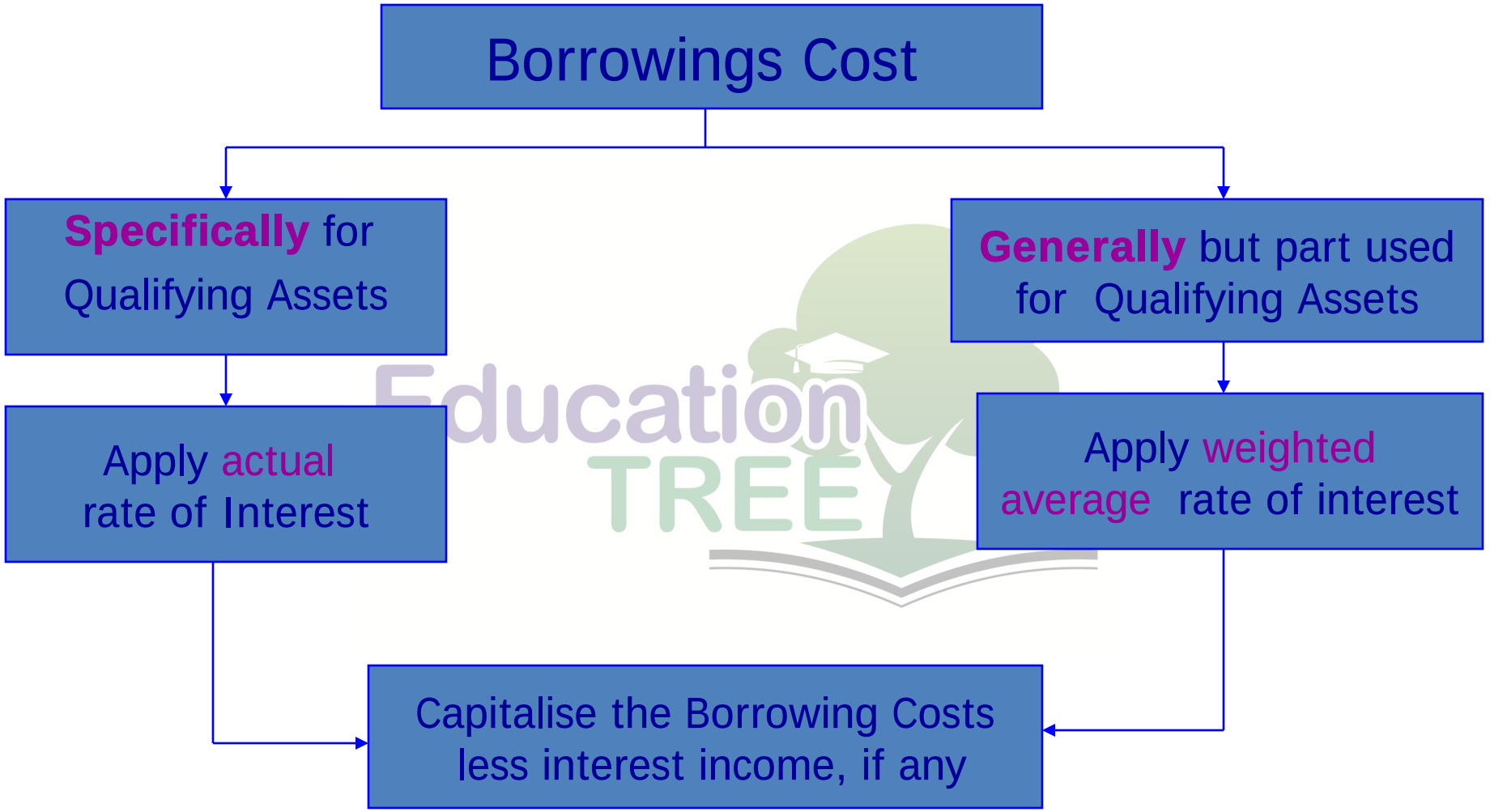
2 important questions

- Do the cost meet the definition of AS-16
- Would these cost been avoided if expenditure on qualifying asset has not been made?

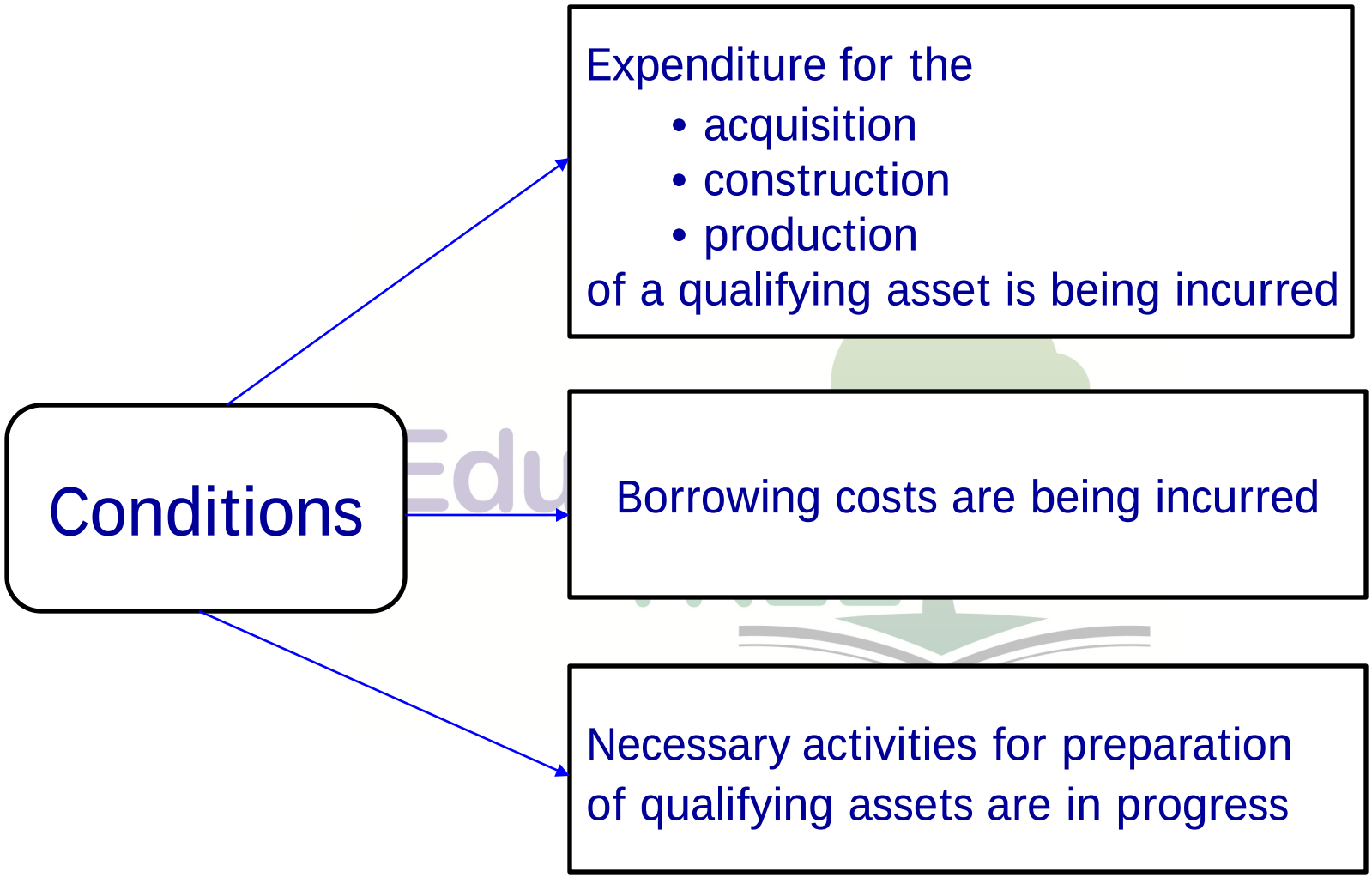
Education TREE

- Expenditure on qualifying asset is incurred through payment of cash, transfer of other asset or interest bearing liability
  - Interest free credit does not qualify as expenditure
- Borrowing cost is interest and other cost incurred for borrowing of funds
- Asset is in commencing stage
  - When no production is going on, such cost will not be capitalized

Education TREE



Education TREE


Conditions
Expenditure for the
• acquisition
• construction
• production
of a qualifying asset is being incurred
Borrowing costs are being incurred
Necessary activities for preparation
of qualifying assets are in progress

Stopping capitalization

- When active development is interrupted
  - Does not mean temporary delay
  - E.g. heavy rains stop work
- Shall cease when all activities necessary to bring the asset into existence are complete
- When work completed in stages where each stage is eligible for capitalizing borrowing cost, shall cease when all stages are complete

Education TREE

- Suspension not to take place in case:
    - substantial technical & administrative work is being carried on
    - temporary delays necessary for preparation of qualifying assets (seasonal rains etc.)

Education FREE

Amount to be capitalized

- Borrowed specifically for the asset
- General borrowing at weighted average borrowing rate of all borrowings
- If the capitalization amount exceeds probable future economic benefit from the asset, apply impairment of asset

Education TREEY

Excess of the Carrying amount of the Qualifying asset over recoverable Amount

Actual Cost of the Asset + Borrowing Cost Capitalised	<=	Recoverable amount of the Asset

Exchange Differences – When to be treated as Borrowing Costs?

- To the extent regarded as 'adjustment to interest cost'.

> Adjustment =
> Interest on local currency borrowing
> – Interest on foreign currency borrowing

- The adjustment is restricted to amount of exchange loss on principal due to devaluation of currency

- Loan Amount : USD 10,000
- Rate of Interest (in U.S.A.) : 8% p.a.
- Exchange rate as at 01.04.2005 : Rs. 40 per USD
- Exchange rate as at 31.03.2006 : Rs. 45 per USD
- Rate of Interest (in India) : 12%

Education TREE

- Computations to be made:

1. Interest for the Period = USD 10,000 x 8% x Rs. 45
   - = Rs. 36,000-
2. Increase in liability towards the principal amount
   - = USD 10,000 x (45-40)
   - = Rs. 50,000/-
3. Interest if loan was raised in India
   - = USD 10,000 x 48 x 12%
   - = Rs. 57,600/-
4. Difference (2-1) = Rs. 57,600 – Rs. 36,000
   - = Rs. 21,600/-

Education TREE

Treatment of Exchange Differences of Rs. 50,000/-

Rs. 21,600/-	Rs. 28,400/-
To be treated as borrowing cost as per AS -16	To be capitalised to loan obligation as per SCH VI

Note: The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during the period

Education TREE

Disclosure

- The financial statements should disclose:

1. the accounting policy adopted for borrowing costs
2. The amount of borrowing costs capitalised

Education TREE

Example

- Name of the Company : **EIH LIMITED**
- Financial Year : 2004-05
- Auditors : Ray & Ray

- Significant Accounting Policy
- Borrowing Costs that are attributable to the acquisition / construction of fixed assets are capitalized as part of the cost of the respective assets. Other borrowing costs are recognized as expenses in the year in which they arise.
-
- Notes to Accounts
- Interest debited to the Profit & Loss Account is net of interest capitalized amounting to Rs. Nil (2004 – Rs. 233,156,467)

Question

- A Ltd. Started construction of manufacturing plant from 1st Jan by utilizing excess cash of Rs.100000/ month. It received loan for the project on 1st June.
  - Borrowing cost is attributable from?

Education TREE

- Differentiate as cease capitalization or suspend capitalization
  - Lack of funds stops construction, funds will be arranged in 3 months
  - Construction of new block of flats is complete apart fro interior doors
  - Phase1 of interior park complete, tenants can move in
  - Floods delay construction of hotel by 3 months

Education TREE

- Calculate the amount to be capitalized?

Date	Amount	Description
15 Oct 2009	5,000	Payment of registration fees at regulatory authorities
1 Nov 2009	7,000	Painting of Head Office
1 Dec 2009	10,000	Architect fees
1 Dec 2009	60,000	First progress payment
15 Dec 2009	90,000	Minor upgrades done to existing shopping centres

- Interest rate is 9% to be valued on 31st march

Education TREE

Date	Event
May 2010	Construction of Wing B suspended; structure for Wing B declared unsafe; engineers consider structural changes/to demolish Wing B
Dec 2010	No work could be carried out on Wing A or Wing B due to adverse weather conditions: heavy snow, ice etc.
Mar 2011	Engineers concluded that the structural defects on wing B could be rectified
31 March 2011	Wing A is completed. The only outstanding work is the finishing touches to the individual shops – attaching signs etc.
1 Apr 2011	Construction of Wing B continues – structural defects to be rectified
31 May 2011	Tenants move into Wing A

- 1.4.2009- borrowed 10lakhs @20% for acquisition of land and construction
- 1.4.2009 purchase land for Rs.5lakhs and start construction
- 1.6.2009 progress payment of Rs.15lakhs
- 1.4.2010- progress payment of Rs.10lakhs
- 1.9.2010- progress payment of Rs.9lakhs
- A loan of Rs.10lakhs@16% is outstanding
- Accounting year January to December

Education TREE

- Average accumulated expenditure

1.4.2009	500000	9/12	375000
1.6.2009	1500000	7/12	875000
		Net	1250000
Specific borrowing@20%		1000000	200000
General borrowing@16%		250000	40000
Interest to be capitalized=			**240000**

Education TREEY

- Interest accrued

1000000*.20*9/12=		1,50,000
1000000*.16*9/12=		1,20,000
	TOTAL	**2,70,000**

Education TREE

- Accounting year 2010

20,00,000*12/12=	20,00,000
10,00,000*9/12=	7,50,000
9,00,000*4/12=	3,00,000
TOTAL	**30,50,000**

Education TREE

Interest on above

10,00,000@20%=	2,00,000
10,00,000@16%=	1,60,000
MAX. PERMISSIBLE AMOUNT	3,60,000

- Whether borrowing cost avoidable or unavoidable?

A. Said to be unavoidable if expenditure on qualifying assets had been incurred and borrowing is taken ,Existing borrowing exercise of judgement required.

Q. Factors to be considered as to whether and to what extent general borrowings have been so used

- A. Information of cash inflows and outflows, close scrutiny required.

Q. General borrowings made but equity specifically infused for financing qualifying assets

A. No question of capitalizing borrowing cost.

Q. Calculation of weighted average borrowing rate?

- A. Based on borrowing during period of expenditure and not borrowings made for the whole year.

- Q. **Date of capitalization?**
- A. Date on which package is ready to commence commercial production.
- Q. **Allocation of incidental expenditure during construction?**
- A. On appropriate basis.
- Q. Treatment of depreciation on infrastructure?
- A. Allocation on appropriate basis to P & L A/c and Expenditure during construction A/c

Education TREE

AS-17: SEGMENT REPORTING

Education TREE

- CA Sumit L. Sarda

- Reporting financial information about:

Different types of products and services an enterprise produces, and

The different geographical areas in which it operates.

Education TREE

Benefits to users

- Better understanding of the performance of the enterprise;
- Assess the risks and returns of the enterprise.
- Make more informed judgments about the enterprise as a whole.

Education TREE

Applicability

LISTED ENTERPRISES or those which are in the process of Listing

Enterprises with **annual turnover more than Rs. 50 crores.**

Education FREE

- Objective being better understand the performance of the enterprise; better assess the risks and returns of the enterprise; and make more informed judgements about the enterprise as a whole.
- If a single financial report contains both consolidated financial statements and the separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements

Education TREE

Non allocation to segment result

- Extra ordinary items
- Interest
- Dividend income
- Income taxes
- Overhead, general administration
- Sales of investments
- Share of profit of associate, joint venture

Education TREE

Operating segment

- Is a component of an entity which
  - Engages in business activities in which it earns income and expenses
  - Whose operating results are reviewed by entity to make decisions like allocation of resources and
  - For which discrete financial information is available

Education TREE

What is a BUSINESS SEGMENT ?

- Distinguishable component of an enterprise.
- Engaged in providing an individual product or service.
- Subject to risks and returns different from other business segments.

Education TREE

What is A GEOGRAPHICAL SEGMENT ?

- Distinguishable component of an enterprise
- Engaged in providing products or services within a particular economic environment
- That is subject to risks and returns that are different from those of components operating in other economic environments

Education TREE

Aggregation criteria

- Two or more operating segments may be aggregated if
  - Aggregation is consistent with AS
  - Segments have similar economic characteristics
    - Nature of products and service
    - Nature of production process
    - Type of class or customer
    - Method used to distribute the product
    - Nature of regulatory environment

Education TREE

Matrix organization

- Overlapping sets of combination
  - M has 3 products sold in 3 different countries
  - It has mix of products and geographical areas
  - **An entity shall disclose information to enable users to evaluate the nature and effectiveness of business activities in which it operates**
  - **Thus risk and return approach is required**
  - In above case, it shall be reported as business segment

Education TREE

Primary and Secondary Segment Reporting Formats

If RISKS AND RETURNS are affected by

Differences in the products and services → BUSINESS SEGMENT

Operation in different countries or geographical areas → GEOGRAPHICAL SEGMENT

Education TREE

Vertical integration

- Operating segments are not limited to those earning revenue from external sales
- Different stages of vertical integration maybe identified

Education TREE

Reportable segments

- Ones segments are identified, reportable segments are determined
- Reportable segment is one for which information is required to be disclosed
- AS-17 gives quantitative thresholds
  - Segment revenue/total revenue >= 10%
  - Segment result/total profit or loss >= 10%
  - Segment assets/total assets>=10%

Education TREE

75% threshold

- If total external revenue attributable to reportable segments is less than 75% of total consolidated revenue, then additional segment needs to be identified

Education TREE

Example

Operating segment	External revenue	Internal revenue	**Segment Profit/(loss)**	**Segment Assets**
Electrical spare parts	3,500	800	1000	40
Truck and auto engine	1750	240	350	28
Fuel components	1,500	0	(100)	15
Others	700	50	50	6
Engine assembly	100	3,000	340	22

	Operating segment	External revenue	Internal revenue	Total revenue	Segment Profit/(loss)	Segment Assets
1	Electrical spare parts	3,500	800	4300	1000	40
2	Truck and auto engine	1750	240	1990	350	28
3	Fuel components	1,500	0	1500	(100)	15
4	Others	700	50	750	50	6
5	Engine assembly	100	3,000	3100	340	22

Education TREE

- Total revenue=11,640
- 10% of total revenue=1164
- Thus reportable segment= 1,2,3,5
- Total assets=111, 10% of assets=11.1
- Thus reportable segments=1,2,3,5

- Total profit= 1740
- 10%= 174
- Thus reportable segment= 1,2,5
- Total loss= 100
- Reportable segment=3

Education TREE

Comparatives

If a segment is identified as a reportable segment in the current period, preceding period segment data is presented for comparative purpose, even if that segment did not satisfy the 10% threshold in the preceding period.

A segment identified as a reportable segment in the immediately preceding period should continue to be a reportable segment for the current period even if it does not meet the 10% threshold.

Education TREE

IFRS

INDIA

- Applies to listed as well as unlisted companies
- Should be made is confirmation of Accounting policies
- Defines risk and return approach for defining segments

IFRS-8

- Applies to listed companies and to be listed companies
- Need not follow accounting policies
- Management approach in defining segments

Education TREE

Disclosures

a. Segment revenue from sales to external customers
b. Segment revenue from transactions with other segments
c. Segment result
d. Total carrying amount of segment assets;
e. Total amount of segment liabilities;
f. Additions to tangible and intangible fixed assets;
g. Depreciation and amortisation for the period
h. Significant other non-cash expenses

Education TREE

Questions

Industry	Revenue	Profit	Assets
Car parts	3,100,000	132,000	1,600,000
Motor vehicles	1,350,000	112,000	1,400,000
Software	3,000,000	96,000	1,000,000
Electronics	900,000	44,000	520,000
Finance	950,000	40,000	460,000
All others	800,000	18,000	240,000

AS18: RELATED PARTY DISCLOSURE

Education TREE

What is related party

- A party is a related party of an entity if directly or indirectly through one or more intermediaries-
  - Controls(under common control)
  - Has as interest(a person holding 20% of the shares)
  - Has joint control

Education TREE

Applicability

- Companies which are listed or are in process of listing
- Banks, financial institutions and insurance companies
- Enterprises having turnover > Rs. 50 cr.
- Enterprises having borrowings > Rs. 10 cr.
- Holding / subsidiary company of any of the above

Education TREE

Deals with ONLY

1. Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise(this includes holding companies, subsidiaries and fellow subsidiaries).
2. Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture.
3. Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual.

Education FREE

4. Key management personnel (KMP) and relatives of such personnel
5. Enterprises over which any person described in (3) or (4) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise

Education FREE

CONTROL & SIGNIFICANT INFLUENCE – MEANING

Control Means

- > 50% voting power
- Control over board composition
- Substantial interest in voting power + power to direct

Significant Influence

- Participation in financial/operating policy decisions
- If > 20% voting power, it is presumed unless proved otherwise

Education TREE

Key management personnel

- Those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Education TREE

Related party transaction

- Transfer of:
  - Resources or
  - Services or
  - Obligations
  - Regardless of whether a price is charged
- There is a defined set of relatives covered
- Non executive director is outside its purview
- Key management personnel covered

Education TREE

Disclosure requirement

- Relationship between parent and subsidiary should always be disclosed whether transaction takes place or not
- Key management personnel compensation to be disclosed
  - Short term employee benefit
  - Post employment benefits
  - Other long term benefits
  - Termination benefits
  - share based payments

Education TREE

Nature of disclosure

- Nature of relation
- Information about the transaction
- Minimum disclosure
  - Amount
  - Balance outstanding
    - Whether secured
    - Details of guarantee
  - Provision for doubtful debts
  - Expense recognized during the period

Education TREE

example

- Entity A and entity B jointly hold entity C
- Entity A sells goods to B and C
- Here C is a related party to A and not B

Education TREE

Related party includes

A

Reporting Entity(60% with A)

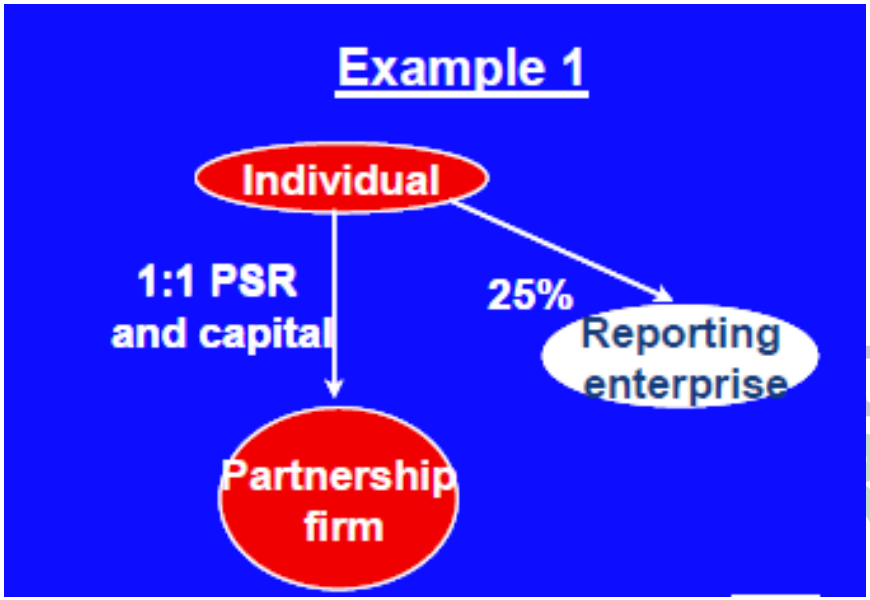
D(55% with A)

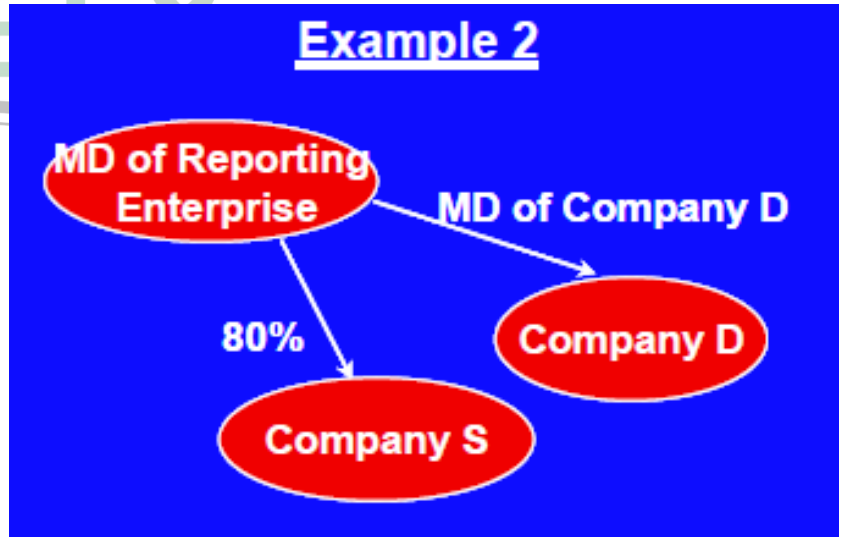
B(21% with RE)

C(50% with RE)

E(60% with D)

Significant influence





SPECIFIC EXCLUSIONS

- Not applicable where confidentiality of data is required as per regulations – e.g.. banks
- 2 companies just because of a common director (provided the director is not able to affect their policies in mutual dealings)
- Single customer, supplier, franchisee, distributor or general agent, just because of significant business volume
- Following parties –
  - Financer, Trade unions, Public utilities, Govt. departments/ agencies/ bodies

Education FREE

Non Executive director

- A non executive director should not be considered as key management person unless he has a authority and responsibility for planning, directing and controlling the activities of the enterprise.
- The requirements of AS 18 should not be applied in respect of non executive director even if he participates in the financial and / or operating policy decisions

Education TREE

IFRS

INDIA

- Relative-Includes specific relation
- State controlled entity-excluded
- No such requirement

IAS-24

- Relative-Includes people who can influence the decision
- State controlled entity-included
- Pricing policy needs to be disclosed

Education TREE

Example

- The Company is a joint venture of X and Y (50:50). Z is the 100% holding company of X. Are the following transactions required to be disclosed as related party transactions?

(a) The Company pays 8% sales commission to Z for the sales promoted by them on company's behalf.

(b) The Company is required as per the agreement to pay license fee and sales commission to X which is not paid and a certificate of waiver has been received for the year.

Education TREE

- X is a 50% Venturer and accordingly Z has the joint control over joint venture through X. Joint control does not give the power to direct financial/operating policies to any one Venturer as decisions are taken jointly. Therefore cannot be said to be applicable.
- Waiver of income/expense is a related party transaction. A transaction under AS 18 is defined as ' a transfer of resources or obligations between related parties, regardless of whether or not price is charged'. Therefore waiver would be a transaction.

Education TREE

Example2

- The Company has transformed the application money paid to Y Ltd (which is a related party) for Deep Discount Bond (DDB) in to security deposits for a property taken on lease from Y Ltd. Application money was given in the previous year. In the current year, the DDB allotment is cancelled and the refund money is transformed into security deposit. Whether the disclosure should be specifically made stating that amount in the form of application for DDB converted in to Security deposit during the year?

Education TREEY

- All related party transactions are required to be disclosed. Related party transactions are any transfer of resources or obligations between related parties regardless of whether or not a price is charged.
- AS 18 requires the disclosure for nature of the transaction. Accordingly, the transaction with Y should be disclosed by way of giving the description. In the given example, the description should state that application money for DDB being converted into security deposit. It will not be correct to show only outstanding amount as security deposit at the year end, since the transaction of transforming refund money into security deposit has taken place during the year, which needs to be disclosed.

Education FREE

Example 3

- The Company has been provided with the technical information and formulation by Z Ltd. Z Ltd is the owner of the product brand which is manufactured and marketed by the Company. The Company pays royalty to Z Ltd as per the license agreement and also the raw materials are imported from Z ltd. Whether the disclosure of Z Ltd is required in the event they are considered to have a significant influence?

Education TREE

- AS 18 states that significant influence may be exercised in several ways. One of the examples given in this paragraph is by way of dependence on technical information. However, definition of related parties does not include as related parties the enterprises which have significant influence over the reporting enterprise. It includes only individuals having significant influence over the enterprise. In the present case, Z Ltd, not being an individual, will not be covered by the related party definition.

Education TREE

- Whether disclosure under AS 18 on Related Party Transactions require auditor's opinion on the measurement of such transactions?
- AS 18 does not deal with measurement issues. But that does not exempt auditors from looking at related party pricing. After all auditors give the opinion that the accounts are true and fair, and it would be difficult for auditors to escape from this responsibility should something major go wrong. Auditors also report specifically on these issues in the CARO.

Education FREE

AS-19: ACCOUNTING FOR LEASES

Education TREEY

- CA Sumit L. Sarda

objective

- Prescribe accounting policies for lesser and lessee
- Disclosure in relation to operating lease and finance lease
- Non applicability
  - Agreement of exploration of natural resources
  - Licensing of patents, copyrights etc.
  - Land lease agreement
  - Service contract

Education TREE

meaning

- Lesser coveys to lessee
- Right to use asset for agreed period of time
- In return for payment or series of payment

Education TREE

CLASSIFICATION

- To be done at the inception of lease (inception is earlier of
- date of –
  - lease agreement, or
  - a commitment by the parties to the principal provisions of lease)

Education TREE

Finance lease

- Transfer of substantially all the risks & rewards of ownership
- Prefer substance over form

Operating lease

- Other than **FL**

+918600364185

Finance lease

- Risk and reward are transferred by lesser to lessee but not legal ownership
  - Lessee gets ownership at the end of lease term
  - Lessee has an option to buy the leased asset at the end at a price lower than fair value
  - Lease term covers major life of asset
  - Beginning term, present value of lease substantially covers fair value
  - Asset is of specialized nature and can be used by lessee only

Education TREEY

Guaranteed residual value

- Residual value guaranteed by lessee to lesser
- Difference between residual value and guaranteed value is unguaranteed residual value
- Gross investment-
  - Minimum lease payment plus
  - Unguaranteed residual value accruing to lesser

Education TREE

Minimum lease payment

- Rent based on sales usage etc. is known as contingent rent
- MLP for lesser
  - Lease rent paid+ guaranteed residual value
- MLP for lessee
  - Lease rent+ amounts guaranteed to be paid

Education TREE

ACCOUNTING TREATMENT – FINANCE LEASE

- For lesser

Recognition:

1. LA as Receivables
2. Receivables at Net Investment in Lease
3. Net Investment = Gross Investment (GI) – Unearned Finance Income
4. GI = MLP (lesser) + Unguaranteed RV
5. Unearned Finance Income = GI – PV of GI

- Recognize finance income in P&L A/c, ensure constant periodic return on net investment o/s

Education FREEY

- For lessee
- Recognize lease as an asset & liability at inception
- Record at lower of –
  - Fair value at inception
  - Present value of MLP (from lessee's perspective)
- Apportion lease payment between finance charge & reduction of o/s liability (finance charge to be calculated in a manner ensuring constant periodic rate of interest)
- Depreciate the asset on a systematic basis

Education TREE

ACCOUNTING TREATMENT – OPERATING LEASE

Lesser

- Do not recognize selling profit
- Show asset on lease as fixed asset
- Recognize cost & depreciation as expense
- Allocate initial direct costs over the lease term in proportion to the recognition of rent income or treat them as period expense
- Recognize lease income on a straight line basis, unless other basis is justified

lessee

- Recognized lease payments as an expense on straight line basis unless other basis is justified

Education TREE

Sale and lease back

- If it is a finance lease
  - Profit on sale not to be recognized immediately
  - Deferred and amortized over the lease term
- If operating lease
  - Profit to be recognized immediately
  - Loss to be recognized immediately
  - If loss compensated by future lease payments, amortize such loss
  - If sale price above fair value, amortize such price above fair value

Education TREE

examples

- WDV- 40 lakhs
  - sale price and fair value- 50 lakhs
  - Fair value 60, SP-50
  - FV-45, SP=38
  - FV-40, SP-50
  - FV-46, SP-50
  - FV-35, SP-39

Education TREE

Disclosure: finance lease

Lesser

- Reconciliation b/w gross investment & present value of MLP receivable at balance sheet date.
- Unearned finance income
- Unguaranteed residual value
- Accumulated provision for uncollectible MLP recognized
- Contingent rent recognized
- General description of significant leasing agreements
- Accounting policy for initial direct costs

Lessee

- Segregate leased asset from owned asset
- Net carrying amount at balance sheet date for each class of assets
- Reconciliation b/w MLP at balance sheet date and present value
- Contingent rents recognized
- Future minimum sub-lease payments to be received under non-cancellable sub-leases
- General description of significant leasing agreements

Education TREE

DISCLOSURES – OPERATING LEASE

Lesser

- For each class of assets –
  - Gross carrying amount
  - Accumulated & period depreciation
  - Accumulated & period impairment loss
  - Impairment loss reversed for the period
- Future MLP under non-cancellable lease
- Contingent rent recognized
- General description of significant leasing agreements
- Accounting policy for initial direct costs

Lessee

- Future MLP under non cancellable lease
- Future minimum sub-lease payments receivable for non-cancellable sub-leases
- MLP & contingent rent recognized
- Sub-lease payments recognized
- General description of significant leasing agreements

Education TREE

IFRS

INDIA

- Not applicable to lease agreement of land

IAS-17

- applicable

Education TREE

Example

- Lease term 4yrs
- Fair value Rs.16lakhs
- Lease rent 5lakhs p.a
- Guaranteed residual value= 100000
- Expected residual value=300000
- Implicit interest rate: 15%

Education TREE

In books of lessee

Year	MLP	Discount rate@15%	PV
1	500000	.8695	434750
2	500000	.7561	378050
3	500000	.6575	328750
4	600000	.5717	343020
TOTAL	**2100000**		**1484570**

Year	Liability	MLP	Finance charge	Principal
0	1484570	-	-	-
1	1207255	500000	222685	277315
2	888343	500000	181088	318912
3	521594	500000	133251	366749
4		600000	78406	521594

Lease rent account				
Year	**Particulars**	**Amount**	**Particulars**	**Amount**
1	To bank	500000	By finance charge	222685
			By lease liability a/c	277315
2	To bank	500000	By finance charge	181088
			By lease liability a/c	318912
3	To bank	500000	By finance charge	133251
			By lease liability a/c	366749
4	To bank	500000	By finance charge	78406
			By lease liability a/c	521594

Lease liability account				
Year	**Particulars**	**Amount**	**Particulars**	**Amount**
1	To lease rental a/c	277315	By fixed asset	1484570
	To balance c/d	1207255		
2	To bank	318912	By balance b/d	1207255
	To balance c/d	888343		
3	To bank	366749	By balance b/d	888343
	To balance c/d	521594		
4	To bank	521594	By balance b/d	521594

Extract of balance sheet

Year 1			
Lease liability	1207255	Fixed Asset	1484570
		Less: Depreciation	(371142)
		net	1113428
Year 2			
Lease liability	888343	Fixed Asset	1484570
		Less: Depreciation	(782285)
		net	752285
Year 3			
Lease liability	521594	Fixed Asset	1484570
		Less: Depreciation	(1113426)
		net	371143
Year 4			
Lease liability	nil	Fixed Asset	1484570
		Less: Depreciation	(1484570)
		net	-

In books of lessor

Year	MLP	Discount rate@15%	PV
1	500000	.8695	434750
2	500000	.7561	378050
3	500000	.6575	328750
4	800000	.5717	457360
TOTAL	**2300000**		**1598910**

Year	Liability	MLP	Finance charge	Principal
0	1598910	-	-	-
1	1338746	500000	239836	260164
2	1039558	500000	200812	299188
3	695492	500000	155934	344066
4		800000	104508	695492

AS-20: Earnings per share

Ordinary share and potentially ordinary share

- Shares which participate in dividend when all other types of shares have been paid dividend are ordinary shares
- Instrument which entitles ordinary shares in future are potentially ordinary shares
  - Preference shares convertible to ordinary shares
  - Convertible debentures
  - Employee share option
  - Share warrant

Education TREE

Basic earning per share formula

- Profits attributable to ordinary shares/ weighted average no. of ordinary shares

- Weighted avg. no. of shares
  - No. of shares at start+
  - No. of shares issued*outstanding period/total period minus
  - No. of shares bought back*(1- issued*outstanding period/total period)

Education TREE

Date of transaction

- Dividend declared with an option to convert dividend into shares- date of declaration of dividend
- Shares given for purchase of goods- date of possession of goods-delivery date
- On 10th July it was declared that dividend outstanding from 1st July will be given in shares- 1st July

Education TREE

List of shares issued, which are to be adjusted	Weight to be considered from
Equity shares issued in exchange of cash	date of cash receivable
Against conversion of debt instrument	date of conversion
Interest or principal of any financial Instruments	interest ceases to accrue
For settlement of a liability	settlement becomes effective
Acquisition of assets	Acquisition is recognized
Services rendered	when service is rendered
Bonus Share	from the beginning of the reporting Period
Amalgamation – Merger	From the beginning of the reporting period
Amalgamation – Purchase	From date of acquisition
Right Share	Adjusted with Right Factor

Education TREE

Bonus issue

- Since bonus issue does not increase equity of company, date is considered from start of the period

Education TREE

Example

- Profit after tax= Rs.50 lakhs
- Pref. dividend paid= Rs.5 lakhs
- Opening equity= 80,000@Rs.10 each
- Bought back= 12th May=10,000 shares
- Issued= 3rd January=20,000 shares

Education TREE

- Weighted average no. of shares
  - Opening 80000

Less Bought back: 10000*(1-42/365)	(8849)
Add Issued: 20000*87/365	4747
TOTAL	75898

Profit=50-5= 45 lakhs

Basic earning p.s.=4500000/75898= 59.29

Education TREE

- Profit= Rs.50lakhs
- Equity shares= 5 lakhs(opening)
- Bonus issue=5 lakhs
- Issued=1 lakh shares on 15th Feb. for settlement of loan to bank, settled on 5th march

Education TREEY

- Weighted avg. shares
  - Opening 500000
  - Bonus 500000
  - Issued 100000*28/365 7671

TOTAL **1007671**

EPS= 5000000/1007671=Rs.4.96

Education TREE

Diluted earning per share

- Provides worse case scenario, how low would the EPS go if potentially ordinary shares become ordinary shares
- Numerator=
  - Profits attributable to ordinary shares plus after tax effect of ordinary shares
- Denominator=
  - Weighted avg. no. of shares plus weighted average no. of potentially dilutive shares

Education TREE

- Weighted average no. of potential ordinary shares
  - Opening potential ordinary shares +
  - No. of potential shares issued during the years*outstanding period/total period –
  - No. of potential shares converted or lapsed*(1-outstanding period/total period)

Education TREE

Identify dilutive potential ordinary shares

- Anti dilutive potential ordinary shares are to be excluded
- Anti dilutive increases profit per share or decreases loss per share
- E.g. M Ltd. Has profit Rs.500000(last year-Rs.1000000)
- Ordinary shares=100000
- It had Rs.500000 15% convertible debenture to be converted into 10000 shares
- Tax rate 30%

Education TREE

2008

- Profit= 10,00,000
- Shares=100000
- Basic EPS=Rs.10/share

- Diluted Profit=10,00,000+ 5,00,000*15%*(1-30%)= 10,52,500
- Shares=100000+10000
- Diluted EPS=1052500/110000

9.56

2009

- Profit=5,00,000
- Shares=100000
- Basic EPS=5/share

- Diluted Profit=5,00,000+ 5,00,000*15%*(1-30%)= 5,52,500
- Shares=110000
- Anti Dilutive EPS=552500/110000

5.02

Education TREE

Options

- Options are dilutive only when the average market price is more than exercise price
- Thus each option and right issue are treated as two contracts
- Contract1: proceeds received are divided by market price to receive ordinary shares issued. These are similar to ordinary shares thus excluded
- Contract2: total shares issued less ordinary shares above will be diluted shares and thus added

Education FREE

- E.g. employees given option to issue 100000 shares @Rs.8/share, average market price being Rs.10/share
- Contract1: 100000*8/10=80000 shares
- Contract2: 100000-80000=20000shares
- Thus weighted average shares to be added will be 20000 shares

Education TREE

Contingent shares

- If condition satisfied, include shares from date of condition being satisfied
- If not, include the contrary statement
- E.g. M Ltd. Declared bonus issue 10000 shares if it achieved profit of Rs.200000. if profits were 220000 for year end and bonus shares were issued on July, will be included from April.
- If M ltd. Had said that if target not achieved bonus issue will be 2000 shares, and year end profit was Rs.150000, include 2000 shares from April

Education TREE

Rights issue

- Rights issue contains a bonus element. Thus bonus element needs to be included from start of issue and rights from date of issue. This can be done with the help of rights factor
- Right factor=fair market price/ex right fair market price

Education TREE

Theoretical ex-right fair value per

$$\frac{\text{Aggregate fair value of share immediately prior to the exercise of the right + Proceeds from exercise of the right}}{\text{Number of shares outstanding immediately after the right issue}}$$

Education TREE

Example

- No. of shares= 400000
- Rights issue= 100000@Rs.15 on 1st October
- Market price= Rs.20
- Profit=2000000
- Market price after rights issue(ex-right price)= (400000*20+100000*15)/500000=Rs.19

Using calculations as option

  - 100000*15/19=78,947
- Dilutive shares(bonus)= 100000-78947=21053

Education TREE

- Weighted average shares= 400000+21053+78947*6/12=**460527**

- EPS=2000000/460527=4.34

Using right factor=

- Right factor= 20/19=1.05263
- Weighted average shares= 400000*1.05263*6/12+500000*6/12

= **460526**

EPS=2000000/460526=4.34

Education TREEY

Question

- Opening= 6,00,000 shares
- 1.10.2009= 100000 shares issued
- 1.12.2009= shares split in 2:1
- 1.3.2010= buyback 100000shares
- 15% convertible preference shares of Rs.1000000 convertible into 100000 shares
- 10% debentures of Rs.500000 convertible into 50000 shares. Tax rate@30%
- Option to buy 100000 shares@Rs.25
- Market price=Rs.40
- Profit= Rs.20 lakhs

Education TREE

- Basic EPS
- Weighted average shares=
  (600000+100000*6/12)*2-100000*(1-11/12)

= 12,91,667 shares

- EPS=2000000/1291667
  =1.54

Education TREE

- Diluted EPS

1. Preference shares

   Profit=15% of Rs.10,00,000=150000

   Shares=100000

   Diluted EPS=1.5

2. Debentures

   Profit= 10% of Rs.5,00,000=50,000*(1-30%)

   =35,000

   Shares=50,000

Diluted EPS=35000/50000=0.7

Education TREE

- Options will be considered most dilutive

  100000*25/40=62500

  Dilutive shares=37500

1. Dilutive effect= 2000000/(1291667+37500)

   = 1.504

2. Dilutive effect from debentures

   (2000000+35000)/(1291667+37500+50000)

= 1.47

Education TREE

- 2009 profit= 500000
- 2010 profit=750000
- No. of shares=50000
- Rights issue on 1.7.2009= 10000@Rs.24
- Market price=Rs.30

Education TREE

- Basic EPS for 2009=500000/50000=10
- Ex right price=(30*50000+24*10000)/60000
  =29
- Right factor=30/29=1.0345
- Basic EPS for 2010=
  750000/(50000*1.0345*3/12+60000*9/12)
=12.94
- Adjusted EPS for 2009
=500000/50000*1.0345=9.66

Education TREE

WA no. of equity shares outstanding

- Merger

2. Amalgamation in nature of Purchase

- 3. Bonus Shares

- 4. Right Issue
- Generally made at price lower
- than Fair Value;
- Therefore, it includes a bonus
- element
- Restatement is required for Pre
- Right Issue EPS

- Included from the beginning of the reporting period
- 2. From the date of acquisition
- 3. Included from the beginning of the reporting period
- 4. No. of equity shares outstanding pre right issue is adjusted with
- Right Factor (R.F.)
- R.F. = FV per share pre Right Issue/ A
- A = (Agg. FV Pre Right Issue + Proceeds from Right Issue)/ Total Number of shares o/s after Right Issue
- 'A' means Theoretical Ex-Right FV

Education TREE

IFRS

INDIA

- Basic and diluted EPS to be disclosed in separate and consolidated financial statement

IAS33

- Only in consolidated financial statement

Education TREE

Disclosures

Mandatory

- Basic & diluted EPS (whether positive or negative)
- Fact of a change in calculations of EPS due to bonus, right etc.
- Reconciliation of net profit or loss with the numerator
- Weighted average no. of equity shares for basic & diluted EPS & their reconciliation with each other
- Nominal value of shares along with EPS figure
- ASI 12: EPS in Part IV Schedule VI only in accordance with AS 20, irrespective of Co. listed or not

Voluntary and recommended

- Per share amount for various components of net profit e.g., profit from ordinary activities
- Terms & conditions of contracts generating potential equity shares
- If P&L A/c includes extraordinary items (as per AS 5 (Revised) then → Basic & diluted EPS on the basis of earnings excluding extraordinary items (net of tax expense)
- Post balance sheet events

Education TREE

AS-21: COMSOLIDATED FINANCIAL STATEMENT

Education TREEY

- CA Sumit L. Sarda

DEFINITIONS

- Subsidiary
  - Enterprise controlled by another enterprise
- Control
  - The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise
  - Control of the composition of the board (in case of company) or the corresponding governing body (other enterprises) so as to obtain economic benefits from its activities
    - *(Control is established where there is power to appoint all or majority of directors/members without the consent or concurrence of any other person)*

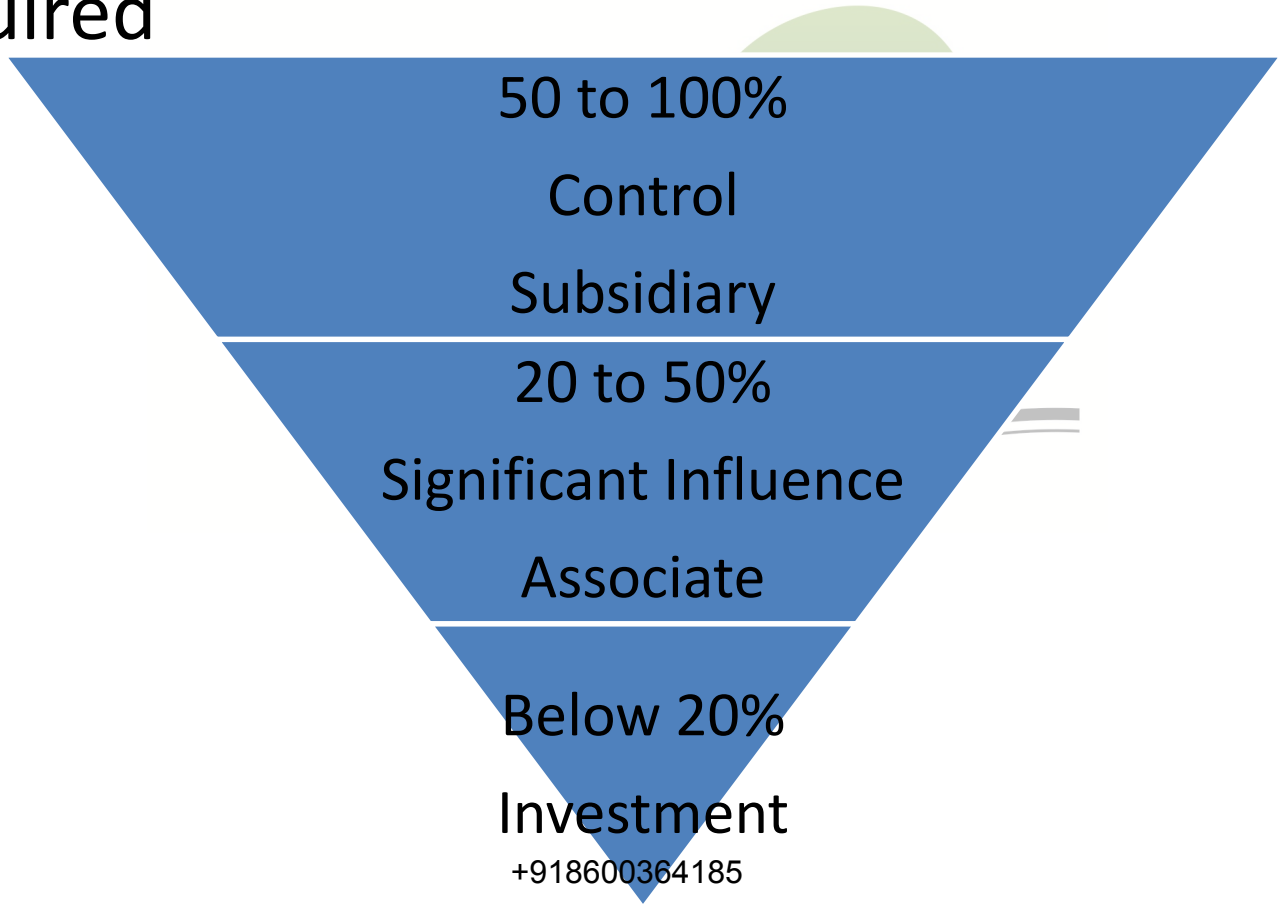
Education FREE

- Minority interest
  - net results of operations and net assets of a subsidiary attributable to interest not owned, directly or indirectly through subsidiary(ies), by the parent.
- Equity
  - Residual interest in the assets of an enterprise after deducting all its liabilities i.e. net worth

Education FREE

Summary of Accounting for Investments

- Percentage of outstanding voting stock acquired



Consolidation procedure

Procedure are applied for consolidation of :

1. Consolidated Balance Sheet
2. Consolidated Profit & Loss A/c
3. Consolidated Cash Flow
4. Consolidated Notes of Account

Education TREEY

Disposal

- Results to be included in the consolidated profit and loss account upto the date parent subsidiary relationship ceases to exist
- Difference between proceeds from investments disposal and equity on the date of disposal recognised in the consolidated profit and loss account

Education TREE

No Exclusions from Consolidation

DISPOSAL	LONG TERM RESTRICTION	DISSIMILAR ACTIVITIES
• Subsidiary was bought and is being held solely for the purpose of resale.	• Severe long term restrictions apply to the Subsidiary, which significantly impair S's ability to transfer funds to P(i.e. liquidation)	• because S's business activities are dissimilar from those of the rest of the group

Minority interest is in negative

- Should be adjusted against majority
- Future profits will be allocated to such majority unless such minority losses borne are covered.

Education TREE

ICAI guidelines

- Two companies being parent of 1 subsidiary, one holding shares and another composition of BOD, both are required to consolidate
- Shares held as stock in trade by parent are not required to consolidate

Education TREE

Disclosures

- List of all subsidiaries including name, country of incorporation, proportion of ownership interest and, if different, the proportion of voting power
- The nature of relationship between parent and subsidiary, if parent does not own one-half of the voting power
- The effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period
- The names of the subsidiaries of which the reporting dates are different from that of the parent and the difference in reporting dates

Education FREE

IFRS

INDIA

- Only listed company required to prepare consolidated financial statement
- Goodwill calculated on historical cost, no requirement of amortization
- Differential period should not exceed 6 months

IAS-27

- Every parent company
- Goodwill is calculated on fair value of assets and amortized
- Differential period should not exceed 3 months

Education TREE

AS-22: ACCOUNTING FOR TAXES ON INCOME

Education TREE

Calculating current tax

- The calculation of current tax can be summarized as:
  Current tax = Tax profit/loss x Tax rate

  Accounting profit/loss
  Add: expenses not deductible under tax laws but recognized for accounting purposes (e.g. accounting depreciation, provisions and fines)
  Add: income included under tax laws but not recognized for accounting purposes
  Deduct: expenses deductible under tax laws but not recognized for accounting purposes (e.g. tax depreciation allowed)
  Deduct: income not included under tax laws but recognized for accounting purposes (e.g. re-measurement of certain assets at fair value)
  = Tax profit/loss

Education TREE

Definition

- **Accounting income (loss)** is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving.
- **Taxable income (tax loss)** is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined.
- **Tax expense (tax saving)** is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.
- **Current tax** is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.

Education TREE

- **Deferred tax** is the tax effect of timing differences.

- **Timing differences** are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.

- **Permanent differences** are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently

Education TREE

Recognition

- Tax expense (Accrued tax)
  - = Current tax + Deferred Tax
- Tax expense should be included in the determination of net profit or loss for the period
- Tax effects of timing difference are included in tax expenses and as deferred tax assets or as deferred tax liability
  - This has to be done for all the timing differences

Education TREE

- Deferred tax assets are recognized subject to the consideration of prudence – i.e. there is reasonable certainty that sufficient future taxable income will be available against which deferred tax asset can be realized – Past record of the enterprise should be referred.

- Tax effects of permanent difference do not result in deferred tax assets or deferred tax liabilities.

Education TREE

Re-assessment of unrecognized deferred tax asset

- Re-assessment of unrecognised Deferred tax assets has to be done at each balance sheet date

- Recognize previously unrecognized deferred tax asset to the extent it is reasonably certain

Education TREE

measurement

- Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws.
- Deferred tax assets and liabilities should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.
- For different tax rates for levels of income – average rates should be used for deferred tax assets and liabilities
- Deferred tax assets and liabilities should not be discounted to their present value

Education TREE

Review of deferred tax asset

- The carrying amount of deferred tax asset should be reviewed at each balance sheet date.
- The carrying amount should be written down to the extent that it is no longer reasonably certain or virtually certain that the future taxable income will be available against the deferred tax asset
- Any such write-down may be reversed to the extent the future taxable income becomes reasonably certain.

Education FREE

Presentation and disclosure

- Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period.
- Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.
- The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts.
- The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

Education TREE

Examples of Timing Difference

- Expenses debited in the statement of profit and loss for accounting purposes but allowed for tax purposes in subsequent years

- Expenses amortized in the books over a period of years but are allowed for tax purposes wholly in the first year

- Where book and tax depreciation differ. This could arise due to:
  - Differences in depreciation rates.
  - Differences in method of depreciation e.g. SLM or WDV.
  - Differences in method of calculation
  - Differences in composition of actual cost of assets.

Education TREE

- Where a deduction is allowed in one year for tax purposes on the basis of a deposit made under a permitted deposit scheme

- Income credited to the statement of profit and loss but taxed only in subsequent years e.g. conversion of capital assets into stock in trade.

- If for any reason the recognition of income is spread over a number of years in the accounts but the income is fully taxed in the year of receipt

Education FREE

Example

- A company, ABC Ltd., prepares its accounts annually on 31st March. On 1st April, 20x1, it purchases a machine at a cost of Rs. 1,50,000. The machine has a useful life of three years and an expected scrap value of zero. Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight-line method is considered appropriate for accounting purposes. ABC Ltd. has profits before depreciation and taxes of Rs. 2,00,000 each year and the corporate tax rate is 40 per cent each year.

Education FREE

- The purchase of machine at a cost of Rs. 1,50,000 in 20x1 gives rise to a tax saving of Rs. 60,000. If the cost of the machine is spread over three years of its life for accounting purposes, the amount of the tax saving should also be spread over the same period as shown below:

Education TREE

Current tax

		(Rupees in thousands)		
		20x1	**20x2**	**20x3**
Profit before depreciation and taxes		200	200	200
Depreciation as per Taxation		150	-	-
Profit before Tax (Taxation P & L)		50	200	200
Tax (@ 40%)	(a)	**20**	**80**	**80**

Education TREE

Deffered tax

	(Rupees in thousands)		
	20x1	**20x2**	**20x3**
Tax effect of timing differences originating during the			
Depreciation as per Taxation	150	-	-
Less: Depreciation as per Accounts	50	50	50
Profit reduced by (b)	100	(50)	(50)
Deferred Tax Liability (b) * 40%	40		
(Since Rs 40/- is required to be paid in future)			
Tax effect of timing differences reversing during the year			
(b) * 40%	-	(20)	(20)
	40	**(20)**	**(20)**

Education TREE

Statement of Profit and Loss
(for the three years ending 31st March, 20x1, 20x2, 20x3)

(Rupees in thousands)

	20x1	20x2	20x3
Profit before depreciation and taxes	200	200	200
Less: Depreciation for accounting purposes	50	50	50
Profit before taxes	150	150	150
Tax expenses			
Current Tax (WN1) - (a)	20	80	80
Deferred Tax (WN2) - (b)	40	(20)	(20)
	60	60	60
Profit after Tax	90	90	90

Education TREE

example

- If in Illustration 1, the substantively enacted tax rates for 20x1, 20x2 and 20x3 are 40%, 35% and 38% respectively, how will be the amount of deferred tax liability computed.

Education TREE

The deferred tax liability carried forward each year would appear in the balance sheet as under:

31st March, 20x1 =	0.40 (1,00,000) =	Rs. 40,000
31st March, 20x2 =	0.35 (50,000) =	Rs. 17,500
31st March, 20x3 =	0.38 (Zero) =	Rs. Zero

Education TREE

Accordingly, the amount debited/(credited) to the profit and loss account (with corresponding credit or debit to deferred tax liability) for each year would be as under:

31st March, 20x1	Debit =	Rs. 40,000
31st March, 20x2	(Credit) =	Rs. (22,500)
31st March, 20x3	(Credit) =	Rs. (17,500)

Example

- A company, ABC Ltd., prepares its accounts annually on 31st March.
- The company has incurred a loss of Rs. 1,00,000 in the year 20x1 and made profits of Rs. 50,000 and 60,000 in year 20x2 and year 20x3 respectively.
- It is assumed that under the tax laws, loss can be carried forward for 8 years and tax rate is 40% and at the end of year 20x1, it was virtually certain, supported by convincing evidence, that the company would have sufficient taxable income in the future years against which unabsorbed depreciation and carry forward of losses can be set-off.
- It is also assumed that there is no difference between taxable income and accounting income except that set-off of loss is allowed in years 20x2 and 20x3 for tax purposes.

Education FREE

Statement of Profit and Loss
(for the three years ending 31st March, 20x1, 20x2, 20x3)

	(Rupees in thousands)		
	20x1	**20x2**	**20x3**
Profit (loss)	(100)	50	60
Less: Current tax	-	-	(4)
Deferred tax:			
Tax effect of timing differences originating during the year	40		
Tax effect of timing differences reversing during the year		(20)	(20)
Profit (loss) after tax effect	(60)	30	36

Deferred Tax Asset	40	20 (40 - 20) *	0

* Since the loss of Rs 50/- is adjusted

Education TREE
+918600364185

- How should interest and penalties on income tax deficiencies be presented?
- Interest and penalties assessed on income tax deficiencies should be presented based on their nature (i.e., either as a finance cost (interest) or operating expense (penalties)) because those items do not meet the definition of current or deferred income tax expense

Education TREE

Question

- When assessing the recoverability of deferred tax assets arising from the carry forward of unused tax losses and unused tax credits, should a deferred tax asset be recognised where the amount of probable future taxable profit available is sufficient only for a portion, rather than the total, of the unused tax losses or unused tax credits?

Education TREE

- Yes
- deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses an unused tax credits can be utilised.
- When assessing the probability that taxable profit will be available against which unused tax losses or unused tax credits can be utilised, an entity assesses whether it is probable that it will have any taxable profits before any portion of the unused tax losses or unused tax credits expire.

Education FREE

AS-23: ACCOUNITNG FOR INVESTMENTS IN ASSOCIATES

Education TREE

CA Sumit L. Sarda

OBJECTIVE

- Recognizing Effects of investments in associates on the financial position and operating results of a group in CFS

Education TREE

Scope

- CFS prepared by the investor to account for investments in associates in accordance with the standard.
- 'Separate Financial Statements' prepared by the investor - standard does not apply – AS 30 applies

Education TREE

Definition

- ***An associate is an enterprise in which the*** investor has significant influence and which is neither a subsidiary nor a joint venture of the investor
- ***Significant influence is the power to*** participate in the financial and / or operating policy decisions of an associates but does not extend to control over such policies.
- Significant influence may be gained by share ownership (20% or more in voting power), statute or agreement.

Education FREE

- The existence of significant influence is usually evidenced in one or more ways:

  a) representation on the Board of Directors or corresponding governing body of the investee;

  b) participation in policy making processes;

  c) material transactions between the investor and the investee;

  d) interchange of managerial personnel; or

  e) provision of essential technical information.

Education TREE

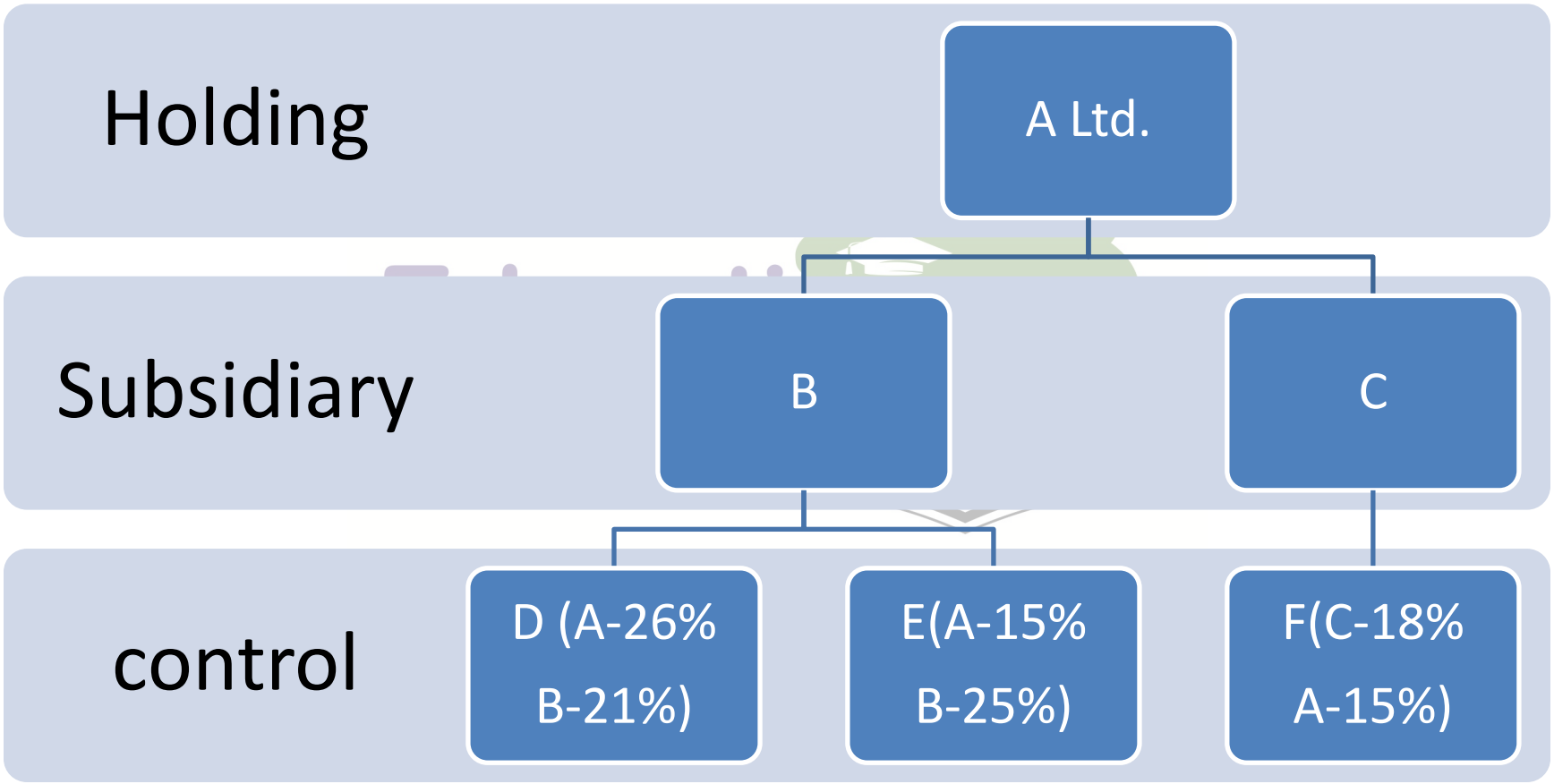
- A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.
- ***Control is exercised either through:***

  a) ownership, directly or indirectly through subsidiary (ies), of more than half of the voting power of an enterprise; or

  b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.

Education TREEY

example


Holding
Subsidiary
control
A Ltd.
B
C
D (A-26%
B-21%)
E(A-15%
B-25%)
F(C-18%
A-15%)

Equity method of accounting

- *Investment in an associate accounted in CFS under the equity method except when:*

  (a) the investment is acquired and held exclusively with a view to its subsequent disposal in the near future; or

  (b) the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor

Education TREE

Equity method of accounting

- whereby the investment is initially recorded at cost, identifying any goodwill / capital reserve arising at the time of acquisition (***included in the carrying amount of investment in the associate but should be disclosed separately).***
- The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee
- or to recognize the investor's share of the profit or losses of the investee after the date of acquisition.

Education TREE

- *Unrealized profits and losses resulting from transactions between the investor (or its consolidated subsidiaries) and the associate should be eliminated to the extent of the investor ’s interest in the associate.*
- *Unrealized losses should not be eliminated if and to the extent the cost of the transferred asset cannot be recovered.*

Education TREE

- ***Reasons for not applying the equity method in accounting for investments in an associate should be disclosed in the CFS.***

Education TREE

Discontinuance of equity method

- **An investor should discontinue the use of the Equity Method from the date:**

  a) it ceases to have significant influence in an associate but retains, either in whole or in part of its investment; or

  b) the use of Equity Method is no longer appropriate because the associate operates under severe long term restrictions that significantly impair its ability to transfer funds to the investor
- Carrying amount of the investment at such date should be regarded as cost thereafter.

Education TREE

Reporting date

- Same reporting date for financial statements used in consolidation; or
- If date of reporting differ, most recent available financial statements of the associate are used –consistency
- Adjustments made for the effects of any significant events or transactions between the investor and associate

Education TREE

Losses

- Ordinarily discontinue recognizing share of further losses and the investment is reported at nil value.
- Additional losses are provided for, to the extent the investor has incurred obligations or made payments on behalf of the associate,
- If the associate subsequently reports profits, the investor resumes including its share of profits only after its share of profits equals the share of net losses that have not been recognized.

Education TREE

Contingencies

- The investor discloses in the CFS Contingencies as per Accounting Standard 29

  a) its share of the contingencies and capital commitments of an associate for which it is also contingently liable; and ,

  b) those contingencies that arise because the investor is severally liable for the liabilities of the associate.

Education TREE

Disclosure

- Investment in associates to be listed and described as to the proportion of ownership interest and, in case of difference, the proportion of voting power held
- Investments classified as long-term investments
- The investor's share of the profits or losses of such investments, disclosed separately in the CFS

Education TREE

- The investor's share of any extraordinary or prior period items separately disclosed.
- The name(s) of the associate(s) of which reporting date(s) is/are different
- Difference in accounting policies

Education TREE

IFRS

India

- Goodwill/Capital Reserve to be disclosed separately
- Permitted only in CFS

IAS-28

- Not required
- Permitted in separate financial statement also

Education TREE

AS-24: Discontinuing Operations

Education TREE

- CA Sumit L. Sarda

Objective

- Users of financial statements make projections of the enterprise by analyzing cash flow, earning generating capacity and financial position
- Thus management must segregate information about discontinuing operations and continuing operations
- Thus to establish principles for reporting information about discontinuing operation
- Covers discontinuing operations and not discontinued operations

Education TREE

Components of enterprise represent

- A separate major line of business
- Geographical area of operations

Education TREE

Discontinuing operations

- **A <u>discontinuing operation</u> is a component of an enterprise :**
- **that the enterprise, pursuant to a single plan, is :**
  - disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or
  - disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or
  - terminating through abandonment; and
- that represents a separate major line of business or geographical area of operations; and
- that can be distinguished operationally and for financial reporting purposes

Education TREE

Exceptions

- Change in scope of operations is not discontinuing
- Gradual phasing of a product line or class of service not a discontinuing operations
- Discontinuing several products within an ongoing line of business not necessarily discontinuing operations
- Shifting of some production or marketing activities- not discontinuing

Education TREE

- Closing activity to achieve productivity improvements in other cost saving- not necessarily discontinuing operations
- Discontinuing operations occur infrequently, all infrequent events are not necessarily discontinuing operations
- Discontinuance is completed when a plan is substantially completed or abandoned, even though full payments are not settled

Education TREE

Dealt in three stages

- Initial disclosure event
  - Entering of binding sale agreement for substantially all assets attributable to discontinuing operations
  - Or Board or similar body approved similar plan and made announcement of plan
- Recognition and measurement
  - Recognition and measurement is not spelt out in this AS rather principles set out in other AS should be applied (i.e. AS 4, AS 5, AS 28 etc) regarding expenses, gains losses etc.
- Presentation and disclosure

Education TREE

Presentation and disclosure

- Initial disclosure
  - Description of Discontinuing operation
  - Segment (Business or geographical)
  - Date/period of completion of Discontinuing operation (if known/determinable)
  - Carrying amount of Assets & Liabilities
  - Revenue & Expenses
  - Pre- tax profit or loss from ordinary activities attributable to the discontinuing operation
  - Cash flow attributable to the operating & financing activities of discontinuing operation

Education TREE

- Other disclosures
  - Gain or loss recognized on the disposal of assets & liabilities of Discontinuing operation
  - Pre- tax Gain or loss & Income tax expense of the above
  - Net selling price of the assets disposed or getting disposed
  - Expected time of receipt & carrying amount of asset in the balance sheet

Education TREE

- Updating the Disclosures (subsequent to initial disclosure)
  - Significant changes in the amount of time
  - In case of discontinuance is abandoned /withdrawn , disclosure is required with reasons thereof.
- Separate disclosure for each discontinuing operation

Education FREE

- Presentation of the required Disclosure
  - only in notes to the financial statement the disclosures are to be made
- Exceptions
  - Computation of prior period information shall be restated for fairer comparison.

Education TREE

IFRS

India

- Deals with discontinuing operations
- Discontinuing operations done after initial disclosure event
- FA carried at historical cost
- Presentation in form of disclosure, nothing on face of balance sheet

IFRS-5

- Both discontinued and discontinuing operations
- Discontinuing operations done after classification of non current asset as 'held foe sale'
- FA carried at fair value
- Presented separately on the face of the balance sheet

Education TREE

AS-25: Interim Financial Statement

- CA Sumit L. Sarda

Education TREEY

- Objective:
  - Prescribe the minimum content of an interim financial report
  - Prescribe the principles for recognition and measurement in a complete or condensed financial statements for an interim period.
- Scope:
  - Does not mandate which enterprise and in what frequency to present interim financial reports
  - If an entity required or elect to prepare interim financials then the requirements of AS 25 should be complied with

Education TREEY

May apply…

- Quarterly reports presented to Board / Bank
- Interim Accounts prepared in M & A deals
- Interim Accounts for IPO offers
- Interim Accounts for the purpose of declaration of interim Dividend
- Interim accounts prepared for consolidation purposes particularly when parent and subsidiaries year ends are different

Education TREE

Challenges in Interim Financial Reporting

- An interim period is a financial reporting period shorter than a full financial year.
- Reporting in this period has inherent difficulties because:
  - Revenue of some businesses fluctuate widely among interim periods because of seasonal factors
  - In some businesses, heavy fixed costs incurred in one interim period benefit more than one interim periods
  - Costs and expenses related to a full year's activities are incurred at infrequent intervals during the year
  - The limited time available to develop complete information required to estimate assets, liabilities, income and expenses.

Education FREE

Contents of an interim financial report

- An interim financial report should include, at a minimum, the following components:

  (a) Condensed balance sheet

  (b) Condensed statement of profit and loss

  (c) Condensed cash flow statement; and

  (d) Selected explanatory notes
- An entity may present the full (complete) set of financial statements

Education TREEY

Distinct views of Interim reporting

- Integral View

  Each interim period is considered as an integral part of the annual period.

  Deferrals, accruals and estimates at the end of each interim period are affected by judgments made with reference to the remainder of the annual period.

  Therefore an enterprise allocates a expense item that might be considered as falling wholly within the fiscal period among interim periods based on estimated time, sales volume, productive activity, or some other basis.

Education TREE

- Discrete View

  Each interim period is basic accounting period.

  The results of operations for each interim period should be determined in essentially the same manner as if the interim period were an annual accounting period.

  Therefore, an enterprise determines accruals, deferrals, and estimates at the end of each interim period by the following the same principles and judgments that apply to annual periods.

Education TREEY

Treatment – Specific Items under AS-25

Particulars	Recognition and Measurement principles
Income Tax	**Follows Discrete approach** **-Interim period income tax expense is accrued by applying the estimated annual income tax rate to the pre-tax income or loss of the interim period** **-Estimated average annual income-tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings**

Treatment – Specific Items under AS-25

Particulars	Recognition and Measurement principles
Tax Credits	**Credits against the tax payable based on amounts of investments, exports, research and development expenditures, or other bases may be provided under the tax statutes.** **- Tax benefits that relate to a one-time event are recognized in computing income tax expense in that interim period.**

Treatment – Specific Items under AS-25

Particulars	Recognition and Measurement principles
Tax Loss Carry forwards	**The benefits of tax loss carry forwards are to be reflected in the interim period in which the related tax loss occurs.** **- A deferred tax asset should be recognized in respect of carry forward tax losses to the extent that it is virtually certain supported by convincing evidence**

Treatment – Specific Items under AS-25

Particulars	Recognition and Measurement principles
Tax Loss Carry forwards	**The benefits of tax loss carry forwards are to be reflected in the interim period in which the related tax loss occurs.** **- A deferred tax asset should be recognized in respect of carry forward tax losses to the extent that it is virtually certain supported by convincing evidence**
Liabilities	**A liability at an interim reporting date must represent an existing obligation at that date, just as it must at an annual reporting date.**

Treatment – Specific Items under AS-25

Particulars	Recognition and Measurement principles
Depreciation / Amortization	**Depreciation for the interim period is based only on assets owned during that interim period. It does not take into account asset acquisitions or dispositions planned for later in the financial year. This rule therefore is more consistent with the discrete view of interim reporting.**
Foreign Currency Translation	**Should be measured by the same principles as for the annual reporting purposes, which is essentially the discrete approach.**
Subsequent Events	**Subsequent events that confirm a condition relating to an asset/liability at the interim period date need to be taken into consideration**

Treatment – Specific Items under AS-25

Particulars	Recognition and Measurement principles
Sales	**Revenue from products sold or services rendered is to be recognized as earned on the same basis as for annual accounting policies. No revenue is booked in anticipation of its accrual in future interim periods.**
Interest and Dividend	**Interest payments are contractual commitments and therefore interest expense/income is recognized on a periodic basis. Dividends are recognized only if the right to receive dividend is established during the interim period.**

- Provisioning for doubtful assets is made considering the discrete approach. How provision for doubtful debts are made….

- The entire amount of the provision should be recognized as expense immediately notwithstanding the length of the accounting period.
- provision for doubtful assets is not in the nature of a period cost and therefore should not be pro-rated

Education TREE

- A bonus is anticipated for interim reporting only if:

  (a) the bonus is a legal obligation or an obligation arising from past practice for which the enterprise has no realistic alternative but to make the payments, and

  (b) a realistic estimate of the obligation can be made. Some bonuses are earned based on a monthly, quarterly, or annual measure of operating result and some are during a time period.
- They may be purely discretionary, contractual, or based on years of historical precedent. Depending on the contractual arrangement there may be bonus liability in the interim period

Education TREE

Valuation principles for inventories

- The standard requires the determination of net realizable value by reference to selling prices and related costs to complete at the end of the interim period.
- Inventory losses from market declines should not be deferred beyond the interim period in which the decline occurs.
- An enterprise will reverse a write-down to net realizable value in a subsequent interim period when the recoveries take place, i.e., subsequent recoveries against the losses recognised should be treated as gains in the interim periods when the recoveries happen.
- Subsequent recoveries may arise due to subsequent sale at higher prices or the net realizable value of the unsold inventory may have gone up due to favorable market conditions.

Education TREE

Question1

- Weak Ltd., is required by its bankers to furnish Balance Sheet, Profit and Loss, and Cash Flow Statement for half year ended 30th September 2004. Is Weak Ltd. required to prepare half year figures only upto September 2004 or is also required to give comparative figures ? If yes, comparatives should be given for which period ?

Education TREE

(a) Balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year. Thus, Weak Ltd. will have to prepare balance sheet as at September 30, 2004 and give comparative balance sheet for the year ended March 31, 2004, being the immediately preceding financial year.

(b) P&L and cash flow for 30. Sept, 2005

Education TREE

Question2

- Unpredictable Ltd., a listed company, decides in December 2004 to change the method of providing depreciation from straight-line method to written-down-value method. In compliance with AS 6, the depreciation method is changed retrospectively. Should Unpredictable Ltd., give effect to such change in third quarter results or will have to restate the financial statements of prior interim periods of the current financial year ?

Education TREEY

- As per AS 25, A change in accounting policy, other than one for which the transition is specified by an Accounting standard, should be reflected by restating the financial statement of prior interim periods of the current financial year. Thus, Unpredictable Ltd., will have to restate the financial statements of prior interim periods upto September 30, 2004 and give effect of the change in amount of depreciation arising due to change in accounting policy for depreciation.

Education FREE

Question3

- High Inventory Ltd., for the quarter ending September 30, 2004, made a write-down of inventory amounting to Rs.50 lakhs based on the principles of AS 2. For the quarter ending December 31, 2004, the net realisable value of the inventory has gone up due to upsurge in demand. As a result, the write- down of Rs.50 lakhs calls for a reversal. Should High Inventory Ltd., restate the quarterly results for September 30, 2004 or give effect of such reversal in results of quarter ending December 31, 2004?

Education FREE

- Reversal of inventory write-down of Rs.50 lakhs, results in a change of estimate. The same should be accounted in the quarter in which the estimate gets revised. Thus, High Inventory Ltd., should give reversal effect in quarter ending December 31, 2004.

Education TREE

Question4

- Star Investments Ltd., a listed enterprise is an investment company. Its main income is income from dividend, which is received mainly in quarter 2, ending September 30, 2004. However, not to distort the working of other quarters, Star Investments Ltd., accounts proportionate income in each quarter commencing from quarter 1, ending June 30, 2004. Is accounting treatment adopted by Star Investments Ltd., appropriate?

Education TREE

- AS 25 states that revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year.
- Thus, revenues such as dividend, royalties and government grants are recognised when they occur. Star Investments Ltd., should recognise dividend income in the quarter in which revenue recognition falls due as per AS 9.

Education TREE

Question5

- Heaven Travels Ltd., sells holiday package tours. It has made advance booking in December 2004, in respect of travel tours to be conducted in May-July 2005. Heaven Travels Ltd., should show relevant income in which quarter ?

Education FREE

- Heaven Travels Ltd., which sells holiday package tours should not recognise revenue on tours until the interim period in which the revenue would be recognised under AS 9 and should not defer any costs into later interim periods unless those costs meet the relevant criteria in AS 26 or are implied by the application of the percentage of completion method in AS 9.
- Thus, Heaven Travels Ltd., will have to book income in the quarter April-June 2005 and July- September 2005, following the revenue recognition criteria as laid down in AS 9 and not in the quarter where booking advance is received

Education TREE

Question6

- High Seasons Ltd., a listed enterprise is in seasonal business, where profits are earned for first three months and incurs losses for the rest of nine months. For the 1st quarter ending June 30, 2004, High Seasons Ltd., made a profit of Rs.200 lakhs, whereas for the next three quarters it expects to incur losses of Rs.40 lakhs in each quarter. High Seasons in its quarter 1 results, ending 30-06-04, mentioned, tax provision will be made at year end as the company is in Seasonal business. Is the contention of High Seasons Ltd. correct ?

Education TREE

- High Seasons Ltd., as per AS 25 will have to make a tax provision in first quarter, whereas for the subsequent three quarters it will have to make a tax write-back on account of losses.
- Assuming the estimated average annual effective tax rate to be 35% for High Seasons Ltd., the amount of income tax expense that will be reported in each quarter will be as under:

Education TREE

	1st Quarter	2"d Quarter	3rd Quarter	4th Quarter	**Total**
Tax expense	70	(14)	(14)	(14)	28

AS-26: Intangible Assets

- CA Sumit L. Sarda

Education TREEY

- The statement gives Guidance on

1. Recognition criterion
2. Measurement norms
3. Disclosure norms

Education TREE

in relation with the accounting of intangible assets

WHAT IS AN INTANGIBLE ASSET

- Identifiable non monetary asset
- Without physical substance
- Held for use in (a) production or supply of goods or services , (b) renting or (c) for administrative purposes
- An asset is a resource controlled by an enterprise and from which future economic benefits are expected to flow.

Education TREE

Examples

- Licenses
- Intellectual property rights
- Brand names, publishing titles
- Computer software
- Patents, copy rights
- Motion picture licenses
- Goodwill
- Customers lists
- Franchises
- Mortgage services rights
- Import quotas
- Customer supplier relationships
- Customer loyalty
- Market share and marketing right

Education TREE

Hardware forming integral part of Intangible asset !

- H Ltd purchased the distribution rights of a motion picture for Rs 50 crores that includes the cost of 2600 prints of CDs, 5000 prints of DVDs and a master copy of the film to enable creating further copies of prints for a period of 6 years. How would the hardware cost be accounted here ?

- Here the intangible asset is contained on the hardware and therefore it is not separable. At the same time the comparative cost element of the hardware is not significant .Therefore the whole amount becomes intangible asset.

Education TREE

Intangible or fixed ?

- X ltd purchased 100 computers from IBM and granted a turnkey contract of installing them in a networked set up . The contract also included the cost of licensed operating systems , anti virus systems , satellite connectivity etc.. The contract further included a tripartite arrangement with Oracle and IBM where in an Oracle based ERP system would be installed and IBM would facilitate the installation.

- Here the contract has two broad elements software and support systems that form an integral part of the hardware and those not forming its integral part. ERP system falls in second category. Therefore it is an intangible asset. However those falling as an integral part of the hardware is part of fixed assets.

Education TREE

Is Identifiable asset means separable asset ?

- Not necessarily .
- If separable, that means the asset is capable of being rented, sold or exchanged, independent of other assets . So identity is easily established.
- Even if not separable , a legal right to use makes it identifiable .

Education TREE

Intangible assets without absolute legal right.

- P ltd has been using a brand name “turmericano” for its ayurvedic product which they transferred to another company for a consideration . The application for registration of brand name is not approved by the authorities. The buyer company continues to treat it as an intangible asset .Auditor’s view lack of control over asset as a reason to derecognize the asset . Comment

- Legal enforceability of a right is not a necessary condition for control if an enterprise is able to control the future economic benefits in some other way.
- As long as there is no restriction to use the brand name and there is market for product, economic benefits can assumed to be accruing to the asset holder.
- Yet, misuse of the brand name by others , in the absence of a legal right , is a threat to “control over the asset”
- Therefore it is a matter of subjective judgment

Education TREE

“Future economic benefits”- in the definition of an asset

- X ltd has created an innovative effluent management system , with the help of which it anticipates 2% reduction in its operating cost. Company intends to capitalize the cost of internally developed technology. Auditors are of the view that this is not a case where future economic benefits from revenue is possible and hence definition of “asset” is complied with . Comment

- It is not necessary that future economic benefit has to accrue through income generation alone. It could be from cost saving too. Hence subject to compliance of other conditions, capitalization is possible.

Education FREE

Do we find difficulty in identifying intangible assets ?

- List of intangible assets of a company include the following . Comment

1. Cost of technical know-how, designs, processes
2. Cost of Rights under licensing agreements,
3. Intellectual property rights, brands, trade marks
4. Computer software expenses
5. Start up expenses
6. Training expenses
7. Expenditure on advertising
8. Expenditure on relocating or re-organising

Education TREE

- The first four only are intangible assets. Even amongst them, for brands and trademarks , only acquisition cost if any is allowed for capitalization.

When is an expenditure recognized as intangible asset

- When an enterprise is able to demonstrate that the item meets the

1. Definition of intangible asset and

2. When it is probable that future economic benefits , attributable to the asset will flow to the entity and

3. That the cost of asset can be measured reliably

Education TREE

Issue of correct assessment of future economic benefits

- A software company has developed a dedicated software for the US financial sector , the cost of which has been capitalized. Auditors have challenged the rationale behind capitalization , pointing out that the ongoing market situation suggests unlikely economic benefits from the product in near future. Comment

- AS 26 requires the entity to assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the economic conditions, that will exist over the useful life of the asset.
- In view of the market condition auditors have a case , a subjective matter

Education TREE

Can fair value be the initial intangible asset value

- AS 26 requires initial measurement at cost
- In case of an acquired intangible asset, fair value and cost may not be different

- In self generated assets , there could be variations where cost must be the basis.

Education TREE

Cost of intangible asset

- Cost of an intangible asset included certain taxes which is allowed to be offset against tax payables. Company capitalized the whole of the cost including taxes and chose to credit the tax advantage as income. Comment

- Cost for the purpose of measurement of intangible asset does not include taxes that are refundable. The accounting therefore is incorrect

Education TREE

Government grants leading to intangible assets

- Government has granted exploration licenses to H ltd for which a nominal licensee fee of Rs 10.00 lakh was charged . Should this be recognized as an intangible asset. Suppose there would have been no fees charged what would have been the difference.

- Cost incurred towards acquisition of an intangible asset or in case it is granted by government as a free license, actual cost or a nominal amount , as may be appropriate, has to be recognized towards intangible asset.

- However in the given case the license is only for exploration. Unless the future economic benefit attributable to this asset is likely to flow to H LTD , it can not recognize it as an intangible asset

Education TREE

Internally Generated Intangible Assets…

- Goodwill
  - Not to be recognized as Intangible Asset as;
    - Not an identifiable resource controlled by the entity
    - Cost can not be measured reliably.
- Difference between the Market value and carrying amount of entity cannot be considered as cost of intangible assets as these difference are due to range of factors that affect the value of entity and are not in control of entity.
- Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognized as Intangible Assets as expenditure on these cannot be distinguished from the cost of developing the business as a whole

Education TREE

Norms on recognition of R&D Expenses

- Expenses incurred in research phase is not an intangible asset and to be charged off to revenue immediately

- Expenses incurred in the development phase is recognized as intangible asset, subject to its probability to contribute to future economic benefits.

Education TREE

Differentiation of R& D expenses

- X ltd has been developing a new production process and on 31-10-2006, it has been able to demonstrate that it is likely to enjoy future economic benefits from the research. It incurred Rs. 50 lakhs on this account till 31-10-06 and Rs24 lakhs afterwards up to 31-03-07.As on 31-3-07 it estimates the recoverable amount of know how embodied in the process at Rs. 22.00 lakhs

Education TREE

- Rs 50.00 lakhs is research expense to be charged to P/L
- Rs 24.00 lakhs is development expenses –intangible asset
- Rs 2.00 lakhs impairment loss to be debited and asset to be reduced.

Asset not operational

- A Company after installing a sophisticated software has not been able to make use of its benefits because of the untrained staff and lack of support from software provider (due to contractual disputes). The company has recognised the software expenses as intangible assets. Auditor has cited reservation in view of the lack of usefulness of the asset . Comments

- Recognition of an intangible asset depends on the future economic benefits available to the company. Appropriate impairment provisions may be made and in future such impairment losses can be reversed if the asset becomes useful.

Education TREE

Internally generated Brand value

- A company has earmarked 30% of its advertisement and sales promotion expenses towards brand value, every year. Auditors objected to the act. Comment

- Internally generated brands, Publishing titles, customer lists and similar items can not be recognized as intangible assets .Auditor is right. Charge them to revenue.

Education TREE

Dealer of Intangible assets

- A is in the business of buying and selling Brand endorsement rights and has in his control different kinds of brand rights at any point of time . How would the cost of purchase of Brand endorsement rights be accounted or amortized in compliance of AS 26 ?

Education TREE

- AS 26 has no application here as the Brand endorsement right as an asset is A's inventory. Therefore AS 2 and AS 9 are applicable here.

Training costs- an Intangible asset

- A BPO company spends Rs 30000.00 per employee as induction training cost and recognizes it as an intangible asset, amortized over 4 years. The company faces 40 % attrition on an average, out of which 50 % or more are employees served less than one year. Comment.

- Control over the resources is not with the company as employees can leave the company . So Training costs are not expected to give future economic benefits to the company with certainty , and are not eligible to be reckoned as intangible assets .They are required to be charged off expenses in the year of incurrence as per paragraph 55-56 of AS 26.

Education FREE

Components of costs in an intangible asset

- Expenses identified in intangible assets under “Product development” includes the following

1. Expenses on materials and services used in creating the product line
2. Salaries, wages and other establishment costs of the set up
3. Legal charges, fees , amortization of license fees and patent cost used for development
4. Depreciation attributable to the set up and
5. Interest attributable to the investment

Comment about the correctness

- provided they were incurred in development phase.

Education TREE

Past expenses

- During the quarter ended 30th sep 2007, X Ltd recognized Rs 2.00 crores towards R&D expenses as expenses although it was realized that it belonged to a new product line ready for commercial launch soon and was to be treated as intangible asset. Company reversed the expenses and capitalized the expenses. Comment.

- As per AS 26 such reversal are not possible.

Education TREEY

Subsequent expenses on intangible asset

- A software was bought in 2007 and was capitalized. In 2008 certain in-house modifications were made to the software through a special project, the cost of which is proposed to be added to the intangible asset's value. Comment

- General principle is that the subsequent expenses are not to be capitalized.
- There are exceptions. When additional expenses have enhanced the future economic benefits and such cost is reliably measured, capitalization is allowed

Education TREEY

INTANGIBLE ASSETS NOT COVERED BY AS 26

- Expenditure on exploration, mining etc..- Guidance note in force
- Contracts between insurers and policy holders- AS not yet introduced
- Accounting for discount/premium on securities- AS 30
- Incidental costs for arranging borrowings – AS 30
- Share issue expenses - No where specifically
- Intangible assets covered by other accounting standard
- Expenditure in respect of termination benefits (AS 15)
- Deferred tax assets (AS 22)
- Goodwill arising on Amalgamation / Consolidation (AS 14 and 21)

Education TREE

Payment for intangible asset deferred LATEST AMENDMENT

- Brand use license for a product was bought, for which payment is to be settled in 5 years. Auditors are of the view that the cost of capitalization shall exclude the interest element involved in the consideration. Comment

- **In case of deferred payments, capitalization is to be done at cash price only . This amendment to AS 26 is consequential to introduction of AS 30 and hence effective from 1-4-2011**

Education TREE

Amortization

- Depreciation, if any, be allocated on systematic basis over the best estimated useful life

- There is rebuttable presumption that the useful life period does not exceed 10 years.

- There must be cogent evidences to establish the useful life beyond 10 years

Education TREE

Method of Amortisation

- A company decides to amortize the cost of its licensee rights for movie distribution as 8:1:1:5:1:1:2 over 7 year period with the reasoning that it expects to reap good revenues after every two year break, with a renewed launch of the movie in the market .Comments

- The method of amortisation shall reflect the pattern in which economic benefits are accrued to the company . If there are empirical evidences to the claim of the company from past, the method can be accepted. Otherwise straight line method may be used.

Education TREE

Economic life Vs Legal life

- A patent right was acquired for 15 year period. The patent is renewable for another 5 years subject to revised terms to be agreed up on at the time of such renewal. Company wants to amortize it over 20 years.

- 10 year period of useful life stipulated in AS 26 is rebutted by evidences in the form of legal agreement which provides the useful life as 15 years.
- Only if the contract is virtually certain to be renewed by virtue of renewal clause, a longer than legal period as useful life period is permitted. Here virtual certainty is not established and hence amortize over 15 years

Education TREE

Residual value

Unless

- there is an active market for the asset (from where residual value can be determined)which would exist at the end of the useful life or
- There is a commitment by a third party to buy the asset <u>at the end of useful life</u>

The residual value is zero

Education TREE

Review of amortization period

- Review the amortization period and amortization method every year and

- For significant differences if any, appropriate changes may be made subject to A S 5

Education TREE

Can an intangible asset be revalued

- No , for the purpose of increasing values
- Impairment principles are applicable

Education TREE

Retirement and disposals

- Derecognize intangible assets when no longer in use or disposed off.

- Gains or losses be charged to revenue .

Comparison with IAS 38

- Largely principles are same under both the statements, except that

- Subsequent measurements can follow revaluation policy also, under IAS .

- Amortization only when there is a definite useful life term. So in case of indefinite life term no amortization required under IAS .

Education TREE

AS-27: Financial Reporting of Interest in Joint Venture

Education TREEY

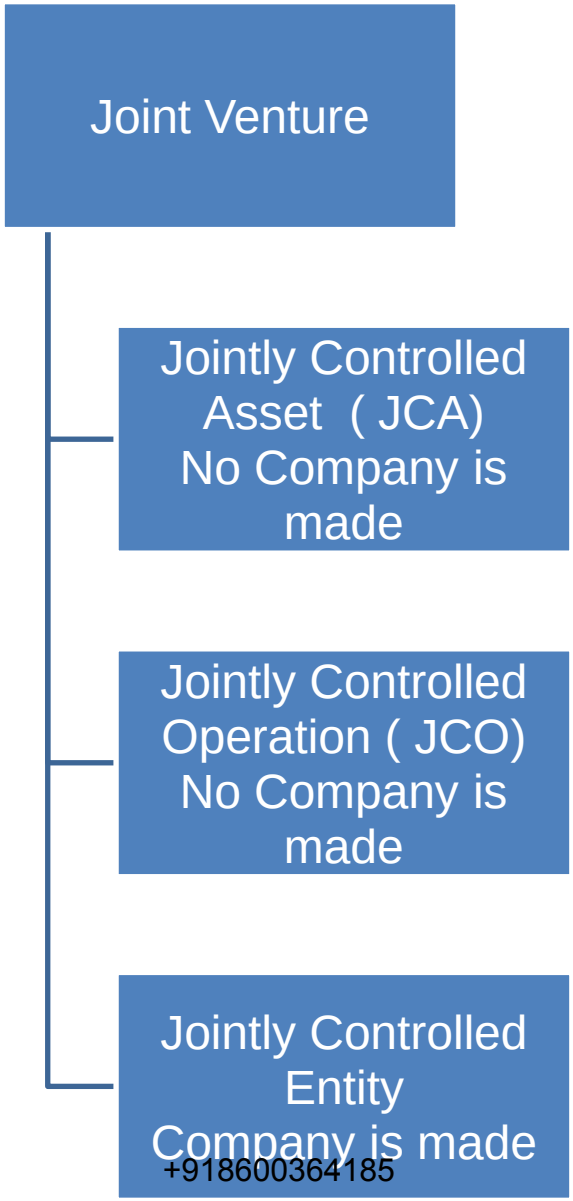
- CA Sumit L. Sarda

- Joint Venture means Contractual Arrangement between two or more parties to govern any Economic Activity.

Education TREE

- Such Entity / Economic activity is Subject to Joint Control.
- Joint Control means power to govern financial and / or Operating matters of entity on Sharing basis.

5. Joint Venture is of Three Type :



Contractual agreement

- Parties bound by Contractual arrangement;
- Contractual arrangement establishes joint control.
- Evidences of C. A.
  - contract between the venturers
  - minutes of discussions
  - articles or other by-laws of the joint venture.
- Contents of C. A.
  - Activity, duration and reporting obligations of the joint venture;
  - Appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers;
  - Capital contributions by the venturers; and
  - sharing by the venturers of the output, income, expenses or results of the joint venture.

Education TREE

Joint controlled asset

JCA means where two or more parties jointly owns any asset.

For e.g: Oil pipeline owned by Indian Oil Co. Ltd & BPCL Ltd.
Separate Books of accounts are not prepared for such jointly owned asset.

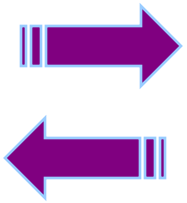
Education TREE

Consolidation is not required since separate Books does not exists.

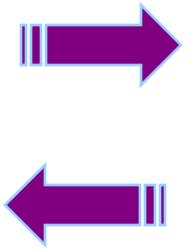
In case of JCA, Share in Asset, Joint Liability, Income and Expense will be reported in Standalone .

Accounting Treatment in Books of Joint Venture

Balance Sheet of One of the Joint Venturer

Share in Liability (in case loan taken to make that asset)		Share in JCA	

Profit & Loss of One of the Joint Venturer

To Share in Expenses		By Share in Income (In case any add income is earned)	

Joint controlled operations

- Where Operations are jointly conducted Generally this is done for economy of Operation.
- In such Books of account of JCO are not maintained. Hence **no consolidation**.
- Share in Income, Expenses and Liability will be reported in Stand alone Statement of venturer.

Education TREE

- Venturer will not earn profit by selling/ Purchase of asset of its own shares in JV.

- Venturer **can recognize loss** from transactions, if such loss is real/ supported by **decline in Market Price**.

Education FREE

Joint controlled entity

- Under this type of JV, a new entity is created for operation of JV.
- Such entity maintain its own Books of Account and such entity is **consolidated** using Proportionate Consolidation Method.
- Under Proportionate Consolidation Method :
  - Assets and Liabilities are consolidated on Line by Line Basis, Proportionately.
  - Minority Interest is not recorded.
  - Calculation of GW/ CR is similar to AS 21.

Education TREE

Disclosure

1. Nature of Joint Venture

2. If Investment in JV are disclosed during the year, than fact should be disclosed.

3. If Financial Statement of JCE are not updated before consolidation, fact should be maintained.

4. Any Contingent Liability of JV should be reported in Venturer Book as contingent Liability to the extent expected.

Education TREE

AS-28: Impairment of Assets

Education TREE

-CA Sumit L. Sarda

OBJECTIVE

To ensure that the assets are carried at no more than recoverable amount

- Recoverable amount not to exceed the amount to be recovered through use or sale of the asset
- Impaired loss to be recognized in the financial statement
- Impaired loss may be reversed in certain circumstances
- To make certain disclosures for impaired assets.

Education TREE

Scope

- To be applied in accounting for impairment of all assets, other than :-
  - Inventories as per (AS-2)
  - Assets arising from construction contracts as per (AS-7)
  - Financial assets including investments as per (AS-30)
  - Deferred tax assets as per (AS-22)

*Applicable to assets valued at cost or at revalued amount

Education TREE

Concept

- Impairment loss - is the amount by which the carrying amount of an asset exceeds its recoverable amount
- Carrying amount- is the amount at which an asset is recognized in the balance sheet(W.D.V.)
- Recoverable - is the higher of an asset's net selling amount price and its value in use

Education TREEY

Net selling price - Sale price - costs of disposal in an arm's length transaction

Value in use - Present value of estimated future cash flows expected from the use of an asset & from its disposal at the end of its useful life

Education TREE

Indications for estimating recoverable amount

External sources

- Decline in market value significantly
- Significant changes with an adverse effect on the enterprise due to technological, market, economic or legal environment
- Decrease in assets value in use due to adjustment in the discount rate as a result of increase in market interest rate or other market rates of ROI
- Carrying amount of the net assets of the enterprise is more than its market capitalization

Education TREE

- Internal sources
  - – Obsolescence or physical damage of an asset
  - Significant changes with an adverse effect on the enterprise, regarding use of asset e.g. - plans to discontinue or restructuring the operation or disposal of asset at an earlier date.
  - Decline in the economic performance of asset
- Concept of materiality to be applied

Education TREE

Recoverable amount

Net selling price

or

Value in use

Whichever is higher

Whether both to be determined - No

If either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount

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.
- Projections
  - Short term - maximum 5 years, unless longer can be justified
  - Based on financial budgets approved by management
  - Do not include financial and taxation cash flows
- Long term projections
  - based on short term projections
  - steady or declining growth
  - growth rates exceeding long term average rates of the product, industry or economy discouraged
  - Estimation for the asset in its current condition (restructuring and capital expenditure on the assets ignored)

Education TREE

- Discount rate should
  - be pre-tax, since cash flows are also pre-tax
  - Be independent of the entity's capital structure
  - reflect the time value of money and the risks related to the assets
  - reflect Weighted average cost of capital (WACC)
- When asset specific rates are not available, following may be considered as a starting point
  - Techniques such as CAPM
  - Cost of borrowing
  - Adjust the same to reflect the risks of the asset

Education TREE

Recognition and measurement of loss

- Asset to be reduced to recoverable amount only if RA is less than CA The reduction is an impairment loss = CA - RA
- Impairment loss to be recognized:
  - As an expense in the P&L Account, immediately, otherwise
  - As a revaluation decrease (if carried at revalued amount)

Education TREE

Value in Use	Net Selling Price (NSP)	Recoverable Amount (RA)	Carrying Amount (CA1)	Impairment	Carrying Amount (CA 2 – after impairment)
900	1100	1100	1000	No	1000
900	800	900	1000	100	900
920	960	960	1000	40	960

+918600364185

Cash generating unit

- The smallest identifiable group of assets that generates cash flows from continuing use that are largely independent from other assets or groups of assets
- Estimate RA for the individual asset. If this is not possible, then estimate RA of the asset's cash generating unit
- Apply cash generating unit concept when the asset does not generate cash flows which are independent from other assets

Education TREEY

- Assets may be bought/sold individually but they are often used in groups
- Revenue and cash arise from use of various assets and cannot be attributed to the individual assets
- Factors to consider:
  - How management monitors the enterprise's operations
  - How management makes decisions about continuing or disposing of the enterprise's assets and operations
  - Segment Reporting

Education TREE

Example

A mining enterprise owns a private railway to support its mining activities. The private railway could be sold only for scrap value & the private railway does not generate cash inflows from continuing use that are largely independent of the cash inflows from the other assets of the mine.

It is not possible to estimate the recoverable amount of the private railway because the value in use of the private railway cannot be determined & it is probably different from the scrap value. Therefore the enterprise estimates the recoverable amount of the CGU to which the private railway belongs i.e. the mine as a whole.

Treatment of impairment loss

Impairment loss for a Cash Generating Unit should be allocated in the following order :

a) Goodwill, if any.

b) Balance, if any, to individual assets in proportion to their carrying cost.

Education TREE

- If an active market exists for the output produced by an asset or group of assets, this asset or group of assets should be identified as a separate cash generating unit, even if some or all the output is used internally.
- When the outputs are used for captive consumption the sale value of output in an active market should be considered in cash flow. Like wise value of inputs also considered.

Education TREE

Bottom up test

- Perform following steps for a ‘bottom-up’ test:
- Identify if goodwill or corporate asset can be allocated on a reasonable and consistent basis to the CGU under review
- Compare RA of cash generating unit (CGU) to its CA (including goodwill or corporate asset) and recognize impairment loss.

Education TREE

example

- An enterprise called ER is a wholly owned subsidiary and has 3 divisions (CGU) A, B and C. There are indications that B is impaired and ER has estimated its recoverable amount to be Rs. 230cr. The value of ER has been estimated, by the ultimate holding company, to be Rs. 1,380cr. The goodwill held in the group accounts in respect of ER can be allocated on a reasonable and consistent basis.

Education TREFY

Cash generating unit	A Rs. cr.	B Rs. cr.	C Rs. cr.	Total Rs. cr.
Net assets directly involved in the activities in the unit	350	150	250	750
Goodwill	210	90	150	450
	560	240	400	1,200

- The goodwill has been apportioned in the ratio that the directly attributed assets bear to each other. The carrying value that would be compared to the recoverable amount is Rs. 240cr. Application of the “bottom-up” test

	Rs. cr.
• Carrying amount	240
• Recoverable amount	(230)
Impairment loss	10

Education TREE

Top down test

- If goodwill cannot be allocated on a reasonable basis then perform ‘top down’ test by applying following steps:
- Identify smallest CGU that includes the CGU under review and to which goodwill or corporate asset can be allocated on a reasonable basis
- Then compare RA of the above CGU to its CA (including goodwill or corporate asset) and recognize impairment loss.

Education TREE

Cash generating unit	A Rs.cr.	B Rs.cr.	C Rs.cr.	Total Rs.cr.
Net assets directly involved in the activities of the unit	350	150	250	750
Goodwill				450
				1,200

Step 1

Application of the "bottom-up" test

	B Rs.cr.
Carrying amount	150
Recoverable amount	(230)
Impairment loss	-

Step 2

Application of the "top-down" test (the next smallest CGU)

	Rs.cr.
Carrying amount	1,200
Recoverable amount	(1,380)
Impairment loss	-

Reversal of impairment loss

- At any balance sheet date if management assess that the impairment loss considered in prior accounting periods may no longer exist or decreased the loss may be reversed
- After reversal carrying amount of individual asset/CGU should not exceed carrying amount if no impairment would have been recognized in the past.
- 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

Education TREE

- Allocate reversal for CGU's to:
- First, pro rata to assets other than goodwill
- Second, to goodwill allocated to the CGU
- i.e., reverse order to allocation of the loss
- But, impairment losses for goodwill should not be reversed unless:
  - Loss was caused by a specific non recurring external event, and
  - Subsequent external events have occurred that reverse the effect of that event

Education TREE

Disclosure

- The amount of impairment loss charged to P/L for each class of asset;
- The reversal of impairment loss considered in P/L for each class of asset;
- The amount of impairment loss adjusted against revaluation surplus;
- The reportable segment to which the asset belongs;
- The reasons for changing the Cash Generating Unit for an asset and the description of the earlier & the changed Cash Generating Unit;
- The discount rate used in reckoning of value in use.

Education TREE

Impact of As-28

1. Valuation of assets

   No up-ward revaluation is permitted

   (Only to the extent of impairment loss recognized in earlier years)

2. Notes to Accounts

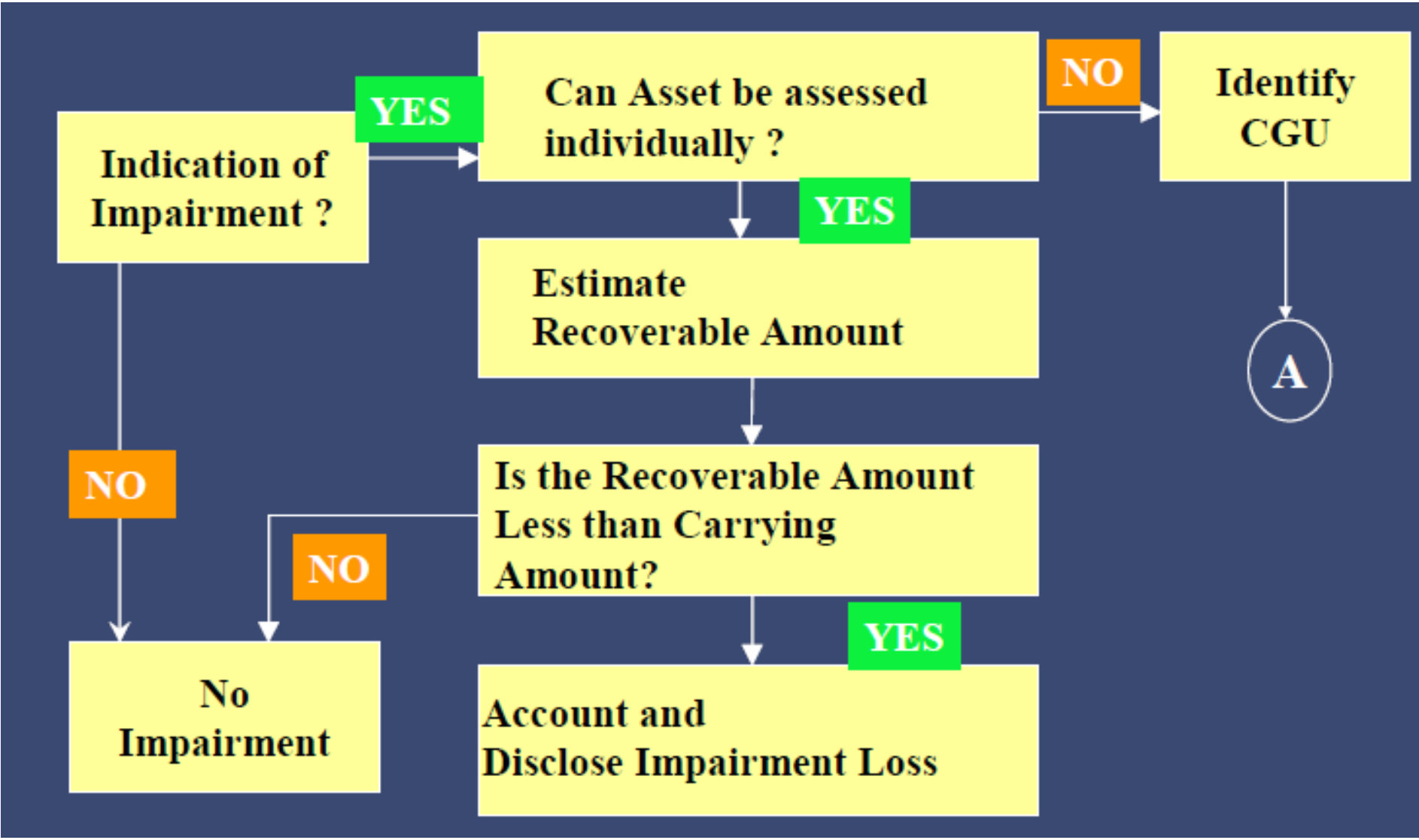
   Fixed assets are valued at their historical cost less depreciation no more required to mention.

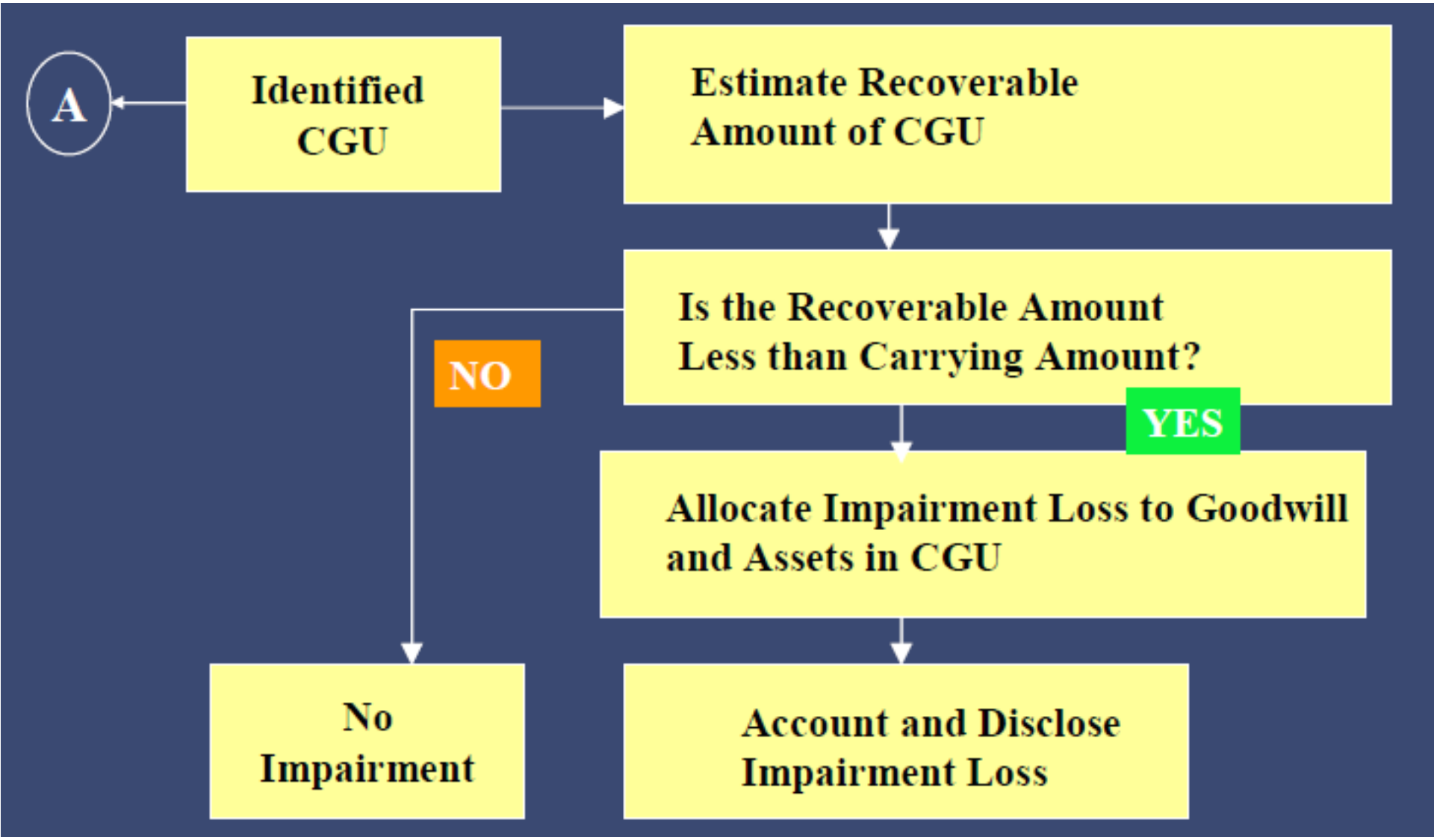
Education TREE

IFRS

- Reversal of impairment losses not permitted in IAS36

Education TREE


Indication of Impairment ?
YES
Can Asset be assessed individually ?
NO
Identify CGU
A
YES
Estimate Recoverable Amount
NO
Is the Recoverable Amount Less than Carrying Amount?
NO
YES
No Impairment
Account and Disclose Impairment Loss


A
Identified CGU
Estimate Recoverable Amount of CGU
Is the Recoverable Amount Less than Carrying Amount?
NO
YES
Allocate Impairment Loss to Goodwill and Assets in CGU
No Impairment
Account and Disclose Impairment Loss

AS-29: Provisions, Contingent Liabilities and Contingent Assets

- CA Sumit L. Sarda

Education TREEY

Objective

- The objective of this Statement is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

- The objective of this Statement is also to lay down appropriate accounting for contingent assets.

Scope

This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:

(a) those resulting from financial instruments that are carried at fair value;

(b) those arising in insurance enterprises from contracts with policy-holders; and

(c) those covered by another Accounting Standard.

Definition

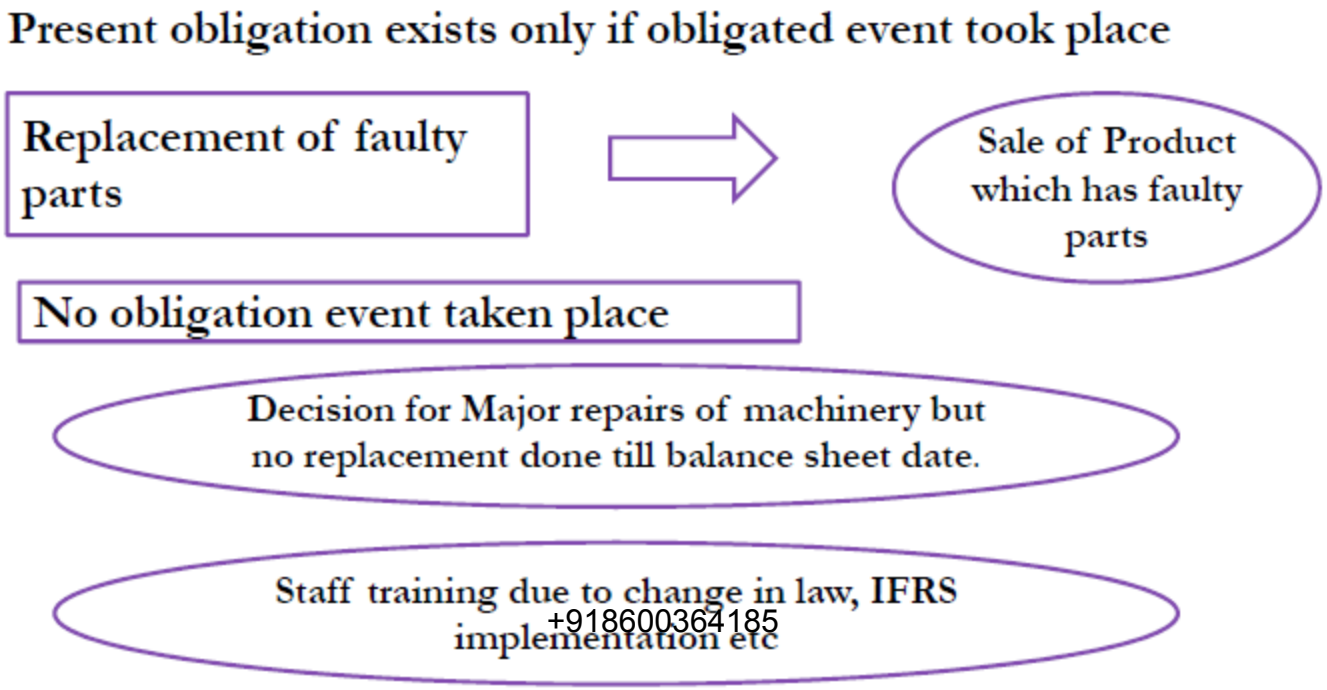
- A provision is a liability which can be measured only by using a substantial degree of estimation.
- A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
- An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

- A <u>contingent liability</u> is:

(a) <u>a present obligation</u> that arises from past events but is not recognized because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) a reliable estimate of the amount of the obligation cannot be made.



- (b) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

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- A contingent asset is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non occurrence of one or more uncertain future events not wholly within the control of the enterprise.

- Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

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- Possible obligation - an obligation is a possible obligation if, based on the evidence available, **its existence at the balance sheet date is considered not probable.**

- A restructuring is a program that is planned and controlled by management, and materially changes either:

  (a) the scope of a business undertaken by an enterprise; or

  (b) the manner in which that business is conducted.

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Recognition

- Provisions

  A provision should be recognized when:

  (a) an enterprise has a present obligation as a result of a past event;

  (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

  (c) a reliable estimate can be made of the amount of the obligation.

- If these conditions (cumulative conditions)are not met, no provision should be recognized.

In the Accounting standard "probable" means more likely then not

CA. Sumit L. Sarda

Most expert feel that a provision is recognized when there is more than 50% chance that an outflow of resources will occur.

Reliable estimates Not Possible

- Liquidated Damages
- Income Tax Investigation
- Environmental Contamination

Legal Requirement to Fit smoke Filters

Under New legislation an enterprise is required to fit smoke filters to its factories by September 31, 2009

Obligation Event

as at March 31, 2010

Default of legal provision by not fitting smoke filter

Provision is required for penalty but not for smock filter as not yet fitted

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- Contingent Liabilities

  An enterprise should not recognize a contingent liability.

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- Contingent Assets

  An enterprise should not recognize a contingent asset.

Measurement

- Best Estimate

  The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value.

- Risks and Uncertainties

  The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

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- Future Events

  Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

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- Expected Disposal of Assets

  Gains from the expected disposal of assets should not be taken into account in measuring a provision.

- Reimbursements CA. Sumit L. Sarda

- Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognized when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation.

- The reimbursement should be treated as a separate asset. The amount recognized for the reimbursement should not exceed the amount of the provision.

- In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognized for a reimbursement.

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- Changes in Provisions

  Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate.

  If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

- Use of Provisions

  A provision should be used only for expenditures for which the provision was originally recognized.

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Application of the Recognition and Measurement Rules

- Future Operating Losses
  Provisions should not be recognized for future operating losses.

- Restructuring
  No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.

  A restructuring provision should include only the direct expenditures arising from the restructuring which are those that are both:

  (a) necessarily entailed by the restructuring; and
  (b) not associated with the ongoing activities of the enterprise.

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Disclosure

- For each class of provision, an enterprise should disclose:

  (a) the carrying amount at the beginning and end of the period;

  (b) additional provisions made in the period, including increases to existing provisions;

  (c) amounts used (i.e. incurred and charged against the provision) during the period; and

  (d) unused amounts reversed during the period.

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- An enterprise should disclose the following for each class of provision:

  (a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

  (b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, as addressed in future events; and

  (c) the amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.

- Unless the possibility of any outflow in settlement is **remote**, and enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

  (a) an estimate of its financial effect, measured under measurement;

  (b) an indication of the uncertainties relating to any outflow; and

  (c) the possibility of any reimbursement.

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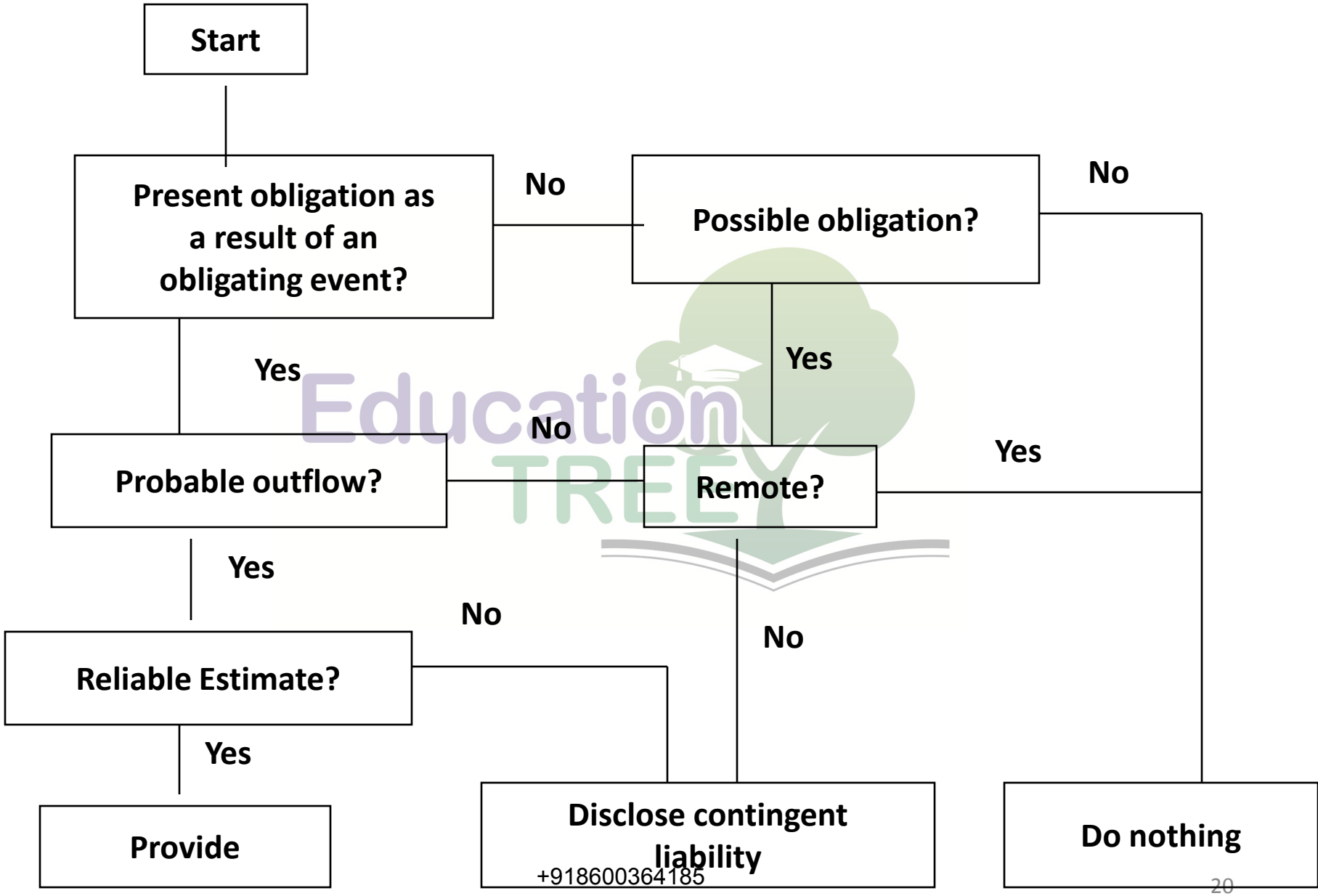
Decision Tree



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- Example 1: warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

- Present obligation as a result of a past obligating event - The obligating event is the sale of the product with a warranty, which gives rise to an obligation.
- An outflow of resources embodying economic benefits in settlement

  Probable for the warranties as a whole
- Conclusion –

  A provision is recognized for the best estimate of the costs of making good under the warranty products sold before the balance sheet date

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- *Example 2:* Contaminated Land - Legislation Virtually Certain to be Enacted

An enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31 March 2005 it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

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- Present obligation as a result of a past obligating event - The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.
- An outflow of resources embodying economic benefits in settlement

  Probable.
- Conclusion

  A provision is recognized for the best estimate of the costs of the clean-up

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- Example 3: Offshore Oilfield

An enterprise operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

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- Present obligation as a result of a past obligating event –

  The construction of the oil rig creates an obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.
- An outflow of resources embodying economic benefits in settlement

  Probable.
- Conclusion –

  A provision is recognized for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it .These costs are included as part of the cost of the oil rig.

  The ten per cent of costs that arise through the extraction of oil are recognized as a liability when the oil is extracted.

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- Example 4: Refunds Policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

- Present obligation as a result of a past obligating event – The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

- An outflow of resources embodying economic benefits in settlement
  Probable, a proportion of goods are returned for refund

- Conclusion - A provision is recognized for the best estimate of the costs of refunds

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- Example 5: Staff Retraining as a Result of Changes in the Income Tax System

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.

- Present obligation as a result of a past obligating event - There is no obligation because no obligating event (retraining) has taken place.

- Conclusion - No provision is recognized

Education TREE

- Example 6:A Single Guarantee

  During 2004-05, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2005- 06, the financial condition of Enterprise B deteriorates and at 30 September 2005 Enterprise B goes into liquidation.

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- (a) At 31 March 2005
- Present obligation as a result of a past obligating event –

  The obligating event is the giving of the guarantee, which gives rise to an obligation.
- An outflow of resources embodying economic benefits in settlement

  No outflow of benefits is probable at 31 March 2005.
- Conclusion - No provision is recognized . The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote

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- (b) At 31 March 2006
- Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.
- An outflow of resources embodying economic benefits in settlement At 31 March 2006, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
- Conclusion - A provision is recognized for the best estimate of the obligation

- Example 7: A Court Case

After a wedding in 2004-05, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year 31 March 2005, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year 31 March 2006, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

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- (a) At 31 March 2005
- Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no present obligation as a result of past events.
- Conclusion -No provision is recognized. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote

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- (b) At 31 March 2006
- Present obligation as a result of a past obligating event –
- On the basis of the evidence available, there is a present obligation.
- An outflow of resources embodying economic benefits in settlement

  Probable.
- Conclusion - A provision is recognized for the best estimate of the amount to settle the obligation

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- Example 8:

  A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

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- Present obligation as a result of a past obligating event - There is no present obligation.
- Conclusion - No provision is recognized

  The cost of replacing the lining is not recognized because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

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- Example 9b:

  An airline is required by law to overhaul its aircraft once every three years.

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- Legislative Requirement An airline is required by law to overhaul its aircraft once every three years.
- Present obligation as a result of a past obligating event - There is no present obligation.
- Conclusion - No provision is recognized The costs of overhauling aircraft are not recognized as a provision for the same reasons as the cost of replacing the lining is not recognized as a provision in example 9A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions – the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

IFRS

India

- Provision is based on estimates, no further guidance
- Restructuring is on legal bases and not on constructive bases
- Contingent assets can be disclosed in the financial statements where as inflow of economic benefits is probable
- Discounting is prohibited

IAS-37

- Method for estimating is provided in standard
- Restructuring provision is bases on constructive obligation
- Contingent assets can not be disclosed in FS but can be in Directors Report
- Discounting is allowed

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AS-30,31,32: FINANCIAL INSTRUMENTS

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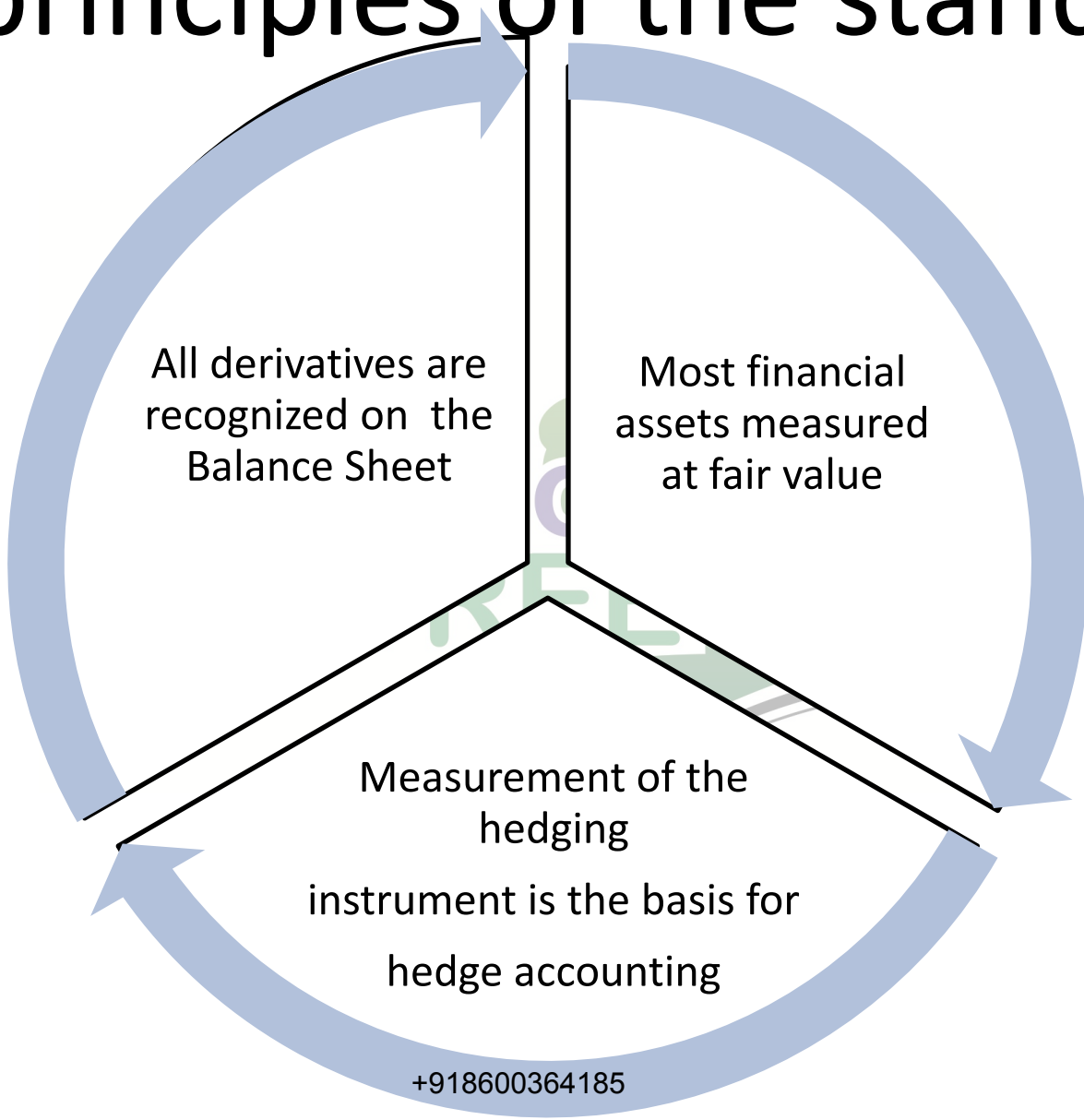
- CA Sumit L. Sarda

Key principles of the standard



Definition

- A **financial instrument** is any contract that gives rise to both:
  - a **financial asset** of one entity, and
  - either a **financial liability** or an **equity instrument** of an another entity
- For example, a receivable of one entity (financial asset) will represent a payable (financial liability) of another entity. An **equity instrument** (or security) is a financial asset for an investor holding the instrument and is equity of the issuer of the instrument.

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Financial Asset

- Cash
- A contractual right to receive cash
- A contract that will be settled in entity's own equity instrument
- Purchased call and put options
- Equity shares of another entity

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Financial liability

- Obligation of the entity that arises from the past event and is expected to result in an outflow of economic benefit of the entity.
- May take the form of bonds, loans or mortgages to another person required it be paid by a specified date

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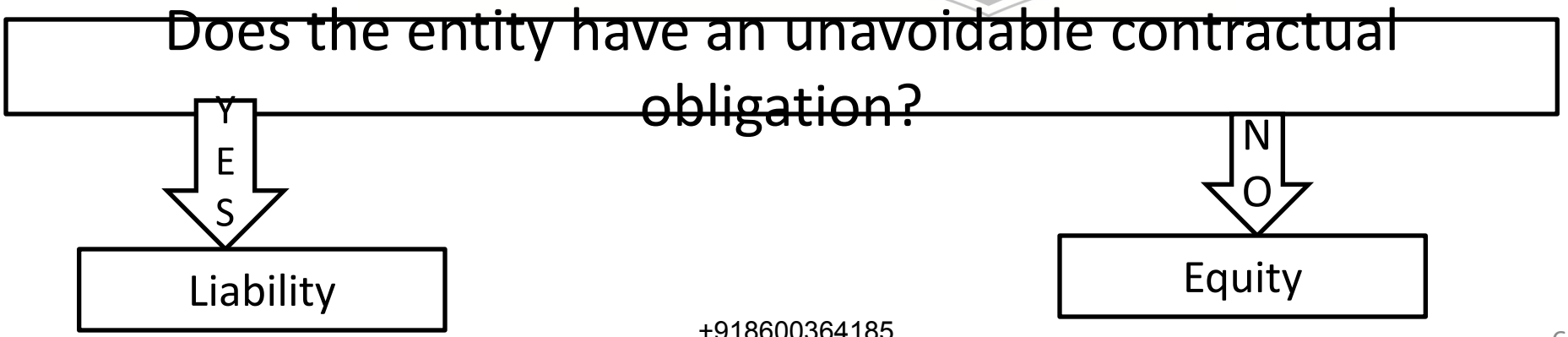
How to classify financial instruments as debt or equity

- existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party or
- exchange another financial instrument with the holder under conditions that are potentially unfavorable to the issuer



Compound instruments

- Instruments that have both liability and equity
- AS requires component part to be separated from equity
  - A convertible bond contains 2 components
  - One is liability, issuers obligation to pay cash
  - Other is equity instrument

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example

- Company issues 2000 convertible bonds. Bonds have three year term, and are issued at par with a face value of Rs.1000. Interest payable annually in arrears at 6%
- Each bond convertible to 250 ordinary shares on maturity
- If the present value to cash flow of instruments is Rs.18,48,122, equity portion will be Rs.(2000000+1848122)=Rs.151,878

Education TREE

Example 2

- Entity A issued a convertible bond on 1 January 2005 for 1,000,000. The interest rate on this bond is 10% per year payable annually, and the maturity is 10 years. The bond is convertible into the company's equity at each interest payment date after 5 years. The market rate for a comparable bond without the conversion features is 12% per year.
- Present value of the principal: 1,000,000 / (1 + 0.12)10 = 321 973
- Present value of the interest: $\Sigma n_{i=1}$100 000 / (1 + 0.12)^i = 565 022
- Total debt amount: 886 995
- The equity is the residual 113 005

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Transactions in own equity

No

- Does the issuer potentially have an obligation to settle gross in cash or in a variable number of own shares?
- Yes- Liability

NO

- Will settlement be the exchange of fixed number of shares for fixed amount?
- Yes- Equity

Derivative

- note that any net cash or net share settlement feature even at issuer's discretion, will lead to derivative treatment

- A has issued preference shares that entitle the holders first preference in the residual interest over equity holders and disentitle them to be designated themselves as creditors of the company . B holds 1 lakh shares and classified under loans and receivables.

- Preference shares have determinable payment amounts and when not quoted in active market it can be under loans and receivables.
- However here the issuer has to categorize it under equity instrument as it is more of equity than a liability,
- Hence it will not qualify as loans or receivables for the holders too. At best it will be under AFS as there is no fixed maturity for it.

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Accounting

- Dividends to holders of financial instruments classified as equity instruments are debited by the issuer of the instrument directly to equity.

- Interest payment on bonds is debited to P&L

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Can asset and liability be set off for presentation in Balance sheet

- Yes , when, and only when, an entity:
  - Currently has a legally enforceable right to set off the recognized amounts; and
  - Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

Education TREE

Classify??

- Inventory
- Own shares
- Payable
- Receivable

A transaction based on own equity

- the contract will be settled by the entity receiving or delivering a fixed number of its own shares for no future consideration, or
- exchanging a fixed number of its own shares for a fixed amount of cash or other financial assets
- Changes in the fair value of a contract on own equity which satisfies the definition of equity are **not** recognized.
  - Example: Share premium account

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Example

- Call option to purchase shares of a company at Rs.150 with a premium of Rs. 5/share
- When premium is paid entry made is
  - Investment a/c dr. Rs.5
    To Cash a/c. Rs.5
- When shares are purchased(if current price is Rs.175)
  - Investment a/c. Dr. Rs.150
    To Cash a/c. Rs.150

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Classification of financial assets

- At fair value through profit or loss (FVTPL)
- Held-to-maturity (HTM)
- Loans and receivables (LR)
- Available-for-sale (AFS)

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Category	Definition
Financial assets at fair value through profit or loss	Financial assets held for trading • Derivatives, unless accounted for as hedges • Financial asset designated to this category under the fair value option
Loans and receivables	Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market
Held-to-maturity investments	Non-derivative financial assets with fixed or determinable payments and fixed maturity that the entity has the positive intent and ability to hold to maturity
Available-for-sale financial assets	All financial assets that are not classified in another category are classified as available-for-sale • Any financial asset designated to this category on initial recognition

Fair value through profit and loss account

- Held for trading(HFT)
  - Acquired for selling in near term
  - Part of portfolio where there is actual pattern of profit taking
  - A derivative financial instrument
- Second is one designated as one to be measured at fair value with changes in P&L

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TYPE OF Financial instrument	• DEBT / EQUITY
INTENT OF INVESTOR	• SELL IN NEAR TERM
INITIAL RECOGNITION	• AT COST
SUBSEQUENT MEASUREMENT	• AT FAIR VALUE

Classification as FVTPL

- designation as FVTPL eliminates or significantly reduces a measurement or recognition inconsistency
- the contract is a hybrid contract that contains an embedded derivative(s) that significantly modify the cash flows that otherwise would be required by the contract
- **Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured cannot be designated as FVTPL**

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- This designation, if chosen, is irrevocable and the financial asset stays in this category until it is sold or matures.
- For held for trading and FVO financial assets, fair value changes are taken to P & L in the period in which they occur.

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- A has a basket of corporate bonds that have different maturity periods. Company's policy is to explore opportunity for booking profits , whenever there is any . Although the company has been able to trade in a few short duration bonds during reporting period, many a number of bonds that had long terms maturity were not sold during reporting period . Should the whole portfolio be classified as HFT.

- Yes .If there is evidence of a recent actual pattern of short term profit booking, on certain items, included in that portfolio, the whole of the portfolio be categorised as HFT

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- A venture capitalist assesses its investment very regularly at its fair values and reports to top management, although the interests in such investments are long term . The assets are classified as “at fair value through P/L”. Comment

- Policy of evaluation of fair value at regular intervals , in view of their nature of business suggest that it should be the part of their risk management policy. The intent of such a policy is to take appropriate positions depending on fair value movement of investments.

- AS 30 permits initial recognition “at fair value through P/L” If according to a documented risk management policy of an entity a group of items are evaluated and reported to key management at fair value basis

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Held to maturity

- Fixed and determinable payment and a fixed maturity and
- Are not designated on initial recognition as assets at fair value and
- Do not meet the definition of loans and receivables
- Investments in equity and pref. shares generally do not qualify as held to maturity as they do not have a fixed maturity
- Measured at amortized cost using effective interest method

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Type of Investment	• Non derivative financial instrument
Intent of investor	• Positive intent and ability to hold till maturity
Initial Recognition	• At cost
Subsequent measurement	• At amortized cost • (adjustment for impairment)

- Treasury note with face value Rs. 100,000, 5 year maturity, 6% coupon rate
- Purchase price Rs. 95,900
- Discount Rs. 4,100
- IRR (i.e. effective rate) is 7%
- Note : Any expenditure incurred for raising finance can also be considered in the working of IRR

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Year	BB	Effective interest	Coupon	Discount amortisation	EB
	a	b=a*7%	c=100000*6%	d=b-c	e=a+d
1	95,900	6,713	6,000	713	96,613
2	96,613	6,763	6,000	763	97,376
3	97,376	6,816	6,000	816	98,192
4	98,192	6,873	6,000	873	99,065
5	99,065	6,935	6,000	935	100,000
Total		34,100	30,000	4,100	

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Loans and receivables

- Supplying money e.g.. Banks
- Supplying goods
- Supplying services
- Participating in loan syndication
- Purchasing debt instruments not quoted in active market

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- Loans and receivables that the entity intends to sell in the near term must be classified as held for trading
- Measured at amortized cost using effective interest method

Education TREE

Available for sale

- Non derivative financial asset designated as AFS on initial recognition
- Measured at fair value with gains and losses in equity except where the asset is impaired or sold
- On sale, cumulative gain or loss is transferred to P&L

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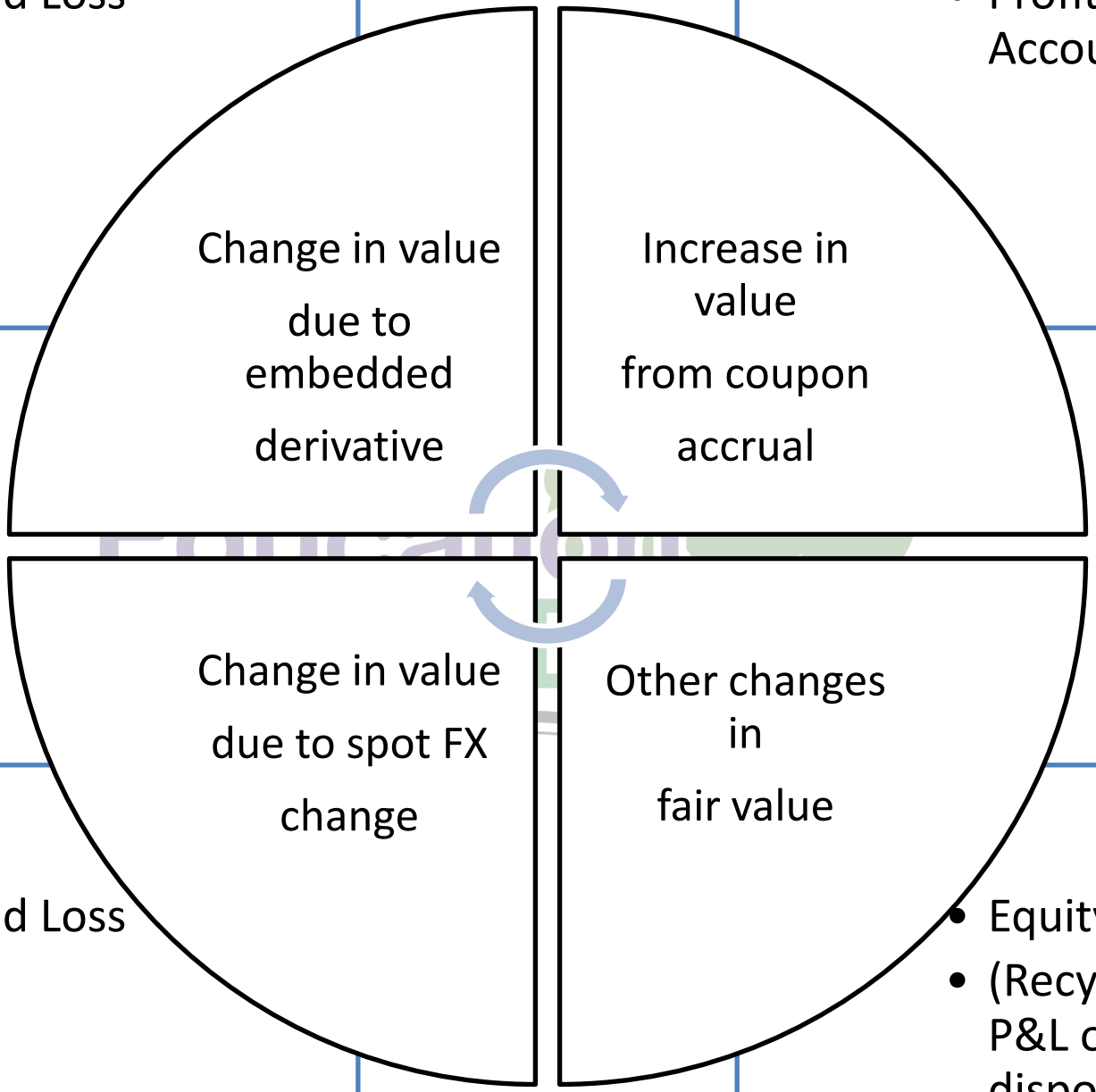
- Profit and Loss Account

- Profit and Loss Account



- Profit and Loss Account

- Equity
- (Recycled to P&L on disposal)

Classify following

- Corporate bond
- Trade receivable
- Perpetual debt
- Option to buy shares of a company

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Tainting

- Sale of HTM category investment calls in question intent of company
- Tainting results in reclassification as AFS and prohibits use of HTM for 2 years

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Exceptions

- Close to maturity
- Occurs after entity has already collected substantially all of the financial assets originated
- Due to isolated event beyond entity's control

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- A liquidated more than 60% of its govt security holdings ,held under HTM, and were maturing in two months time, immediately prior to reporting date in order to find liquidity. Auditors are of the view that the remaining 40% of gov securities need to be categorized under AFS and be valued at fair value

- If liquidation of assets , (even if it involves a significant amount) is done close to its maturity date (say less than 3 months), that changes in market rates would not have any significant effect on the fair value of asset, then such sales or reclassification does not require remaining assets declassified from HTM

- This is an exception to the general rule

- Terms of Bonds provided for 50% redemption after third year , 40% after fifth year and the balance along with interest (approx 41%) at the end of sixth year. The company had received the first two installments. It sold a significant part of the bonds which were under HTM category before reporting date, although maturity date is 8 months away. Will the classification change ?

- Here the company has already received substantial part of the investment back on respective maturity dates. Sale or reclassification after that does not disentitle it to be in HTM

- This is an exception to the general rule

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- Employees' demand to settle retrenchment compensation immediately was defended in the court with a plea that the HTM investment that would mature after three years would be used and any early liquidation would make the whole class declassified from HTM, that would affect the profit of the company. Court ordered liquidation of required amount of HTM investments. What about the classification.

- The remaining investments can remain in HTM as the sale was attributable to a non recurring isolated event , beyond the control of the company

- This is an exception to the general rule

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- In response to regulators call to maintain increased working capital , a Bank decided to sell of a major chunk of its HTM assets. How is classification affected

- If the sale was exclusively for the purpose of complying with regulatory requirement , classification of other HTM assets is not going to be affected. Because it can be considered as unanticipated, isolated and non recurring

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Example

- Significant deterioration in issuer's credit worthiness
- Change in tax law eliminating tax exemption on same
- To maintain entity's interest rate position
- Change in regulatory requirement

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- HTM category of investments consisted of government securities worth Rs 300 crores, corporate bonds worth Rs 150.00 crores and bank fixed deposits of Rs 350 crores. During 07-08, it pre closed deposits worth 35 crores. Will the categorization be affected on account of this

- If in the current year or in the immediate two previous years , a more than insignificant share in a portfolio has been sold or reclassified from HTM before maturity, the entity shall not classify those financial asset under HTM.
- Here total HTM value is 800 crore. Rs 35 crore which is just 4% is not more than insignificant, there fore classification will not be affected

If assets classified as HTM are (a) pledged (b) under repo agreements or (c) security lending agreement will it affect its classification

- No, if intention to hold till maturity remains as same, classification will remain HTM.

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Reclassification of assets

- HTM tainted- classify as AFS
- AFS to HTM
  - Previously classified as tainted corrected
  - Change in intention
  - Reliable measure of fair value no longer available
- From FVTPL and L&R- **not permitted**

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- 6 year 10% debentures with put option after 1 year were purchased, put premium being 2%. Repayment amount varies up on exercising the option, depending up on the time of exercise. Investing company has classified it as HTM and valued at amortized cost . Instrument is quoted and traded. Auditors are of the view that it has to be under loans and receivables. Comment

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- Paying for a put option , contradicts the intention to hold till maturity. So it can not be HTM.
- When traded in an active market it can not be under loans and receivables . So it has to be under AFS and be valued at Fair value.

Examples of classification

Description	Reason	classification
Investment in 7 yr 13% bonds intended for trading	Trade intended	AFV T PL
Quoted Equity instruments held in a company intended to be held on long term basis	No maturity date No determinable amts	AFS
Staff advances	No market exists	L&R
12% Cumulative irredeemable preference share intended not to be sold.	No maturity date	AFS
Sundry debtors	No market exists	L&R
Unquoted equity instruments	No maturity date No determinable amts	AFS
Investments in put options	Derivative not as hedge	AFV T PL
Shares held in subsidiary	If AS 30 option used	AFS

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Classification of Financial liability

- FVTPL
  - HFT
  - Measured at fair value through P&L
- HFT includes
  - Derivatives
  - Financial asset borrowed by a short seller
  - Liability incurred with an intention to repurchase the same in near future

Education TREE

Category	Definition
Financial liabilities at fair value through profit or loss	Financial liabilities held for trading • Financial liability designated as at fair value through profit or loss on initial recognition (fair value option)
Other financial liabilities – at amortised cost	All financial liabilities that are not classified at fair value through profit or loss

Instrument	Measurement	Value changes
Financial assets at fair value through profit or loss	Fair value	P&L
Held-to-maturity investments	Amortised cost (effective interest rate)	Not relevant (unless impaired)
Loans and receivables	Amortised cost (effective interest rate)	Not relevant (unless impaired)
Available-for-sale	Fair value	Equity (unless impaired)
Financial liabilities at fair value through profit or loss or designated as such	Fair value	P&L
Other liabilities	Amortised cost	Not relevant
Derivatives unless hedged	Fair value	P&L

Interest free loan to staff

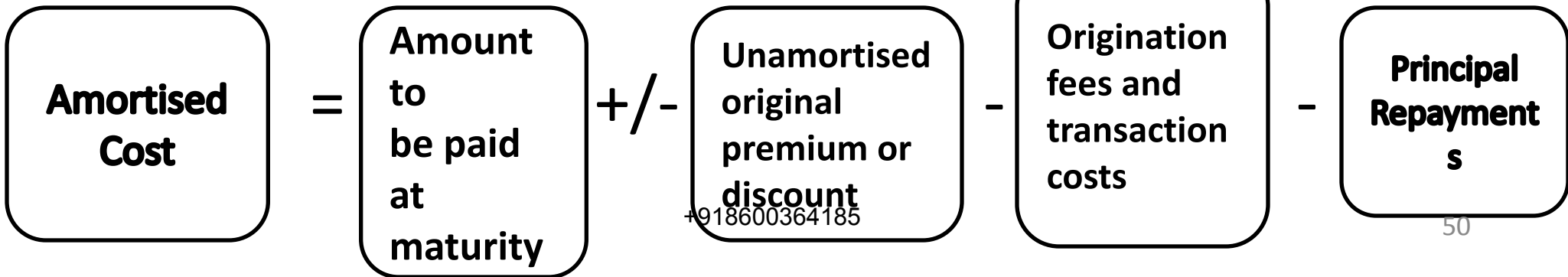
- An interest free loan, say, Rs 1.20 L was given recoverable in 8 quarterly installments . Rate of interest in market is, say, 10%. How would the loan be initially recognized.

- Fair value being the present value of future cash flows , from monthly recoveries , when discounted at 10% is say 107550.00. Then the balance Rs 12450 is employee benefit falling with in IAS 19.
- In future periods it would be valued at amortised cost (which has to be the PV of future cash flows discounted at 10%)

Education TREE

Amortized cost

- Cost including transaction cost
- Minus principal repayments made
- Plus/minus cumulative amortization of diff. between initial amount and maturity amount(e.g.. Effective interest)
- Minus impairment if any



Education TREE

Effective interest method

- IRR or
- Yield to maturity

AFS and FVTPL measurement

- At fair value on financial statements
- If not in financial statements, then as note in bottom
- Fair value will be measured as
  - An active market with quoted prices
  - No active market: valuation technique
  - No active market: equity instruments
    - Cost less impairment

Education TREEY

Indication of active market

- Readily and regularly available prices
- In an actual and regularly occurring market at arm's length
- Current bid prices:
  - Mid market prices for offsetting risk positions
  - Bid or offer prices for net open positions
- No current fair value – use most recent transaction (as long as no significant change in economic circumstances)
- Significant economic changes – reflect in fair value (using similar financial instruments)
- No published price for a financial instrument in its entirety. Component parts valuation (Day 1 P&L should be considered)

Education TREE

Active market

- Bid(entry) price to be used for asset held and liability to be incurred
- Bid(ask) price for asset to be purchased and liability incurred

Education TREE

No active market

- Arm length price
- Current fair value of another instrument substantially same
- Discounted cash flow analysis

Education TREE

Example

- Rachel Ltd, a manufacturing corporation, has a machinery which it is assessing for impairment and is therefore in the process of identifying fair value for the asset. To arrive at the fair value, it has obtained bids for the machinery from various parties. Which of these bids would be considered appropriate for fair value measurement?

Education TREEY

Bid received

Bid of USD 2 million received from Phoebe Ltd, its parent company
Bid of USD 1.8 million received from Gunther Ltd, an unrelated company, whose primary business is securities trading, willing and able to transact
Bid of USD 2.1 million received from Monica Ltd, a fellow competitor, which has filed for bankruptcy
Bid of USD 1.75 million from Ross Inc, a fellow competitor, willing and able to complete the transaction

Answer

Bids received	Yes/ No
Bid of USD 2 million received from Phoebe Corp, its parent company	NO
Bid of USD 1.8 million received from Gunther Inc, an unrelated company, whose primary business is securities trading, willing and able to transact	NO
Bid of USD 2.1 million received from Monica Inc, a fellow competitor, which has filed for bankruptcy	NO
Bid of USD 1.75 million from Ross Inc, a fellow competitor, willing and able to complete the transaction	YES

Recognition on trade date or settlement date accounting

- 1000 bonds were bought on 28-3-2008 for Rs 120000.00 Fair value at year end (on 31-3-08) Rs 121000.00 . Fair value on settlement date (2-4-08) Rs 123500.00
- Accounting depends on classification
- Trade date or settlement date accounting can be opted

Education TREE

If trade date accounting

	HTM	AFS	HFT(FV 'P/L)
28th March Fin Asset	120000	120000	120000
28th march Fin liability	120000	120000	120000
31st March Fin asset	120000	121000	121000
31st March Fin Liab	120000	120000	120000
31st March Fair value gain equity		1000	
31st March Fair value Gain P/L			1000
2nd April Fin asset	120000	123500	123500
2nd April Fair value gain equity		2500	
2nd April Fair value Gain P/L			2500

Education TREEY

If settlement date accounting

	HTM	AFS	HFT(FV 'P/L)
28th March Fin Asset	-	-	-
28th march Fin liability	-	-	-
31st March Receivable		1000	1000
31st March Fin Liab			
31st March Fair value gain equity		1000	
31st March Fair value Gain P/L			1000
2nd April Fin asset	120000	123500	123500
2nd April Fair value gain equity		2500	
2nd April Fair value Gain P/L			2500

Education TREE

Derivative

Chemistry and Math's

Change in function due to change in input

Input= underlying

Thumb rule: Derivative cannot exist without underlying

Derivative

- whose value changes in response to the change in an **underlying variable** and
- that requires **no initial net investment** or an initial net investment that is **smaller than would be required** for other types of contracts that would be expected to have a similar response to changes in market factors and
- that is settled at a future date

Education TREE

- Derivatives are held for trading financial instruments and are measured at fair value with fair value gains and losses taken to the P&L immediately unless they are designated hedging instruments in a hedging relationship.

Education TREE

Example of underlying

- Interest rates
- Prices
- Foreign exchange rates
- Indices
- Credit rating
- Other variables
- ***Thumb Rule : Underlying is any variable whose changes are observable or otherwise objectively verifiable***

Education TREE

Underlying variable

- Reference for determining the value of derivatives contract
- Change in such variable leads to change in fair value
  - Price
  - Interest rate
  - Exchange rate
  - Sales volume

Education TREE

- Price
  - If price of sugar changes, fair value of futures of sugar changes
- Interest rate
  - If interest rate fall, fair value of fixed rate receivable will increase. If bank lends at 10%, and interest rate today is 8%, bank will benefit from such loan as it will be receiving at higher rate. Thus fair value of interest rate swap contract will change

Education IBEF

- Exchange rate
  - Change in exchange rate will lead to change in fair value of forward contract
- Sales volume
  - If rent is dependent on sales volume, fair value changes with change in sales volume

Education TREE

Derivative is a notional amount

- Of currency
- Of no. of shares
- No. of units of weight and volume
- E.g.
  - Interest rate swap of 7.5% fixed here and 3 months LIBOR be calculating such interest on an amount fixed by parties, say Rs.10 lakhs. This will first be converted into Pound on interest date and interest payable on such amount will be calculated. Thus 10lakhs is a notional amount

Education TREE

Fixed payment provision

- If notional amount is not there, it is a fixed payment provision derivative.
- E.g.
  - If sensex increases by 200 points, you promise to pay Rs.1 lakh. Such a deal is a fixed payment provision

Education TREE

No initial investment

- Either there is no investment of initial investment is less than what will be required to buy such a contract
- Even options are considered derivatives because of such definition
  - Option to buy 100 shares of Rs.1000 in 4 months at Rs.2,000. current price is say Rs.990. thus price charged is less than actual contract price

Education TREE

Contract for non financial item- derivative??

- Contract to buy or sell non financial item, say computer in 4 months at a fixed price can be a derivative instrument
- If such contract is settled in cash of after delivery for immediate sale, such contracts are meant for short term benefit and thus covered under derivatives
- It will be outside its scope if purchased for usage requirement

Education TREE

Types of risk

- E.g.
  - Farmer grows wheat is vulnerable to fall in price of wheat in future
  - Bank is vulnerable to interest rate change
  - Importers and exporters are vulnerable to exchange rate change

Education TREE

- Forward and futures market deals with contracts made today to buy or sell at a specified future date
- Commodities market deals with futures. Forwards are dealt with in private
- E.g. farmer growing wheat enters into a forward contract to sell wheat in 6 months time for Rs.10,000/ ton. Spot rate is 10,000/ton and he expects rate to fall. Suppose rates fall to Rs.9500/ton he gains 5000/ton. If rates increase to 10500, he is at least insured of rate fall risk

Education FREE

Examples of derivative products

- Options
- Forward contracts
  - Futures
  - Forward rate agreements
  - Swaps
- Contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments

Education TREE

What is the underlying in each of the above cases?

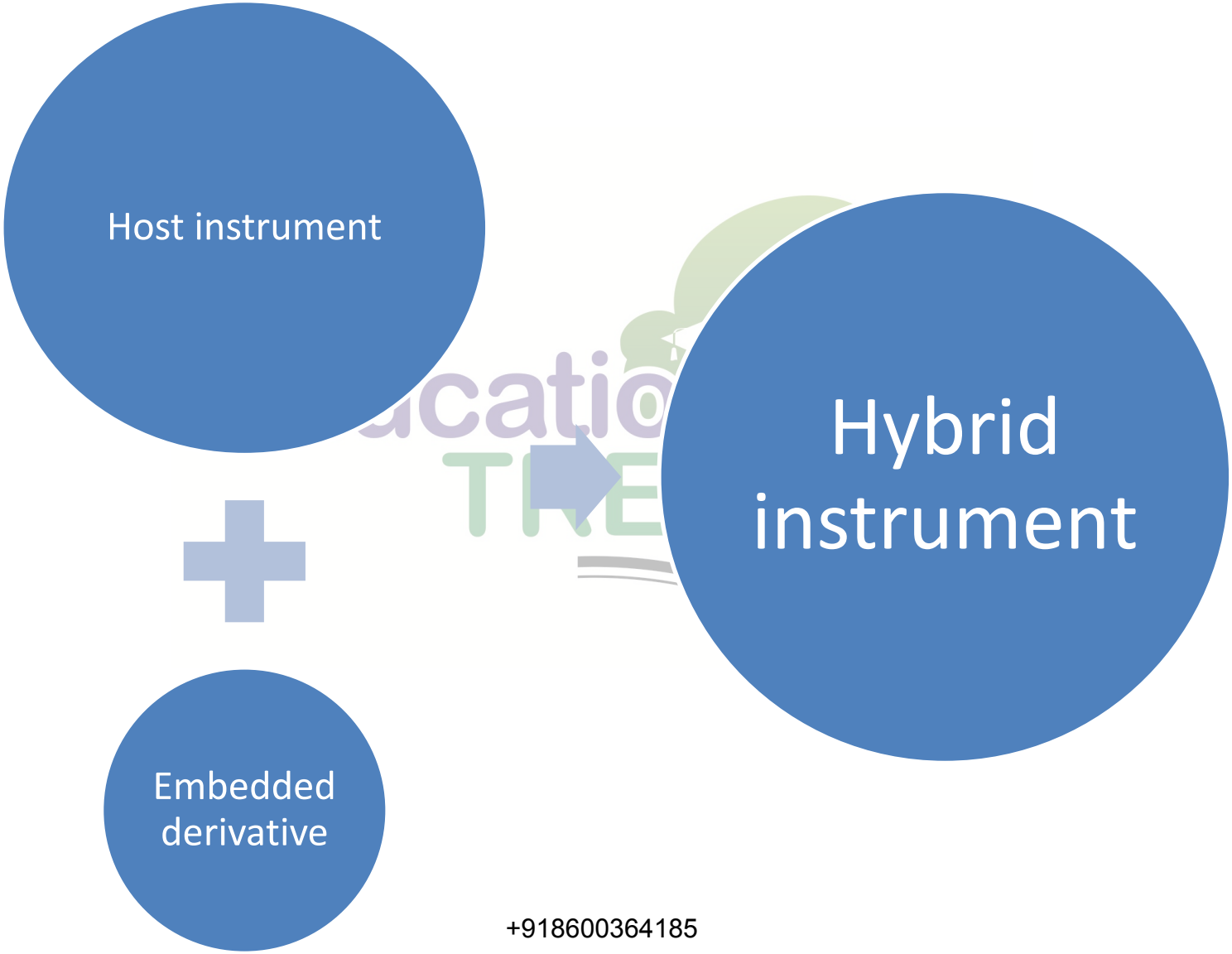
- ***Mr Chang has entered into an interest rate swap (IRS)*** **which has the following arrangement: At every quarter end he will receive interest at a variable rate of 3-month LIBOR + 200 basis points and pay interest at a fixed rate of 7%, both computed on a notional amount of USD 10 million.**
- **As per a contractual arrangement *Pigeon Plc must pay Duck LLC USD 5 million if, Duck LLC does not receive* from *Crow Corp. payment of interest computed @ LIBOR*+ 50 basis points on a loan lent by *Duck LLC to Crow Corp.***

Forward contracts are derivatives

- its value changes in response to the change in an ‘underlying’ variable - the value of the farmer’s forward wheat sale contract varies in accordance with the price of wheat
- it requires no initial net investment or an investment smaller than would be required for other types of contract with a similar response to changes in market factors - the forward wheat sale contract required no initial net investment as the farmer paid nothing up-front
- it is settled at a future date - the forward wheat sale contract is settled at a future date

Education FREE

Embedded derivative



Embedded derivative

- An implicit or explicit term in a contract that makes it behave like a derivative
- Derivative included in a non derivative
- E.g. convertible debenture
- Embedded derivative changes the fair value of contract
  - Convertible debenture is differently priced than non convertible
- Should be accounted for separately if can be separated from non derivative.

Education TREE

- E.g. lease of plot with an inflation factor
  - Non-derivative- LEASE
  - Derivative- RPI
- Export of goods with credit of 2 months
  - Non-derivative- sale
  - Derivative- exchange rate

(these are closely related derivatives, however if export contract is in different currency than of importer, it is not closely related contract)

Education TREE

Types on contracts

- Instruments with conversion features
- Index linked payments
- Transactions in “third currency”
- Instruments with option to extend the term of debt
- Purchase or sale of contracts in foreign currency (other than currency of major party, or currency in which the contract is normally denominated)

Education TREE

Conditions for separately accounting embedded derivative

- Hybrid instrument not accounted for in fair value
- Stand alone will the separate instrument be considered a derivative
- Embedded derivative is not closely related to contract

(if fair value of embedded derivative not determinable, it will be diff between fair value of combined agreement and present value of non-derivative)

Education TREE

E.g.. Not closely related

- Interest or principal payments whose amount is indexed to the value of equity instruments or commodity prices
- An option or automatic provision to extend the remaining term to maturity that does not also provide for a concurrent adjustment to the approximate current market rate of interest at the time of the extension
- A call option, put option, or prepayment option whose exercise price is not approximately equal to the debt instrument's amortized cost on each exercise date

Education TREE

- closely related
  - Embedded derivative that can change its interest rate on interest bearing host instrument
  - Interest cap and floor specified

Education TREE

Classify as derivative to be accounted separately or not??

- Purchase forward contracts which are net settled if delivery postponed by a month, and such practice followed consistently
- Leased a land in Australia on which payment is to be made in Australian $ but is subject to indexation in UK relative price index
- Sold goods in Australia for exchange receivable in US $

Education TREE

To bifurcate or not to bifurcate

- Is contract carried at fair value through P&L?
  - Yes: not a derivative
  - No: Would it be a derivative of free standing?
    - No: not a derivative
    - Yes: is it closely related to host contract?
      - Yes: not a derivative
      - No: can fair value of derivative component be reliably measured?
        - » No: classify as held for trading
        - » Yes:bifurcation required

Education TREE

Clearly and Closely Related Characteristics or Risks

- Economic relationship between host and embedded derivative component determine whether their characteristics and risks are clearly and closely related.
  - Prepayment option in a callable debt?
  - Equity-indexed debt that pays the holder return based on Standard & Poor's (S&P) 500 Index?

Education TREE

Example

- **Australian company leases an aircraft from a UK company for 2 years. Monthly rentals of Euro 20,000 are payable at the beginning of each month.**
  - What is the host contract?
  - Are there any derivatives embedded in it?
  - Do the derivatives need to be separated?

Education TREE

- **What is the host contract?**

  – Lease contract (not carried at fair value)
- **Are there any derivatives embedded in it?**

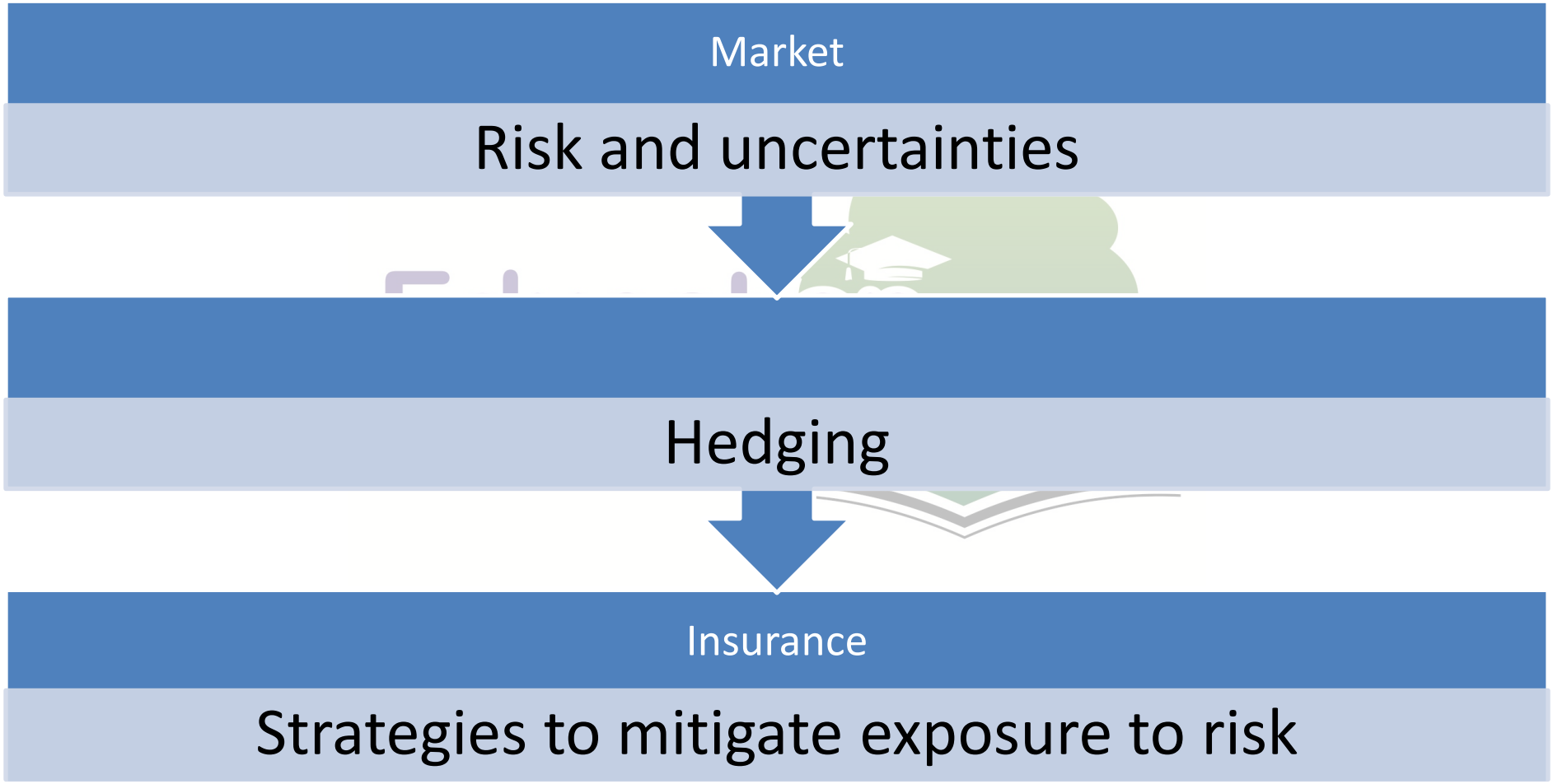
  – Yes, there are implied forward contracts to sell Euro (which are within the scope of AS 30)
- **Do the derivatives need to be separated in year 1?**

  – Yes, there are 23 embedded forward contracts to exchange Euro 20,000 for Australian dollars (each of these embedded forward contracts is a derivative that is within the scope of AS 30 and the host contract is not carried at fair value.)

Hedge accounting

- Companies enter into hedge transactions to reduce risk exposure
- Hedge accounting is used for consistent timing of recording of gains or losses
- E.g. forward contract to hedge currency fluctuations
  - Interest rate swap to hedge variable rate fluctuation
  - Put option to sell investments

Education TREE


Market
Risk and uncertainties
Hedging
Insurance
Strategies to mitigate exposure to risk

Commodity price risk must be hedged in their entirety

- Company A enters into oil swap to hedge part of its exposure to the price of fuel (the price of fuel is made up of several components including the cost of oil). Can the swap be designated as hedging the oil exposure component of the price risk?
  - AS 30 does not permit a hedge of a component of the pricing of a non-financial asset or liability. The risk must be hedged in its entirety.
  - As such a correlation must be established between the price of the hedged component (the oil swap) and the jet fuel price to qualify for hedge accounting.

Education TREE

Three types of hedge accounting

- Cash flow hedge accounting
  - Recognizes changes in hedge instrument in balance sheet and recycles them in P&L when hedge effects the same. Called cash flow hedge because it is exposure to future cash flow
- Fair value hedge accounting
  - Assets and liabilities hedged are recognized at fair value with changes in P&L
- Net investment hedge
  - For foreign operations, recognized similarly to cash flow hedge

Education TREE

Requirement of hedge accounting

- Hedge relationship must be documented at inception.
  - Risk management objective and strategy for the hedge
  - Identification of the hedging instrument
  - The related hedged item or transaction
  - The nature of the risk being hedged
  - How hedging instrument's effectiveness will be assessed
- Hedge must be effective- able to cover 80-125% of risk
- Hedge effectiveness can be reliably measured
- Actual hedge effectiveness must be measured
- In the case of hedging future cash flows, there must be a high probability of that cash flow occurring
- Ineffectiveness measurable and transferred to P&L

Education TREE

Qualifying hedged item

- **To qualify for designation the hedged item should create an exposure to risk that ultimately affects profit or loss**
  - Recognized asset or liability
  - Unrecognized firm commitment
  - Highly probable forecast transaction
  - Net investment in foreign operation that could affect P&L
  - Non-financial assets/liabilities for foreign currency risk or the entire risk

Education TREE

- Firm commitment – definition:

  A binding agreement for the exchange of a specified quantity of resources at a specific price on a specified future date(s)
- Forecasted transaction – definition

  A transaction that is expected to occur (highly probable) for which there is not a firm commitment Does not give an entity any present right to future benefits or a present obligation for future sacrifices

Education TREE

Firm commitment and forecast transaction

- Firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates
- Such commitment is cash flow hedged
- Forecast transaction is uncommitted but anticipated future transaction
- Such transaction is fair value hedged

Education TREE

- Fair value exchange risk may be fair value hedged or cash flow hedge
  - M Ltd. Purchased a machine from US to be delivered 6 months form today
  - They enter into forward agreement of $
  - Such forward commitment maybe fair value hedged or cash flow hedged

Education TREE

Non qualifying items

- Intra group transactions- not designated in consolidated balance sheet because they do not expose to risk
- Overall business risk- cannot be measured reliably
- HTM- can be hedged only for foreign currency risk
- Own shares

Education TREE

Qualifying hedging **instrument**

- A hedging instrument is normally a **derivative**. But for a hedge of the risk of changes in foreign currency exchange rates only, a hedging instrument can be:
  - a **non-derivative financial asset** or a **non-derivative financial liability**, whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item so that the hedged item is effectively hedged

Education FREE

Natural hedges of Foreign Exchange risk permitted in limited circumstances

- All of the derivative must be used in the hedge relationship
- Derivative cannot hedge another derivative
- More than one derivative can be used in a hedging relationship
- Profit related hedges not permitted
- Permitted strategies include:
  - partial term: - 5 year swap used to hedge part of 10 year debt as part of cash flow hedge
  - proportional hedging

Education TREE

Other points…

- A written option cannot be designated as a hedging instrument unless it is designated as an offset to a purchase option
- Hedging more the one item is possible
- Hedging a risk with more than one instrument is permitted
- Hedging can be with a combination of

Education TREE

Which of the following classify as hedging instrument

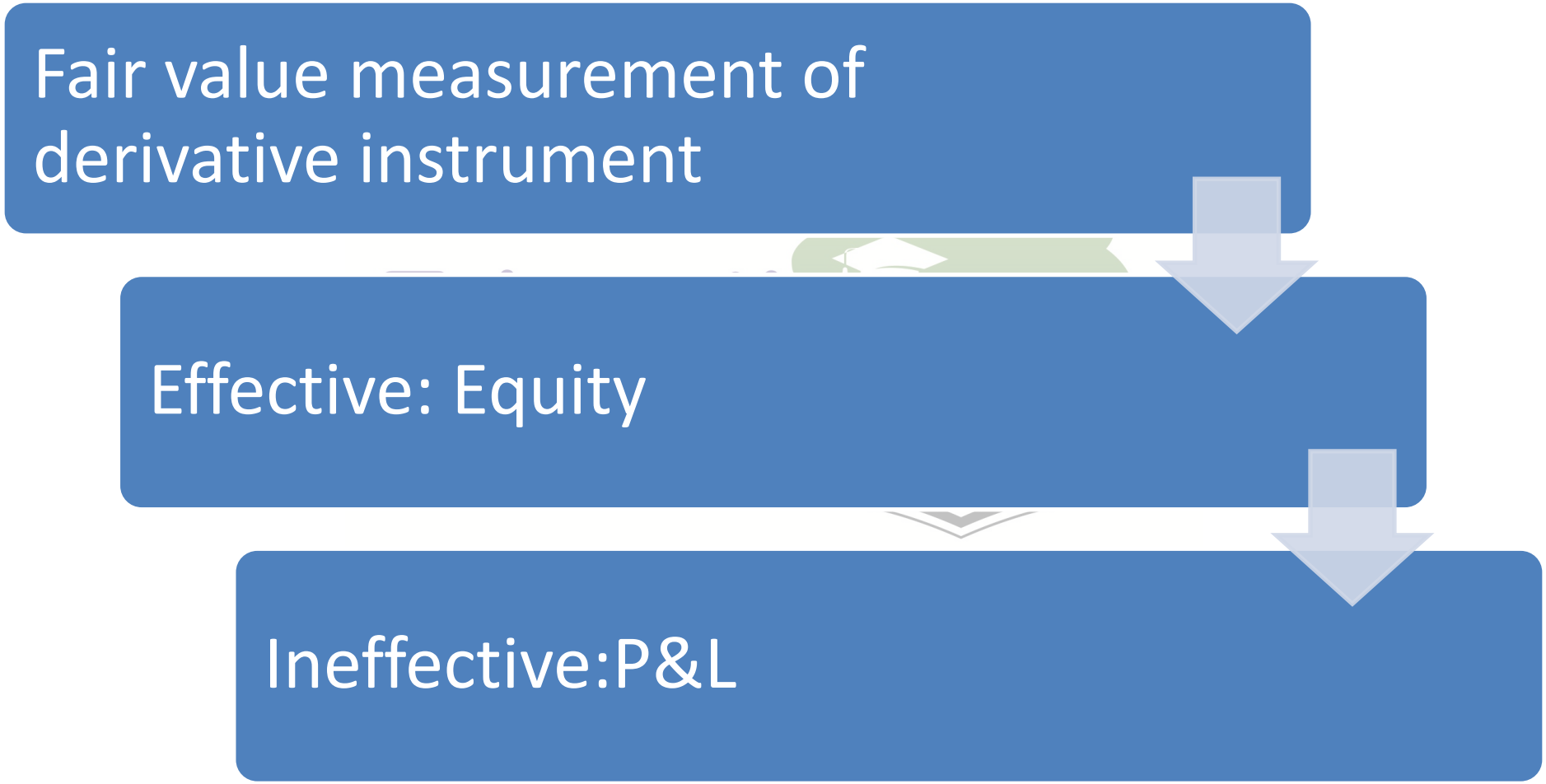
- Purchase of shares with simultaneous purchase of put option
- Interest rate swap on Rs.10lakhs. Want to use 60% of it to hedge variable interest rate loan of Rs.6lakhs
- 7 year variable interest loan, to be swapped with 10yr. Fixed rate loan

Education TREE

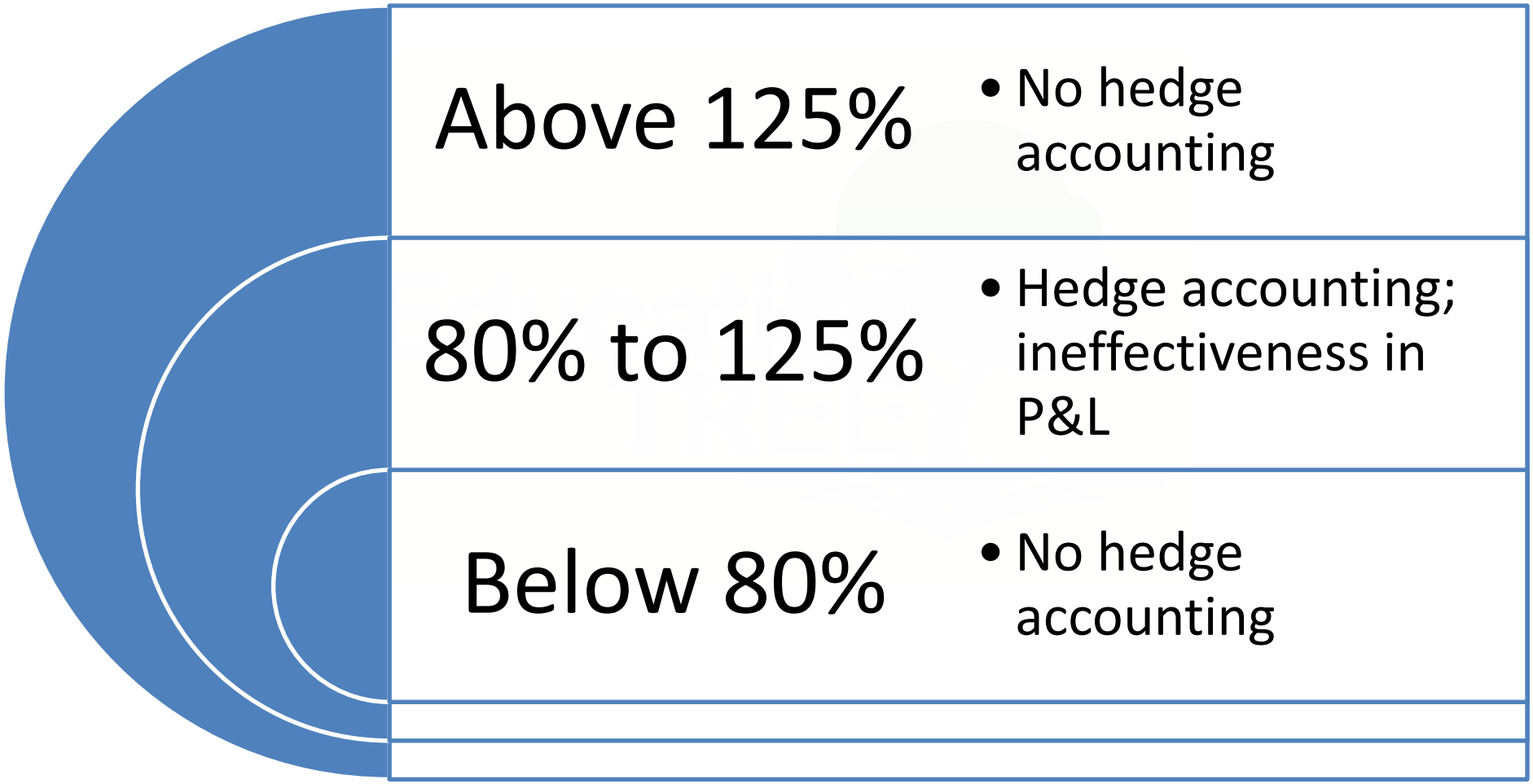
Cash flow hedge accounting

- Transactions covered
  - Variable interest loan payable
  - Investments
  - Future purchase of goods
  - Future sales of goods
- Accounting treatment
  - Effective portion is deferred in separate reserve
  - When hedge effects P&L, such deferment is transferred to P&L
  - Ineffective portion immediately recognized in

Education TREE


Fair value measurement of derivative instrument
Effective: Equity
Ineffective:P&L

Hedge in effectiveness



Hedge ineffectiveness

- any ineffectiveness must be recognized in P&L even if hedge relationship is effective
  - Different notional and principal amounts for the derivative and hedged item
  - Basis differentials
  - Different maturity and re-set dates
  - Currency differences
  - Credit differences
  - Inclusion of time value

Education TREE

- Deferred gains or losses to be deferred are lesser of
  - Cumulative gain or loss on hedging instrument

  And
  - Cumulative change in fair value of hedged item

Education TREE

Example

- value of future cash flow decreases by Rs.230 and fair value of hedged instrument increases by 221.
  - P&L a/c. dr. 230
    to hedging item 230
  - Hedging derivative a/c. dr. 221
    to equity 221

Education TREE

- Fair value of future cash flow increase by Rs.4000 and hedging instrument decreases by 4200
  - Hedging item d/r. 4000
    to P&L a/c. 4000
  - Equity a/c. Dr. 4000
    P&L a/c. dr. 200
    to hedging derivative 4200
- Fair value of future cash flow increase by Rs.2000 and fair value of hedging instrument decreases by Rs.4000
  - Not an hedging instrument

Education TREE

Question?

- Assume following particulars in hedging relationship

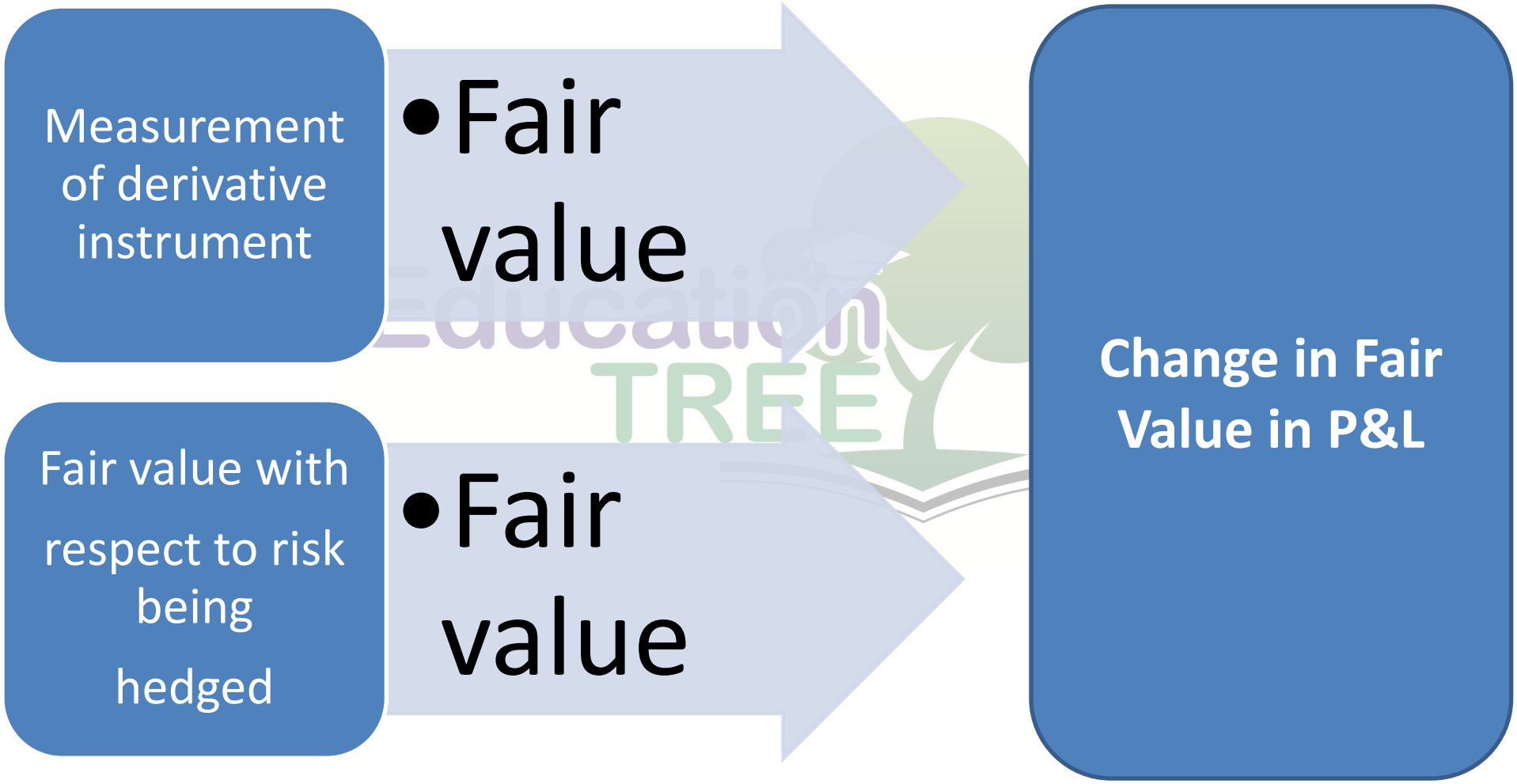
Period end	FV* of Derivative	FV* of hedged item
30 Jun	55	(65)
30 Sep	59	(61)
31 Dec	63	(64)

- *Evaluate whether the above hedging relationship is highly effective at the end of each period.*
- *How can hedge ineffectiveness be measured?*

Fair value hedge accounting

- E.g.
  - Investments is fixed rate bonds
  - Investment in equity shares-put option
- Change in fair value of instrument is directly recognized in P&L

Education TREE


Measurement of derivative instrument
• Fair value
Fair value with respect to risk being hedged
• Fair value
Change in Fair Value in P&L

example

	issued debt	swap
• 1.10.2003	(100)	-
• 31.3.2004	(105)	5
• 31.5.2004	(102)	2

Education TREE

- 1.10.2003- no entry
- 31.3.2004
  - P&L 5
    to debt 5
  - Swap 5
    to P&L 5
- 31.5.2004
  - Debt 2
    to P&L 2
  - P&L 2
    to Swap 2

Education TREE

Hedge of net investment in foreign operations

- Foreign operation mean
  - Subsidiary
  - An associate
  - Joint venture
  - Branch of a reporting entity
- Required to account for only for consolidated balance sheet for subsidiary, associate or joint venture
- Permitted to account for in separate financial statements for branch.

Education TREE

Nature of hedged risk amount of hedged item

- Hedge accounting maybe applied only for foreign exchange risk between functional currency and parent currency
- Hedged item can be equal to or less than carrying amount of net assets of foreign operations
- Accounted for similarly as cash flow hedging

Education TREE

Discontinuation of accounting hedge

- Instrument expires
- No longer meets hedge accounting criteria
- Future transactions no longer expected to occur
- Entity de-designates hedging relationship
- Amount in equity is transferred to P&L

Education TREE

Classify entries

- Sale to be made 1 year from today for $1,00,000
- Enter into forward agreement to convert 1$=Rs.50
- 6 months from today 1$=52
- 1 yr. hence 1$=54

Education TREE

- Today- no entry
- 6 months hence
  - Equity a/c. dr. 2,00,000
    to forward 2,00,000
- 12months hence
  - Equity a/c. dr. 2,00,000
    to forward 2,00,000

Forward a/c. dr. 4,00,000
to cash 4,00,000

Cash 54,00,000
to sales 54,00,000

P&L 4,00,000
to equity 4,00,000

Education TREE

De recognition

- Contraction right of asset cash flow expires
- Asset transfers and transfer qualifies for de recognition
  - Transfer means ownership and enjoyment of benefit transferred
- E.g. outright sale with no repurchase condition to un related party
  - A call option deeply out of the money

Education TREE

Pass through arrangements

- A transaction is treated as a transfer of financial assets, if all three criteria are met:
  - An entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset;
  - An entity is prohibited from selling or pledging the original asset; and
  - An entity has an obligation to remit any cash

Education TREE

securitization

- Making use of portfolio of assets to obtain cost effective funding
- Primary objective to isolate asset from party providing them to avoid credit exposure to the investor
- Typical securitisation structures include:
  - swaps between a transferor and transferee
  - cash collection accounts used for reinvestment purposes
  - "reserve fund" used to cover future cases

Education TREE

When cannot be derecognized

- In substance, the activities of the SPE are being conducted on behalf of the entity.
- In substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an Autopilot mechanism, the entity has delegated these decision-making powers.
- In substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to the risks of the SPE.
- In substance, the entity retains the majority of the residual or ownership risks related to the SPE, or its assets, in order to obtain the benefits from its activities.

Education TREE

- A Bank Ltd transferred a pool of loan assets to B Bank Ltd. The agreement provides for a call option by A bank Ltd or a Put option by B bank Ltd. Should the asset be recognized ? How would the options be accounted?

- When there is option available to seller or buyer to call back or put back the assets , the risks and rewards can not be said to have been substantially transferred. So asset can not be derecognized.
- If the options are recognized here as a separate asset or liability , it would amount to double counting .Hence no separate accounting needed for options as derivatives

Education IBEF

- 1000 shares in A Ltd having a fair value of Rs 30000.00 , held by B Ltd , was replaced by 500 shares with fair value Rs 32000.00 in C ltd consequent to C Ltd taking over A ltd. The assets were held as AFS by B Ltd and the cumulative fair value loss recognised OCI was Rs 2500.00

- The transaction demands for derecognition of shares in A Ltd and recognition of shares in C Ltd,at its fair value. Along side the unrecognised loss in equity needs to reclassified

Equity shares in C ltd	Dr	32000	
P/L account	Dr	500	
Equity shares in A ltd	Cr		30000
Equity account (OCI)	Cr		2500

+918600364185

State whether true or false for SPE

- Entity that acquired assets from SPE is known as transferor
- Entity that transferred assets to SPE is known as transferor
- Vehicle that issues notes is known as Bank
- Vehicle that issues notes is known as SPE

Education TREE

Accounting for de recognition

- When liability is extinguished, recognize in P&L difference between its carrying amount and consideration paid including any-
  - Non cash asset transferred
  - New liabilities assumed

Education TREE

renegotiation

- Modification of existing liability
  - Modification fees added to carrying value of existing liability
  - If terms of renegotiation are substantially different then account for extinguishment of existing liability and account for new liability

Education TREE

example

- An unsecured loan waived of his right to receive his loan of Rs.10lakhs@10% if company takes a new loan of Rs.8.5lakhs@10%
- If company would have agreed to waive of 1.5lakh with change in interest rate, it will be renegotiation.

Education TREE

Financial instruments: Disclosures

- The objective is to provide disclosures on:
  - The significance of financial instruments for the entity
  - The nature and extent of risks arising from financial instruments to which the entity is exposed
- Both qualitative and quantitative disclosures are required

Education TREE

- **Balance sheet**
  - Carrying value of the four categories of financial assets and financial liabilities
  - The change in a designated at fair through p&l financial liability's fair value due to its credit risk and amount payable at maturity
  - Amount of reclassification from fair value to amortized cost or vice versa
  - Information about transferred financial assets that don't qualify for derecognition
  - Information about collateral pledged and collateral received
  - Details of the allowance for credit losses account
  - Compound instruments with multiple embedded derivatives

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- **Income statement**
  - Gains and losses on the four categories of financial assets and financial liabilities
  - Total interest income & expense for financial assets & liabilities not at fair value through the p&l
  - Fee income and expense arising from financial assets & liabilities not at fair value through the p&l and trust and other fiduciary liabilities
  - Interest income on impaired financial assets

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Other disclosures

- Accounting policies
- Hedge accounting
  - Description of hedge types, instruments, nature of risks, when cash flows are expected to occur
  - For cash flow hedges, amount deferred and removed from equity, also amount included in cost of non-financial asset
  - Gains/losses for fair value hedges on re-measuring hedged item and instrument
  - Ineffectiveness recognised in the p&l for cash flow and net investment hedges

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